Burned By Madoff, SEC Turned The Page

By Max Stendahl

Law360, New York (December 11, 2013, 7:28 PM ET) -- One day in early December 2008, U.S. Securities and Exchange Commission enforcement chief Linda Thomsen burst into the office of a top agency official with some alarming news. Flanked by other SEC employees, Thomsen recounted in a somber voice that federal officials had just discovered that a money manager named Bernard Madoff had been running a massive Ponzi scheme for years, according to one attendee.

It was the first time that the official and others in the room had ever heard of the fraud. But it would not be the last.

In the five years since Madoff’s arrest on Dec. 11, 2008, the SEC has endured withering criticism over its failure to catch the largest Ponzi scheme in history despite numerous red flags. Harry Markopolos, a financial industry whistleblower, alerted SEC staff as early as 2000 that Madoff might have been running a fraud, but his concerns went largely ignored. The agency investigated Madoff’s investment firm several times, but each time failed to act.

Thomsen resigned two months after Madoff’s arrest. The SEC also got a new chairman, Mary Schapiro, who replaced Christopher Cox.

And the scandal sparked a broader restructuring at the agency. The SEC streamlined its enforcement division, created industry-specific enforcement units, upgraded its technology and set up a new whistleblower program designed to help detect corporate fraud. The result, attorneys say, has been a more competent and watchful Wall Street cop.

"In light of the Madoff crisis, there is a renewed sense of urgency at the SEC with respect to investigations and aggressively pursuing litigation," said White & Case LLP partner Gregory Little, who previously served as agency trial counsel. "For as long as I can recall, if you’re at the SEC, you’re very concerned that you’ll miss a major fraud."

For SEC officials, the Madoff fallout was swift and severe.

Five days after the arrest, Cox issued a statement apologizing for the agency’s lapse in oversight, saying he was “gravely concerned” by the decadelong failure to thoroughly investigate or to sue Madoff. Thomsen and other officials were grilled by lawmakers in February 2009, during a contentious House Financial Services subcommittee hearing. And in September of that year, the agency’s inspector general, H. David Kotz, issued a biting 22-page report detailing the various lapses in oversight.

In a later report, Kotz faulted SEC general counsel David Becker for working on the case despite having personally inherited funds from a Madoff account.
Things got so bad for the SEC that the agency was accused in a lawsuit of missing the fraud because employees were too busy surfing the Internet for pornography. That case, filed by a Madoff investor, was eventually dismissed.

Since then, a new approach to detecting fraud has helped the SEC repair its battered reputation.

In May 2010, the enforcement division launched “specialized units” in five key areas, including asset management, foreign corruption and complex financial products. The SEC established the Office of Market Intelligence to pore over thousands of tips and complaints about potential wrongdoing. And it took a cue from criminal prosecutors by developing cooperation agreements and embedding FBI agents within the enforcement group.

Meanwhile, the SEC has increasingly sought to recruit staff with private-sector expertise, while ramping up training for current employees, according to the agency.

Dorsey & Whitney LLP partner Thomas Gorman, a former SEC attorney, said staff members got better at sharing information internally. The enforcement division, for example, has worked closely with the Office of Compliance Inspections and Examinations, an investor protection group that conducts examinations of investment firms and other entities.

"Historically, there were always some complaints that the divisions were somewhat siloed," Gorman said. "They’ve worked pretty hard to overcome that.”

Schapiro and Rob Khuzami, who replaced Thomsen as enforcement chief, also deserve credit “for taking a ship that was sinking and righting it,” Gorman added.

A major turning point in the SEC’s transformation came in August 2011, when the SEC’s new whistleblower program became effective. Since that time, the Office of the Whistleblower has received thousands of tips while doling out hefty rewards to tipsters who help alert government officials to fraud. Experts say each bounty has the effect of encouraging more whistleblowers to come forward.

BuckleySandler LLP partner Thomas Sporkin, a former SEC official who led the Office of Market Intelligence and also helped to launch the whistleblower office, said the post-Madoff reforms had made the SEC “a leaner, smarter, swifter and more strategic agency.”

"At some point, the government can't stop every fraud out there,” he said. "But I think in the regulated space for broker dealers and asset managers, the commission is now infinitely better prepared to detect, minimize and even prevent a Madoff-style fraud from occurring again."

--Editing by Kat Laskowski and Chris Yates.