Alleged Stanford Financial Group Fraud:
Regulatory and Oversight Concerns and the Need for Reform

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Testimony of Onnig H. Dombalagian
George Denègre Associate Professor of Law, Tulane University*

I would like to thank Senator Vitter, the U.S. Senate Committee on Banking, Housing and Urban Affairs and their staffs for inviting me to participate in this hearing to discuss regulatory and oversight concerns relating to the $8 billion fraud alleged to have been perpetrated by the various entities comprised in the Stanford Financial Group ("SFG" or "Stanford"). Ponzi or pyramid schemes, such as those devised by the Stanford Financial Group, are neither new nor easily susceptible to detection. They are traditional "confidence" games in that they exploit investors' reliance on the reputational integrity of the ringleaders or a shared religious, ethnic, or cultural affinity among investors. They succeed, almost inexplicably, in inducing their victims to part with large sums of money for returns that defy expectation, and in a manner that discourages due diligence and minimizes regulatory scrutiny.

No regulatory system, however efficiently run or tightly maintained, can completely foil the ingenuity of the promoters and perpetrators of such schemes: Regulators necessarily rely on the scrutiny of investors, the integrity and diligence of

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* B.A., Harvard College, *summa cum laude*, 1992; J.D., Harvard Law School, *cum laude*, 1995. Prior to joining the Tulane Law School faculty, I served as an attorney fellow in the SEC's Division of Market Regulation from 2001 to 2003, and practiced with a private law firm for five years in the field of broker/dealer regulation.

individuals employed in the securities industry, and the watchfulness of peer firms, industry groups, the media and other members of the public to root out such fraud. It is nevertheless useful at moments such as these to focus on the gaps, inefficiencies, and material weaknesses in our current regulatory framework that may impede the early detection and neutralization of such schemes. To say that fraud cannot be prevented is not to say that fraudulent schemes cannot be checked before they reach the unfortunate size and scope of the Stanford Financial Group.

Without considering in detail whether the particular steps that the SEC and FINRA took in this case were adequate, you have asked me specifically to discuss the current oversight authority of the SEC and FINRA with respect to affiliates of the Stanford Financial Group, and the strengths and weaknesses of, and gaps in, our regulatory scheme that affect the detection of such frauds. You have also asked me to consider the role that the Securities Investor Protection Corporation ("SIPC") plays in the aftermath of such frauds, and the consequences for our regulatory framework if SIPC becomes an "insurer of last resort" for their victims. Finally, you have asked for any recommendations I may have for enhancing investor protection through legislative action. I discuss each of these in turn.

A. The Current Oversight Authority of the SEC and FINRA with Respect to Broker/Dealers and Investment Advisors

In general, the SEC has statutory authority to oversee a broad range of securities professionals and securities intermediaries, including brokers, dealers, exchanges, investment advisors, investment companies, clearing agencies, transfer agents, and their associated persons. All brokers and dealers, and all investment advisors with over $25

million in assets under management, are required to register with the SEC. The SEC, inter alia, has the statutory authority to require registered professionals to maintain books and records prescribed by regulation, as well as to produce reports on their securities-related activities. The SEC's Division of Trading and Markets (for broker/dealers, exchanges, SROs, clearing agencies, and transfer agents) and the SEC's Division of Investment Management (for investment advisors and investment companies) have the primary responsibility of carrying out the SEC's mandate in these areas.

The SEC also possesses the statutory authority to conduct periodic examinations of securities professionals. The SEC carries out this responsibility through its Office of Compliance Inspections and Examinations ("OCIE"), which conducts both cyclical and targeted inspections of broker/dealers and investment advisors, among other securities professionals. The agency also has the power to initiate investigations into activities that violate federal securities law, and in particular the antifraud provisions thereof, and to subpoena testimony and books and records in connection therewith. The SEC also has the power to take administrative action against registered professionals as well as to seek injunctive or monetary relief in U.S. district court. These powers are exercised by the Division of Enforcement.

FINRA is a self-regulatory organization ("SRO") registered under the Securities Exchange Act of 1934 (the "Exchange Act"). FINRA is the entity resulting from the merger of the regulatory arm of the New York Stock Exchange and the National Association of Securities Dealers. The Exchange Act requires all brokers and dealers that conduct a public customer business to become members of FINRA. FINRA has the authority to promulgate rules governing the business conduct of its members and their

associated persons and has statutory authority under the Exchange Act to discipline members for violations of its rules and for violations of the federal securities laws, in each case subject to Commission review. FINRA also conducts routine and focused examinations of its members to ensure compliance with its rules and with federal securities law.

FINRA does not have statutory authority to regulate the activities of investment advisors. As a result, the activities of registered broker/dealers are overseen by both the SEC and FINRA, whereas the activities of investment advisors are overseen solely by the SEC at the federal level. Thus, among the affiliates of Stanford Group Holdings, the holding company of Stanford's financial empire, (i) Stanford Group Company ("SGC"), which is both a registered broker/dealer and an investment advisor, is subject to both SEC and FINRA oversight, and (ii) Stanford Capital Management, a registered investment advisor, is subject solely to SEC oversight at the federal level. Stanford Investment Bank, Ltd. ("SIB"), a bank regulated under Antiguan law, was not to my knowledge subject to regulation by any U.S. federal regulator or self-regulatory authority.

B. Strengths and Weaknesses of SEC and FINRA Oversight and Gaps in Regulatory Authority

In general, the dual oversight of brokers and dealers by the SEC and FINRA has proven to be an economically efficient allocation of resources, given the sources of revenue available to federal and self-regulatory bodies and the statutory mandates that they are each required to fulfill. While there have been complaints that the SEC did not exercise adequate diligence in compiling its case against Stanford during its nearly four-year investigation, the SEC's Office of the Inspector General ("OIG") concluded that the

delays were largely the product of obstruction by Stanford and Antiguan regulators, as well as the SEC's obligation to coordinate its civil investigation with the criminal investigation initiated by the Department of Justice ("DOJ").[1] The SEC acknowledged in its complaint, moreover, that FINRA played an important role in the investigation of SGC's marketing of the SIB certificates of deposit ("CDs") at issue.

Questions are perennially raised, however, about the allocation of responsibility for inspections, examination, and enforcement between the SEC and SROs; the imbalance in regulation between broker/dealers and investment advisors; and the desirability of expanding the SRO model to include investment advisors. I discuss these in turn.

1. Compliance Inspections, Examinations and Enforcement

One of the most difficult challenges for the SEC and FINRA is to develop a system for coordinating routine inspection, examination, and enforcement activities to avoid subjecting firms to redundant regulation and to free resources for investigation of areas of emerging concern. The SEC necessarily relies on FINRA to take the lead in conducting cyclical oversight examinations of broker/dealers. FINRA is better suited to ensure that broker/dealers comply with reporting and recordkeeping requirements and ethical standards related to their communications with customers, custody of customer funds and securities, and solicitation and execution of customer transactions. As a self-

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[1] SEC OFFICE OF INSPECTOR GENERAL ("OIG"), INVESTIGATION OF FORT WORTH REGIONAL OFFICE'S CONDUCT OF THE STANFORD INVESTIGATION: REPORT OF INVESTIGATION 10 (Case No. OIG-516) (June 19, 2009). Targets of criminal investigations are, of course, entitled to heightened constitutional protections, which may be jeopardized by an ongoing SEC civil investigation.

regulatory organization, it derives its legitimacy from the collective interest of the brokerage and dealing industry to ensure uniform standards for dealings with other members and with the public.

With the consolidation of the NYSE and NASD inspection and examination authority, concerns of inconsistent funding or regulation across SROs—as well as concerns about favoritism shown toward more prominent members of rival SROs—should diminish over time. Because there will always be concerns that FINRA, as a self-regulatory organization, will not devote adequate resources to or rigorously investigate the activities of its more influential members, the SEC must continue to maintain a periodic compliance and inspection examination program; indeed, it appears to have been a referral from the OCIE that initiated the initial investigation into Stanford by the SEC's Forth Worth regional office. The SEC must also periodically audit the effectiveness of FINRA's compliance program by conducting regular reviews pursuant to its statutory authority over self-regulatory organizations. Nevertheless, this historic structure has proven an effective way to defray the cost of broker/dealer oversight.

The key problem with Ponzi schemes, however, is that they are designed to evade detection using traditional inspection and examination tools. Periodic on-site examinations and review of books, records and reports may ensure that firms are complying with their affirmative obligations under SEC and SRO rules and uncover technical violations, but absent "red flags" or evidence of anomalous activity, it is difficult to detect the workings of complex fraudulent schemes until they reach their breaking point. Additional mandatory third-party verification—such as through audits of custodial accounts by PCAOB-registered accounting firms—may help deter frauds such

as the Madoff or Stanford scheme, but these impose a high cost on honest firms. Moreover, in the case of Stanford's foreign affiliates—such as SIB—such mandates may create conflicts with foreign bank secrecy laws and other regulations.

The SEC and FINRA therefore must also rely to a significant degree on internal compliance controls and the integrity of employees and counterparties if they are to succeed in nipping such schemes before they reach critical thresholds. To ensure that securities professionals appreciate their obligation to prevent fraud by their employers, both broker/dealers and investment advisors are required to maintain internal compliance controls under SEC and SRO rules. FINRA requires its member firms to maintain written procedures to supervise the types of business in which they engage and to supervise the activities of registered representatives and associated persons. The SEC likewise requires registered investment advisors to implement written policies and procedures reasonably designed to prevent violation of the Investment Advisers Act. And, in the wake of financial scandals, one of the first steps regulators can invariably take is to augment such internal control programs and procedures.

At the end of the day, however, such programs are only as effective as the compliance and operational personnel responsible for enforcing them. While the Madoff and Stanford frauds, for example, were orchestrated by a handful of persons, it is difficult to imagine that employees of each firm were unaware of suspicious activity relating to trading, movement of funds and securities, or other telltale signs of fraudulent conduct. The SEC has alleged, for example, that Stanford's financial planners were well aware of SIB's "improbable, if not impossible" returns and yet were discouraged from asking questions about how those consistently high returns were generated. Similarly, one of

SGC's clearing firms—Pershing—eventually refused to process further wire transfers from SGC to SIB in light of its inability to get a "reasonable level of transparency" into its portfolio.

The effectiveness of SEC and FINRA oversight, through its compliance inspections and examination activity, in unearthing such schemes therefore turns on their ability to foster an atmosphere in which employees and counterparties take compliance with internal controls seriously and are forthcoming about potentially illegal or unethical conduct. Naturally, the SEC may seek enforcement action against securities professionals, including both employees and counterparties, that aid and abet fraud. Congress and the SEC have also imposed heightened professional obligations on accountants and attorneys to report up credible evidence of securities violations within a firm and to encourage disclosure to the SEC if consistent with ethical obligations. But only a culture of compliance—and assurances of prompt investigative action—can ensure that valuable business relationships will not be forgone in vain if securities professionals cooperate with authorities. To do so, regulators must ensure that employees and counterparties have confidential access to regulatory personnel to report potential violations, promptly follow up on tips and complaints, and ensure that retaliatory action is not taken against whistleblowers.

With respect to investigation and enforcement, the Commission has recognized that its organization of the Enforcement Division may have resulted in too many layers of bureaucracy and stifled the initiative of enforcement attorneys to commence and pursue investigations against major targets. The SEC has already announced its intention, under the supervision of the new Director of Enforcement, to flatten the hierarchy in the

Enforcement Division and to develop specialized enforcement units to deal with recurrent issues in our securities markets. This builds on a history of creative thinking by the Commission to identify emerging market abuses and devote specialized resources to combating them—such as the Commission's Office of Internet Enforcement.

For such reforms to have more than superficial effect, however, we must give the Commission greater latitude to investigate potential frauds, if we are to avoid scandals such as the Madoff and Stanford schemes. Both Madoff and Stanford were well-respected members of the business community, and regulators may have been deterred from devoting significant resources to such investigations because of the low chance of finding fraud and the high reputational cost of prosecuting innocent members of the financial community. While the SEC's investigation of Stanford began in 2005, it appears the Stanford was able to use the significant resources at its disposal to prolong or hinder investigative or enforcement action, including by procuring the complicity of the Antiguan regulator responsible for oversight of its affiliated bank. In the Madoff scandal, it has been suggested that Madoff's prominence in the securities industry and in charitable circles led regulators to shy away from closer scrutiny of his activities.

2. Uniform Fiduciary Standards for Broker/Dealers and Investment Advisors

Another important step that lawmakers and regulators can take to deter frauds such as those in question is to standardize the duties of investment advisors and broker/dealers when dealing with members of the public. Investment advisors have traditionally been considered fiduciaries of their clients; their fiduciary duties entail, among other requirements, putting the interests of the client ahead of the firm when

recommending or purchasing securities. By contrast, broker/dealers have traditionally been subject only to a duty to ensure that the securities they recommend to a client are suitable in light of the client's financial condition and investment objectives. Because broker/dealers play a vital role in the distribution of securities and the maintenance of secondary markets, it has been considered less feasible to apply fiduciary duties that might hinder their ability to engage in underwriting, market making, and other proprietary trading activity.

These regulatory distinctions nevertheless have consequences. Broker/dealer sales representatives who are not subject to fiduciary duties may have little incentive to investigate financial products that they recommend to their clients, because the burden rests on customers to establish state of mind and reliance in any subsequent private litigation or arbitration. By contrast, broker/dealers and their sales representatives often receive commissions and other transaction-based compensation for selling financial products. For example, SGC reportedly received a 3% commission, and its "financial advisors" received a 1% commission, on sales of the SIB CDs. Such incentive-based sales schemes naturally distort the incentive for broker/dealers and their sales representatives to conduct diligence into the securities they sell.

Because the regulatory distinctions between broker/dealers and investment advisors are not immediately obvious to customers, moreover, confusion can ensue. Customers may believe, for example, that a brokerage firm's sales representatives are bound by fiduciary duties when they recommend securities or other financial products as part of a "financial plan," when in reality they may simply pushing an affiliate's or client's product. One study has suggested that investors are generally unable to

distinguish the type of services provided or to appreciate the conflicts of interest that permeate a web of interconnected financial intermediaries.[2] Moreover, brokerage firms are increasingly experimenting with alternative fee structures—including "wrap fees" for a full complement of brokerage, research and advisory services based on assets under management rather than transactions—that make them increasingly indistinguishable from financial planners or investment advisors.

Several commentators have encouraged Congress and the SEC to adopt a uniform fiduciary standard for broker/dealers and investment advisors. I believe a uniform standard is appropriate: Broker/dealers and investment advisors, when offering investment advisory services such as financial planning, asset allocation, or discretionary trading, should be subject to a unitary federal fiduciary duty—including duties to disclose and minimize conflicts of interest with proprietary underwriting or trading activities. The contours of such fiduciary duties, moreover, should be developed through SEC rulemaking authorized by statute, rather than through judicial decision making or the SRO rulemaking process, in order to ensure uniformity and consistent interpretation.

3. Self-Regulation of Investment Advisors

Although SRO regulation has worked well for broker/dealers, I do not believe a self-regulatory organization for investment advisors—be it FINRA or a new freestanding SRO—is necessarily appropriate. Efforts to extend the mandate of FINRA to include

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[2] Angela A. Hung et al., *Investor and Industry Perspectives on Investment Advisers and Broker/Dealers* (LRN-RAND Center for Corporate Ethics, Law, and Governance, Jan. 2008) (finding that "[i]nvestors had difficulty distinguishing among industry professionals and perceiving the web of relationships among service providers").

investment advisors would stray substantially from its core mandate and lead to a further drain on resources. The conflicts of interest between the brokerage industry and the investment advisory industry, moreover, are too great for FINRA to exercise a meaningful role in the oversight of investment advisors. As a recent D.C. Circuit decision involving the applicability of the Investment Advisers Act to broker/dealers illustrates,[3] competition between the brokerage industry and independent financial planners and investment advisors has become increasingly tense. A broker/dealer-dominated SRO might therefore have an incentive not to adopt rules that enhance investment advisors' obligations if by doing so broker/dealers would be precluded from offering competing investment advisory services.

There is perhaps even less justification for a self-regulatory organization devoted to investment advisors. Broker/dealer SROs were created out of stock exchanges and other voluntary industry associations that predated the Exchange Act, and the rulemaking and enforcement apparatus they employ are direct outgrowths of rules developed by broker/dealers for their mutual and reciprocal benefit. By contrast, there is tremendous variety in the types of business conducted by investment advisors, and sufficiently little interaction among them for me to believe that there is an interest in mutual regulation. While SEC registration is limited to those investment advisors with $25 million or more in assets under management, there is considerable variety in the conduct of their business, the handling of customer funds and securities, and the risks their activities pose to clients.

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[3] *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

As a result, I believe that there would be little benefit to using the financial resources and operational expertise of industry members to develop and enforce industry standards.

Moreover, many investment advisors do not act as custodian for customer funds, or manage customer assets only through regulated affiliates such as brokerage accounts or mutual funds, and therefore would balk at the cost of subsidizing enforcement of those advisors whose use or transmission of customer funds warrants regulatory scrutiny. Regulators should focus on requiring increased disclosure of the activities of investment advisors, coupled with more rigorous inspection and examination authority over the financial intermediaries (be they broker/dealers, banks, or other custodians) responsible for the transmission or safekeeping of their customer assets. Moreover, to the extent that investment advisors do not employ third-party "qualified custodians" for their client assets, FINRA and bank regulators could be given enhanced authority to investigate the activities of investment advisors who might have indirect access to customer funds and securities held with a broker/dealer or bank affiliate.

C. The Role of SIPC in the Aftermath of Financial Frauds

SIPC was created to protect customer funds and securities when a broker/dealer encounters financial difficulty, outside of the traditional bankruptcy process. SIPC was created by the Securities Investor Protection Act of 1970 ("SIPA") as a nonprofit organization whose membership generally consists of all registered brokers/dealers under the Exchange Act. The Act accords those claimants in a SIPA liquidation proceeding who qualify as "customers" of the insolvent broker/dealer priority over the distribution of "customer property." Thus, SIPC is empowered to file an application for a protective

decree and seek appointment of a trustee for the liquidation of a failing broker/dealer's business and distribution of customer property pursuant to the special provisions of the Act. SIPC may also advance funds to the trustee for the prompt payment and satisfaction of net equity claims of customers (not to exceed $500,000 per customer, and for cash claims, $100,000 per customer). The SIPC fund is maintained through periodic assessments upon its members: In its statement of financial position as of December 31, 2008, which does yet not account for the liabilities incurred as a result of the liquidation of Bernard L. Madoff Investment Securities LLC, the SIPC Fund consisted of cash and U.S. government securities aggregating nearly $1.7 billion.

To qualify for priority, claimants in a SIPA liquidation proceeding must demonstrate that they are "customers" and that their claims relate to "customer property" held in a securities account on the books of a member broker/dealer. Moreover, SIPA is not designed to protect customers of a broker/dealer against fraud committed by an *issuer* of the securities, but rather to preserve a customer's cash and securities positions notwithstanding the insolvency of the customer's *broker/dealer*. Thus, for example, SIPC would be responsible for insuring, up to the statutory cap, that customers of an insolvent broker/dealer received any funds and securities held in their securities account, but would not be responsible for ensuring the payment of interest or distributions, or the return of principal, by the issuer of the securities.

This limitation on SIPC's mandate is designed to dovetail with the customer protection rules that apply to broker/dealers. Unlike FDIC-insured banks, which are subject to routine examination and supervision by bank regulators to ensure that customer deposits are not used to finance speculative investments, most SEC-regulated

broker/dealers' obligations to their customers are subject to customer protection rules that require segregation of free customer credit balances and fully paid/excess margin securities. This structure allows broker/dealers to engage freely in proprietary underwriting, market making, and dealing activity without putting customer funds at risk. By segregating such customer funds and securities, securities regulators can ensure that, in the event of a broker/dealer's insolvency, the SIPC trustee will have access to sufficient assets to make customers whole after netting customer debits and short positions. SIPC insurance is used to make up the difference, if any.

Courts have enforced this narrow reading of SIPA's mandate. While some cases have required SIPC to reimburse customers who had purchased fictitious securities from a broker/dealer, SIPC's obligation to insure a customer's securities positions is generally satisfied if it can locate identical securities from the broker/dealer's customer property or otherwise purchase identical securities on the market for distribution to the customer. Moreover, SIPC does not insure cash balances or other loans made to a broker/dealer apart from cash deposited for the purpose of purchasing securities. For example, SIPC would not insure commercial paper or promissory notes issued by a broker/dealer to finance its operations.

Naturally, the SIPC trustee(s) for insolvent broker/dealers in the Stanford family will make an initial determination as to the extent to which SIPC will satisfy the claims of its customers. Several arguments could be made, however, that SIPC is not obligated to tap the SIPC fund to make purchasers of SIB CDs whole. First, SIPC could take the position that the CDs are neither "cash" nor "securities" for purposes of SIPA, since they are bank products issued by a foreign regulator. To the extent that the CDs are securities,

SIPC could maintain that its obligation is limited to purchasing equivalent CDs in the event of a shortfall in a particular customer's account, but not to guarantee principal or interest payments; even if the CDs were considered notes issued by SGC, or to be guaranteed by SGC, these might be characterized as direct obligations of SGC rather than securities held by SGC for the account of customers. Moreover, to the extent that customer funds and securities were held at Stanford Trust Company ("STC"), an affiliated trust company organized under Louisiana law, SIPC would likely maintain that STC is not a SIPC member and is therefore not insured by the SIPC fund.

Based on the limited information available to me, assuming that SIB's certificates of deposit were not protected to deposit insurance (such as by the Federal Deposit Insurance Corporation or a similar Antiguan regulator), purchasers of SIB certificates of deposit are only entitled to receive a distribution from the assets recovered by the U.S. and Antiguan receivers appointed with respect to the Stanford Financial Group's various affiliates. To hold otherwise would require SIPC to act as insurer for every unprofitable investment scheme and to fulfill every illusory or fraudulent promise made by a promoter with respect to the securities they market. In the case of the Stanford Financial Group, much of the $8 billion raised from the sale of SIB CDs appears to have been invested in speculative or illiquid investments, the proceeds of which are not remotely sufficient to make the holders of the certificate of deposit whole. Were a court to require SIPC to use its insurance fund to return the principal payments SIB had promised on these CDs, the cost of SIPC insurance would skyrocket.

D. Other Recommendations for Enhancing Investor Protection

In addition to the foregoing observations, I believe there are a number of steps that lawmakers could take both to prevent and detect fraud.

1. Increasing SEC Enforcement Resources

Perhaps the most critical step Congress can take to address financial fraud is to increase funding for the SEC's enforcement program. The events culminating in the SEC's actions in this $8 billion fraud case required a significant dedication of SEC investigative and enforcement resources over a period of almost four years. According to the SEC inspector general's report, the SEC staff contacted existing and former purchasers of Stanford products and former sales representatives, reviewed a multitude of documents produced by Stanford (in an apparent effort to obfuscate its activities), and worked with multiple whistleblowers to determine how the funds in CDs were being invested before filing its complaint and its various requests for injunctive relief. When taken in light of Stanford's active resistance and the certainty that the SEC's enforcement actions would be vigorously challenged, it cannot be gainsaid that the staff devoted significant resources to a case the outcome of which was by no means certain.

As SEC Chairman Mary Schapiro indicated in her recent testimony before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, SEC staff levels and compensation have not kept pace with the growth of the financial services industry. The Chairman estimated that the SEC had a staff of 3,652 full-time employees for the 2009 fiscal year, responsible for overseeing 11,300 investment advisers, 5,500 broker/dealers, 8,000 mutual funds, and 12,000 public

companies, as well as clearing agencies, securities exchanges, self-regulatory organizations, and credit rating agencies.[4] In particular, the Chairman noted that even as the amount of assets managed by investment advisors increased by 105% between FY2003 and FY2009 (from $21 trillion to $43 trillion), examination staff increased by a modest 13% during the same period (from an estimated 399 to 452 full-time employees).

A number of academic commentators have suggested that SEC funding levels should be tied more directly to growth in market activity.[5] On a purely intuitive level, investment frauds are most likely to blossom during heady market conditions, as investors are lulled into believing that high returns can be achieved without high risk. The number of tips and complaints received by the SEC staff and other financial regulators also grows significantly as the number of transactions increase, and regulators cannot hope to accord them each equal attention without the resources to do so. More practically, growth in the financial services industry not only increases the workload of financial regulators, but also lures away their best and brightest employees with the promise of higher salaries and the potential for equity participation. It should not be a surprise that turnover at financial regulatory agencies increases dramatically during ebullient market conditions.

One way to effect such a link is to dedicate a portion of the revenue from securities transaction fees to fund additional enforcement resources. As market activity

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[4] http://www.sec.gov/news/testimony/2009/ts071409mls-appendix.pdf

[5] *See, e.g.*, Joel Seligman, *Self-Funding for the Securities and Exchange Commission*, 28 NOVA L. REV. 233 (2004); *see also* Steven A. Ramirez, *Depoliticizing Financial Regulation*, 41 WM. & MARY L. REV. 503, 525 (2000) (arguing that self-funding contributes to the independence of the Board of Governors of the Federal Reserve System).

increases, the SEC budget would automatically be supplemented to keep up with the agency's increasing workload. To ensure the proper use of such funds, the agency could be instructed to use such funds solely for the purpose of ramping up or retaining front-line personnel responsible for reviewing corporate disclosures, conducting inspections and examinations, or investigating tips and complaints and initiating enforcement actions. Some commentators have suggested offering performance bonuses to staff members as a bounty for unearthing major frauds or other securities violations. I do not support such an idea, as it may prove more of a distraction than an incentive for proper deployment of enforcement resources: Just as regulators should not focus solely on petty frauds at the expense of investigating major scandals, regulatory personnel should not have a financial incentive to focus exclusively on larger frauds at the expense of protecting mom-and-pop investors from retail scams.

2. Improving Investor Communications

It is also important to help consumers understand what they are buying by standardizing the terminology used by purveyors of financial products. Lawmakers should strongly consider promoting greater uniformity in the marketing of financial products, regardless of how they are regulated. The products at issue in the Stanford scandal were styled "certificates of deposit," purportedly issued by a foreign bank subject to foreign regulation. At least one commentator has observed that the marketing of financial products using such terms created an undue impression that such "CDs" were

safe as compared to other products.[6] Had one or more financial regulators been armed with the authority to standardize the meaning of terms used for marketing retail products and to prohibit their misuse, investors in the Stanford scheme might have triggered earlier regulatory scrutiny of Stanford's actions. Whether Congress ultimately decides to create a financial products safety commission, or leave regulation of financial products to federal securities, commodities, and bank regulators, it is a worthy goal to standardize sales practices, communications with customers, advertising and sales literature, and the use of financial terms in describing products across all regulated entities.

3. Modifying the Threshold for Disclosure Exemptions and Safe Harbors

As a final matter, one of the most tragic features of the Stanford Financial Group's fraudulent scheme was the impact on individual investors who had invested substantial portions of their life savings upon which they relied for retirement income. This type of distribution was possible, in part, because the Stanford CDs were marketed in purported reliance upon exemptions and safe harbors under the Securities Act of 1933, such as Regulation D, designed for the benefit of sophisticated and high net worth "accredited" investors. Such exemptions and safe harbors are appropriate to the extent that they reduce the cost of capital formation for issuers and promoters if they offer or sell securities exclusively to investors who are otherwise able to "fend" for themselves. Such safe harbors also allow regulators to focus their review of offering documents on securities marketed to the public.

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[6] Ron Lieber, *Not All Certificates of Deposit Are Plain Vanilla — or Safe*, N.Y. TIMES (Feb. 20, 2009).

Nevertheless, policymakers should be mindful that these filters may not adequately protect investors, particularly to the extent that promoters may manipulate such exemptions and safe harbors to avoid disclosures or fend off regulatory scrutiny. First, the thresholds for accredited investors under Regulation D—such as for natural persons, $1,000,000 in individual or joint net worth or $200,000 to $300,000 in annual income—have not changed since Regulation D was adopted in 1982. Moreover, to the extent that net worth includes illiquid assets, such as home equity, appreciation in home prices may count toward the regulatory thresholds even if investors do not appreciate the consequences of putting such equity at risk. As a result, a greater number of individuals are eligible to purchase securities in Regulation D offerings without the benefit of any mandated financial disclosures. Second, as the holding periods for Regulation D and other private placements have decreased—one year in the case of securities not subject to registration under the Securities Exchange Act of 1934 (the "Exchange Act")—it becomes easier to resell such securities to unaccredited and unsophisticated retail investors.

Taken together, these developments suggest that it is easier for promoters to sell securities to a broader class of individuals who, on paper, possess sufficient wealth to qualify as "accredited investors" and then permit those initial purchasers to flip those securities to retail investors in as little as a year—all without any mandatory disclosure regarding the issuer or promoters of the securities offered. Naturally, the SEC retains the authority to investigate such offerings using its antifraud jurisdiction, but without diligence by investors and counterparties, there is no way for the SEC to detect fraudulent conduct on the basis of a simple Form D filing. As in the context of the marketing of

hedge funds and other investment vehicles, regulators have been rightly concerned about the misuse of such exemptions to offer securities to individuals who cannot absorb the risk of losses.

One way to address this problem is to change the definition of accredited investors to use liquid net worth or investment securities as the appropriate measure. These are the measures that are used in other contexts, such as for "qualified purchasers" under the Investment Company Act of 1940 or "qualified institutional buyers" under Rule 144A. A second possibility is to exclude home equity, assets held in retirement accounts, college savings accounts, medical savings accounts or other special purchase accounts for these purposes. Finally, policymakers may wish to consider whether the absolute dollar thresholds for accredited investors should be adjusted periodically for inflation. The SEC has proposed rulemaking to revisit the definition of "accredited investors" along some of these lines, but has not yet taken action to do so.[7]

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I thank the Committee and its staff for allowing me an opportunity to participate in this hearing and would be happy to provide any additional information you request in connection with my testimony.

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[7] *See, e.g.*, *Revisions of Limited Offering Exemptions in Regulation D*, Securities Act Release No. 8828 (Aug. 3, 2007).