

U.S. Securities and Exchange Commission must step up fraud detection efforts

The past 15 years haven't been kind to the Securities and Exchange Commission in its role as the markets' top cop. On too many occasions, it has missed signals that the investing public was being scammed. Among the frauds that the SEC missed were the accounting shenanigans at Enron Corp., which led to the demise of Arthur Andersen LLP, the mutual fund market-timing scandals, the Madoff con and the alleged Ponzi scheme perpetrated by Robert Allen Stanford. In most of these cases, the relevant SEC divisions not only failed to detect the fraud through regular oversight, they failed to act even after they had been tipped off by Wall Street watchers and insiders that something was amiss.

The key question now is: How many of these misses were due to the anti-regulatory ethos prevailing at the time, and how many were due to the SEC's own mindset? Those that resulted from the former likely will be addressed by the change in tone in Washington in favor of tighter regulation, as well as the new laws passed in the wake of the financial crisis. Those resulting from the bureaucratic mindset within the agency will be more difficult to address. And if ill-advised actions are taken, new problems will emerge. Take the Stanford case. |

In 1997, the examination staff at the SEC's Fort Worth (Texas) District Office alerted the enforcement staff about Stanford Financial Group of Cos.' broker-dealer operations because of a concern that the company's certificates of deposit sales were fraudulent and that the company was operating a Ponzi scheme. The enforcement staff, after a brief inquiry, closed the matter. Further referrals to the staff in 1998, 2002, 2003, 2004 and 2005 went nowhere.

The SEC's Office of the Inspector General examined these failures, which appear to have cost investors millions of dollars, and attributed them partly to a perception on the part of the enforcement staff that they were being judged on the number of cases that they brought and that bringing a "novel" or "complex" case was frowned on. The enforcement staff appeared to live by the old business school adage: "What gets measured gets managed."

The inspector general's office recommended that the Division of Enforcement consider the potential harm to investors when deciding whether to bring an action, and also consider whether this factor outweighs others such as litigation risk. It also recommended that the SEC make it clear that bringing difficult-to-win cases that have important investor protection elements will be a factor in evaluating the performance of enforcement staff members and regional offices. It also recommended that the enforcement staff be trained better about laws governing broker-dealers and investment advisers.

(Investment News, 4 October 2010)