

**Written Testimony**

**of**

**Harry Markopolos, CFA, CFE**

**Chartered Financial Analyst**

**Certified Fraud Examiner**

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**Urban Affairs Committee**

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## **Introduction**

I would like to thank Chairman Dodd and Ranking Member Shelby for inviting me to submit written and oral testimony to the Senate Banking, Housing and Urban Affairs Committee today. I appreciate your invitation to testify on my experiences with the SEC with regard to the Bernard Madoff scandal, the SEC Inspector General's Report and recommendations, along with my own recommendations on regulatory reform.

## **The Current Situation**

The current situation is dire. The cost to this nation's capital markets due to criminal acts by white-collar fraudsters is still being totaled up but easily runs into the trillions of dollars. The only question is: how many trillions will be required to clean up the banking system, the insurance companies, and the shadow financial institutions and rid their balance sheets of toxic debt? We still don't know and won't know for several more years.

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. These troubles were of our own making and due solely to unchecked, unregulated greed. We, as a nation, get the government and regulators that we deserve, so let us be sure to hold not only our government and our regulators accountable, but also ourselves, as citizens, for permitting these situations to occur.

Far too much attention and money has been paid to violent crime and drug offenses while white-collar fraudsters have been allowed to roam freely and openly without fear of

getting caught. For example, too many FBI agents were assigned to chase down bank robbers who dared hold-up bank tellers at bank branches and steal small amounts of money in the mere thousands. Bank robberies are better left to state and local police while federal resources are targeted to attack the high-level white collar frauds originating in the C-level suite. Meanwhile the true banksters were the top officials of our nation's largest financial institutions who looted millions and hundreds of millions in unmerited bonus payments from these financial institutions while apparently no FBI agents were investigating the white-collar frauds these fraudsters were perpetrating.

White-collar criminals cause far more economic harm to this nation than armed robbers, drug dealers, car thieves, and other assorted miscreants put together. These fraudsters steal approximately 5% of business revenues annually, dwarfing the economic losses due to violent crime, yet not nearly enough federal law enforcement resources are devoted to catching them. White-collar criminals have the best resumes, have attended good universities and many of them hold graduate degrees. They live in the nicest neighborhoods and have the best reputations – until they get caught. But the worst white-collar criminals cause far more damage to the nation than common criminals because they wipe out pensions, bankrupt companies, throw thousands of out work, and destroy investor confidence.

Sub-prime loans, liar loans, option-arms, collateralized debt obligations (CDO's), credit default swaps (CDS's), collateralized loan obligations (CLO's), and other toxic structured products were the evidence of their crimes but so far, all too few have been brought to justice. An entire criminal class consisting of corrupt real estate agents, property appraisers, mortgage lenders, ratings agencies, and Wall Street investment banks openly

colluded to originate, package and sell toxic debt securities to pension funds, individuals and other unsuspecting victims. And all of these crimes occurred right under the noses of our nation's incompetent financial regulators who saw nothing, said nothing and did nothing, in effect they stole their government paychecks. So here we are today with a regulatory system that is beyond broken.

Bernard Madoff is merely the poster child for what went so horribly wrong with our financial system. His fraud destroyed the lives of thousands of direct investors. Entire generations of families went from riches to rags literally overnight. Some victims cannot pay for medical care while others have seen their children's college education funds wiped out. Charities, schools and endowments have shut down or seen their operations curtailed. The millions of indirect victims of the Madoff fraud are those individuals and organizations that received services, scholarships or grants from the direct victims.

The reputation of the US capital markets as a desirable place to invest is also a victim. No foreign government or investor holding US securities thinks our capital markets are properly regulated. Some foreign investors will be adding an "American Fraud Risk Premium" to their expected rates of return which increases the cost to American businesses which need access to affordable capital. This raises the cost to all Americans. Each one of us will be paying higher fees and higher interest rates to our foreign creditors as a result of our failure to properly regulate our markets.

The mess in which we find ourselves took decades to manifest itself and it will take a considerable number of years to repair the damage to our nation's balance sheet and to our nation's reputation as a safe place to invest.

## **My Comments on the SEC IG's Madoff Report**

I realize that the Committee invited me here today to verify that the SEC IG Madoff Report was both truthful and accurate. The 477- page IG Report contains an accurate depiction of what transpired during my dealings with the SEC. I have seen no discrepancies between what I saw and heard and what the SEC IG has reported. If there was a cover-up or a white-wash, I would have spotted it and vehemently refuted all discrepancies in my testimony today.

I am impressed beyond my ability to express myself by how open, honest, transparent and how exceptionally well researched and well written the SEC Inspector General's report is. As a key figure who probably accounts for approximately a third of the report's length either directly or indirectly, I was at ground zero of the Madoff fraud investigation for 8 ½ years. Tragically, what the SEC IG depicts in his report fits with my experiences with the SEC during the time period 2000 to the present.

I have to thank H. David Kotz, the SEC's Inspector General (the "IG") for his team's tireless efforts while under great stress to write this report. My counsel, Dr. Gaytri Kachroo, Esq. (LL.L, LL.B, LLM, SJD) and I have worked closely in assisting the IG's team with the portions of the report that are relevant to my team's investigation and others. Thanks also to my investigative team members, Frank Casey, Neil Chelo, and Michael Ocran for cooperating with the IG team.

I have read many government inspector generals' reports and, all too often, they have been nothing but white-washed, cover-up jobs. This IG report is different because this IG is

different. If you go back and read the SEC's IG reports since Mr. Kotz became the IG, you'll see that all of his reports are hard-hitting and very embarrassing to the agency. They also contain coherent and constructive recommendations on fixing the problems. The Madoff IG Report is consistent with the high quality of work that I have seen from his office. With these kinds of reports the SEC cannot help but get better faster and Lord knows we need them to get better faster.

I would be remiss if I didn't also thank the key individual who allowed this report to be written in an open and transparent manner. Mary Shapiro, the SEC Chairman, supported her IG office's writing and release of this report. I'm sure there are many within the SEC who wished she had scuttled this report or at least heavily censored it. I admire her dedication to the truth, to openness and to transparency. I am sure the internal pressures to censor this report were tremendous but Chairman Shapiro demonstrated superior leadership in allowing the IG write and deliver this hard-hitting report to the American public. This report defines her courage and her leadership of the SEC as it rebuilds itself.

To all Americans who are thinking that the level of incompetence, inexperience and laziness depicted in the full 477-page report just can't be true, sadly, I can assure you it is all true. My February 4, 2009 testimony before the House Capital Markets Sub-Committee details the low regard I held this agency in pre-Madoff and pre-Mary Shapiro.

Unfortunately, this IG report is frighteningly accurate. Even a great fiction-writer like Stephen King couldn't have made up the nightmare that the SEC was pre-December 11<sup>th</sup>, 2008. The SEC's actions and inactions during the Madoff investigation were a comedy of horrors.

No doubt it would have been far better for the agency if it turned out that Mr. Madoff had bribed one or more of the SEC staff to waylay investigations of his criminal enterprise. Catching an SEC employee or employees who were paid to look the other way would have resulted in far less embarrassment and turmoil for this agency. It is my opinion that if there was an internal corruption case to be made, the SEC appeared to me to be pulling out all of the stops to make corruption cases against its own employees which I will cover in some detail below. But it wasn't corruption that led to Madoff operating a multi-decade long Ponzi scheme that went unchecked for so long - it was systemic and structural incompetence.

At no time did I notice criminal activity by SEC staff examiners or enforcement personnel. Clearly, I feared that if the SEC staff were corrupt then one or more of them would have taken money from Bernard Madoff, handed him copies of my SEC submissions and Madoff would have attempted to silence me soon thereafter. That did not happen. My being here refutes the conspiracy theorists who mistakenly think that anyone connected to the SEC's 2006 - 2008 Madoff investigation related to my November 2005 SEC submission must have been corrupt.

It was clear to me during my first call with the SEC IG in late December 2008 that he was conducting a thorough and wide-ranging investigation of the SEC staff. My first call with him told me a lot about him both as a person and as a professional. He asked me if I would be willing to make a full production of Madoff case documents because he wanted to double-check the document production he was getting internally from the SEC. In other words, he wasn't going to meekly accept whatever documents his own agency was giving



him, he wanted an independent third party, namely myself and my counsel, to provide our documents and e-mails as a check on his own agency's veracity.

When I first met him in person on February 5, 2009, it was also clear that his investigation did encompass possible criminal acts by SEC staffers at all levels. He read my 2005 SEC Submission and must have thought to himself, *"there's no possible way that an SEC enforcement team could miss the Madoff Ponzi scheme with this kind of detailed road map in their hands. It's just not possible, there must be internal corruption involved somewhere."* He asked me pointed questions about high level employees bowing to outside political pressures. He also asked pointed questions about possible corruption at lower levels involving team, branch and regional staff. I can assure you that the IG went down all the proper paths in his questioning of me to thoroughly explore any and all possible criminal acts that might have occurred involving SEC employees. Given my knowledge of what transpired, I never felt any SEC staffers were corrupt and the fact that the IG's investigation asked plenty of questions that were corruption related suggests a proper investigation was conducted.

I am a certified fraud examiner (CFE) and I have been investigating large, half billion dollar and up, white collar fraud cases full-time for over five years now. I could tell from Mr. Kotz's questions where his investigation had gone and where it was going. It was as thorough and wide-ranging as it could be. Like all investigations, you are forced to go down every possible path you can identify, most of which turn out to be dead ends, in order to finally arrive at a fair interpretation of the truth. No one is capable of conducting the perfect investigation nor does any report contain a full 100% of what transpired – humans and memories are way too fragile for that. Investigators, no matter how good they might

be, are incapable of perfectly recreating the past. I am a pretty fair investigator myself and I know for a fact that I could not have done nearly as good a job as Mr. Kotz and his team did. This IG Report is the absolute best inspector general's report I have come across.

In my opinion this IG Report is a fair and accurate depiction of what I experienced. My hat is off to the SEC for conducting a proper and thorough investigation and delivering such a detailed and powerful report. I also commend this agency's leadership for having the moral courage to release it to the American public. If a harder hitting IG Report than this has ever been written, please let me know so that I can obtain a copy and read it.

### **Where are the other Financial Regulator's Inspector Generals' Reports?**

It is a breath of fresh air that the SEC has stepped forward and delivered a comprehensive and transparent report about what transpired during the Madoff crime spree for the sixteen year time period 1992 – 2008. Now where are the IG Reports for the other financial regulators, namely the Federal Reserve (FED), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS)? These regulators were far more incompetent than the SEC yet they seem intent on lying low in the weeds and avoiding blame.

One can argue that the banking regulators' lapses were far more egregious than the SEC's and that their examiners were even less competent – and that's quite a feat! If the entire SEC staff were seated in Fenway Park for the afternoon and couldn't find 1<sup>st</sup> base, then I'm not too sure that banking regulators could even find Boston, much less Fenway Park. And at the top levels of these non-functional banking regulators, there are more than a few who I doubt could even find the east coast.

I urge the Committee to task each banking regulator to prepare its own inspector general's report for their agency and to make their reports at least as hard-hitting as the SEC IG's. The bank regulators' failures to regulate have cost the American taxpayers a lot more money and lost reputation than the SEC's failures and it is past time they be taken to the woodshed too. They need to be exposed and held accountable just like the SEC has been exposed in this report and held accountable.

### **Comments on the SEC's Reforms to Date**

Plainly put I have never seen a government agency embrace reforms as rapidly as the SEC has. Of course, I've never seen an agency do such a bad job first-hand like this either. For the SEC it's definitely a case of sink or swim. If this agency fails to right itself and quickly, it is doubtful that they would get included in the new regulatory structure due to be enacted by this Congress. The SEC's very survival depends upon embracing change at a rapid pace in a bid to show they deserve to survive and not have their enforcement powers parceled out to other agencies after they were disbanded.

The Madoff Ponzi scheme exposed this non-functional agency's every wart and took it to its lowest point in its 75-year history. The scandal was so big and all encompassing and took place over such a long time frame that it called into question the entire agency's structure, staffing, willingness and ability to protect investors and to ensure the safety, soundness and transparency of our nation's capital markets.

When a scandal of these epic proportions hits it is like a 100-year flood – it occurs every century or so. If the Stock Market Crash of 1929 and subsequent Great Depression was last

century's 100-year financial flood, then Bernard Madoff and the Panic of 2008 are this century's version of that. The regulatory structures put into place in the wake of the Great Depression are now over three-quarters of a century old and inadequate to police our financial markets. Madoff brought this point home to the SEC and they seem to have gotten religion after their multi-decade long slumber.

By now you've seen the SEC's list of Proposed Post-Madoff Reforms dated June 29, 2009. I support each of these recommendations without exception. There are other much smaller, less newsworthy reforms that are not on this list of which even Mary Shapiro may not be aware because the SEC's regional offices adopted them on their own. They saw a need for change and took the initiative to make the changes within their power to make. I happen to have found out about them either from SEC staffers who are personal friends of mine or professional acquaintances of mine. I would like to share two of these instances with you.

First, one regional office held its own series of internal meetings to discuss changing the way exams are performed. They just knew the current methodology wasn't effective and discussed new methods on their own without being told to do so by their Washington headquarters. Second, another regional office was reviewing a company's restated earnings and discovered an old internal auditor's report that bluntly stated that the company's CEO and CFO were cooking the books. The internal auditor was fired on the spot when he refused to withdraw the report and then mailed it to the Audit Committee Chairman. The SEC went in, found the report in the company's files, and then, several years after the report was written, flew a team out to meet the fired internal auditor to conduct a follow-up investigation. These are only two examples of how the SEC is changing rapidly

and for the better. Before Madoff turned himself in, the SEC staff didn't seem to care about anything other than showing up and collecting their paychecks. Nowadays it does seem that the agency is operating with a speed and vigor which it hasn't exhibited in many years.

I would rate the SEC in its current state as still being non-functional but at least they are trying to get better and they are trying at an enviable pace. As they say, you have to crawl before you can walk, and you have to walk before you can run. Right now the SEC is learning to crawl again. It took decades of sloth, abysmal leadership, under-funding and benign neglect to get this bad and realistically it will take them at least a few years to become the effective, efficient cop on the beat that investors expect.

My biggest worry is that the SEC will backslide once their agency is out from under public scrutiny. It is up to Congress to ensure that they keep close watch over the SEC and perform close oversight to ensure that the pace of reform continues and that these reforms are funded. I encourage Congress to write enabling legislation where required to enact and fund the SEC's proposed reforms.

### **Recommendations for Regulatory Reform**

<p><b>Recommendation # 1: Combine all of the Nation's Financial Regulators under one Umbrella</b></p>
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The SEC IG report details how the Boston, New York, and Washington offices of the SEC were incapable of coordinating the Madoff investigation amongst themselves. Worse, within the New York Regional Office, the Examination team (OCIE) that had just finished an exam of the Madoff operation in 2005 did not coordinate effectively with the Enforcement

team (DOE) that started investigating Madoff shortly thereafter. If regional offices from a single agency could not coordinate with each other and if teams within one regional office could not coordinate with each other, what sense does it make to keep FED, OCC, FDIC, SEC and the CFTC as stand alone regulators? Worse, each of the five regulators would have its own computer system and none of them would know what the other regulators were doing with respect to a particular company.

Regulators are facing off against financial institutions magnitudes larger than those that existed back in the 1930's when the current regulatory system was formed. Today, unfortunately we still have gigantic "too big to fail – too big to succeed – too big to regulate" companies like Citigroup, Bank of America, American International Group and others. These ultra-large companies may have subsidiaries operating banks, insurance companies, mortgage lenders, credit card companies, investment-banks and securities broker-dealers not only domestically but also internationally. Sending in several separate regulators to spot problems is akin to tackling the problem peace-meal. If the SEC can't coordinate within its own agency, what hope is there that separate agencies can coordinate effectively? Is it any wonder the three financial institutions I've listed above collapsed last year and needed government rescues to survive?

Our nation has too many financial regulators and this leaves too many gaping holes for financial predators to engage in "regulatory arbitrage" and exploit these regulatory gaps where no regulator is looking or the regulator that may be investigating is trumped by another. I have seen one institution where individuals 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. But let's assume that both the SEC and FED were to come in and inspect fraud in the company's pension accounts under management, well then the company might say, *"Oh but these are ERISA accounts and they fall under the Department of Labor, so you don't have jurisdiction."* Clearly this situation has to be corrected so firms can't play one regulator off against the others or worse, choose to be regulated by the most incompetent regulator 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 whom American businesses must respond.

I recommend that one super-regulatory department be formed and that it be called the Financial Supervisory Authority (FSA). Under it's command should be the SEC, the FED, a national insurance regulator and some sort of Treasury / DOJ law enforcement function with staffs of dedicated litigators carrying out both criminal and civil enforcement for the SEC, national insurance regulator, and the FED. All banking regulators should be merged into the FED so that only one national banking regulator exists. Pension fund regulation should be moved from the Department of Labor to the SEC. The CFTC should be merged into the SEC so there exists only one capital markets regulator. 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. Right now financial institutions pay a lot in fees for regulation but they certainly aren't getting their money's worth.

<p><b>Recommendation # 2: Pass a Sarbannes-Oxley (SOX) Equivalent Law for Government to Hold Agency Heads Accountable to Taxpayers</b></p>
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In the wake of the accounting scandals that felled Enron, WorldCom, Global Crossing, Adelphia and others, Congress passed very strict laws that held corporate CEO's and CFO's accountable for their company's financial reporting. CEO's and CFO's suddenly became accountable for everything that happened or failed to happen with their company's financial reporting. No longer could they claim "*they didn't know what was happening*" under their watch. If a CEO and CFO signed off on a company's books and it turned out that for whatever reason the books were materially inaccurate, it was a 10-year prison sentence. If the CEO and CFO were willfully cooking the books, it meant a 20-year prison sentence.

I propose that Congress pass similar legislation that holds agency heads just as responsible as we currently hold corporate CEO's and CFO's for their financial reporting. If an agency fails to enforce this nation's laws, as passed by Congress, then a criminal referral to the Justice Department seems in order.



Right now there is no accountability in government. All of this nation's financial regulators failed to regulate the industries they were charged with regulating and they've gotten away scot-free without any punishment. At the SEC a few high-level department heads were allowed to resign "to pursue other growth opportunities" called "pogo-ing out" but how fair is that to taxpayers? It sure would be nice to see a few agency heads sent to prison for their willful blindness in letting our nation's financial system collapse but, unfortunately, there are no laws on the books to help in this regard.

If Congress passes a law, we as taxpayers should want to see it enforced fairly for all. Currently it seems that entire government agencies can remain comatose and let the industries they are charged with regulating commit whatever crimes they wish with impunity. Putting agency heads in prison for willful blindness, malfeasance, and corruption seems like it's long overdue.

SOX for government would also go a long ways toward eliminating "regulatory capture" whereby regulators stop protecting the public because they become beholden to the industries they are charged with regulating. Government is supposed to be representing the public's interests but all too often these government agencies become captive and start representing their industry's interests over those of the citizenry. For instance, the overall goal of the SEC investigation and examinations, as the IG's report iterates time and again, is and was to protect investors, current and future, not deep pocketed and influential industry firms.

<p><b>Recommendation # 3: Use Congressional Public Censure to Punish Incompetent Government Agencies</b></p>
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One way to light a fire under under-performing or non-performing government agencies that are non-responsive to Congressional oversight is to publicly censure these wayward agencies. For example, Congress could censure an agency by voting into law that for the next X number of months or years, that offending agency be termed "*A national disgrace by Act of Congress dating from today – Month Y.*" The censured agency would then have to include this censure in every e-mail sent out by its employees during the time period the censure was in force for. This shaming mechanism is a low-cost but effective means for Congress to express its displeasure over the lack of regulatory zeal by certain agencies, some of whom are repeat offenders. The road toward gaining respect would then be earned through every successful effort by employees, who would in turn be incentivized to work together to improve the entire organization through their individual and team efforts.

<p><b>Recommendation # 4: Regulate all Over-the-Counter Products, Mandate Centralized Clearing and Wherever Possible Put Them on Exchanges</b></p>
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Over-the-Counter (OTC) is unregulated space. It's where the financial industry's cockroaches congregate because there is no light, only darkness. This is also where the industry's highest margins exist so they will fight like the dickens to protect their profit margins.

Laws should be passed that dictate that US investors cannot trade OTC products offshore and receive government protection in the form of bailouts. In other words, no more

trading through unregulated entities such as AIG's London-based Financial Products unit where the risk ends up getting transferred back on-shore domestically and US taxpayers end up footing the bill. If US regulators don't have visibility into an OTC product that's traded off-shore, then strict risk and capital limits should be placed on US based traded counter-parties in order to avoid systemic risk.

You cannot regulate common sense but some sort of guidelines should be available to investors on the SEC's website that if you don't know how to model an OTC derivative yourself, then you, your company or your municipality should not be trading them. The SEC should closely investigate all disclosures in the OTC municipal derivatives market because this sector of the marketplace is rife with fraud. In many instances it is still a pay-to-play market with opaque disclosure documents and even more opaque pricing mechanisms which only serve to defraud government entities.

In my own state, Massachusetts, our Turnpike Authority ended upside down on a series of interest rate swaptions they did not understand. The last press account I saw in late 2008 put the amount of fiscal carnage in Massachusetts at \$450 million. I can assure you that no one in our state's government knows how to price interest rate swaptions. Our Turnpike Authority was "picked off" by several Wall Street firms because they were lured into these OTC transactions and did not understand either the pricing or the risks. But since you cannot regulate common sense, at least regulate the OTC markets so they don't remain lawless like the Wild Wild West of the late 19<sup>th</sup> century.

## **Recommendations for the SEC**

## **Recommendation # 1: A Maximum of One Lawyer on the SEC Commission Itself**

Currently the SEC is dominated by lawyers, in fact all five of the current SEC Commissioners are lawyers so is it any wonder the SEC is ineffectual? I have nothing against lawyers but putting them in charge of supervising our capital markets has been an unmitigated disaster. Very few SEC lawyers understand the complex financial instruments of the 21<sup>st</sup> century and almost none of them have ever sat on a trading desk or worked in the industry other than in a legal capacity. If you want to know how things became so bad at the SEC it's because predominantly most or all of the five SEC Commissioners have been lawyers who haven't a clue as to how the industry really operates.

Putting lawyers in charge of regulating the capital markets makes no sense, something the financial services industry recognizes. Most financial firms are run by businessmen with capital markets or banking expertise – not that this prevented the industry from a near-death experience in 2008 but just about anything is better than being led by lawyers who have no understanding of the finance industry they are governing.

Lawyers within the SEC need to be relegated to back-seat roles and removed from most positions of senior leadership within the agency and replaced by people with the proper backgrounds to understand the markets and institutions being regulated. Yes, the Director of Enforcement should be a lawyer but as for the other departments, very few should be led by lawyers.

Read the SEC IG's report for how the SEC's enforcement lawyers did not have a clue as to what Bernard Madoff was telling them about his trading strategy. They couldn't recognize the obvious lies because none of them had any financial expertise to understand

the capital markets. The typical SEC attorney would have trouble finding ice cream at a Dairy Queen so tasking them to uncover financial frauds would be about as fruitful.

The law is the lowest form of acceptable behavior but ethics are a higher standard that the SEC's securities lawyers seem to ignore time and again. For instance, mutual fund market-timing wasn't illegal so the SEC's lawyers ignored it while individual investors lost tens of billions to market-timers and hedge funds engaged in the practice. However, any industry professional with a moral compass could have told you this activity was unethical and needed to be stopped. SEC lawyers are not trained within the industry, and so they have little idea of the ethical dilemmas industry professionals face everyday. Lawyers are trained in the black letter law and regulation instead. This, in a nutshell is why it is better to have industry professionals running the show and not lawyers because securities laws are a very low behavioral bar. Securities laws are outdated as soon as they are passed because new financial instruments are invented to skirt these laws, which is another reason that lawyers shouldn't be running the SEC. We need to raise the bar and insist upon transparent and fair dealings for all which is a standard of behavior that is leaps and bounds higher than merely following existing securities laws. Therefore having lawyers run the show allows too much bad behavior to occur since they have blinders on and can only distinguish between lawful and unlawful behavior. Only finance professionals can keep up with the modern financial instruments of the 21<sup>st</sup> century. Therefore they should be in positions of authority. It would be very difficult to do a worse job than the securities lawyers have already.

<b>Recommendation # 2: Conduct a Skills Inventory of the Professional Staff and</b>
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**Terminate Those Not Qualified to Hold Their Positions.**

It's clear that a significant portion of the SEC's professional staff, perhaps 50% or more of them, need to be let go because they are not qualified to hold their positions. For example, quite a few of the New York Regional Staff depicted in the SEC IG report should be immediately fired if they haven't already resigned. Fortunately, given the layoffs on Wall Street, plenty of vastly more qualified industry professionals who do understand the capital markets, are available and could be brought on board quickly. The SEC's staff needs to be dramatically upgraded and there's no better economic environment to be in than today's from a hiring standpoint.

**Recommendation # 3: Hire Qualified Industry Professionals with Over 10 Years of Experience**

Hiring kids right out of college is not the way to detect financial fraud. These greenhorn twenty-something's couldn't find steak at an Outback. For the broker-dealer exam teams, hire experienced brokers with as many years of experience as you can. Send veteran traders and veteran back office personnel in to conduct trading floor exams. For the money management and hedge fund teams, hire experienced portfolio managers, analysts and buy-side back office personnel to conduct asset manager exams. The same goes for hiring experienced accounting professionals to examine required corporate filings.

Let me tell you about the following story from Boston. A person I know rather well with over 10 years of industry experience, an under-graduate degree in economics and math, an

MBA and a Chartered Financial Analyst 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 70 hour work weeks were 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. And that's the problem. Since the SEC only hires unqualified, uneducated people without financial industry experience, all they want to do is check pieces of paper to make sure all the paperwork that existing (outdated) securities law requires is being complied with. Is it any wonder, given the current SEC staff, how major financial felonies go unpunished while minor paperwork transgressions are flagged for attention?

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. We were considered "high risk" because we managed derivatives and received SEC inspection visits every three years like clockwork, so 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. A good thing my firm was honest because if we weren't we could have pulled a Madoff on them and they would have never been the wiser. Second, the teams are very, very young and they don't 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 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's books and records were in compliance.

Now let's examine what went wrong with the examination process described above. First, the team only interacted with the inspected firm's compliance team, not the traders, not the portfolio managers, not the client service officers, and not top management. The problem with this process is that the SEC examiners only examined paperwork but neglected the tremendous human intelligence gathering opportunities that were 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 if they ever run across anything the SEC should be looking into either at their firm or any other firm. These are basic internal auditing techniques that every accountant, internal auditor, and fraud examiner uses when conducting audits. But the SEC staff is so untrained, it's almost as if this is advanced rocket science, because the SEC examiners are so inexperienced and unfamiliar with financial concepts they are afraid to interact with real finance industry professionals and choose to remain isolated in conference rooms inspecting pieces of paper.



Right off the bat, the incoming SEC Chair needs to get these examiners to focus on interacting with the industry professionals and querying them on what's going on in their firms and their competitors' firms. Sitting like ducks getting fed controlled bits of paper by inspected firms isn't getting the job done and the current examination process is an insult to common sense. It also seems like a waste of taxpayers' or investors' money. This also reinforces the need to increase the pay scale and add in 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 are miniscule at best.

<b>Recommendation # 4: Adopt the Industry's Compensation Model</b>
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The problem is that the SEC pays peanuts and then wonders how it ended up with so many monkeys. Industry pays salary plus bonus and the SEC needs to be competitive in order to attract the best talent. Compensation at the SEC needs to be both increased and shifted to include incentive compensation tied to how much in enforcement revenues each office collects. Of course, the SEC Commissioners would be setting the levels of fines for enforcement actions, but each SEC Regional Office should get back some percentage, and I recommend a 10% level initially, toward that office's bonus pool.

Regional enforcement teams that bring in a \$100 million case deserve to be compensated for that. And, to prevent taxpayers from having to pony up these multi-million dollar bonuses, I would insist that the fines be triple the amount of actual damages,

that the guilty transgressors pay the actual costs of the government's investigation, so that SEC staff bonuses end up being paid for by the guilty transgressors.

In expensive financial centers' like New York and Boston, cost of living adjustments bringing base compensation to the \$200,000 level make sense. This would be enough to attract the nation's best, brightest and most experienced industry practitioners. All compensation over and above this amount would need to 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 settle will get asked to leave and make room for people who can come in and produce solid cases.

<b>Recommendation # 5: Move the SEC's Headquarters to New York</b>
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This might be the single best way to quickly upgrade the SEC's talent pool at the highest levels. Move the SEC's headquarters out of Washington because Washington is a political center not a financial center, so you won't find very many qualified finance professionals there. 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 New York City, West Chester County, New York or Fairfield County, Connecticut makes a lot of sense. This puts the SEC's headquarters right in the center of the financial industry and offers easy access to both Boston and Washington. If the SEC wants to attract the top talent, relocating its headquarters to somewhere between New York City and Stamford, CT is where this agency

will best attract the foxes with industry experience it so desperately needs to be on the right side of the fence.

**Recommendation # 6: Administer Competency Exams for Professional Staff Before Hiring**

Amazingly, the SEC does not give its employees a simple entrance exam to test their knowledge of the capital markets! Is it any wonder that most SEC staffers, particularly the Staff Attorneys don't know a put from a call, a convertible arbitrage strategy from a municipal bond, or an interest-only from a principle-only fixed income instrument? The Chartered Financial Analysts Level I exam covers the material that I would expect all of the SEC's professional staff to have mastered **before** being hired. I doubt that even 20% of the SEC's current staff would be able to pass this exam. For SEC Staff Attorneys that number would likely be less than 5%.

**Recommendation # 7: Fund Subscription Budgets**

If you walk into any sizeable investment industry firm, they'll have a library of professional publications for their 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. If you walk into an SEC office, you won't see any of these journals nor will you see an investment library. 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 makes sure its staff remains uneducated.

<b>Recommendation # 8: Mandate and Fund Business Cards for All SEC Staff</b>
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The SEC doesn't provide its staff with business cards. I know, it's hard to believe but it's true. It's sort of hard to get a call back from someone you've met at an industry conference or an employee of a firm that you just asked, "*please give me a call if you ever spot a securities fraud,*" if you haven't handed them a business card. Some SEC staff pay for their own business cards but if private industry provides business cards for its employees then the SEC should also. It's only common sense.

All business cards should also tell what professional credentials each SEC staffer has obtained. Credentials such as CFA, CFE, CFP, CIA, CISA, CPA, JD, Ph.D., and others should appear prominently on all staff business cards. Printed at the bottom of each card should be something like, "*To report a securities fraud please call me.*" This would send a message that each SEC staff member is a fraud-fighter first and foremost. Upon receiving calls to report a fraud, each SEC employee will immediately forward the call to competent authority per the SEC's standard operating procedure for handling whistleblower tips.

Secretaries and clerks should also have business cards since this is a low cost means of advertising that your employer is in the securities fraud-fighting business.

**Recommendation # 9: Change Performance Metrics Away From the Number of Exams Undertaken**

Measuring performance by the number of exams a Regional Office conducts each year totally misses the point. The SEC's mission is to protect investors and to find or prevent fraud. As the SEC IG's report has shown, conducting poorly planned and executed exams and then promoting staff based upon the completion of shoddy exams is not a deterrent to fraud. The goal should never be how many pieces of paper were inspected, it must become how much fraud did we catch?

Obvious success metrics which the SEC should start measuring are fine income, dollar damages recovered for investors, dollar damages prevented, 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. Exams catch so little major fraud that they are the least important metric to follow unless one actually believes that catching minor technical violations is a felony deterrent.

**Recommendation # 10: Increase the Risk of Fraud Detection by Funding SEC Attendance at Industry Events**

The most important thing the SEC can do is increase the risk of detection for securities fraudsters. To do that the SEC needs to put its staff out among the industry's employees wherever and whenever possible. Interacting with industry professionals before and after industry functions is a great way to obtain tips on nascent fraud schemes and stop them before they become Madoff-sized or sub-prime sized.

Large cities with robust financial centers have financial analyst societies, CPA societies, securities traders associations and economic clubs which hold educational meetings of just the sort the SEC staff needs, but the SEC typically doesn't allow its staff time off to attend these meetings nor does it reimburse its staff for attending industry meetings of this nature. Rarely does anyone see SEC staff attending these educational events and we all know it isn't because the SEC has no need for industry knowledge.

<b>Recommendation # 11: Fund Development of an SEC Knowledge Base</b>
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Think of how different it would have turned out if the SEC exam and enforcement teams in New York could have turned on their PC's, typed in the word "Ponzi" to an on-line SEC knowledge base and have appear on the screen diagnoses of past Ponzi schemes and a list of checklists on how to most efficiently solve such cases. Unfortunately, the SEC staff did not have such a system and as a result SEC exam and enforcement teams were not able to solve one of the easiest fraud schemes there is, the simple Ponzi scheme. Ponzi schemes are not that hard to figure out because there is no underlying investment product, there is no trading and the assets are being diverted to pay off old investors.

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 collate and sort through every fraud that the SEC finds. These frauds would be diagnosed for both common and unique elements that each had so that the odds of future frauds going unchecked are further reduced.

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 to this knowledge base.

<b>Recommendation # 12: Properly Arm SEC Exam &amp; Enforcement Teams</b>
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If the SEC staff in New York had Bloomberg machines and if they knew how to use them, they could have quickly analyzed actual OEX Standard & Poor's 100 index options trades that Bernard Madoff purported to trade on certain dates and proven that no such trades actually occurred. The case would have been cracked open quickly but, of course, the SEC staff doesn't have easy access to Bloomberg machines nor are they trained in how to operate them.

The Bloomberg machine is the key knowledge tool used in the finance industry but it is expensive, costing over \$20,000 per machine per year. Industry allocates one Bloomberg machine per trader, analyst and portfolio manager so that they can conduct the business of finance. The SEC is lucky to have one Bloomberg machine per Regional Office! Sending SEC teams into exams and enforcement actions without a Bloomberg is akin to sending unarmed teams to a gunfight and then wondering why they come back to the office hanging their heads in defeat each time.

When a financial analyst is about to analyze 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, its financial statements, financial ratios, look up the firm's weighted cost of capital, and start running a horizontal and vertical analysis of the firm's financial statements. The trained analyst will also use the Bloomberg to read all news stories out on a company, look at the firm's SEC filings, and use all of the information collected to build a set of questions he/she needs to answer before investing. The trained analyst will also obtain Wall Street's research reports on the company to see how those analysts approached their analysis to see if there might be something they missed.

Unfortunately, the SEC staff examiner rarely can do this because either they can't get access to a Bloomberg or they are not trained in how to use one. For SEC compliance purposes I don't see how their staff can function effectively without having at least one Bloomberg assigned per exam and enforcement team. Their work, in brief, cannot be done without it. Those Bloomberg machines are the lifeblood of the industry and they contain most of the data that an SEC staffer would need for a basic fraud analysis of a company. Not funding these machines is penny-wise but pound-foolish.



**Recommendation # 13: Establish an SEC Office of the Whistleblower**

According to the Association of Certified Fraud Examiner's 2008 Report to the Nation (please refer to the attached Appendix II for the relevant portions of this report or you can find it a [www.acfe.com](http://www.acfe.com) ) whistleblower tips detected 54.1% of uncovered fraud schemes in public companies. External auditors, and the SEC exam teams would certainly be considered external auditors, detected a mere 4.1% of uncovered fraud schemes. Whistleblower tips were 13 times more effective than external audits, hence my recommendation to the SEC to encourage the submission of whistleblower tips.

Other interesting statistics from the ACFE Report are that employee tips are 57.7% of all whistleblower tips received. How easy would it be for SEC enforcement teams if an internal whistleblower came in and presented them with hidden books and records? Customers provided 17.6% of whistleblower tips followed by vendors (12.3%) and shareholders (9.2%).

**Recommendation # 14: Authorize an SEC Whistleblower Bounty Program Similar to Those of the Department of Justice and the IRS**

The Internal Revenue Service (IRS) started its Office of the Whistleblower in December 2006 and in less than three years has grown this office to a staff of 18. The IRS now receives the largest cases with the absolute best quality of evidence in its history.

Consider the cost of 18 IRS employees versus the billions in additional tax revenues they will be responsible for bringing into the US Treasury.

The IRS offers bounty payments of 15% - 30% to whistleblowers for cases that lead to successful recoveries for 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 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, then my bet is that hundreds of cases would walk in the door each year, and that several dozen 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.

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, the issue of self-regulation and whistle-blowing. 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 and identified themselves? Unfortunately, I may have been the only one.

Getting rid of the shysters, fraudsters and banksters 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.

## APPENDIX I

### **NOTICE OF MISINFORMATION IN THE PRESS AND MEDIA FROM HARRY MARKOPOLOS, CFA, CFE, SEPTEMBER 10, 2009**

1. Per a recently released Madoff book, I am not an accountant nor do I hold a B.S. degree in Accounting from Loyola College (now called Loyola University) of Maryland. I do hold a Bachelor of Arts degree in Business Administration from Loyola.
2. Per several news agencies reporting, I am not a Certified Public Accountant (CPA) nor am I an accountant. I am a Chartered Financial Analyst (CFA) and a Certified Fraud Examiner (CFE).
3. Per a major news service's reporting, I am not writing a book entitled, "An Army of One," due for release this fall. First, "An Army of One," is a US Army recruiting slogan. Second, this title would be wholly inappropriate because I led a team of four. Together, we are writing a book but we have not selected a title yet and our anticipated publication date has always been March 2010.
4. Per a major news service's reporting, I did not pay my way through college, my parents did. I did pay my way through graduate school.
5. Per an internet-only newspaper's reporting, I never commanded a civil affairs unit on active duty for seven years in Western Europe and Africa. I was a part-time

reservist for 17 years, having served first in the Maryland Army National Guard (MDARNG) and then in the US Army Civil Affairs and Psychological Operations Command (USACAPOC). I also never served as a commando of any sort nor did I ever hold a top-secret clearance nor was I ever an army intelligence officer. I have held a secret clearance and I left the reserves in April 1995 so that I could apply for and enter graduate business school at Boston College in September 1995.

6. Per a major news service's reporting, I never said, "The SEC roars like a lion and bites like a flea." I did say, "The SEC roars like a mouse and bites like a flea."
7. Per a major newspaper's gossip column that reportedly quoted me as saying larger fraud schemes than Madoff's were out there, I never said that. An audience member said that during the question & answer period at one of my presentations. I did say that someday way into the future there would be someone who will break Madoff's record for fraud because white collar fraudsters are always getting smarter.

## APPENDIX II

2008 ACFE Report to the Nation Excerpts

## APPENDIX III

June 2009 Fraud Magazine Interview with Harry Markopolos