FEDERAL AND STATE ENFORCEMENT OF FINANCIAL CONSUMER AND INVESTOR PROTECTION LAWS

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

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FRIDAY, MARCH 20, 2009

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

FEDERAL AND STATE ENFORCEMENT OF FINANCIAL CONSUMER AND INVESTOR PROTECTION LAWS

Friday, March 20, 2009

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:07 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Waters, Moore of Kansas, Green, Foster, Carson, Driehaus, Maffei; Campbell, Posey, and Lee.

Also present: Representatives Cummings, Scott of Virginia, and Gohmert.

The CHAIRMAN. The hearing will come to order. I apologize for the delay. This has been a somewhat busier week than usual. And let me begin by saying when I asked that this hearing be on Friday—I didn't ask, I decided—I was told there would be votes. And I understand, obviously, there are members who left town. I will confess that coming and seeing a manageable number of members rather than 72, which is our quota, does give me some encouragement, because I think we may be able to not be here all day.

But I do want to explain that it is an important hearing. I am not trying to slight it, obviously, by having it on a day when there were no votes. We were told there were going to be votes. And we do have a very busy schedule, which we are trying to accommodate.

I also want to express my appreciation to my colleagues on the Judiciary Committee, because we have before us officials who are under the jurisdiction of the Judiciary Committee. One of the things I have worked very hard on with my colleagues is to avoid jurisdictional disputes. We have tried to be cooperative. I have spoken to Mr. Conyers. I know he has spoken to his Republican counterpart. And we have with us the gentleman from Virginia, Mr. Scott, and the gentleman from Texas, Mr. Gohmert, the chairman and ranking member of the subcommittee of the Judiciary Committee. So to that extent, this is a joint hearing.

We are joined by our colleague, Mr. Cummings of Maryland—who also has had a great interest in this—from the Oversight and Reform Committee. So it is a joint effort to that extent. And it is important, because one of the questions we are going to be asking of the assembled panel is whether going forward, there is any legislative authority that you would like enhanced. We, if that was the

case, in the Financial Services Committee would have jurisdiction over some of that, but the Judiciary Committee would have jurisdiction over other parts of it. Anything that is criminal, of course, goes to the Judiciary Committee, plus staffing or other requirements for recommendations from the people in the Justice Department. And given the rules about personnel and salaries that have come up, the Government Reform Committee has jurisdiction. Because one of the things we have been asked in the past is, in some cases, frankly, to make some special rules so some of these agencies could acquire the degree of expertise they would need in dealing with this. So that explains it all procedurally.

I am very grateful to the witnesses. It is a panel that is fully representative of the capacity of the Federal Government to enforce the various laws, both civil and criminal, that try to keep our financial system honest in the literal sense.

You can start my 5 minutes now. I started it. I used up 10 seconds.

There are two reasons for this hearing, candidly. One is the substance of the subject. We do want to know what, if anything, we, the Congress, the relevant committees taking the lead, can do to enhance your ability to protect the public, which is what you do. And there are agencies that have dual functions. You have general functions for keeping the market going, but every one of you has some law enforcement activity as well, both civil and criminal. And so it is important for us to know what, going forward, we can do to help you.

And I want to make this very clear now. I know there is OMB and all those other people. I am asking you on behalf of the Financial Services Committee, and I believe the Judiciary Committee, we are directing you to volunteer to us—not to volunteer, but to respond if you need more resources. This is not a case of you being accused of coming here behind OMB's back. We insist on knowing what your honest assessment is of your resource needs, because we cannot have a situation where the public is being told that we don't have enough people to do this.

We have had efforts before on a bipartisan basis out of this committee; we have talked to Judiciary to try to get more resources, for instance, to the Justice Department to deal with mortgage fraud. And mortgage fraud is obviously one of the issues that we are talking about.

The second part of that, and mortgage fraud gets me into it, is there is in America today a justifiable level of anger at the fact that the great majority of Americans are suffering economically because of the mistakes of a relatively small number of people and of a system that was inadequate to the task. Some of those problems, as I say, resulted from an inadequate system. We cannot prosecute people for breaking rules when the rules didn't exist. And part of what we have to do is to think about what rules we need to have going forward. And you should feel free to tell us about those as well.

But it is also likely that there are people who violated the rules, and if we are to sustain the capacity to govern effectively, if we are to provide the resources that are needed to deal with the current situation, we have to satisfy the American public that everything

is being done that can be done legitimately to hold accountable the people who caused this problem. And so it is important for people to know that to the extent there were crimes committed, and there certainly were crimes committed as we hear, that there will be prosecutions if these are possible to achieve. And we will have a second panel of State attorneys general whom we understand have a large part of the criminal jurisdiction. There are also civil recoveries that can be made. There are debarments that can be issued.

A great deal collectively can be done to protect the public, and it is important to do that, because if we don't convince the American public that this is being done effectively, their response will be, I believe, one that will shut down some of these efforts. That might be paradoxical, but it will be there.

And then, of course, we do want to make sure that going forward, we are better able to protect our financial system from the kind of action and inaction that brought us where we are today.

So this hearing is very important. Just to summarize, we want you to tell us—no agency represented here today should go out of this room and be able to say, the problem is they didn't give us enough resources, or we need this change in the law, unless you have told us that and given us a chance to respond.

I will give you one example. We had a hearing with the FHA in January, still under the previous Administration, about their role in reducing and issuing mortgages of the sort that wouldn't lead to the subprime crisis. What evolved in that hearing is they did not have sufficient power to debar past bad actors. We elicited that in testimony—my colleagues from California Ms. Waters and Ms. Speier. We elicited that testimony. In the bill that the House passed a couple of weeks ago, we gave the FHA that authority. That is an example of the kinds of things we are looking to do.

And let me say the last thing is we are not asking for names. We are not the prosecutors. This is not an appropriate forum in which individuals should be attacked. We are interested in your plans for going forward and what you intend to do going backward. That is, what do you intend to do to prosecute and recover funds where we can? What do you need to make sure you do the best possible job going forward? This is not a hearing in which, as I said, we want you to name names. That would not be an appropriate legislative function.

And with that, let me call on the gentleman from Texas, Mr. Gohmert, for an opening statement.

Mr. GOHMERT. Thank you, Mr. Chairman. I appreciate being included in this hearing. In several former lives ago, I was hired as outside counsel to clean up some banking messes and illnesses, and so I have a real interest in this. Those who would seek to commit mortgage fraud often prey on the elderly and other members of society who are most vulnerable. And obviously, they shouldn't be allowed to defraud the American public. Honest Americans must have the confidence to know they can enter into a financial deal and the person on the other side won't be able to cheat them without consequences.

Unfortunately, reporting of mortgage fraud on the Suspicious Activity Reports filed with the Treasury's Financial Crimes Enforce-

ment Network shot up by 36 percent from 2007 to 2008, with 63,173 reported last year.

The problem of mortgage fraud is getting worse. Federal and State entities that police these activities obviously must have the resources and tools to deal with them.

One of the things that may surprise some folks here that has brought together the ACLU, the Heritage Foundation, and, maybe more surprisingly, Mr. Bobby Scott and me all on the same side is that we have often been overcriminalizing way too many activities, and so one of the things some of us have wanted to start taking a look at is if there are ways to stop or slow a bad activity by other means. If there is not criminal intent, if there is not mens rea, then would a civil fine or some kind of dollar penalty address the issue?

You look at mortgage companies who intended to put people in mortgages so it didn't matter if they put people in homes they couldn't afford, it didn't matter if people put down fraudulent information in order to get a mortgage because they intended to turn around and immediately sell those, package them into a neat little security package and sell them without recourse. Maybe if there was recourse civilly, you would address this issue and you wouldn't see fraud skyrocketing, because the people would have a real incentive, like Countrywide would have a real incentive, to make sure that people did not put down fraudulent information, they didn't get in homes they couldn't afford because they didn't want people coming back to them for the costs of this thing.

But I am glad to hear the FBI has increased the number of special agents specifically devoted to mortgage fraud nationally by half over the last year from 120 to 186. And I am looking forward to hearing from the witnesses and learning about how this all affects them and their suggestions. But my time as a lawyer, as a prosecutor, judge, chief justice, and Congressman has taught me that crises such as the scourge of mortgage fraud can lead to overreaction in the form of new criminal laws that potentially cover people who had no guilty intent. For example, in this area, they were greedy, but they didn't intend to commit a crime.

But one of our problems is this overreaction; let us criminalize some conduct, let us put people in prison. We have heard some terrible anecdotal evidence of some Federal agencies who couldn't wait to get their own SWAT team with the red lights and the ability to slam people to the ground and handcuff them in public, because there apparently is a pent-up desire to do that among some people. And wow, you can do it and get paid for it at the same time. So we have to be careful about spreading that ability to do that among people who should not have that.

But perhaps we could hear thoughts on whether to outlaw combining mortgages into securities. I know I have friends who think I shouldn't talk like that, but when you lump mortgages into a security, and you don't examine the value of each mortgage and whether the payments have been made on time or the property underlying the mortgage is keeping its value, then you are going to end up needing to buy some insurance, or we will call it a credit swap, and that way we don't have to hold money in reserve in the event the insurable event ever occurs.

So there are a number of things we need to look at. If greed is the problem, but there is no criminal intent, let us address it with a proportional monetary cost to the wrongdoer and pop them right where they hurt the worst, in the pocketbook. And if there is criminal intent, then let us go after them. I may be one of the few people in this room who has watched his hand sign an order to have somebody taken and the death penalty administered. I am serious about crime, but I do want to make sure there is criminal intent; otherwise, if it is just greed, let us hit them in the pocketbook where they really hurt.

Thank you, Mr. Chairman.

The CHAIRMAN. At this, if I could take a second to express agreement with him. That is why I did stress both civil and criminal. And that is why we have people here from both the civil and criminal jurisdictions. And it is why we are working with Judiciary, because we don't want this to be narrowly done. The gentleman is absolutely right, and I think he speaks for a great majority of both committees.

Mr. GOHMERT. And that is why I do appreciate this hearing and being included. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Virginia, who is chairman of the subcommittee on the Judiciary Committee.

Mr. SCOTT OF VIRGINIA. Thank you, Mr. Chairman, for inviting the Judiciary Committee to participate in this hearing on Federal and State enforcement of financial, consumer, and investor protection laws. As a member of the House Judiciary Committee and the Chair of the subcommittee overseeing crime issues, we are exploring ways to hold accountable unscrupulous mortgage brokers and Wall Street executives who are an integral part of the problem. With the Department of Justice and FBI witnesses, I hope this hearing will give more insight into what is being done and what needs to be done, particularly what is needed in the way of resources to investigate those suspected of serious criminal activity which contributed to the crisis, and what needs to be done to make sure they are prosecuted to the full extent of the law.

The Financial Services Committee has been relentless in investigating and uncovering the causes of the financial and mortgage crisis. As banks and private mortgage companies relaxed their standards for loans, approving riskier mortgages with less scrutiny, they created an environment that invited fraud. In the last 3 years alone, the number of criminal mortgage fraud investigations opened by the FBI has more than doubled. The FBI has testified before the Senate that it currently has 1,800 mortgage fraud investigations that are open, but only 240 agents specifically assigned to those cases.

It is my view that to fully protect law-abiding taxpayers from criminal conduct, it is essential that appropriate resources be dedicated to meet the challenges of investigating mortgage and financial fraud. I am not persuaded that more laws are needed, but what is needed is more resources to enforce existing laws.

Many in this industry knew that they were dealing with worthless paper. They had even names for the paper. They had mortgages like ninja loans, no income, no job. When these are passed off as triple A assets, someone has committed common law fraud.

I believe that Federal mail and wire fraud criminal statutes should be sufficient to address the problem. Those penalties for those violations are substantial. Mail and wire fraud violations carry a maximum penalty of 20 years, and any mail or wire fraud that affects a financial institution increases that maximum sentence to 30 years.

It is just not mail and wire fraud that is at the disposal of Federal prosecutors. The FBI itself has identified nine applicable Federal criminal statutes for which this fraud—for which those committing the fraud may be charged. In addition to the Federal criminal law, these crimes can also be aggressively prosecuted by State and local law enforcement officials under aggressive and very punitive State criminal law provisions as well. So it seems that we may have enough in the way of criminal code provisions, but what we need is to make sure that we have adequate resources to State and Federal authorities to battle fraud. And we need to ensure that the Federal authorities are also coordinating their activities with local and State officials.

So, Mr. Chairman, what we need to do is find out what resources law enforcement officials need to prosecute the fraud, whether it is consumer I.D. theft, contracting fraud in Iraq, or even mortgage fraud before us today. I was happy to see that the 2009 Omnibus Appropriations Act provided $10 million to the FBI to dedicate additional agents to the mortgage fraud investigations. I am also supportive of other bills that provide more resources in this area.

In conclusion, Mr. Chairman, I support more resources for the Department of Justice to assist the FBI and the States in enforcing fraud laws to recover the billions of dollars that have been lost. We also need to make sure that we have in place the prosecution and investigations to prevent these same schemes from happening in the future. Today's hearing is an opportunity to fully discuss these issues, and I look forward to hearing from the witnesses. And I thank you again, Mr. Chairman, for your relentless action to make sure that the public is actually protected.

Thank you, and I yield back.

The CHAIRMAN. I thank the gentleman.

The gentleman from California, Mr. Campbell, will be giving an opening statement from the Financial Services Committee. He had a conflict, which is an unavoidable fate of all of us. He is on his way. I would assume it will be all right with the members if we proceed with the testimony, and if Mr. Campbell has a statement when he arrives, he will give it. And given the large number of witnesses, I cannot tell you how nice it is to have the witnesses outnumber the members, because we will get some real conversation going.

We will now begin with our first witness, the Honorable Elizabeth Duke, who is a Governor of the Board of Governors of the Federal Reserve system, and then go down the list. Governor Duke?

STATEMENT OF THE HONORABLE ELIZABETH A. DUKE, GOVERNOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Ms. DUKE. Thank you, Mr. Chairman.

Chairman Frank, and members of the committee, I want to thank you for the opportunity to discuss the Federal Reserve Board's ongoing efforts to address and prevent mortgage-related fraud and abusive lending practices in the institutions we supervise.

While the expansion of the subprime mortgage market over the past decade increased consumers' access to credit, too many homeowners and communities are suffering today because of lax underwriting standards and other unfair and deceptive practices that resulted in unsustainable loans. The Federal Reserve is committed to improving consumer protections and ensuring responsible lending practices through each of the roles we play, as supervisor for safety and soundness, as supervisor for consumer compliance, and as rule writer.

Let me first address the steps that the Federal Reserve is taking to combat mortgage fraud. In recent years, there has been a significant increase in suspected mortgage fraud and other mortgage-related criminal activity. Federal Reserve staff regularly review Suspicious Activity Reports filed by the financial institutions we supervise. In appropriate circumstances, and particularly when bank insiders may be involved, we initiate investigations, make criminal referrals, coordinate with law enforcement and other regulatory agencies, and pursue enforcement actions against individuals, including seeking prohibition orders and, in appropriate cases, civil money penalties and restitution. We are currently pursuing numerous investigations involving insiders related to possible mortgage-related fraud, both commercial and residential.

More generally, the Federal Reserve's enforcement efforts begin with the examination of its supervised institutions. In the Federal Reserve's regular safety and soundness examinations of State member banks and bank holding companies, we evaluate their risk management systems, financial condition, and compliance with laws and regulations.

In assessing a bank's risk management systems, examiners evaluate the adequacy of the bank's practices to identify, manage, and control the credit risk arising from the bank's mortgage lending activity. Examiners look at the bank's underwriting standards, credit administration practices, quality control processes over both its own originations and third-party originations, and appraisal and collateral valuation practices. Institutions with weaknesses are expected to take corrective actions that include improving their underwriting practices in the future. In those instances where the bank is not willing to address the problem, we have and use a full range of powerful enforcement tools to compel corrective action.

The Federal Reserve conducts regular examinations of State member banks to evaluate compliance with consumer protection laws. Each examination includes an evaluation of the bank's fair lending compliance program. Our objective is to identify compliance risk at banks before they harm consumers, and to ensure that banks have appropriate controls in place to manage those risks.

When examiners identify banks with weak and ineffective compliance programs, they document the weaknesses in the examination report and take appropriate supervisory action. In addition, when examiners identify patterns or practices of lending discrimi-

nation, the Federal Reserve makes referrals to the Department of Justice as required by the Equal Credit Opportunity Act. Furthermore, Federal Reserve consumer compliance examiners routinely participate in the review and assessment of the adequacy of large bank holding company compliance risk management programs.

In addition to our supervisory activities, in 2008 the Federal Reserve Board finalized sweeping new rules for home mortgage loans to better protect consumers and facilitate responsible residential mortgage lending. The rules, which amended Regulation Z, prohibit unfair, abusive, or deceptive home mortgage lending practices.

Importantly, the rules apply to all mortgage lenders, not just to the depository institutions supervised by the Federal banking and thrift regulators. The rules apply to a newly defined category of higher-priced mortgage loans secured by a consumer's principal dwelling. The higher-priced thresholds would cover all, or virtually all, of the subprime market. For these loans, the rules will prohibit a lender from making a loan without regard to the borrower's ability to repay the loan from income and assets other than the home's value. In addition, lenders are prohibited from making stated income loans, and are required in each case to verify the income and assets that they rely upon to determine the borrower's repayment ability.

Again, I want to thank you for the opportunity to discuss what the Federal Reserve does to address and prevent mortgage-related fraud and abusive lending practices in the institutions we supervise. I would be happy to answer any questions. Thank you, Mr. Chairman.

[The prepared statement of Governor Duke can be found on page 81 of the appendix.]

The CHAIRMAN. Next, the Comptroller of the Currency, John Dugan.

STATEMENT OF THE HONORABLE JOHN C. DUGAN, COMPTROLLER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. DUGAN. Thank you, Mr. Chairman, and members of the committee. I welcome this opportunity to appear before you today to discuss the OCC's enforcement authority and how we have exercised that authority.

Recent unprecedented losses at financial firms, the mortgage crisis, and shocking examples of both fraud and excess have prompted your questions about the adequacy and use of enforcement powers by Federal and State authorities. The OCC vigorously applies laws and regulations to national banks through both supervisory activities and enforcement actions to protect the safety and soundness of national banks and their customers.

The OCC and the other Federal banking agencies have a broad range of supervisory and enforcement tools that are used to supervise banks and protect consumers, investigate and halt fraudulent activities, and remove and prohibit those responsible from ever working in the banking industry again. Unlike the Department of Justice and the FBI, however, the Federal banking agencies are not criminal law enforcement agencies, and we do not have the authority to investigate and prosecute crimes of fraud. Rather, the Fed-

eral banking agencies refer suspected criminal fraudulent acts to the Department of Justice for prosecution.

My written statement today covers the OCC's activities and perspectives on enforcement in four areas. The first is our approach to enforcement. National banks are subject to comprehensive, ongoing supervision that, when it works best, enables examiners to identify problems early and obtain early corrective action before enforcement action is necessary. Once problems or weaknesses are identified, we expect bank management and the board of directors to correct them promptly. And because of the tremendous leverage that bank supervisors have over banks, management normally takes great pains to do so.

That is not always true, however, and in other cases, the seriousness of the problem requires an enforcement response. In those circumstances, we have a range of enforcement tools at our disposal, from informal enforcement actions such as a commitment letter or memorandum of understanding, to formal enforcement actions such as a formal agreement, cease and desist order, or removal and prohibition order.

We use all of these tools, depending on the circumstances, to vigorously implement our safety and soundness and consumer protection mandates, as the chart in my written statement summarizes. These include actions taken to address a wide range of issues, including capital adequacy, unfair and deceptive practices, managerial competence, mortgage fraud, and many others.

The second part of my testimony describes how we have employed enforcement actions in problem bank situations to protect consumers and eliminate fraud. Problem banks warrant special supervisory attention, and our actions here are designed to remedy various unsafe and unsound practice and compliance violations. The various corrective measures incorporated into our enforcement actions have included requiring the bank to raise capital, restrict borrowings, eliminate certain activities and even entire business lines, adopt appropriate underwriting standards and policies to govern lending activities, limit the transfer of assets, and eliminate payments of bonuses or dividends.

The third part of my statement describes how we coordinate with State and Federal regulatory agencies and law enforcement agencies. As an example, when the OCC issues a remedial enforcement action against a national bank, the Federal Reserve Board will often take a complementary action with respect to the bank's holding company.

We also coordinate extensively with other regulatory agencies and with law enforcement authorities. The OCC has entered into similar information-sharing agreements with most State banking agencies and all 50 State insurance departments, and recently with the Federal Trade Commission, and we regularly share information with the SEC. When we suspect criminal conduct, we make referrals to the Department of Justice.

Finally, my statement concludes with a description of the measures we have taken to address mortgage lending practices. Abusive lending practices by mortgage lenders and brokers and the current foreclosure crisis understandably have raised questions about the role and effectiveness of bank regulators in anticipating and pre-

venting mortgage lending abuses. This area represents a good example of how we apply our approach to supervision and enforcement. It is important to be clear about who did what.

The OCC extensively regulates the mortgage business of national banks and their subsidiaries, and as a result of the standards applied by the OCC, national banks originated less than 15 percent of all subprime loan mortgages. In contrast, the vast bulk of such loans were originated by nondepository institution mortgage lenders and brokers that were not subject to our regulation. It is these lenders and brokers that have been widely recognized as the overwhelming source of abusive subprime mortgages resulting in waves of foreclosures.

The OCC has been aggressive in combating abusive lending practices and in preventing national banks from engaging in such activities. We were the first Federal banking agency to issue antipredatory lending regulations, and in recent years we have issued, with the other agencies, a number of supervisory issuances covering payday loans, title loans, unfair and deceptive practices, risks associated with subprime mortgage practices, and other related issues. Although many of these statements were issued as guidance, compliance is not optional for national banks. We require it.

We describe a number of enforcement actions that we have taken in our testimony, including several that I won't go into the details of here because the details were reported there.

And thank you very much. I will be happy to answer questions.

[The prepared statement of Comptroller Dugan can be found on page 62 of the appendix.]

The CHAIRMAN. Next, we have Commissioner Elisse Walter, a relatively new Commissioner, of the Securities and Exchange Commission. Commissioner Walter?

STATEMENT OF THE HONORABLE ELISSE B. WALTER, COMMISSIONER, U.S. SECURITIES AND EXCHANGE COMMISSION

Ms. WALTER. Thank you, Mr. Chairman, and good morning to you, the members of the committee, and the members of the Judiciary Committee. I am one of the five Commissioners of the Securities and Exchange Commission, and I am testifying here today on behalf of the Commission as a whole. I very much appreciate the opportunity to discuss our enforcement program and, more specifically, our efforts to address violations of the law arising out of the current financial crisis. We are fully committed to pursuing wrongdoers and returning as much money as possible to injured investors.

The Commission's enforcement program is in a critical transition period. Since joining the Commission in January, our new Chairman, Mary Schapiro, has been taking important steps to bolster our enforcement efforts and restore investor confidence to our markets. Among other things, she has hired a new Director of Enforcement, Robert Khuzami, an accomplished former Federal prosecutor who is scheduled to join the agency at the end of this month. And she has begun streamlining our enforcement processes.

Today, as detailed in my written statement, I would like to talk about the SEC's law enforcement authority and the steps we are

taking to address the current crisis. As you know, the SEC is a capital markets regulator and a law enforcement agency. We are charged with civil enforcement of the Federal securities laws, and our Enforcement Division is authorized to investigate any potential violation of these laws. We have the authority to take action against any form of fraud in connection with the purchase or sale of securities.

Our Enforcement Division, which numbers about 1,100, initiates investigations based on information from many sources, including referrals from within the Commission itself and from other regulators, investor complaints, and tips. In Fiscal Year 2008, the Division received more than 700,000 complaints, tips, and referrals.

The enforcement staff coordinates its work with other law enforcement bodies across the country and around the globe in order to leverage enforcement resources effectively. In our actions, we seek a variety of remedies, including disgorgement of ill-gotten gains, permanent injunctive relief against violations of the law, remedial undertakings, civil penalties, revocation of registration, and bars to prevent a wrongdoer from serving as an officer or director of a public company or from associating with any broker-dealer or investment adviser.

Whenever possible, the Commission seeks to return monies to harmed investors under the Fair Funds provisions of the Sarbanes-Oxley Act. Under the authority granted to us by Congress in that legislation in 2002, we have authorized approximately 220 Fair Funds, with an estimated total value of more than $9.3 billion that has been or will be distributed to investors.

To halt an ongoing fraud or to prevent misuse of investor funds, we have the ability to seek emergency relief in court, including temporary restraining orders, preliminary injunctions, asset freezes, and the appointment of a receiver to conduct operations during the case or to marshal any remaining assets for the benefit of injured investors. During this fiscal year thus far, we have already obtained 20 temporary restraining orders to halt ongoing frauds.

I would like to take a minute to give you a few examples of our recent work to address the current crisis. Our Enforcement Division has already filed nine cases involving subprime issues, and has many more under active investigation. And through the collective efforts of SEC enforcement, State regulators, and FINRA, the self-regulatory organization for broker-dealers, over the past year, tens of thousands of auction-rate securities investors have received or will soon receive over $67 billion of liquidity. These cases involve the largest monetary settlements in the history of our agency.

Also, we are investigating the possible manipulation of the securities of six large financial issuers involved in the recent market turbulence, with particular focus on claims that credit default swaps were being used to manipulate equity prices.

We have also brought many cases involving hedge funds. As you know, hedge funds and their advisers are not required to register with us, but we still have authority to pursue fraud cases against them. The SEC has dozens of active investigations involving individuals associated with hedge funds.

Over the past 2 years, the Commission has filed enforcement cases against the perpetrators of more than 75 Ponzi schemes, including 12 such cases since December 2008. For example, we recently filed an emergency action against Robert Allen Stanford and others, alleging a massive Ponzi scheme. At our request, the court issued a temporary restraining order, appointed a receiver, and ordered an asset freeze.

Also this week, we filed a complaint alleging fraud by the accountant who purportedly audited the firm run by Bernard Madoff. A criminal fraud case was brought at the same time.

The SEC is committed to finding ways to improve, to act more quickly and efficiently. Within days after her appointment as SEC Chairman, Mary Schapiro repealed the pilot project under which enforcement staff were required to seek preauthorization from the five-member Commission before negotiating civil money penalties against public issuers. In addition, she streamlined the process for obtaining formal orders, and now they can be authorized by a single Commissioner. We are also working with the Center for Enterprise Modernization, a federally funded research and development center, to establish a centralized process that will more effectively identify leads for potential enforcement as well as areas of high risk for compliance.

But these steps are just the start. We are carefully examining our processes from top to bottom. However, while our job has grown substantially, our resources have not kept pace. Our staffing levels have actually declined in the recent past, and our technology must be improved.

As the sole agency charged with protecting investors, the SEC is committed to restoring the confidence needed for our marketplace to thrive. Thank you again for the opportunity to testify, and I look forward to answering any questions you have.

[The prepared statement of Commissioner Walter can be found on page 223 of the appendix.]

The CHAIRMAN. Next, Martin Gruenberg, who is the Vice Chair of the Federal Deposit Insurance Corporation.

STATEMENT OF THE HONORABLE MARTIN J. GRUENBERG, VICE CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. GRUENBERG. Thank you, Mr. Chairman, and members of the committee. I appreciate the opportunity to testify on behalf of the FDIC regarding enforcement of consumer and investor protection laws.

Earlier this month, in a speech before the National Association of Attorneys General, FDIC Chairman Bair stated that many of the current problems in the economy were caused by a widespread failure to protect consumers. She noted that it is essential that those whose actions contributed to the current crisis and who are engaging in practices harmful to consumers be held accountable, and that we take steps to prohibit these practices from occurring again.

The FDIC has a strong commitment to the vigorous and effective enforcement of consumer protection laws and other statutes under its jurisdiction. The FDIC brings a unique perspective to this issue because of the variety of functions it performs, including deposit in-

surer, bank supervisor, and receiver for failed insured depository institutions.

Immediately following the closing of every failed institution, FDIC investigators and attorneys begin an investigation. The purpose is to determine whether the failed institution's directors, officers, and professionals such as accountants, appraisers, and brokers were responsible for its losses, and if so, to hold them accountable.

Recent failures of insured institutions, 3 in 2007, 25 in 2008, and 17 thus far this year, have resulted in a substantial increase in our investigations and professional liability workload. Since the beginning of 2007 through today, investigations of mortgage fraud claims have increased from 0 to 4,375. Investigations of professional liability claims other than mortgage fraud have increased from 34 to 427. And mortgage fraud lawsuits have increased from 0 to 113.

As receiver of a failed institution, the FDIC has the authority to terminate contracts upon an insured institutions's failure. The FDIC routinely terminates compensation and other contracts with senior management whose services are no longer required.

In addition to the development and support of civil claims brought by the FDIC with regard to failed institutions, our investigators also identify signs of possible criminal activity in a failed institution. These findings support the Department of Justice's subsequent prosecution of the wrongdoers. The FDIC also coordinates with other Federal, State, and international agencies to detect and deter bank fraud.

The FDIC, in addition, pursues enforcement actions against open insured depository institutions, their directors and officers, employees, and other institution affiliate parties where warranted, including third parties and independent contractors such as accountants, attorneys, and appraisers, under its Federal Deposit Insurance Act authority.

When FDIC examiners find other violations of law, breaches of fiduciary duty, unsafe and unsound practices or mismanagement in banks' consumer protection responsibilities, the FDIC requires corrective action. During 2007 and 2008, the FDIC issued 142 cease and desist orders and 102 removal and/or prohibition orders banning individuals from banking. These enforcement actions were based on a variety of harm or risks caused to an insured institution, and included theft and embezzlement by employees of the bank, poor lending policies or procedures, and fraudulent actions on the part of a lending officer.

Removing from office and prohibiting from banking those who commit financial crimes is a primary goal of FDIC enforcement actions. The employees found to have committed financial crimes are removed from positions of trust, and are often required to make restitution and pay a financial penalty to remedy these transgressions.

The FDIC's Office of Inspector General brings another level of enforcement. The OIG conducts investigations of fraud and other criminal activity in or affecting FDIC-regulated open financial institutions, all closed institutions in receiverships, and other FDIC-related programs and operations. Currently, the OIG has about 170

active investigations involving open and closed institutions. The work focuses on various types of fraud, including mortgage securities and crimes such as embezzlement and money laundering.

Investigations of financial institution fraud currently constitute about 88 percent of the OIG's investigative caseload. Over the last 2 years, it has closed about 100 investigations, with the crimes occurring almost exclusively in open institutions. These investigations have resulted in over 230 indictments, 170 convictions, and over $530 million in fines, restitution, and monetary recoveries.

The FDIC expects the enforcement challenges in both the closed bank and open bank context to increase for the foreseeable future. In order to handle the substantially increased workload in the closed bank area, we are increasing our enforcement staff as well as retaining outside counsel. We have also added to both our civil and criminal investigations staff. In the open bank area, the FDIC has added 87 full-time compliance examiners in 2007 and 2008, and has authorized the hiring of 79 more. Since 2007, we have increased our legal staff responsible for open bank enforcement by 29 attorneys.

The FDIC's core mission is to maintain public confidence in the banking system. Critical to the achievement of that mission is to hold accountable those who do not comply with applicable laws and regulations. The FDIC looks forward to continuing to work closely with the committee to achieve that goal.

Thank you, Mr. Chairman.

[The prepared statement of Vice Chairman Gruenberg can be found on page 114 of the appendix.]

The CHAIRMAN. Next, the Acting Director of the Office of Thrift Supervision, Mr. Scott Polakoff, to whom this committee gave, I think, 2 days off this week. So welcome back, Mr. Polakoff.

STATEMENT OF SCOTT M. POLAKOFF, ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. POLAKOFF. Thank you, sir.

Good morning, Chairman Frank, and members of the committee. Thank you for the opportunity to testify on the enforcement authority that the OTS exercises over regulated institutions and their affiliates, and in particular OTS enforcement of consumer protection laws.

The OTS has broad powers to protect customers of federally regulated thrifts, their affiliates, and thrift holding companies. These powers include specific authority regarding truth in lending and unfair or deceptive practices. As you know, the OTS used that authority over unfair practices to initiate a process resulting in a final interagency rule in January of 2009 banning unfair credit card practices.

We exercise our enforcement authority when our examiners find problems during their examinations of thrifts as well as when we receive consumer complaints and referrals from other agencies.

Throughout 2008 and into 2009, we have seen a steady increase in OTS enforcement actions. Formal actions, such as cease and desist orders and monetary penalties, increased by 45 percent from 2007 to 2008, and the pace is accelerating further this year.

I would like to highlight two particularly notable cases. The first one occurred in June of 2007 and involved a Federal savings bank and two affiliates that were charging excessive fees to mortgage customers and failing to adequately evaluate their creditworthiness. We required these institutions to immediately stop these practices, establish a fund of $128 million to reimburse consumers, and commit an additional $15 million to support financial literacy and credit counseling.

The second case, in June of 2008, involved a Federal savings bank and its subsidiaries that were charging inappropriate and, in some cases, very large broker and lender fees to mortgage customers. The enforcement action required the bank to reform its practices and establish a $5 million fund to reimburse consumers. Since 2007, I believe that OTS is the only Federal banking agency to require institutions to make restitution to bank customers for abusive lending practices, enabling the customers to stay in their homes.

On criminal matters, the OTS makes referrals to the Department of Justice and U.S. Attorneys' offices. The number of these referrals is increasing, particularly in the fair lending area. Five recent cases involve steering customers to more expensive mortgages based upon their race or national origin.

I would also like to point out that the OTS has been increasing its enforcement resources for several years. Since 2006, the agency has increased the number of attorneys in its Enforcement Division by 67 percent. The agency has also been expanding the size of its staff devoted to fair lending issues.

As we discuss actions that will better protect consumers, I think it is important to point out that gaps in laws and regulations over mortgage lending leave some sectors of the financial market underregulated, and therefore may leave consumers unprotected. These sectors include mortgage brokers and mortgage companies.

We urge Congress to establish a level playing field in mortgage lending, with the same rules and oversights for all players. Consumers do not understand, nor should they need to understand, distinction between types of lenders offering to provide them with a mortgage. They deserve the same service, care, and protection from any lender.

Finally, I would like to offer two suggestions for legislative changes that would improve consumer protection. Number one, expand and enhance the temporary cease and desist authority to make it easier to apply in consumer protection cases. Number two, improve the jurisdiction of Federal banking regulators over third parties such as mortgage brokers, appraisers, and consultants to whom depository institutions outsource key parts of their business.

Thank you again, Mr. Chairman.

[The prepared statement of Acting Director Polakoff can be found on page 152 of the appendix.]

The CHAIRMAN. Thank you, Mr. Polakoff. Those last two points are very much what we were hoping to hear.

And next, with the cooperation of the Judiciary Committee, which has the primary jurisdiction over the Department of Justice, Ms. Rita Glavin, who is the Acting Assistant Attorney General of the Criminal Division.

STATEMENT OF RITA M. GLAVIN, ACTING ASSISTANT ATTORNEY GENERAL, CRIMINAL DIVISION, U.S. DEPARTMENT OF JUSTICE

Ms. GLAVIN. Good morning, Mr. Chairman, and members of the committee, and members of the House Judiciary Committee. Thank you for your invitation to speak today.

The Nation's current economic crisis has had devastating effects on the mortgage markets, credit markets, the banking system, and all of our Nation's citizens. And although not all of our current economic ills are the result of criminal activity, the financial crisis has laid bare criminal activity such as Ponzi schemes that may have otherwise gone undetected for years.

The Department of Justice is committed to redoubling our efforts to uncover abuses involving financial fraud schemes, mortgage lending and securitization frauds, foreclosure rescue scams, government program fraud, bankruptcy schemes, and securities and commodities fraud. And we are committed to adopting a proactive approach for better detecting and deterring such fraud in the future. Put simply, where there is evidence of criminal wrongdoing, including criminal activity that may have contributed to the current economic crisis or any attempt to criminally profit from this crisis, the Department will prosecute those wrongdoers. We will work tirelessly to recover assets and criminally derived proceeds and strive to make whole victims of such schemes.

Historically the Department has had tremendous success in identifying, investigating, and prosecuting massive financial fraud schemes. Last year, for example, the Department secured the convictions of five former executives, including the owner and president of National Century Financial Enterprises, one of the largest health care finance companies in the United States until its bankruptcy in 2002, on charges stemming from an investment fraud scheme resulting in $2.3 billion in investor losses. Similarly, last year the Department obtained the conviction of a former AIG executive and several Gen Re executives who engaged in corporate fraud by executing two false reinsurance transactions to conceal a $59 million decrease in the loss reserves of AIG.

From the Department's prosecution of executives of Enron to WorldCom to Adelphia to Revco, the prosecution of mortgage fraudsters and architects of Ponzi schemes across the country, the Department has considerable institutional experience which it can and will draw upon in fighting crimes that relate to the current crisis. Indeed, in recent weeks the Department has made clear that its commitment to prosecuting financial crimes will not abate.

The Department secured a guilty plea from Bernard Madoff for securities fraud and mail fraud violations. The Department filed a criminal complaint against the chief investment officer of Stanford Financial, alleging that she obstructed a Securities and Exchange Commission investigation into the activities of Stanford Financial. And these are just two examples of the Department's ongoing vigorous enforcement efforts.

The Department has approached the current financial problem with three primary goals. The first is coordination. The Department has sought to aid in coordination among law enforcement agencies. The sharing of information and ideas is essential to iden-

tifying and prosecuting financial fraud in the mortgage fraud problem. Accordingly, the Department has encouraged and led by example a comprehensive information-sharing effort within the Department and amongst our partner agencies.

Second, investigation and prosecution. The Department has focused on the investigation and prosecution of financial fraud and mortgage fraud for many years. When criminals go to jail, we deter similar conduct by others. The Department over the last several years aggressively prosecuted mortgage fraud cases, and we have yielded nationwide sweeps, resulting in hundreds of convictions, and sending criminals to jail when appropriate.

Third, in addition to deterring, detecting, and prosecuting crimes, the Department is committed in its responsibilities to help the victims of financial fraud and mortgage fraud schemes, and, to the extent possible, attempt to make them whole. To this end, prosecutors and law enforcement partners work to locate and recover assets from the criminals and provide restitution to the victims.

Unquestionably, the crisis now demands an aggressive and comprehensive approach, and we are going to do that, doing it the way we have always been doing it, through vigorous investigations and prosecutions of those people who defraud their customers, the American taxpayer, and may otherwise have unlawfully placed billions of dollars of private and public money at risk. We are committed to the effort. We are going to look at allegations of fraud closely, follow the facts where they may lead, and bring our resources to bear to prosecute those who have committed crimes. Thank you for the opportunity to address the committee, and I would be happy to answer any questions.

[The prepared statement of Acting Assistant Attorney General Glavin can be found on page 102 of the appendix.]

The CHAIRMAN. Thank you.

Our next speaker is John Pistole, who is the Deputy Director of the FBI.

STATEMENT OF JOHN PISTOLE, DEPUTY DIRECTOR, FEDERAL BUREAU OF INVESTIGATION

Mr. PISTOLE. Thank you, Chairman Frank and, from the Judiciary Committee, Chairman Scott, and other members of the committee.

Today, I would like to give just a very brief overview of what we in the FBI are doing in facing the challenges that we have, and I will describe some of the current efforts to combat the fraud that has been described previously.

To state the obvious, we have experienced a significant increase in mortgage-fraud-related cases since 2005, when we had approximately 720 investigations. Today, the FBI has more than 2,000 active mortgage fraud investigations and an additional 566 corporate fraud investigations, a trend which we expect to continue. Our work in mortgage-fraud-related crimes generally appears in two distinct areas: fraud for profit; and fraud for housing.

Our primary focus is in the fraud-for-profit area, which refers to those individuals who falsely inflate the value of property or issue loans related to fictitious properties. These schemes rely on industry insiders, those appraisers, accountants, mortgage brokers, and

other professionals—who override lender controls designed to prevent this crime from happening.

The second area, fraud for housing, occurs when an individual borrower, often with the assistance of a real estate professional, acquires a house in which to live under false pretenses.

The current financial crisis has also produced an additional consequence—the exposure of pervasive fraud schemes that have been thriving in the global financial system. These schemes are not new but are coming to light, as has been described, as a result of market deterioration. For example, numerous Ponzi schemes, such as Madoff and other investment frauds, have been uncovered which we are actively pursuing in the following ways:

We have shifted resources and now have over 250 agents and approximately 50 financial analysts and other intelligence analysts assigned to mortgage fraud and related investigations. We also have another 100-plus agents working corporate fraud matters. We also augment our efforts with approximately 250 State and local law enforcement officers assigned to 18 mortgage fraud task forces and 47 working groups. We also established at our FBI headquarters a national mortgage fraud team to coordinate and to prioritize the FBI efforts across the country and to provide tools to identify the most egregious fraud perpetrators and to work even more effectively with our counterparts in law enforcement, and regulatory and industry leaders.

Even before the creation of this national initiative, we were seeing results from our increased focus in this area. For example, last June, we completed the initial phases of what we called "Operation Malicious Mortgage," involving the arrest of more than 400 offenders nationwide believed to be responsible for more than $1 billion in estimated losses. This initiative has focused on three types of mortgage fraud: lending, of course; mortgage rescue schemes; and mortgage-related bankruptcy schemes. Our work on that initiative and others continues.

In closing, it is clear to us in the FBI and to our law enforcement partners that more must be done to protect our country and our economy from those who try to enrich themselves through illegal financial transactions. We are committed to doing so, and we appreciate the committee's support. Thank you.

[The prepared statement of Deputy Director Pistole can be found on page 144 of the appendix.]

The CHAIRMAN. Let me begin with Mr. Polakoff.

On page 17, Roman numeral V, as to closing the regulatory gaps, you talk about establishing a level playing field. You talk about unregulated or underregulated people in the mortgage market.

The Federal Reserve has proposed some rules, as you know. Actually, under the better-late-than-never category, the Federal Reserve is invoking authority that this Congress gave it in 1994. It was not used. Mr. Bernanke, to his credit, decided to use it.

Is that the kind of thing you are talking about? What specific language would you be looking for?

Mr. POLAKOFF. Mr. Chairman, what I am talking about is boots-on-the-ground examiners.

The difference is, you take your respective State; Steve Antonakes does a great job with examining mortgage brokers and

mortgage companies in your State. Not all States have such a robust program. Sometimes it is because they do not have a sufficient budget, and there are other reasons, so the rules need to be consistent across-the-board, but the boots on the ground actually examine—

The CHAIRMAN. Do you think we need uniform Federal mortgage regulations for the nonbanks? I assume we are talking about nonbanks.

Mr. POLAKOFF. Yes, sir, but it is the two parts. It is the uniform regulation, and then it is the prudential supervision of such.

The CHAIRMAN. In those cases where you think the States may not have enough, would you authorize Federal regulators to step in? How would we deal with that?

Mr. POLAKOFF. Yes, sir. We are suggesting that the State charter remain as it currently is for these mortgage brokers or mortgage companies, and there would be a joint examination program with a Federal partner and a State partner.

The CHAIRMAN. That is an interesting approach.

Triggered by the State's request or would you have the right to go in with or without a request?

Mr. POLAKOFF. Just like State-chartered banks now, we would suggest it would be an alternating program.

The CHAIRMAN. I am not sure I know what that means.

Mr. POLAKOFF. I am sorry. So right now, for a State-chartered bank, typically the State examiners go in one year to conduct the examination. Then, the FDIC or the Federal Reserve goes in the other year to conduct the examination.

The CHAIRMAN. And you would do the same with the OTS?

Mr. POLAKOFF. Our recommendation is there should be a Federal agency. We would love to take that responsibility. It would be up to you, sir, and Congress.

The CHAIRMAN. All right. Then I also appreciate your very specific request about cease and desist power and the third parties, and we will be taking those seriously.

Mr. Pistole, if that is not the correct pronunciation, I apologize.

Mr. PISTOLE. It is correct, Mr. Chairman.

The CHAIRMAN. On the other hand, I do not pronounce anything that well.

Mr. PISTOLE. "Pistole" is correct.

The CHAIRMAN. Obviously, the complaint, accusation, explanation has been that, since September 11, 2001, understandably, you have become the first line of defense for American safety in ways that we had not anticipated. We are all grateful for that.

The argument has been made that it has led to a diminution of activity elsewhere. For instance, mortgage fraud lacks the sense of physical threat. So I have a two-part question: Has enforcement in that area suffered because of other priorities? If so, do we need to do something to overcome it? I guess that is the general sense and not a criticism of the FBI, because I think people would say, if we had to choose between being blown up and being defrauded, defrauded would win. Can we avoid that choice in some ways, and is that a legitimate explanation of what has happened in the past?

Mr. PISTOLE. Thank you, Mr. Chairman.

After 9/11, obviously, we moved a number of our traditional criminal investigative resources to national security, particularly counterterrorism. Most of those resources were in our drug enforcement areas, recognizing the Department, obviously, the DEA, had that primary responsibility and that the FBI did not, frankly, need to be in the drug enforcement business.

There were some lower level, white-collar crimes such as bank teller fraud and things like that, and we did get out of that business, so we did have that, but we did continue in the significant corporate fraud investigations and other financial frauds, as appropriate, depending on the U.S. Attorney's Office's prosecutive guidelines and all that.

So, as I mentioned, we have more than doubled our resources toward the mortgage fraud/corporate fraud investigations in the last 2 years, trying to address those allegations that have been coming in and also trying to be proactive. I would note that we have several ongoing undercover operations, for example, in the corporate fraud and financial fraud areas where we are being proactive about seeking out perpetrators of frauds on a wide-scale basis, not just sitting back, waiting for referrals to come in.

The CHAIRMAN. Thank you.

The gentleman from California, who has graciously waived his opening statement, will have his 5 minutes.

Mr. CAMPBELL. I do not know how gracious I was by being tardy, but I will accept that.

The CHAIRMAN. I would just say to the gentleman, as chairman of the committee, I never mind members' absences.

Mr. CAMPBELL. Should I take that personally, Mr. Chairman?

Anyway, thank you all for being here.

My question is going to be very broad and is to all of you. I could go specifically and all that, but in front of us today, we have representatives of the Federal Reserve, the Comptroller of the Currency, the SEC, the FDIC, the Office of Thrift Supervision, the Department of Justice, and the FBI. So we have seven separate agencies all testifying in reasonable detail about the investigative things you are doing relative to the financial services area and issue.

My first overall question is: Do any of you believe that there are duplicative areas where two out of the seven of you or three out of the seven of you have an overlapping jurisdiction or responsibility that results in and that has a lack of coordination? Or, alternatively, are there areas where there is a gap in the current jurisdiction, and so none of the seven of you believe that it is actually your primary responsibility to investigate? Do not all speak at once.

Mr. POLAKOFF. Congressman, I would offer only one example, and it is not a gap. It is possibly an overlap, but I do not think it is bad.

The example I would offer, sir, is if, in a financial institution, there is an individual who may have his or her activities warrant an investigation on our part to possibly remove that individual from a bank, quite possibly, the FBI or Justice will be looking at that same individual and will ask us to stand down while it completes its investigation. That is not bad. That is an overlap, and we

will work together through that. That is the only example I can think of off the top of my head, sir.

Mr. CAMPBELL. Yes. Commissioner Walter?

Ms. WALTER. Thank you.

In the securities arena, there are gaps in the SEC's authority with respect to certain types of instruments or entities.

For example, a few years ago, we attempted to regulate hedge funds and those rules were struck down by the courts so that, today, we do not regulate hedge funds. As I noted in my oral statement, we do have antifraud authority, but what we do not have is the access to information about who all of them are unless they voluntarily register, what the principals are, the nature of their activities. Similarly, we specifically have no authority with respect to the credit default swap market.

So there are a number of areas in which there are regulatory gaps that should be filled so that the appropriate regulatory agencies—in this case, we think the SEC—have full information about what is going on and can proceed vigorously.

Mr. CAMPBELL. Thank you.

Ms. Glavin?

Ms. GLAVIN. What I was going to mention from the Department's perspective is that we work with each of these agencies. One of the best, most recent examples is we are working now with the SEC on the Stanford financial investigation. They work at it from the civil side. We work at it from the criminal side.

One of the ways that we try to check on overlap and on coordinating our efforts is that we have within the Criminal Division a Bank Fraud Enforcement Working Group where we meet on almost a monthly basis, with a number of the agencies that are represented here, to talk about what they are doing regulatory-wise, and we do some information sharing and coordination. There are a number around the country, and it is not limited to just the agencies here, but there are task forces and working groups around the country that are specifically formed with the aim to try and coordinate our efforts, do deconfliction where it is appropriate, and do coordination where it is appropriate as well so that the taxpayer gets the most bang for his law enforcement regulatory buck.

Mr. CAMPBELL. Okay. Do any of the rest of you wish to comment? Yes, Comptroller?

Mr. DUGAN. I would just highlight and amplify what Director Polakoff said earlier about having a common mortgage standard that goes across all providers so there are no gaps in what the rules are and, secondly, to have comparable kinds of supervision and enforcement to make sure those rules are enforced comparably. I think that was a big issue that led to where we are now with respect to the mortgage crisis, and I think the kind of legislation the committee passed last year with some amendment, I think, is quite appropriate.

Mr. CAMPBELL. Thank you.

Governor Duke, did I see you?

Ms. DUKE. I would really echo what Comptroller Dugan said, and would point out that this was the focus of the HOEPA regulations that the Federal Reserve issued last year, which was to cover all lenders.

Also, we had a pilot program to go in with both Federal and State examiners into the subsidiaries of holding companies that we supervise and look at the mortgage operations for consumer compliance as well as consumer protection. I think using the authorities that we already have in new ways is also going to be important in addition to any new authorities we might get.

Mr. CAMPBELL. Thank you very much.

My time has expired.

Ms. WATERS. [presiding] Thank you very much. I will recognize myself for 5 minutes.

In my work on the foreclosure crisis, I have noticed an explosion of fake Web sites that try to confuse homeowners into believing that they are official government sites.

On Wednesday, I contacted the Federal Trade Commission and the Federal Communications Commission to alert them about such a fraudulent Web site that was purporting to offer loan modifications through the Making Home Affordable Program. Of course, within hours of my letter, the Web site was taken down.

However, I am really concerned about those Web sites and the national ads. For example, there is one called the Federal Loan Modification Company that is getting more and more aggressive. There is no oversight for a business that springs up, purporting to do loan modifications with names that sound like government names.

What can be done? Who is doing something about that or who is at least looking at it?

Mr. PISTOLE. We in the FBI, ma'am, look at any fraud that would be perpetrated by one of those businesses, primarily through our Internet Fraud Complaint Center, which receives thousands of complaints from people around the country, such as you have seen on the Web sites, so we look at it from the fraud perspective and whatever type of fraud it is, but we are not in the prevention business, if you will, of preventing those sites from going up. Obviously, we do not do that, but we have a number of those types of investigations ongoing right now.

Ms. WATERS. Let me just ask you: The Federal Loan Modification Company is advertising that, for $3,500, when you talk to them, and I have called them, they will take care of modifying your loan. They almost guarantee it. They assure you that they can do that, and they collect $3,500 from you, but they say, "We tried, and the loan servicer just would not cooperate."

What is that? Is that fraud?

Mr. PISTOLE. I do not know the specifics about that one, but typically, that is an advanced fee scheme where somebody is required to pay a fee for a service that is not rendered, and it is oftentimes used by people around the world. The Nigerian fraud schemes are prevalent. In fact, my name and Director Mueller's name have been used in saying the FBI has endorsed this, so it is okay to provide that information. So I will get calls from friends and family saying, "Is this accurate?" It is, obviously, not.

Ms. WATERS. Do we need to regulate this whole servicer industry? It has become very important. We have servicers who are independent and some who are working for our own government agencies. Everybody has to have them, whether it is Fannie or Freddie,

etc. They all have servicers that they are contracting with, but I do not know who the servicers are. I do not know where they get their training. There is no licensing required, and anybody can be a servicer. Do we need some new public policy to deal with servicers?

Mr. PISTOLE. I would suggest that we would work with the Department and the committee to explore that further.

Ms. WATERS. All right. I have another little question I want to ask, but it may not seem so big or important.

Yesterday, I heard information about overdrafts that really bothered me. I understand that there are debit cards that students may use, that parents get for them. They buy a cup of coffee or something at Starbucks, and they can use that card even if they do not have enough money on it, and then they follow up with a $35 charge on a $4 item.

What is that considered? Let the marketplace work as it may? Should there be any consumer protection in that at all?

Mr. PISTOLE. I would defer to my colleagues on that one.

Ms. DUKE. Yes, ma'am.

The Federal Reserve has regulations out for comment right now that would govern overdrafts and particularly those that are with electronic means, debit card overdrafts, and those regulations are out for comment. I am not sure exactly how far we are through the comment period, but it would address exactly that.

Ms. WATERS. But it is something you are taking a look at?

Ms. DUKE. Yes, ma'am.

Ms. WATERS. Finally, let me just say to all of you:

Obviously, Countrywide emerged as the poster nonbank for what was wrong with predatory lending and the subprime market. How did they stay in business so long and get so far as a nonbank with the kind of exotic products that they were putting on the market with untrained brokers on the street? Who was looking at that? What could have been done with what Countrywide was doing? Anybody? Somebody?

Mr. POLAKOFF. Congresswoman, from an OTS perspective, I can only speak from early 2007 when Countrywide converted to a thrift. As you very astutely point out, a good portion of the predatory lending business or subprime business was conducted outside of the insured financial institution, so we would have looked at that. Looking back and looking at all of those activities, it would have been under the responsibility of the State banking or the State entity to look at that particular mortgage company.

Ms. WATERS. Yes.

Mr. DUGAN. Before it became a thrift, Countrywide had a national bank, and it also had a holding company that engaged in its mortgage activities. A relatively small proportion was conducted in the bank. We did not allow the subprime to be put in the bank, and so the mortgages that were actually booked in the bank were not the issue, but it eventually left our charter and became a Federal thrift.

Ms. WATERS. I have to go to our next member now, but—

Mr. GOHMERT. Madam Chairwoman, if there are others who want to respond, I would love to hear from them.

Ms. WATERS. Oh, I am sorry. Are there any others who would like to respond? Yes, just one second. Okay. We do not have anyone else who would like to respond.

Lastly, the so-called "exotic products" that keep springing up and all of the products that were on the market, whether they were Alt A or adjustable rates options, etc., am I to understand that any product that can be thought of by somebody—a mathematician or somebody assisting banks in ways to make more money—can go on the market without your stopping them? Does anybody have the ability to stop an exotic product that, obviously, is going to defraud our consumers?

Mr. POLAKOFF. I will take the first stab at it.

What all of the banking regulators have the ability to stop is a predatory product, an unsafe and unsound product. So the important test for us, Congresswoman, is whether the borrower has the capacity to repay, whether that is properly assessed. Equally as important is whether the borrowers have the ability to understand the product that they are committing to.

The CHAIRMAN. The gentleman from Texas.

Mr. GOHMERT. Thank you, Mr. Chairman. I am pleased you came back just to hear me. Thank you.

I am curious. We have had the credit default swaps brought up a number of times. What do you think would have been the most effective way to regulate or to control these things that really threaten to bring down our financial system? Obviously, it is a threat. Should they have been regulated by some type of insurance standards or do one of you all have the ability and the wherewithal to actually regulate them effectively? What do we need to do? I am throwing that open to anybody.

Ms. WALTER. Let me start.

I believe that, like many other innovative financial products, it is very important that there not be a lack of transparency. That is the first critical step.

Mr. GOHMERT. Do you think there might have been some?

Ms. WALTER. Oh, only a little, perhaps, but when you have a product like this spring up and grow by leaps and bounds and become huge and become systemically important before anyone has any information about it, I think that is the first place to start. We can all attack the issues to a certain extent from the institutions we regulate. For example, we regulate broker-dealers and investment advisers, but unless there is transparency within the marketplace itself—

Mr. GOHMERT. I agree with the transparency, but I am asking specifically: Who really should have the ultimate authority now that we know how untransparent they were? Who should have the ultimate authority to regulate them? Who would have the wherewithal to do it most effectively?

Ms. WALTER. I think it would be a combination of different regulators. We, on the one hand—

Mr. GOHMERT. That is pretty specific. Could you be just a little more specific?

Ms. WALTER. Of course. I will go on from there.

I think that the SEC has a role to play in terms of looking at the market forces that go on in terms of how these instruments are

traded. You are right. They are, essentially, an insurance product, so there may be a role for insurance regulators to play.

There, obviously, is a role for my colleagues up here at the table to play because a lot of these instruments are held by institutions they regulate. I do think, in the first place, you need a market regulator who can look at the forces that are operating and at the trading that is going on in the market as a whole.

Mr. GOHMERT. And you are talking specifically about which market regulator?

Ms. WALTER. I am talking about the market actually in trading and the transactions that are going on in the credit default swap market.

Mr. GOHMERT. No. What entity? When you say it requires a market—

Ms. WALTER. I believe that the SEC is the right regulator to do that.

Mr. GOHMERT. All right. That is what I was trying to get to. All right.

Anybody else?

Governor Duke?

Ms. DUKE. The Federal Reserve has believed for some time that these should be traded on a central exchange, and we have just approved a central exchange for counterparties for that. The Federal Reserve Bank in New York has been working on this for a number of years, and there is now one up and running. I think that will also improve the trading of the credit default swaps.

Mr. GOHMERT. Do you think that these things that you have both mentioned would be enough to control what has become, basically, criminal because of the effect on our economy? Civilly, would that be sufficient to regulate this group without imposing new criminal laws?

Ms. WALTER. I believe that the criminal laws that are out there are sufficient to cover it.

One of the things that will happen with the centralized counterparties—and there are two others that are going to be up and running soon, we think, and have been approved—is that you will get more regularized pricing information, which will provide the public with some indicators that are better than the ones that are out there. But if you put them in a system, for example, where you call them "securities," securities fraud will apply. The mail fraud, as well, will apply. So I believe that the criminal statutes are sufficient, but I would defer to the criminal authorities to my left.

Mr. GOHMERT. Let me ask a quick question regarding the FBI. My time is running out.

Mr. Pistole, I appreciate your being here.

From my experience and from what I have seen, white-collar crime requires more experience, more expertise, more training. I know that since Director Mueller has been in charge, he has this 5-year up-or-out policy that has forced out thousands and thousands of years of experience.

Are you still forcing out all of our best experienced agents in charge out in the field or have you backed off of that policy a little bit?

Mr. PISTOLE. We have modified that policy.

Mr. GOHMERT. Because I have not heard that from the field yet.

Mr. PISTOLE. We have modified that for our field supervisors from 5 years to 7 years, and have even given them an option to go up over 8 years if they do some time back at headquarters. Yes, we have modified that.

Mr. GOHMERT. Okay. I see my time has expired.

Thank you.

The CHAIRMAN. Let me now turn to the Chair of the Judiciary subcommittee, who is our partner, Mr. Scott—or Mr. Moore first. Let us go to Mr. Scott first to recognize the joint jurisdiction.

Mr. SCOTT OF VIRGINIA. Thank you, Mr. Chairman.

I want to follow up on the last question a little bit, to Ms. Glavin and Mr. Pistole.

If everybody knew that they had these so-called ninja loans—no income, no jobs, no assets—and they were passed off as AAA assets secured by real estate when, in fact, no one had done any due diligence to ascertain the reasonable value of the collateral or whether or not the borrower had any capacity to pay for the loan after the readjustment from a teaser rate; if everybody knew all of that was going on and an investor bought the package based on a AAA rating, is there any problem with the criminal law, fraud, wire fraud, and other things to go after that kind of activity? Do we need any new criminal laws?

Ms. GLAVIN. There is a bill that just came out of the Senate Judiciary Committee which the Justice Department supports. It is the Fraud Enforcement and Recovery Act of 2009, sponsored by Senators Leahy and Grassley.

A couple of the key provisions of that Act, which would add tools to a prosecutor's arsenal beyond traditional mail fraud and wire fraud, are that it would amend the definition of "financial institution" in title 18 to include private mortgage lending businesses. So if you make a false statement to a private mortgage lending business, which did a lot of these subprime loans, we can prosecute you under some different statutes, not just the mail and wire fraud statutes. That would be helpful, and it would expand the menu of options that prosecutors can use. Also, I think it could help us make cleaner presentations to grand juries and to juries.

Mr. SCOTT OF VIRGINIA. Is that a jurisdictional issue that you do not have to prove mail and that you can just prove a financial institution?

Ms. GLAVIN. With mail and wire fraud, you do have to find the mails and the wires. On the amendments to that particular statute, I think there has to be some type of a Federal nexus, which, I think, you would probably be able to find in a lot of the private mortgage lending companies. If there is an interstate—

The CHAIRMAN. If the gentleman would yield, only very few of them operate intrastate.

Ms. GLAVIN. Yes.

The CHAIRMAN. I do not know of any company that does its business only intrastate.

Ms. GLAVIN. So I do not think there would be difficulty in a lot of cases if prosecutors wanted to use statutes beyond 1341 and 1343 to prosecute fraud on the mortgage lending businesses.

In addition, one of the things that particular proposed statute does is, the major fraud statute, which I believe is 1031, would also explicitly cover fraud in connection with TARP funds and fraud in connection with the stimulus package. That is not to say that we do not have other tools with which we can prosecute such fraud, but it gives us a broader menu of options, which the Department supports.

Mr. SCOTT OF VIRGINIA. In your comments, you mentioned restitution involving the Iraq contracting. At a previous hearing in the last Congress, we heard that the Department was hesitant to get involved in False Claims Act cases involving Iraqi fraud. In fact, it had many of the cases sealed, which put whistleblowers out on a limb, where they could not get evidence to prove what they were saying.

Is that policy of being reluctant to go after false claims cases in Iraq and sealing those cases going to change?

Ms. GLAVIN. Congressman Scott, I come from the criminal side of the Department. I think you are referring to the False Claims Act, which is enforced by the civil side of the Department. I am not aware—and I am happy to get back to you on this—of a slowdown, and I think you are talking about the sealing of cases, the qui tam cases, and I think there are time limits for when it can be sealed.

Mr. SCOTT OF VIRGINIA. If you could get back to me on the details.

Ms. GLAVIN. Yes, I would be happy to do that.

Mr. SCOTT OF VIRGINIA. Finally, I guess, for you and Mr. Pistole, how many accountants would you need to effectively go after these cases without transferring people from Homeland Security's terrorist cases?

Mr. PISTOLE. Look, Congressman, to give you some context, we have a little over 250 agents currently working on these types of investigations along with about 50 financial analysts, forensic accountants, and intelligence analysts. To go back to the S&L crisis, we had about 1,000 agents. Obviously, the scope of what we are dealing with now just hugely dwarfs the S&L crisis, so we are—

Mr. SCOTT OF VIRGINIA. Has the Department submitted a potential budget so we know, if we wanted to deal with it, we could deal with it?

Mr. PISTOLE. In the 2009 budget, we received an additional 58 positions, which we are getting on board, and are applying to that. Also, we are going through the 10 process right now.

Mr. SCOTT OF VIRGINIA. Mr. Chairman, I think he said 59. The order of magnitude he was suggesting was that 1,000 would not be enough. So, obviously, we have a lot of work to do.

The CHAIRMAN. Thank you. It does sound like that is a piece of legislation where our two committees would be able to cooperate, but it does sound to me like something we would want to move on.

The gentleman from Florida.

Mr. POSEY. Thank you very much, Mr. Chairman.

I have a lot more questions than we have time to have answered here today. I wish I could have about an hour with each of you individually.

The CHAIRMAN. Of course, we do have the option of getting the follow-up answers in writing.

Mr. POSEY. Thank you, Mr. Chairman. I was going to ask for your permission to do that. Thank you, Mr. Chairman.

The first thing I would appreciate from all of you, if you can see your way clear, would be a one-page summary, not a book but a one-page summary and without corroborating your theories with each other, of what you think the root cause of this financial crisis is, not just the word "greed."

If your life depended on solving this puzzle, how would you do it, and what do all indicators point to? If you think that Congress is somehow culpable, I would expect you to say that in all honesty and forthrightness for which you all have a reputation. Stealing is still stealing even if the government is doing the caper, unfortunately.

Also, since time will not allow an answer to these, I just will request that you respond to us in writing.

First, to Governor Duke, the number of employees that you have and the number of prosecutions and convictions to date that you have had.

To Mr. Dugan, if and when you find criminal conduct, you said you would refer it to an agency. I want to know how often you have ever found criminal conduct and who you have referred it to.

Commissioner Walter, I notice in your testimony, you have 1,100 attorneys in your organization. It looks like an attorney handles a case every other year. It does not say anything about convictions. I am interested in knowing how many convictions they have ever had, if any.

I want to know, after the Madoff fiasco and when Mr. Markopolos took that thick dossier to your organization almost a decade ago and tried to get them to investigate Bernard Madoff and you refused to do it—your agency, not you—I wonder what discipline was taken for the employees who disregarded the best interests of the citizens of this country and allowed that to be perpetrated and allowed $75 billion to disappear from the face of the Earth? There are quite a few people in my constituency who think crime would not pay if the SEC were in charge of it.

Just to put it in a local perspective, if you have a local police force and your street cops write one ticket every other year, you probably have more than you need or they are not doing enough.

Mr. Gruenberg, yours does not say how many employees you have or how many prosecutions or convictions you have had, just that you have had 4,375 mortgage fraud claims filed, and they are expected to result in 900 additional civil mortgage fraud lawsuits over the next 3 years. I would like your estimate, your prognosis on what you think the success rate will be, what justice you think will come to the American public, what amount of money you think we will be able to recover from the bad people involved in that.

Mr. Polakoff, there is a list attached of the total numbers of OTS formal enforcement actions. It is a very, very modest number. It looks like it is probably under 200. I wonder how many employees it takes to get this many enforcement actions, but more importantly, I would like to know how many of them were criminally prosecuted successfully, and how many you expect to see successfully prosecuted. Thank you.

Ms. Glavin, your agency has 62,000 suspicious activity reports. I would be interested in knowing or of having a breakdown of how those were handled and how they were referred. That was between just the years of 2007 and 2008. I wonder if your agency needs an invitation to invite the companies who received TARP money to be investigated under the RICO, the racketeering statutes, and if you would need Congress to ask you to do that or if somebody from the Treasury or someone else could ask for that. I think the public would just like a good cleansing of the possibility that there is racketeering involved.

Ken Lay went to prison for fleecing investors. We have people in some of these companies who have fleeced every member of the American public and future generations as well, and I think the public deserves to know there was no racketeering involved if, in fact, there was not any.

I would pose that same question, basically, to the FBI. I would like a short summary of the prognosis you have for the team you established in 2008. Unfortunately, I think we were a day late and a dollar short in getting in front of this crime wave. We got behind it, and we have a lot of cleanup to do, but I would like your thoughts as to a prognosis of what you forecast statistically, if necessary, to be the consequences and the results of the new fraud team that you have put in place there.

Again, I would wonder if you have done any investigations on any of the companies that received TARP money or bailout money and, if you have not, what it would take to have you take a perfunctory view to see if there is evidence of racketeering there. I think much of the public suspects that it is there, and for better or for worse, I think we probably deserve to know. Thank you.

Thank you very much for your indulgence.

The CHAIRMAN. Yes, we would like those answers, obviously, in writing. They will be made a part of the record and will be shared with all members of the committee.

The gentleman from Kansas, the chairman of the Oversight Subcommittee.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman.

Mr. Pistole, in your written testimony, you discuss the rise in mortgage fraud investigations the FBI is conducting.

You say, "The number of FBI mortgage fraud investigations has risen from 881 in fiscal year 2006 to more than 2,000 in fiscal year 2009. In addition, the FBI has more than 566 open corporate fraud investigations, including 43 corporate fraud and financial institution matters directly related to the current financial crisis... The increasing mortgage, corporate fraud and financial institution failure case inventory is straining," and I repeat straining, "the FBI's limited white collar crime resources."

Mr. Pistole, if you would, please, give us your best estimate of how many more agents you need, that the FBI needs now, to keep up with the growing number of fraud investigations.

Mr. PISTOLE. Thank you, Congressman.

We are obviously doing a scrub of all of our investigative resources internally, initially, to assess whether we can move additional resources first from within our criminal investigative division, from violations that are not as high-priority as this, and that

is where we have gleaned those additional bodies, doubling from 2 years ago to where we are now. We also look at the enhancement through the task forces, which I also mentioned. I would have to get back with you in terms of a precise number, but we obviously—

Mr. MOORE OF KANSAS. I would appreciate that, sir.

Mr. PISTOLE. We will do that. We are also working with the Department and with OMB to assess what we may be able to get in the out-years, 2010 and beyond. In the meantime, we are moving those resources as we can do that.

Mr. MOORE OF KANSAS. That would be very helpful because I think every member of this committee would want to make sure that your Department, your agency, has sufficient personnel resources to conduct the investigations necessary to stop what is going on.

Mr. PISTOLE. Thank you, Congressman. I greatly appreciate that.

Mr. MOORE OF KANSAS. Thank you.

Ms. Glavin, I was a district attorney for 12 years in my home district, and I certainly understand how important personnel resources are, especially prosecutors, in trying to stop some of what is going on here.

My question to you is basically the same as I just asked the FBI agent: Do you have, do you think, adequate personnel resources in terms of prosecutors right now, the Department of Justice, to do what needs to be done to get this thing under control?

Ms. GLAVIN. It just so happens the Attorney General made some public comments about this a couple of days ago, and had indicated that he had asked the President and OMB to take a look at our budget numbers from 2010 to give additional resources for what the Attorney General calls the "traditional side of the Department," which would be the non-national-security side, so that we have the ability to hire new agents, look at financial fraud matters, as well as hire additional prosecutors to look into those matters.

Mr. MOORE OF KANSAS. Thank you, Ms. Glavin.

I truly, truly believe that every member of this committee, Republicans and Democrats, believes that we want to provide sufficient resources to the agencies here to stop what is going on when there are abuses and violations of criminal law, and I thank you for that. If you can provide any more written information about what you need, we would appreciate that as well.

Thank you, Mr. Chairman. I yield back my time.

The CHAIRMAN. The gentleman from Texas.

Mr. GREEN. Thank you, Mr. Chairman.

I thank the witnesses for appearing today, and I also thank my colleagues for the questions that I have heard. The questions, themselves, have been beneficial to me.

Ms. Walter, ma'am, you indicated that the credit default swaps were, and I am using my terminology now, under the radar such that they had become quite pervasive before we had an opportunity to discover the impact. Is this a fair rendition of what you are saying, or would you prefer to say it another way?

Ms. WALTER. Yes, Congressman, I think that is part of what happened because, unlike with respect to instruments that trade on an organized and regulated market, the information was not available. Everyone knew they were growing and growing fast, but we knew

very little about the underlying aspects of them, and because they were not standardized, the terms varied.

Mr. GREEN. I have a follow-up question quickly. My time is limited. I am sorry.

Ms. WALTER. That is okay.

Mr. GREEN. If this is true, is there some agency that these products are required to be registered with? Is there some clearinghouse, or is there some methodology by which we can ascertain that such a product exists so that we can make some determination as to the worth of it?

Ms. WALTER. There has not been an agency with which these types of instruments have to be registered. We do obtain piecemeal information about them, various of us up here, through institutions that we regulate.

As Governor Duke mentioned earlier, there is now one central clearinghouse that is up and running, and that will cause some further information to come forth. There are likely to be at least two more, and that will cause some standardization of the instruments as well, but we think participation in a central clearinghouse should be mandatory, and there should be an information flow to the regulators across-the-board.

Mr. GREEN. Just for my edification, does everyone agree with the commentary accorded, just presented? If you disagree, would you kindly extend a hand into the air?

If such a clearinghouse is needed and if it should be mandatory, should the penalty for failure to comply be civil or criminal? Can you give me some indication as to how we would enforce such a penalty, please?

Ms. WALTER. If there were a requirement placed by statute, depending on the statute in which it was placed, there would be civil law enforcement authority. I, once again, will defer to the criminal law enforcement authorities about how best to address criminal sanctions for failure to follow the law.

Mr. GREEN. Are you of the opinion that they should be criminal as well as civil, the penalties and sanctions?

Ms. WALTER. Yes, I would certainly support that, of course, with the appropriate state-of-mind requirements and the like that are true in general with respect to criminal prosecution.

Mr. GREEN. Mr. Pistole?

Mr. PISTOLE. Yes, Congressman, I think we would have to look at the details. If it is tantamount to a false statement, then, obviously, there would be those criminal sanctions, but absent that, in terms of a central clearinghouse, I think the thing we would not want to happen is to slow down anything in terms of the sense of urgency, and would want to focus on where we are going. We have fairly robust reporting requirements now to the individual components here, so my only concern would be in going to a central clearinghouse that somehow slows something down. If it acts as a deconfliction mechanism, that has always been beneficial.

Mr. GREEN. My concern is that these products embrace so many people and so many lives. Do we slow down at the end and prosecute over some long period of time, or do we take the time to make sure that they are products that will not harm us, is the question?

Listen, do not answer that. I want to go to a closing statement.

I do not favor invidious persecution. I do favor vigorous prosecution. I think the public is not privy to prosecutions that are taking place. I believe you when you say they are, but my suspicion is most members of the public would say not enough is being done. If it is as you say it is, we have to find a way to get this message to the masses so that not only will they know that the prosecutions are taking place but also such that there will be a proper deterrent.

My time has expired. I yield back.

Ms. WATERS. [presiding] Thank you very much.

Mr. Foster?

Mr. FOSTER. Governor Duke, my first question, do you think that the detection of fraudulent mortgage originators would have been quicker without teaser rates and so on that temporarily hid a borrower's inability to repay?

Ms. DUKE. I am not sure that I can understand the characterization of the fraud as the inability to pay, because, at the time, the ability to pay was not necessarily required by regulation or by statute. It was only in the HOEPA regulations that the requirement of identification and verification of the income that would be used to pay became a requirement for making a mortgage loan, if that is responsive to your question.

Mr. FOSTER. I was just wondering,if the only kind of mortgage that was allowed to be originated was one that had a constant level of payment, just this sort of fraudulent—

Ms. DUKE. The regulations, actually, address not only fixed-rate mortgages but also variable-rate mortgages, and require that they be underwritten to the fully indexed rate so that they be underwritten to the rate that they would automatically go to after the teaser time expired.

Mr. FOSTER. Okay. Is there anyone else who would like to make a comment on that?

Mr. GRUENBERG. Congressman, I would just say that the teaser rate was one of the means by which those who engaged in predatory practices drew in borrowers who did not fully understand the terms of the mortgage, such as when it would adjust upwards. So, in a sense, it was part and parcel of the problem. The guidance and the rules issued by the Fed under HOEPA tried to address that by requiring lending based on the borrower's ability to pay, which hopefully would address that kind of a mortgage product.

Mr. FOSTER. Okay. Comptroller Dugan, I guess, this question is for, how comprehensive is the list of banned individuals? Is the list public? Is it nationwide? Does it span all financial services industries?

Mr. DUGAN. I am sorry, Congressman. Could you repeat that?

Mr. FOSTER. Oh, yes.

I was just wondering how comprehensive the list of banned individuals is. Is it public? Is it nationwide? Does it span all financial services industries?

Mr. DUGAN. Yes, it is public. We publish it whenever we issue such an order, and it is put on our Web site, and it is distributed to all the law enforcement agencies as well, while understood in the community.

Mr. FOSTER. Okay. Is it easy for consumers to sort of get at it and be aware that—

Mr. DUGAN. Yes. There is a central Web site. There are links from all the agencies about who is banned and who is not.

Mr. FOSTER. Okay. Then the last question I have, I guess it is to everyone, and it will probably require a written response. I am trying to get my arms around what is the optimum level of effort and money to put into enforcement. So what I would like and if you could answer first is, what is your budget associated with enforcement activities? What is a best estimate of the losses in the area under your purview?

So, for example, for the SEC, that would be security fraud and related activities. What would be the effect of an increased avoidance of losses for a 10 percent and a factor of 2 increase in your budget? Do you understand my question?

I am trying to sort of prod the shape of the curve. From a purely economic point of view, there is some best amount to spend on enforcement activities. If we are underspending, then giving you an additional dollar will result in more than one dollar of losses avoided. If we are past that point, giving you an additional dollar will result in less than a dollar of avoided losses. I am just trying to get some feeling for where we are on that curve for each of your activities.

Okay. I yield back.

Ms. WATERS. Thank you very much.

Mr. Carson?

Mr. CARSON. Thank you, Madam Chairwoman.

I appreciate, first of all, all of the witnesses joining us today to discuss these very important issues.

My colleagues briefly touched on the recent growth of mortgage foreclosure rescue schemes. I represent Indiana's Seventh Congressional District, a district that has seen dramatic rates of foreclosures in the past 2 years. I am extremely invested in making sure my constituents are armed with an effective knowledge base about these scams.

My first question goes to Mr. Pistole, a fellow Hoosier. You said earlier, sir, that the FBI has open cases, and you mentioned the problems with foreclosure rescue fraud in your testimony. Will you please elaborate on the most common forms of scams your agency and its regulatory partners have seen lately and what specific kinds of actions the Bureau has taken so far against these operations?

Mr. PISTOLE. Thank you, Congressman.

Yes. What I can talk about is from the Operation Malicious Mortgage, which I mentioned, that is ongoing, but it is where we have had over 400 people arrested. Part of that was focused on the, obviously, upfront lending, all the false statements and the fraud involved in those mortgage applications. We have also seen areas of bankruptcy fraud associated with that, so you are further downstream in terms of the fraud where people who are caught up simply cannot pay, and then there may be even unwitting people involved there, but then there is a bankruptcy fraud committed.

Another aspect is, even in the reverse mortgage area, where people, senior citizens, are able to get reverse mortgages, there has

been fraud that has been uncovered in that area. We are looking at all of those to try to assess the systemic nature of it and the numbers that would represent, again under prosecutive guidelines for each U.S. Attorney's Office, what makes sense in terms of trying to prioritize our limited resources in a way that can have the maximum impact, for example, on Indianapolis. So those are some of the areas that we have focused on.

As one of the other members mentioned earlier, virtually any scheme that could be conceived or devised has been, and we believe we have uncovered, virtually, all of them. It is simply a matter of applying those resources to the problems in the various districts, and that is where we are right now.

Mr. CARSON. Thank you, sir.

Secondly, Mr. Gruenberg and Mr. Dugan, would you please comment on whether or not banks have been stepping up their outreach to troubled borrowers, at least warning them of these scams that are taking place?

Mr. DUGAN. Speaking for the OCC, we have put information up on our Web site about the scams.

And I also wanted to mention that the NeighborWorks organization, which a number of us sit on the board of and it is funded by Congress in part, also has an initiative that is specifically related to this particular issue, which we support.

Mr. GRUENBERG. Congressman, I should mention that pursuant to a directive from the Congress, the FDIC recently conducted a large nationwide survey of banks' outreach efforts, particularly with respect to consumers who lack access to mainstream banking institutions. I think it is fair to say that our survey indicated that, in terms of outreach efforts to inform people in the community about the services that mainstream financial institutions offer, there has been an increasing effort by insured depository institutions to do that.

Mr. CARSON. Thank you, Madam Chairwoman. I yield back the balance of my time.

Ms. WATERS. Thank you very much. Mr. Gohmert had a request.

Mr. GOHMERT. Yes. Thank you, Madam Chairwoman.

I have two questions that I would like to ask for written answers to, if I could, to be submitted within the next 2 weeks.

Ms. WATERS. Yes.

Mr. GOHMERT. If that would be appropriate.

One, this is to everybody. We have a pretty amazing panel here, when you look at everybody's title; and it is this question: What would you recommend we do legislatively to keep at least some financial risk with those who put people in mortgages and with those who package and sell them as securities?

If your answer is, do away with mortgage-backed securities, fine. But I am not looking for a treatise on what all is involved or who could—the question is very specifically: What do you personally recommend? Because if you don't have suggestions on something that has nearly brought down the financial system, then we are in bigger trouble than I thought.

The other question is to the FBI; and that is, what is the status of providing the States access to criminal history information through the Nationwide Mortgage Licensing System and Registry

as required by the SAFE Act. Specifically, since States are going to need that information this summer, has that or when will that access be granted? Two, what is the status of setting up the distribution mechanism between the Department of Justice and the appropriate State agency? And, three, who within the FBI is responsible for granting this access? And, last, can the FBI provide this committee and the Judiciary Committee with periodic progress reports on the status of this issue?

That will take care of it.

Ms. WATERS. Thank you.

Mr. Posey, I think you had an additional question you wanted to ask.

Mr. POSEY. Thank you very much, Madam Chairwoman.

This would be for Ms. Glavin and Mr. Pistole, written responses, too, just in the interest of time. I appreciate your patience, Madam Chairwoman.

To what extent are the RICO laws useful to convict those committing white collar crimes? I understand that the DOJ prosecutor did not use the RICO approach very often. How often is it used and why is it not used more often? Are the RICO statutes sufficiently broad to capture the kinds of activities white collar criminals engage in? What are the limitations of a RICO approach in deterring and prosecuting financial white collar crimes? How do prosecutors determine criminal intent apart from recklessness or general incompetence? And then, finally, how best could Members of Congress strengthen criminal statutes to discourage some executives from running off with big bonuses while running their companies into the ground?

That is the bottom line that we are looking for. I thank you all for your attention and your courtesy and for appearing here today.

The CHAIRMAN. Did the gentleman from Virginia want to ask some questions?

Mr. SCOTT OF VIRGINIA. Yes, if I could, Mr. Chairman. If I could very briefly pose a couple of questions to be answered for the record.

Ms. Walter indicated some of the exotic instruments that are being used. One of the problems we have had is the deviation from insurance standards, what are essentially insurance products. If you could comment on the need for assets to back what are essentially insurance products and the deviation from the need for an insurable interest before you can buy what is essentially an insurance product.

And for Ms. Glavin, whether or not there are any changes that we need and restitution laws to make sure that we can get our assets recovered and whether conspiracy laws are sufficient to—and, also, Mr. Pistole, if you could answer this—whether conspiracy laws are sufficient to get those who may also be involved, like the accountants and others that may be involved.

And then, finally, to Mr. Polakoff, you indicated cease and desist orders. Could you give us an idea of what you are using these cease and desist orders for? Because my initial reaction is that some of these could possibly be referrals for criminal activity, rather than to stop breaking the law. If you could give us an idea of what you are using those for?

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the panel. It has been useful. And I must say I thought the questions asked by my colleague, Mr. Posey from Florida, were useful ones. We will look forward to those answers.

Mr. Polakoff, you gave us some specific legislative suggestions; Ms. Glavin did as well. All of those will go to the Judiciary Committee. I promise you we will take all of them very seriously, because we clearly, collectively have to do a much better job than we have done as we go forward.

The next panel is now before us.

The panel will be seated. You can all be polite to each other outside, please. I will ask the staff to close the doors, and we will begin.

One of the points noted was the multiplicity of jurisdictions, and we wanted to make clear that a very important set of jurisdictions exist here at the State level.

Let me make a preliminary statement here. One action that happened under the Bush Administration, although it was done by a Clinton Administration holdover appointee, the Comptroller of the Currency, was what I believe to be an excessive preemption by the Comptroller of the Currency of the ability of States to enforce laws against nationally chartered banks; and I believe that left us with a vacuum because the Federal authorities did not have the power to promulgate a code to fill the vacuum.

That was a resistance of the Federal Reserve. We have improved that some. But there is clearly a role for the States.

And I will say it is not entirely irrelevant that on the panel before us today at least two are elected. Mr. Ropp, are you elected or appointed?

Mr. ROPP. My boss is elected.

The CHAIRMAN. We do have two directly elected officials. Your boss, the Governor or the—

Mr. ROPP. The Attorney General of the State of Delaware.

The CHAIRMAN. The Attorney General.

I will say this: Consumer protection, particularly when you have individual cases, for a variety of reasons does not have the same aura that making grand policy does; and I have found that, in the absence of a direct electoral spur, consumer protection sometimes lags. Those of us who are in an elected office here in the Congress are often asked by individuals in our districts to do this, and we pursue it.

At the State level, unlike the Federal level, much of the administration of consumer protection law is in the hands of directly elected officials: the Secretary of the Commonwealth of Massachusetts, the Attorney General of Illinois, the Attorney General of Delaware; and I think there is a great deal to be gained there.

So there are reasons for involving the State in consumer protection both in terms of federalism, but, also, I believe that having elected officials be charged with some of the responsibility for consumer protection helps us overcome the institutional lag that exist.

And your people say, these consumer things, they can be annoying. When people vote for you, they become a lot less annoying. So that is, I think, a mechanism that we want to take a shot of.

With that, I will begin with my former colleague in the Massachusetts Legislature, who has done a very good job of administering securities law. In Massachusetts, the Secretary of the Commonwealth is the Securities Administrator, William Galvin.

STATEMENT OF THE HONORABLE WILLIAM FRANCIS GALVIN, SECRETARY OF THE COMMONWEALTH OF MASSACHUSETTS

Mr. GALVIN. Thank you, Mr. Chairman.

Chairman Frank and members of the committee, I am pleased to have this opportunity to testify on the crucial role of State securities regulators in financial regulation and investor protection.

As Secretary of the Commonwealth, I am the Chief Securities Regulator for Massachusetts. The Securities Division regulates to protect investors and promote confidence in securities markets. In the United States, securities regulations are regulated by the Securities and Exchange Commission and by States' securities agencies and by a system of complementary regulation. State regulators serve an important backstop to other regulators if they are not acting to protect investors.

Massachusetts, along with other States, has been at the forefront to bring enforcement actions to protect investors. These include actions against brokerages using bogus stock analyst reports to entice customers to buy low-value stocks and debt securities, cases against mutual fund companies that illegally facilitated market timing trades, actions against the abusive sales of variable annuities, actions against the use of spurious senior credentials to sell inappropriate investments to older investors, actions against unsuitable sales and fraudulent practice in the sales of auction rate securities to retail and municipal investors, and investigations and actions against pyramid schemes including the Madoff scheme and their feeder funds and several hedge fund cases.

The Massachusetts Securities Division has acted promptly and decisively to protect the interest of investors, particularly retail investors. Massachusetts and other States have negotiated substantial refunds for investors and imposed significant fines against violators. Massachusetts was the lead State in 3 auction rate securities cases that ended with settlements that returned $33.9 billion to investors. The States' combined efforts in these cases will bring back $61.3 billion to date to investors across the country.

The State enforcement powers, however, go beyond monetary sanctions. The Securities Division has revoked the licenses of serious violators in order to drive them out of the securities business. Massachusetts has often required financial firms to admit wrongdoing.

The current crisis in financial services has once again exposed a failure of aggressive enforcement, particularly at the Federal level. For too long, a culture of compromise and accommodation has overwhelmed enforcement efforts. Too often, the guilty neither admit nor deny any wrongdoing and routinely promise not to cheat again until they come up with a more clever way to do again what they just said they would not do again. I ask this committee and the Congress to give the States the tools we need to maintain and enhance our ability to regulate effectively and protect investors.

The National Securities Markets Improvement Act of 1996, NSMIA, removes State regulatory authority over mutual funds, most private offerings of securities and over large investment advisors. Since the adoption of NSMIA, jurisdiction over investment advisors has been split between the Federal Government and States. I ask that Congress restore the States' powers to act against federally registered investment advisors, particularly for dishonest and unethical business practices.

The States Securities Act permits the States to impose a range of remedial sanctions against violators, including that violators make rescission to investors—that is repayment to investors—for violation of laws. These sanctions give the States the ability to recover money for defrauded investors. The rescission remedy is particularly important because it helps make the investors whole.

Unfortunately, several recent court decisions have held the Federal Arbitration Act preempts the States' ability to order rescissions for security violations. These cases hold the rescission remedies preempted because arbitration is the sole mechanism for investors to recover their losses. We strongly dispute these decisions which ignore the remedial and deterrent purposes of State-ordered rescission. We urge Congress to amend the Federal Arbitration Act to clarify that it does not preempt the States from ordering securities law violators to make rescission to their victims.

Another area—under current law, broker-dealer firms deal with their customers without fiduciary obligations. In contrast to brokers, investment advisors work solely for their customers and acknowledge a fiduciary duty of them.

Brokerages like to have the issue both ways. Among other practices, they frequently give their salespeople the title "financial advisor." This term blurs the nature of the firm's relationship with its customer by making the broker appear to be an investment advisor. However, when a dispute arises between the customer and the broker, the broker will strongly assert that it does not work for the customer but instead has only an arm's-length relationship with the customer.

The Securities Division has seen examples of brokers dealing unfairly and improperly with customers, and we have witnessed customers who have recovered little or nothing for their losses through the pro-industry arbitration system and due to the fact that brokers are not considered fiduciaries.

This system should be changed. I urge the committee and the Congress to require that brokerages be in a fiduciary relationship with their customers, at least with respect to individual retail customers.

There are, finally, several problems on the horizon that I would like to bring your attention. Many hedge funds are liquidating because their investment strategies did not work and because the advisors anticipate they will not receive an incentive share of funds profit for the years to come—the investors, that is, will not receive profit for years to come.

We can expect many of the people who ran and advised the last generation of hedge funds to set up new funds and start again. Unless regulation of hedge funds is significantly improved, we can expect to see a replay of past problems which can and have caused

great damage to our economy, including wild speculations and essential commodities. I ask the committee and the Congress to take steps to make hedge funds more transparent and their activities more visible.

Lastly, American households now rely on mutual funds to help fund retirement costs. Because so many retail investors have their savings in mutual funds, I urge the committee and the Congress to give mutual funds appropriate scrutiny.

No topic or type of investment should be off the table as Congress enacts regulatory reform and improvements to investor protection. Congress has an urgent need to restore confidence in the financial markets. Effective regulation or enforcement are desperately needed.

Thank you for this opportunity to testify on these important issues, and I will welcome your questions.

[The prepared statement of Mr. Galvin can be found on page 94 of the appendix.]

The CHAIRMAN. Next, Attorney General Lisa Madigan, State of Illinois.

STATEMENT OF THE HONORABLE LISA MADIGAN, ATTORNEY GENERAL, STATE OF ILLINOIS

Ms. MADIGAN. Mr. Chairman and members of the committee, thank you for inviting me to testify today.

My testimony is divided into two parts: first, I am going to summarize the major enforcement actions that have been brought by my office and other State Attorneys General against lenders and other participants involved in the collapse of the mortgage market; and second, I will identify some of the key impediments to effective enforcement of consumer protection laws at the State level.

Because State Attorneys General are on the front line of consumer fraud, we hear about problems as they are happening. And let's debunk the myth that the predatory practices in the mortgage lending industry just started a year or two ago. In fact, we have been pursuing predatory mortgage lending practices for over 10 years. In that time, State Attorneys General have often targeted very large mortgage lenders for investigation, because our aim is to bring cases that will have an impact on the lending practices of the industry as a whole.

In 1998, Illinois, Massachusetts, and Minnesota brought civil consumer fraud suits against First Alliance Mortgage Company, a California-based lender. FAMCO's business and lending practices will, unfortunately, sound very familiar to you. FAMCO sold high-cost home loans to subprime and prime borrowers. Most of its loans were re-fi's, with borrowers typically placed into a 2/28 ARM, one of the same products that is causing so much trouble in the current market.

Another foreshadowing of today's crisis, FAMCO bundled and sold its loans on Wall Street to Lehman Brothers. As a result of being sold unnecessarily high-cost home loans, FAMCO borrowers paid the price in the form of higher monthly payments and lost equity. In a settlement of the lawsuit in 2002, the States recovered well in excess of $50 million in restitution for consumers' losses;

and FAMCO was ultimately forced out of business and into bankruptcy.

In the years since FAMCO, the States have brought a succession of enforcement actions against some of the biggest names in mortgage lending. These actions include a multistate investigation of the subprime mortgage giant Household Financial, which culminated in a $484 million settlement in 2002.

Following the Household settlement, the States launched a probe of Ameriquest, the largest subprime lender in the Nation at the time. The Ameriquest investigation was resolved in 2006 when the lender entered into a $325 million settlement agreement with the States.

All of these enforcement actions targeted the kinds of fraudulent, unfair, and deceptive practices that eventually led to the collapse of the mortgage market.

By the fall of 2007, as the subprime mortgage market was starting to crumble, my office opened an investigation into the lending practices of Countrywide Home Loans. At the time, Countrywide was the largest prime and subprime mortgage lender in the Nation. My investigation, which was conducted in conjunction with the California Attorney General's Office, revealed that Countrywide had engaged in a wide range of deceptive lending and marketing practices in relentless pursuit of greater market share and profits.

As a result of our investigation, I filed a lawsuit against Countrywide in June of last year; and in October, I and several other State Attorneys General announced a settlement with Countrywide's new owner, Bank of America. That settlement established a mandatory loan modification program that covers approximately 400,000 borrowers nationwide. The program is estimated to provide $8.7 billion worth of loan modifications to borrowers and give them a fighting chance to stay in their homes. A mandatory loan modification program which requires the lender to reviewer its most toxic products and modify its loans is at the heart of the Countrywide settlement.

In my view, saving homes and stabilizing communities must be the primary goal of any enforcement action against predatory mortgage lenders. Unlike previous settlements with major lenders, the Countrywide agreement could not prevent the company from engaging in deceptive lending practices in the future. This is because once we subpoenaed Countrywide, the company moved all its lending business to its federally-chartered subsidiary which State Attorneys General are arguably prevented from investigating due to OCC regulations. In other words, the lenders, supported by the OCC, argue that the States are preempted.

We devote a tremendous amount of resources to investigating and prosecuting the many other State-licensed participants involved in the mortgage meltdown, including brokers, title companies, and appraisers.

Congresswoman Waters, to address your concern about mortgage rescue fraud, I want you to know that the State of Illinois has brought 22 lawsuits against mortgage rescue fraud companies; and we have outlawed up-front fees being paid for these services. Our prosecutions of these wrongdoers are both civil and criminal and remain a vital part of our enforcement efforts.

While the States have been aggressively pursuing enforcement actions against major lenders and other industry participants, for years our efforts have been impeded by a number of obstacles. State enforcement actions have been hamstrung by the dual forces of preemption of State authority and lack of oversight on the Federal level.

In the run-up to the crisis, many federally-chartered lenders were engaging in the same predatory practices as State-licensed lenders. The States, however, could not pursue these Federal lenders, even though we would have liked to. When a report showed that several lenders in the Chicago area had possibly violated fair lending laws, I could send subpoenas only to the State-licensed lenders implicated in the study. Two of those State lenders have since moved to Federal charters to avoid our investigation.

Preemption is a clear impediment to our investigations of fair lending and consumer protection violations by Federal banks. To give you an appreciation of the preemption battle, there is currently a case before the United States Supreme Court where a coalition of national banks is challenging the authority of State Attorneys General to investigate violations of State fair lending laws; and we all know the reason that national banks have fought so hard to block States from enforcing State laws against them.

Over the years, efforts to preempt State consumer protection powers have left a large gap in regulatory authority. So far, the Federal agencies have been unwilling to fill this gap, and the national banks are counting on their regulators to remain similarly resistant in the future.

As home loans grew increasingly complex and risky, Federal regulators could have and should have taken steps to ensure that lenders evaluated borrowers' ability to repay their mortgage loans. Unfortunately, Federal regulators chose not to exercise their authority to enact uniform marketwide underwriting standards until the mortgage market showed the first signs of the meltdown. By then, it was too little and too late.

To conclude, I would say that the best thing you can do to prevent further preemption is to give us the authority that we need to go after federally-chartered banks as well.

Thank you for this opportunity to testify, and I would be happy to answer any questions you may have.

[The prepared statement of Ms. Madigan can be found on page 133 of the appendix.]

The CHAIRMAN. Next, Commissioner Sarah Bloom Raskin of the Maryland Office of Financial Regulation—you should know that Congressman Cummings is a great supporter of yours. He was here earlier and was called away but is clearly very pleased that you are here.

STATEMENT OF SARAH BLOOM RASKIN, COMMISSIONER, MARYLAND OFFICE OF FINANCIAL REGULATION

Ms. BLOOM RASKIN. Thank you for that.

Chairman Frank and distinguished members of the committee, my name is Sarah Bloom Raskin, and I am the Commissioner of Maryland's Office of Financial Regulation. Thank you for inviting

me to talk about my efforts and those of my counterparts in other States to address the crisis of mortgage fraud.

The downturn in our economy has ripped the veneer off of a lot of predatory transactions that the good times kept hidden from view. And what we are seeing today in the States is ugly indeed. Let there be no doubt: We have a mortgage industry in America; and we have a mortgage fraud industry in America. In my office, people come in every day with heartbreaking stories of bank accounts depleted, life savings wiped out, homes lost, families bankrupted, and American dreams turned to living nightmares with eviction notices and foreclosure sales.

In our Federal system, State officials play the leading part in regulating mortgage activity which brings together a buyer, a mortgage company, a house, and a neighborhood. State Commissioners license and regulate over 77,000 mortgage companies, another 50,000 branches, and over 400,000 loan officers. This makes sense, because we are in proximity to the transactions and to our citizens. Like neighborhood cops who know their beats, we can detect both positive and negative trends right as they emerge, and we have the flexibility at ground level to respond.

But, as you know, the financial underpinnings of the mortgage industry are national, if not international, in scope and scale. Capitalization, securitization, wholesale funding, servicing, and other integral functions are consolidated and national in character. As State regulators, our reach into these functions is minimal. Oversight in these fields is either federalized or, as we have too frequently seen, nonexistent.

As State bank supervisors, we can meaningfully address only the end point of the problem, the final rip-off of the mortgage purchaser; and that is usually after the fact. But we are without power to regulate the essential structural incentives in the national banking industry or the basic content of industry practices and transactions.

Now, don't get me wrong. State authorities have been effectively pursuing unfair and deceptive mortgage practices. Through several landmark settlements, State regulators have recently returned nearly $1 billion to consumers who had been ripped off by their mortgage companies.

In 2002, a settlement forced Household Financial to pay consumers $484 million in restitution. A settlement with Ameriquest Mortgage Company 4 years later produced $295 million in restitution, and home buyers got back $60 million in a settlement with First Alliance Mortgage Company.

My office responds to some 2,500 consumer complaints per year. We conduct over 1,000 mortgage exams. Nationwide, States took almost 6,000 enforcement actions against mortgage lenders and brokers.

Furthermore, we have worked with our State legislatures to enhance consumer protections to address rank abuses ungoverned by Federal law. In Maryland, we have expanded legal protections for homeowners in delinquency and foreclosure to thwart the financial scam artists who inevitably descend on financial victims like vultures on highway roadkill.

But one key point I want to make is that Congress should eliminate the preemption of consumer protections enacted by the States. I urge Congress to promptly implement a recommendation made by the Congressional Oversight Panel in its special report on regulatory reform to eliminate Federal preemption of the application of State consumer protection laws to national banks.

The magic of federalism is that if one level of government falls asleep at the wheel or has too much to drink at the party, another can drive everybody home safely. But when you preempt our best laws, you take away the keys to the car and our license to drive.

Today, we all share the same goals of stabilizing homeownership, stopping foreclosures, ending the mortgage crime wave, and getting our communities moving again. Such ability to expand upon a basic Federal standard is essential to the development of effective responses to new mortgage abuses as they emerge.

Today, as you have heard, we have seen another mortgage storm brewing in the area of loss mitigation consulting. Historically, we confronted fraudulent transactions where title was conveyed as part of a scheme to strip homeowners of their equity. Today, there is no equity left to strip, so the rip-offs have become fee-based with so-called consultants charging high up-front fees to vulnerable consumers to help them get a loan modification.

Up-front fees are restricted in Maryland, and our office has recovered more than $80,000 for consumers to date. We have worked through the State Foreclosure Prevention Working Group to raise the issue with the Administration and to warn those overseeing the President's housing program of the potential for these practices to cause further financial instability.

On behalf of the 50 State banking supervisors, I want to thank you for the opportunity to testify and restate our commitment to working with you to reform and revitalize our mortgage industry. We view close collaboration as the best way to come out of this crisis and Federal preemption of our laws as an impediment to swift recovery. And I look forward to answering any questions you may have.

[The prepared statement of Ms. Raskin can be found on page 172 of the appendix.]

The CHAIRMAN. Thank you.

And next, Mr. Ropp.

STATEMENT OF JAMES B. ROPP, COMMISSIONER, DELAWARE DIVISION OF SECURITIES

Mr. ROPP. Chairman Frank and members of the committee, I am Jim Ropp, Delaware Securities Commissioner and Chair of the Enforcement Section of the North American Securities Administrators Association.

The CHAIRMAN. Could you pull the microphone a little closer to you, please?

Mr. ROPP. I am sorry. I didn't turn it on, sir.

The CHAIRMAN. That is the alternative.

Mr. ROPP. I appreciate this opportunity to focus on the role of State securities regulators in the current economic crisis.

Since the Securities Division is part of the Delaware AG's office, we have statutory jurisdiction over administrative, civil, and crimi-

nal actions to address securities fraud. And we do not have to refer our cases to an independent prosecutorial agency. This allows us more freedom to pursue offenders criminally, and we do not shy away from bringing criminal cases.

Delaware was recently the first to indict a Ponzi scheme operator who was offering investments in fraudulent real estate deals. In another case, Delaware indicted a broker who had defrauded a senior citizen out of more than $200,000. The broker diverted funds from the client's account into a fictitious account. Shortly thereafter, the broker withdrew the money and left the country. Warrants are still outstanding and we are attempting to secure his extradition to the United States.

In short, criminal prosecutions are an important tool for effective enforcement of Federal and State securities laws.

Delaware obtains cases in a number of ways. The primary source of securities cases comes from investor complaints about fraud and misconduct. We obtain cases from branch office examinations, referral from local law enforcement agencies, referral from other States, NASAA, the SEC, and FINRA.

Mr. Chairman, as you noted during last year's ARS hearings, in a number of States it has been the State securities officials and law enforcement officials who have taken the lead. High-profile national cases receive great public attention, but they should not obscure the more routine and much larger caseload representing the bulk of the State's enforcement work. Those are the cases which affect everyday citizens and their local communities across the country.

During the past 3 months, the States have been very active. Washington, working with the FBI and the IRS, broke up a $50 million oil and gas investment Ponzi scheme. Hawaii, with the assistance of the SEC and the CFTC, shuttered a suspected Ponzi scheme targeting a deaf community in Hawaii, parts of the mainland, and in Japan.

An investigation by Texas resulted in a 6-year prison sentence for a Ponzi scheme operator who stole at least $2.6 million from investors. Arizona stopped a religious community fraud and ordered more than $11 million returned to investors.

Since January, the Alabama Securities Commission has announced the conviction of nine individuals convicted of securities fraud. These convictions encompass cases of fraud and abuse ranging from classic Ponzi schemes to violations of Reg D Rule 506. All convictions and charges were felonies. Currently, Alabama has 27 defendants awaiting trial for securities fraud in 19 separate cases.

During our most recent 3-year reporting period, State securities regulators have conducted more than 8,300 enforcement actions, which resulted in $178 million in monetary fines and penalties and more than $1.8 billion ordered returned to investors.

We are responsible for the sending of fraudsters away for a total of more than 2,700 years in prison over the last 3 years, and yet, over a number of years, there has been a concerted industry effort against State regulation which calls for the preemption of both State regulation and enforcement.

For example, NSMIA did preempt much of the State's regulatory authority for securities trade on national markets, and although it

left State antifraud enforcement largely intact, it limited States' abilities to address fraud in its earliest stages before massive losses had been inflicted on investors.

A prime example in this area is the private offerings under Rule 506 of Regulation D. These offerings enjoy an exemption from registration under Federal securities laws, so they receive virtually no regulatory scrutiny. As a result, since the passing of NSMIA, we have observed a steady and significant rise in the number of offerings made pursuant to Rule 506 that are later discovered to be fraudulent.

Although Congress has referred the State's authority to take enforcement actions for fraud in the offer and sale of all covered securities, including Rule 506 offerings, the power is no substitute for the State's ability to scrutinize offerings for signs of potential abuse and to ensure that the disclosure is adequate before harm is done to investors.

The time has come for Congress to reinstate State regulatory oversight over all Rule 506 D offerings. There are a number of legislative proposals pending now to significantly increase funding for Federal law enforcement agencies. NASAA supports these efforts, but urges Congress to consider establishing Federal grant programs to assist State agencies, including securities divisions, involved in the prevention, investigation and prosecution of certain financial crimes.

State securities regulators have learned how to do more with less. However, there is little doubt that additional resources during this economic downturn would help prosecute these cases, which have resulted in vulnerable investors looking to recover their losses. State securities regulators welcome the opportunity to work with our regulatory partners at the SEC and the SROs to collectively use our resources to protect investors.

To facilitate communication and coordination, on all financial service issues, NASAA believes the President's working group should be expanded to include representatives from the State agencies that regulate banking insurance and securities. Another improvement would be more consistent cooperation between States and their regional counterparts at the SEC.

In conclusion, State securities regulators are dedicated to pursuing those firms and individuals who have violated securities law. We want to ensure that we not only maintain but enhance our authority to regulate at the local level and bring enforcement actions with appropriate remedies against those firms that violate securities laws in their jurisdictions. With additional resources and support from Congress, State securities regulators will continue to provide an indispensable layer of protection to Main Street investors.

Thank you.

The CHAIRMAN. Thank you, Mr. Ropp.

[The prepared statement of Mr. Ropp can be found on page 203 of the appendix.]

The CHAIRMAN. And finally, Mr. Merle Sharick from the Mortgage Asset Research Institute.

Mr. Sharick?

STATEMENT OF MERLE D. SHARICK, Jr., MORTGAGE ASSET RESEARCH INSTITUTE (MARI)

Mr. SHARICK. Good afternoon, Chairman Frank, and distinguished members of the committee. My name is Merle Sharick, and I am with MARI, the Mortgage Asset Research Institute, a LexisNexis service. I commend the chairman and the members of the committee for holding this hearing and for your dedication to protecting consumers and promoting the principles of responsible lending.

For over 18 years, MARI has managed and maintained the only cooperative contributory database existing today in the mortgage industry specifically established to keep track of mortgage professionals and companies. This database, known as MIDEX, the Mortgage Industry Data Exchange, includes public financial sanction information from over 200 government regulators and nonpublic incident reports provided by subscribers when fraud or misrepresentation is confirmed in a loan transaction.

MARI became a key part of LexisNexis in 2008. Our current focus is driving and supporting the installation of a loan fraud prevention database for loan origination pipelines for all lenders to share and compare loans and process to prevent fraud early in the mortgage process.

This month, MARI released its 11th periodic mortgage fraud case report to the Mortgage Bankers Association, of which all committee members have a copy. This report found that reported cases of mortgage fraud in the United States are at an all-time high and increased by 26 percent from 2007 to 2008. Additionally, the report found that for the first time, Rhode Island ranked first in the country for mortgage fraud with more than 3 times the expected amount of reported mortgage fraud for its origination volume. Florida ranked first in 2000 and 2007 and 2006, but dropped to second place for 2008 instances and is followed by Illinois, Georgia, Maryland, New York, Michigan, California, Missouri, and Colorado.

The top fraud incident type in 2008, representing 61 percent of all reported frauds, was application fraud. For the 5th year in a row, it topped the list. Second were frauds related to tax returns and financial statements, which jumped 60 percent from 17 percent of reported frauds in 2007 to 28 percent of reported frauds in 2008. Additional documented fraud types included in order of their volume frauds related to appraisals of valuations, verifications of deposit, verifications of employment, escrow or closing costs and credit reports.

In 2008, Rhode Island made its first official appearance on MARI's top 10 list. But since last year's case report, reports of material misrepresentation have bolstered the State's ranking to number 5 in our current snapshot of loans originated in 2007.

The significant drops in reported incidences in Nevada, Utah, California, and Michigan are most likely the result of the lack of investors for subprime and alternative lending products and tightened underwriting guidelines on conforming products and that the flurry of delinquent and foreclosed loans does not allow servicers significant time to investigate default causes. Future reports that we will issue will indicate whether this is just a 2008 phenomenon or not.

Some observations about fraud types: Many of the percentage figures shown in our report are similar to those MARI has reported for several years. Notable differences in the 2008 data include the percentage of reports of tax return and financial statement misrepresentation nationwide is higher in 2008 than in previous years. The same is true for verification of employment misrepresentation. Credit report fraud has decreased and incidences reported for both 2007 and 2008.

Appraisal fraud is higher at the time of this report in past years. Typically, appraisal fraud numbers grow as more issues are uncovered.

There are many mortgage schemes out there, and I won't elaborate on all of them, but I do want to comment on some emerging fraud trends that have been reported by our subscribers. These emerging fraud trends are further draining lender, law enforcement, and consumer resources in the industry's most challenging times ever.

Our subscribers reported an increase in traditional mortgage misrepresentation of income inflation and bank statement fraud. Our subscribers reported an increase in foreclosure prevention schemes. Our subscribers also reported an increase in elderly and immigrant identity fraud and a significant increase in builder bailout fraud.

We must use technology more wisely, and we must pay attention to details to return confidence and integrity to the mortgage loan to attract the capital from a variety of sources that the industry will need in a recovery. Combating mortgage fraud is critically important to restoring integrity in the mortgage loan transaction and attracting the necessary capital to meet the needs of prospective homeowners in the industry. It is also critical to rebuilding consumer trust in the industry's professionals when the real estate market segment begins to improve. We believe that the mid- to longer-term systemic return of the real estate market segment must be anchored by improved fraud prevention and lending practices already being pursued by lenders.

Mr. Chairman, we look forward to working with the mortgage industry, this committee, the States, the Federal financial regulatory agencies, and other stakeholders to combat mortgage fraud, protect consumers and promote the principles of responsible lending.

I very much appreciate the time.

[The prepared statement of Mr. Sharick can be found on page 218 of the appendix.]

The CHAIRMAN. Thank you, Mr. Sharick.

Should that show any difference in terms of their originations between the banks and the mortgage companies, to the extent to which they are regulated at the Federal or State level? Has that been in any way—is there any distinction?

Mr. SHARICK. I think we will see that in future reports particularly. But the change that has happened in the mortgage industry over the last couple of years, the banks and government-regulated financial institutions are the main survivors.

The CHAIRMAN. And they have done a less bad job?

Mr. SHARICK. They have, I think, more controls in place.

The CHAIRMAN. So that they have been less contributory.

The other question is, for those outside of that—and you say they are survivors, but would you recommend—you said, tighten the underwriting guidelines.

We still have some entities which operate outside of these kinds of regulations. Would you recommend some kind of statutory or other establishment of better guidelines?

Mr. SHARICK. I am not sure. What I would recommend is more due diligence, tightening underwriting guidelines.

The CHAIRMAN. Due diligence by whom?

Mr. SHARICK. By everybody who is involved as far as the lender and the lending transaction.

The CHAIRMAN. You would recommend that to the lender. But if we have lenders that aren't doing it, would you mandate it?

Mr. SHARICK. I think that is something that could be looked at. We would be happy to talk with you about that some more.

The CHAIRMAN. Thank you.

Let me turn back to the question of preemption, which is an important one. Attorney General Madigan, I think you were referring to the case of Andrew Cuomo as the lead against the central clearinghouse. I am pleased to reference here the amicus brief signed by myself, the chairman of the Judiciary Committee, Mr. Conyers, and several other senior members of this committee on the side of the attorneys general.

Ms. MADIGAN. We appreciate it.

The CHAIRMAN. There is no question. But I often learn from my former colleague, Mr. Galvin. In the area of bank preemption, we don't need to change the statute. What happened was, the Comptroller of the Currency, a Clinton appointee who stayed over until the Bush Administration, Mr. Hawke, issued, I think, an excessive degree of preemption. It was challenged in court; and what the Supreme Court said basically was, this is a matter that is very much within the discretion of the administrator.

It was an extreme case of matters of discretion. What it means was that—and it was a very extreme preemption. What it says is that virtually no State laws can apply to banks—no State law specifically related to a lot of banks; and even where a State law or general application applies to banks, they have to get the national bank people to administer it. Fair lending, for example, would not hear the case the attorney general and I were referring to. It is not an effort to regulate sort of core banking decisions; it is a fair lending issue.

The Comptroller of the Currency can undo what the Comptroller of the Currency did. I was asked, I will say, by members of this Administration, what my view was on the reappointment of the current Comptroller. I have found him to be responsible in a number of ways, for instance, in his refutation and the argument that the Community Reinvestment Act has been the cause of serious problems. And he was not the one who did the preemption and he has been somewhat flexible in his approach to it.

But I have asked—and I am in the process of asking all three of the agencies, organizations represented here—the State attorneys general, the State bank supervisors and the State securities administrators—to create a working group; and we will meet under our guidance with the Comptroller of the Currency to un-preempt

in the banking area. But my colleague tells me that, apparently, in the securities area that has to be statutory.

So we will do that as well, and we will have a—actually, it will be the attorneys general and the State bank supervisors in kind of a working group to dial back the preemption there. But we will be asking the securities administrator, Mr. Ropp, and Mr. Galvin to give us the statutory changes.

I think there is no question that this could work well. And it would be my hope to have some hearings essentially on this, maybe one in each of the two relevant subcommittees and a full committee hearing. It is a very important subject, and I would hope by the end of this year or early next year we could have gotten an agreement to undo some of the excessive preemption by the Comptroller and get back into—and change some of the statutory matters that have to be done.

So I appreciate this, and I do not think—certainly in the mortgage area, we didn't suffer from overenforcement. And I think we are able to do this in a way—and it is a legitimate complaint by a potential enforcement target, one of them being hit in a contradictory way. I think we could work out among ourselves ways to avoid that, so you could have a primary guide or you could have some degree of coordination. But that is very high on our list.

The gentleman from Texas.

Mr. GOHMERT. Thank you, Mr. Chairman, and thank y'all for being here today. I am sorry; I try to avoid saying y'all when I am up here, and I let one out. I know Jeff Foxworthy is right; when people hear a southern accent, they deduct 50 IQ points from how smart they think you are.

But thank you. We appreciate you being here.

Mr. Ropp, you indicated the SEC has been criticized for inaction toward securities fraud. Do you think that is a result of a lack of commitment on the SEC's part, a lack of resources or a need, heaven help us, for larger Federal regulatory situation or a restructuring?

Mr. ROPP. I think it is a combination of things. I think you have hit on most of them.

I think part of it probably is resources. I understand their budget has not been raised for a number of years until recently. I think that they focus on big cases and cases that will bring them a lot of publicity. And unlike the States, where we try to handle as much as comes along from the Main Street investors, they rarely look at this one-person case, two-person case, or the ones where there is a $25,000 loss or $30,000 loss, which are real cases and real losses to these people.

I think, because of the size and their resources, they do look at the larger cases and don't necessarily look at some of the smaller cases.

Mr. GOHMERT. Thank you.

And I am a big proponent of States' rights. I hate to see more and more States' rights usurped when I think the 10th amendment means what it says, those powers are not specifically enumerated, but are reserved for the States and the people.

But in that regard, you have been here. You have heard the testimony of the other panel as they have talked about the credit de-

fault swaps flying under the radar for way too long, getting too big too fast. We are finding the inadequacies of the Federal system in not picking that up sooner, before it got us in some significant trouble.

What was it, do you think, that kept the States from picking up on this, this growing, burgeoning fiasco? What kept you guys from being able to pick up on it?

We know the Fed had problems. How about yourselves?

Mr. GALVIN. If I may, I think part of this relates to the preemptions that have been put into the law over the last couple of decades.

Mr. GOHMERT. As I understand it, some of the problem with the credit default swaps was, we didn't have control over it. We didn't jump in and take over, and that is why—

Mr. GALVIN. It is a definitional issue. Part of the problem here is, you had entities creating new instruments that were unheard of before, new types of risks.

I don't think—I don't presume to speak for anybody else on this panel, but I personally do not—I am not arguing for the absence of a Federal regulator. There has to be a national market regulator and that has to be Federal.

I think the issue really is, how do the two sides—this isn't a competition between the States and the Federal regulators; this is about making sure the States have the ability to protect their citizens.

I do think there needs to be a national regulator. I know you are going to revisit the whole issue of the structure, and I think some of the gaps we have seen are now exposed. The reality is, I think—the biggest lesson I think we can all take from what has happened most recently is, these industries, they aren't just some other business. This is a business that affects every other business and all of us—indeed, you might say even beyond the confines of the country.

So when we are talking about some sort of a regulatory process, there has to be a national market regulator. There has to be an entity that can step in and deal with the definitional issues that you were touching upon in your question. But at the same time, there has been this conscious effort to peel back the rights of the States to protect their citizens. And in most instances, those State laws are more aggressive than the Federal laws.

Mr. GOHMERT. Okay. I was trying to be specific on the credit swap because if we can figure out exactly how we let this get—or fall between the cracks so nobody picks it up, then maybe we can avoid it. Because, let's face it, people on Wall Street, people who came up with these ideas—Countrywide pushed sometimes—they are smart people and they look for these loopholes. And with credit swaps, heck, it basically sounds like insurance. But if you don't call it insurance, you don't have to put money in reserve to reserve against the insurable event. And then we have a big problem.

So I am just looking for suggestions you might have on how we keep it from falling between the cracks of the States and the Federal Government.

Attorney General Madigan, I know you want the Federal Government to run it all, but maybe you could elaborate.

Ms. MADIGAN. Obviously, one of the problems—and I don't think we have specifically addressed it with this group—is, it comes down to resources. I went through this Countrywide investigation and lawsuit—six lawyers, and I have one of the largest consumer protection bureaus in the country in an attorney general's office.

So, obviously, resources was an issue. Last year alone, we got over 33,000 consumer fraud complaints; we got 8,000 calls from people who are struggling to pay their mortgages, who are already in foreclosure. So we are attempting at the local level to keep people in their homes and to do all we can to hold the people involved in the mortgages.

Mr. GOHMERT. My time is running out. I really appreciate what you are doing. I am just looking for a way to figure out how we keep another credit default swap from overwhelming.

I know my time is running out, Mr. Chairman.

If I could ask to submit in writing any suggestions you might have as to how we can do it more effectively—I don't need a term paper, just your own personal opinion of what we can do to avoid this in the future.

Thank you, Mr. Chairman.

The CHAIRMAN. I am going to ask unanimous consent to just take—the gentleman asked a very important question. I think there is this distinction, because the problem with credit default swaps was not that individuals were being swindled as much as the cumulative impact was great. And that is not something a State can do. The problem was that you had accumulation of these that went beyond the capacity of the system to handle them.

So I think there is a very important role for the States in protecting investors from being mistreated. But when we are talking about a systemic impact, that is inherently, I think, a Federal thing. And that isn't always the case, but I think that was the problem.

The problem with all insurance risk securities was that people were not getting paid back. They weren't a systemic risk. The problem with credit default swaps is that they became a risk beyond any individual or any company nationally.

Mr. GOHMERT. If I could just explain my question, though. People at the State level often pick up on these quicker, and even though it is a national problem, we should be the ones to do something about it. There ought to be a way that they can alert the Feds more quickly.

The CHAIRMAN. I appreciate the gentleman. If the gentleman would yield, again, part of the problem though is—the problems that went beyond any one State or the transactions in any one State. One of the things we need to say, to be able to accumulate these things, to keep track of all of them.

But there certainly needs to be—it is a cooperative relationship and the States can, and have in some cases. I believe the problem with auction rate securities, for example, first came from the States alerting us.

The gentlewoman from California.

Ms. WATERS. Thank you very much, Mr. Chairman, and I am very appreciative for this hearing.

I am very appreciative for this panel. I was about to regret that I had taken my Friday to come because the first panel was obviously brain dead or something, except for maybe the FDIC and the AG's office, I was beginning to feel a little bit hopeless that we could get any real help in dealing with these problems.

I think, Mr. Chairman, one of our real challenges is, how do we have a clearinghouse on products without interfering in "let the marketplace work?" It seems to me as you gather in the kind of interaction that you have described, that is one thing that perhaps you can take a look at.

I know there are people who would think that, oh, you can't have a clearinghouse where mere human beings would perhaps interfere with products that were thought up by mathematicians and others in the back room. But I think it is very important that we find a way to look at these products before they hit the market, so that we can at least do some kind of assessment about what harm they may be causing to the citizens of this country.

I want to especially thank this panel and, of course, Attorney General Lisa Madigan and also Commissioner Bloom Raskin. You have, I think, really inspired me and given me a lot of hope that we certainly can do more.

Just the information that you gave us today about up-front fees, I think can be executed also at the Federal level—and in just talking with my chairman, as we whisper back and forth, he seems to have liked that idea also.

And, of course, the preemption issue that he is talking about, engaging the States and the Feds, I think is something that can lead us to avoiding the kind of problems that we have experienced in this meltdown and in this crisis.

I want to thank you for the work that you did on Ameriquest and Household Finance. Household Finance had been around for years, ripping off minority communities. I can remember as a young woman with a family having been interactive with Household Finance. So I want to thank you for all of that.

And I am just hopeful that you won't be in the position of continuing to chase these bad actors all the way up to the Fed door and then have the Fed door slammed in your face. And I hope you come up with some real help to us in how you can take your knowledge and your experience and all that information and somehow work with the Feds to continue the chase until you get them.

And that is it. Thank you very much.

The CHAIRMAN. The gentleman from Virginia.

Mr. SCOTT OF VIRGINIA. Thank you, Mr. Chairman. I wanted to follow up on what you and the gentleman from Texas were talking about on credit default swaps, because they are essentially insurance products without the insurance regulation.

There are a couple of—and in terms of the marketplace working, if you don't have to back these insurance products with assets, you get to collect the assets, the premiums every year, and when the house burns down, you don't have any money. That is a very profitable business when—when the house burns down, you either declare bankruptcy or get bailed out.

Ms. WATERS. Yes.

Mr. SCOTT OF VIRGINIA. But in the meantime, it is a very profitable business.

One of the things that the insurance requires is, one, it has to be backed by assets. And it can't get out of control because you have a finite amount of assets to back up your insurance assets guarantee.

The other thing is, you have to have, if it is insurance, an insurable interest. Because if you don't have an insurable interest, then you are just betting on outcomes and everybody gets to play, and nobody is really—so if something bad happens or good happens, people are just kind of betting on the side.

Can the panelists say something about the need for anything that looks like insurance to actually have assets backing it up and whether or not the principle of having an insurable interest is still a good thing?

Mr. GALVIN. I don't have insurance jurisdiction. But I served in the legislature for a long time, and I was on the Insurance Committee in a leadership role.

I think one of the things we have seen is—and this does touch upon the earlier discussion we were having about preemption—there is an ongoing discussion about where insurance should be regulated, where appropriately it should be regulated. Wholly, the market has become national and international, but some of the principles have been lost. Those two principles you are talking—speaking about, assets and a particular insurable interest, are fundamental to anyone who has studied insurance or knows anything about the concept that there has to be some interest in why you are getting this insurance policy.

I think what has happened in the migration from insurance to credit default swaps is those principles have been lost. I certainly think that the problem—and I tried to touch upon this in my remarks—is the problem with trying to regulate credit default swaps, as we now know them, it is almost like a bacteria. It is going to change into something else; by the time we have a vaccine to deal with the current outbreak, we will have something new.

So I think that it does argue—and I know there has been some discussion of this—of having some sort of a national regulator deal with some of these more exotic products. I think you may well have to look at that, and you may have to look at the concept that the lady from California mentioned about some sort of a clearinghouse of products or an identification of products, a definition of terms.

Frankly, the credit default swaps issue touches quite close to home to me, coming from Massachusetts. One of the major problems we are having in our finances right now is one of our larger public entities, the Massachusetts Turnpike Authority, got into some very bad credit default swaps at this point, and they are having difficulty living up to the terms of them to the extent they had to vote the State's credit behind it.

It is a real problem. But I don't think simply trying to identify what happened before is going to solve the problem going forward.

I am not arguing for an insurance—national insurance regulator exemption of the States or preemption of the States. I am saying, I think you have to start identifying these products where they

really exist, in anticipation there will be new products that will take their place.

Mr. SCOTT OF VIRGINIA. You can kind of call them different things and tweak them here or there. But if you are ultimately liable, if something occurs and there is insurance, you have to have assets around it. And that will cure any getting out of control because you only have limited assets. And then the insurable interest will limit the number of people who can get into the thing.

Let me ask all of the witnesses to talk about the cooperation with the Feds. We talked about eliminating the preemption, but in law enforcement, there has to be some cooperation so you can effectively use all of your resources.

How has the Federal Government helped or hindered your ability to go after the bad actors?

Ms. MADIGAN. I can address that. And I know some others have as well.

Most, if not all of us, are involved in essentially mortgage fraud task forces. I think there are 18 of them, regional ones, and I know there are about 47 that are smaller in nature. And so we work mainly on criminal matters cooperatively with the Feds.

But in terms of the Countrywides, the Ameriquests, rarely were we working with the Feds. We were working with the other States, we were working with the other State bank regulators as well.

Ms. BLOOM RASKIN. I would only add, in Maryland, for example, we have teamed up with our U.S. attorney and with a variety of State regulatory agencies in the area of mortgage fraud to create a Maryland mortgage task force; and we find these mechanisms to have great potential because they provide for a sharing of information, a real two-way street in terms of what we are all seeing.

And we all bring different things to the table in terms of the levels of enforcement, the number of feet we have on the ground, and these turned out to be critical mechanisms for spotting trends very early.

Mr. ROPP. From my standpoint, I work with the Federal Legislation Subcommittee with NASAA, and almost every Federal act that we look at has some preemption language in it, preempting State action in certain areas; and I am not sure it is always thought through what the impact of this is going to be.

Secretary Galvin and I both spoke about the situation with Reg D 506 offerings, private placements where States have effectively been taken off the case except for where we know there is fraud. So we can't look at them to see if there are dishonest, unethical practices or bad actors or people who have prior records, which we used to be able to do. And frankly, now we get notice filings which we just sort of look at quickly and file away because we really have no authority anymore because of preemption under NSMIA to look at these things. These are some of the concepts; and Secretary Galvin has also mentioned them in his remarks, where the Federal Government has preempted the States from being able to do what we think is our job of protecting investors.

The CHAIRMAN. The gentleman from Illinois.

Mr. SCOTT OF VIRGINIA. Mr. Chairman? If we could, if the witnesses, in writing, could respond, we have had ways where we could hinder. If you could make recommendations how we can actu-

ally effectively help these investigations, we would appreciate those.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Illinois.

Mr. FOSTER. Secretary Galvin, you had mentioned market timing trade frauds. What fraction of market timing trade frauds do you think are actually detected? And do you view this as basically a State or a national problem?

Mr. GALVIN. The market timing issue—which Massachusetts brought, I think, the first case in the Putnam Investment case—was clearly a national trend in the mutual fund industry.

One of the amazing things about that case was that as we got deeper into it, we had company after company saying, oh, well, we did it too. And when we tried to go back at them and say, well, why? Well, everyone was doing it. So it kind of argued against the policing, the self-policing of the industry.

I mentioned in my oral testimony the necessity of looking at mutual funds. I think mutual funds again are an area of financial services that morphed over time. Initially, they started out as fairly small, pooled assets—people thoughtfully investing your money, safety in numbers—and they got into something very different.

I think the common thread that runs through both the market timing scandal and many of the other issues that we have dealt with is the idea that you have two different types of investors. Special people are taken care of. Market timing was all about you took care of the special customers, you let them trade at a higher rate, you let them get out and make a quick profit, while the average person that was relying on mutual funds for their financial security, they were stuck.

So I think that these issues, as they emerge, while they are different in the particular, are similar in the fact that they really get back to the idea that there are two sets of customers—special treatment for special customers. And what we at the State level, I think, are more likely to find is, when that is occurring, we are able to move more nimbly sometimes.

That is not to argue with the Federal people. We work with the SEC, we worked with them on auction rate securities. We have to work together. This is not a case where, as I said, we are competing.

Mr. FOSTER. Thank you. I have to move on to a few other issues, but I think this is a ball we have to keep our eye on.

Attorney General Madigan, you mentioned that several institutions had changed to a Federal charter to basically avoid subpoenas. Is that effect instantaneous, or can you look back to the years when they were—in fact, were State-chartered?

Ms. MADIGAN. We have to decide whether or not we are going to essentially fight a preemption battle with these entities when things of that nature occur. So when we look at potential targets and we know there are bad actors out there, the first thing we have to do is determine, are we going to fight that battle or are we going to go after the other bad actors? And there are plenty of them.

And so, on a going-forward basis, I think what I mentioned in terms of Countrywide, part of that settlement and previous settle-

ments with Ameriquest and others, we put in injunctive measures—so no prepayment penalties; certain notifications have to be made if you are going to change the terms.

We couldn't do that in Countrywide because on a going-forward basis we wouldn't be able to. Arguably, once they have moved, we will have to engage in a preemption battle even for past conduct.

Mr. FOSTER. Okay. And did the large settlements against FAMCO and Countrywide and others that you mentioned, did those result in anyone being added to the black list of banned individuals that are not allowed to participate in financial—

Ms. MADIGAN. I don't know the answer to that question. We can find out.

Mr. FOSTER. Okay. That is a very interesting one.

And does anyone on the panel have any reservations about Attorney General Madigan's assessment of the value of freezing and rolling back the Federal preemption? Is there any downside to that you can see?

Ms. MADIGAN. Not on this panel.

Mr. FOSTER. Okay.

Mr. Sharick, how does tax return fraud typically work? And are there technological fixes that might make this harder to accomplish?

Mr. SHARICK. Tax return fraud is accomplished by altering documents in some way, altering the information. There are a number of solutions now that allow certain vendors to go directly to the IRS and to the Social Security Administration to verify information. But the great percentage of fraud that you see in the mortgage industry has to somewhere center itself around altered documentation.

Mr. FOSTER. Okay.

And I guess my last question is the same one I posed to the previous panel as to the cost-effective amount of resources to put into enforcement.

And so, if you could, each of you, I guess the first four members of the panel, provide an estimate of your total budget for enforcement activities, the total value of losses averted—just an estimate, do the math—and how many additional losses might be avoided by a 10 percent increase and a factor-of-two increase in your enforcement efforts?

Mr. GALVIN. I am not sure I am good at math questions, but I will tell you that my division, the Securities Division, is relatively small.

My total operating budget for all my divisions is about $40 million. The Securities Division probably is about $3 million of that. We do recoup some fines for our use. Most of it goes to our general fund.

In terms of what we have saved, I did cite in my testimony literally millions of dollars. Just in the last year, we returned over $10 million to Massachusetts investors. But in some of the larger cases where we cooperated with our colleagues in other States, the States led the effort, for instance, on auction rate securities; and as I noted in my testimony, over $61 billion has been freed up by that.

So I think in terms of bang for your buck, you are getting a very good bang for your buck at the State level.

Mr. FOSTER. I would just like to see that quantified across the range of enforcement activities so we can think sensibly about where to put the increase in enforcement activities.

Ms. MADIGAN. As I mentioned, our legal team who dealt with Countrywide—six lawyers. I don't have financial investigators in the office, so we end up hiring experts. Total, statewide, I probably have 28 lawyers who do consumer fraud work.

There is an endless number of bad actors in the mortgage meltdown that we could go after—literally hundreds, if not thousands of brokers. In terms of just the volume of consumer fraud complaints around mortgage fraud that we received last year, 2,400.

And so we could always use more resources. With more resources, we would have the ability to prevent, as well as recoup, potentially, some of those losses and keep people in their homes, which is what our priority is right now out of the attorney general's office in Illinois.

Mr. FOSTER. So, for example, doubling your budget would double the amount—you are still in a situation where doubling your budget would double the amount of bad actors and losses you would avoid?

Ms. MADIGAN. Potentially. And we would love it if you could help us do that.

Mr. FOSTER. I yield back.

The CHAIRMAN. I do want to add—yes, Mr. Ropp, go quickly.

Mr. ROPP. I just wanted to say, our budget, I would love to have Secretary Galvin's $3 million budget. I have $800,000 in Delaware. And we had two investors in the auction rate securities who had $1,250,000 returned to them just in those two complaints based upon the leadership work done by the States and Secretary Galvin's office and Texas and Missouri and other States. So there can be a huge bang for the buck.

And in another case, we had one fraud actor who ripped off 11 Delawarians for $400,000, which would have been half of my budget.

Now, we didn't get all the money back, but certainly the cases we do on a very inexpensive basis do a lot of good for the citizens of the States.

The CHAIRMAN. I am just going to—Mr. Ropp, you did say that you could use some help with the funding. I would say this.

I do believe that the States should be given more power, but I don't think I could support sending the money with it. I don't think you are going to see the Federal Government subsidizing the State enforcement. And I think you can point out the amount you could recover; and at some point, we are all going to have to explain to the American people who in the absence of a sufficient level of taxation, they cannot expect the government activity that they need to protect themselves. So I do think, at some point we yield to that.

The only other thing I just want to underline, and Commissioner Bloom Raskin talked about—I think it was Commissioner Bloom Raskin—the $25,000 fraud, the case of an individual who would look to some of the Federal people, like a fairly small case.

And the answer is, I think that is precisely why elected officials need to be in the mix, because the anger of individual constituents and the fear that one of them will go to the newspaper and look terribly sympathetic and unaided is a powerful goad to an elected official intervening.

As you percolate up to the appointed officials here in Washington, that gets attenuated. So as I said, there is a good political science reason why you want to connect State officials, because you don't want the electoral process so—I don't want the consumer complaint process as insulated from electoral politics as it is here.

The hearing is concluded. We appreciate this, and we will be pursuing many of these issues.

[Whereupon, at 1:10 p.m., the committee was adjourned.]

A P P E N D I X

March 20, 2009

Committee on Financial Services

"Federal and State Enforcement of Financial Consumer and Investor Protection Laws"

March 20, 2009 – 10:00am

Statement of Congressman Elijah E. Cummings

Thank you, Mr. Chairman:

I have spent a lot of time in this Committee room this week, and I appreciate the chance to return today.

I thank Chairman Frank for his tireless leadership on efforts to protect consumers – and I also thank Subcommittee Chairman Kanjorski for convening this week's hearing on AIG.

From the instant the decision was made to inject taxpayer dollars into the private capital markets, I have beaten a drum for the rights of our nation's "involuntary investors."

I applaud the work that your Committee has done to uphold and strengthen consumer and investor protections for our constituents.

From quote "loss mitigation" consultants to corporate bonuses and retention payments, we've seen too many examples of our hard-working constituents getting taken advantage of at a time when many are truly desperate.

I'm happy that the committee will hear from my friend, Ms. Sarah Bloom Raskin, the Commissioner of the Maryland office of Financial Regulation, who has been a determined advocate for the citizens of my district and all of Maryland.

She is a veteran of both public and private banking issues and policy, having been an attorney with the Federal Reserve, the Senate Banking Committee, and most recently with the consulting firm Promontory Financial Group.

She has spearheaded Maryland's aggressive tactics to address foreclosures, including our State's efforts to lengthen the foreclosure timeline to provide borrowers with time to find a solution, and to work with loan servicers to encourage modifications. She has performed outreach at all levels.

Just last month, she appeared with me at a forum in my district to discuss financial services and the TARP program with my constituents.

She has also been working hard to combat the fraud and abuse that helped create the problems we have today.

Maryland has imposed an affirmative duty of good faith and fair dealing on our mortgage professionals.

I feel strongly about this last point – this requires that servicers offer *only those* transactions which provide a tangible net benefit to the borrower.

One of the themes of today's hearing is the need for tough statutes and effective enforcement.

In Maryland, we've passed the Maryland Mortgage Fraud Act, explicitly making mortgage fraud a specific crime, and giving direct enforcement authority to Ms. Raskin's office.

The Act also creates an affirmative obligation for all mortgage brokers and lenders to report cases of fraud, theft, or forgery.

More recently, her office has seen the emergence of these so-called foreclosure or loss mitigation consultants. These scam artists charge high up-front fees to vulnerable consumers to supposedly help them have loans modified.

Too often, these efforts result in both wasted money and wasted time. Ms. Raskin's office has already recovered more than $50,000 for consumers.

In my district, and on my own street, folks are struggling to stay in their houses. I've got an employee at my district office that spends 100% of her time helping constituents with mortgage problems. She's doing all she can, but we could only make limited progress without the efforts of Ms. Raskin and her counterparts around the country.

I commend the Committee on the work done to represent all taxpayers, and I know Ms. Raskin and the Maryland Office of Financial Regulation show how proactive and effective regulation at the state level is critical to protecting our residents.

I thank the Committee for inviting her to testify and again applaud the tireless leadership of Chairman Barney Frank.

For Release Upon Delivery
10 a.m. March 20, 2009

TESTIMONY

OF

JOHN C. DUGAN

COMPTROLLER OF THE CURRENCY

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

OF THE

U.S. HOUSE OF REPRESENTATIVES

March 20, 2009

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent those of the President.

INTRODUCTION

Chairman Frank, Ranking Member Bachus, and members of the Committee, I welcome this opportunity to appear before you today to discuss the OCC's supervisory and enforcement authorities. In your letter of invitation, the Committee expressed interest in actions we have taken against financial fraud and violations of consumer protection laws and regulations; any impediments that we face to effective enforcement of fraud and other financial consumer protection standards; coordination and cooperation among the agencies responsible for enforcing consumer protection standards and laws targeting financial fraud; and any gaps in the civil and criminal authorities of those agencies.

Recent unprecedented losses at financial firms, the mortgage crisis, and shocking examples of fraud and excess, including the arrests of high-profile private fund managers for alleged theft of client funds, have prompted the Committee's questions about the adequacy and use of enforcement powers by federal and state authorities. The Committee has expressed interest in how the Federal banking agencies ("FBAs") have used their existing enforcement authority. You have also asked whether federal and state financial regulatory agencies and law enforcement authorities have the tools and resources they need to aggressively pursue financial institutions and individuals that commit fraud, abuse their positions, and violate the law.

The OCC vigorously enforces laws and regulations applicable to national banks through our supervisory activities and informal and formal enforcement actions to protect the safety and soundness of national banks and national bank customers. As described below, the OCC and the other FBAs have a broad range of supervisory and enforcement tools that are used to supervise banks and protect consumers, investigate and halt fraudulent activities, and remove and prohibit those responsible from ever working in the banking industry again. Unlike the Department of

Justice ("DoJ") and the FBI, however, the FBAs are not criminal law enforcement agencies, and we do not have authority to investigate and prosecute crimes of fraud. Rather, the FBAs refer suspected criminal fraudulent acts to DoJ for prosecution.

The Committee's interest spans a potentially broad range of topics, involving different types of financial firms and different regulatory regimes. My testimony covers the OCC's activities and perspectives on enforcement in four key areas: 1) our approach to enforcement and how we use different types of enforcement actions; 2) how we have employed enforcement actions in problem bank situations to protect consumers and eliminate fraud; 3) how we coordinate with state and federal regulatory agencies and law enforcement agencies; and 4) the measures we have taken to address mortgage lending practices.

I. THE OCC'S ENFORCEMENT PHILOSOPHY, AUTHORITY, AND APPROACH

The OCC addresses operating deficiencies, violations of laws and regulations (including violations of consumer protection standards), and unsafe or unsound practices at national banks through the use of supervisory actions and civil enforcement powers and tools. National banks and their operating subsidiaries are subject to comprehensive, ongoing supervision that, when it works best, enables examiners to identify problems early and obtain early corrective action. Because of our regular, and in some cases, continuous, on-site presence at national banks, we have the power and ability to promptly halt unsafe or unsound practices or violations of law.

The heart of our enforcement policy[1] is to address problems or weaknesses before they develop into more serious issues that adversely affect the bank's financial condition or its

[1] OCC's Enforcement Action Policy describes the OCC's policy for taking appropriate enforcement action in response to violations of laws, rules, regulations, final agency orders and/or unsafe and unsound practices or conditions, and was publicly released as OCC Bulletin 2002-38.

responsibilities to its customers. Once problems or weaknesses are identified and communicated to the bank, management and the board of directors are expected to correct them promptly. Management's response to addressing problems is an important factor in determining if the OCC will take enforcement action, and if so, the severity of that action. Of course, in the unprecedented market and economic conditions we now face, problems appear and deteriorate far more quickly than in normal times, making them more challenging to address at an early stage.

Even so, our approach permits most bank problems to be resolved through the supervisory process, without having to resort to an enforcement action. Relevant supervisory actions include the issuance of comprehensive Reports of Examination, supervisory directives, and Matters Requiring Attention ("MRAS") tailored to the specific problems existing at the bank.

As an example, during the period from 2004 through 2007, the OCC issued 123 MRAs requiring corrective actions in connection with national banks' residential mortgage lending activities. By the end of 2008, the OCC had determined that satisfactory corrective action had been taken with respect to 109 (88.6%) of those MRAs, and they were closed.

When the normal supervisory process is insufficient or inappropriate to effect bank compliance with law and the correction of unsafe and unsound practices, Congress has provided the OCC with a broad range of potent enforcement tools. For less serious problems, the OCC begins at one end of this enforcement spectrum with informal enforcement actions. In ascending order of severity, informal actions take the form of a commitment letter, memorandum of understanding, or "Part 30 compliance plan." In situations where the bank's capital is impaired, the OCC may also require the bank to submit an acceptable Capital Restoration Plan, or establish

an Individual Minimum Capital Ratio ("IMCR") requiring the bank to achieve and maintain capital levels higher than regulatory minimums.

These informal actions frequently involve specific and detailed steps that the bank must take before the action is terminated. Informal enforcement actions deal with all aspects of bank operations, ranging from asset quality and credit administration to loan review, underwriting, and consumer compliance. Specific areas that affect a bank's safety and soundness that are often addressed through informal actions include articles relating to: loan documentation, credit underwriting, interest rate exposure, asset quality, earnings, management competence, internal controls and management information systems, audit systems, and employee training and staffing. Informal enforcement actions also often address issues relating to compliance with consumer protection laws in all areas of bank operations, such as disclosure of loan terms, protection of consumer financial information, and avoidance of inappropriate lending practices. In the OCC's experience, national banks usually go to great lengths to take the corrective steps necessary to achieve compliance with informal enforcement actions.

This is not universally true, however. In some circumstances, informal action will not be appropriate, such as when the bank has serious problems coupled with less than satisfactory management; there is uncertainty about the ability or willingness of management and the board of directors to take corrective measures; or the underlying problem is severe. In such cases, the OCC can and will take formal enforcement action, as our track record clearly demonstrates. (Unlike informal actions, formal actions are both public and directly enforceable.) Section 8 of the Federal Deposit Insurance Act ("FDI Act"), 12 U.S.C. 1818, gives the FBAs power to require correction of unsafe and unsound practices and compliance with any law, rule, or regulation applicable to banks, including consumer statutes such as the Truth in Lending Act, Fair Housing

Act, Equal Credit Opportunity Act, Real Estate Settlement Procedures Act, and the Federal Trade Commission Act ("FTC Act") – the principal Federal laws that provide protection for consumer credit applicants and borrowers. We also have authority to, and do, enforce applicable state consumer protection laws, such as laws prohibiting unfair and deceptive practices.

For example, in the safety and soundness context, the OCC will either negotiate a Formal Written Agreement or Cease and Desist Order ("C&D") with a bank or will file a Notice of Charges seeking issuance of a C&D order requiring the bank to take appropriate corrective actions. These may include raising capital, increasing liquidity, improving internal controls, divesting troubled assets, or restricting the payment of dividends or bonuses. Where a bank's capital is impaired, the OCC may also issue a Capital Directive or a Prompt Corrective Action ("PCA") Directive, when authorized by law. Similarly, in the consumer protection context, the OCC may issue a Written Agreement or a C&D requiring a national bank to cease engaging in activities that violate the law, and/or to provide restitution to affected consumers.

OCC may also impose civil money penalties on banks and bank-related individuals. In addition, we have the powerful tool of removing or prohibiting individuals from serving as directors, officers, or employees of federally insured depository institutions. OCC also refers cases to DoJ for criminal investigation and prosecution where criminal activity is suspected. Removal and prohibition ("R&P") authority is our most effective tool in dealing with suspected fraud, because an R&P Order is a lifetime ban on the individual working in the banking industry.

Because most bank supervisory issues are resolved informally, the number of public enforcement actions reported on the OCC's website reflects a minority of all types of corrective actions taken by the agency. The following chart reflects the large number of formal (and

informal) enforcement actions brought by the OCC against institutions and individuals during the past several years:

OCC Enforcement Actions

Type of Enforcement Action	**FY 2005**	**FY 2006**	**FY 2007**	**FY 2008**	**FY 2009 through February**
Cease and Desist Orders	23	14	8	21	13
Temporary Cease and Desist Orders	1	2	1	0	0
Bank Civil Money Penalties	11	12	14	10	3
Formal Agreements	27	27	20	54	28
Bank Individual Minimum Capital Ratio Letters	0	0	0	15	32
Memoranda of Understanding	14	16	9	17	15
Commitment Letters	5	7	1	9	6
Prompt Corrective Action Directives	0	0	0	1	0
Safety and Soundness Plans	1	3	1	4	3
Personal Cease and Desist Orders	21	21	29	16	2
Personal Civil Money Penalties	52	41	65	28	5
Suspension Orders	4	0	1	1	0
Removal/Prohibition Orders	24	42	37	32	9
Notifications of Prohibition, Following Conviction for Crimes of Dishonesty	410	232	108	211	70
Letters of Reprimand	15	41	8	13	9
Totals	**608**	**458**	**302**	**432**	**195**

The list of OCC enforcement actions in recent years illustrates the OCC's ability and willingness to take formal actions where warranted to require correction of unsafe or unsound banking practices, and to address unfair treatment of bank customers. As the above chart indicates, during the past 4+ years, the OCC has taken hundreds of enforcement actions against banks and bank insiders. These include hundreds of different types of actions to address a wide range of issues relating to unsafe or unsound practices or conditions, including capital adequacy, liquidity, asset quality, earnings, loan portfolio management, information technology, audit

procedures, internal controls, managerial competence, book and records adequacy, and many other issues. For example, a 2007 Order against a mid-sized bank restricted insider-related transactions with bank senior officers;[2] a 2007 Order against a community bank required it to address capital levels, interest rate risk policy, credit underwriting and external audit deficiencies, and to appoint two new independent directors;[3] and a 2007 Order against a community bank required it to prepare an acceptable strategic plan for the bank, to improve capital levels, to conduct a loan quality review, and to engage an external auditor to review specific accounts associated with questionable lending activity.[4] These cases are illustrative of a very large number of formal actions taken by the OCC during the past several years specifically to address the deteriorating financial condition at some banks; to remedy weaknesses to bank programs, operations and performance; require qualified management; and to ensure that bank management follows safe and sound banking practices.

The OCC has also taken a number of significant formal enforcement actions to protect consumer interests. For example, in 2008, the OCC took an enforcement action directing Wachovia Bank to pay restitution to all consumers harmed by its relationships with third party payment processors for telemarketers who engaged in marketing a range of questionable and worthless products and services, often targeting the elderly. As a result of the OCC's action, in December 2008, the bank issued restitution checks totaling over $150 million to over 740,000 consumers. Our action was based on our findings of unsafe or unsound practices, and unfair practices in violation of Section 5 of the FTC Act. The settlement also required the bank to

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[2] *In the Matter of Commerce Bank, N.A., Philadelphia, Pa.,* OCC No. 2007-065 (June 28, 2007).
[3] *In the matter of The First National Bank of Stratton, Stratton, Colo.,* OCC No. 2007-033 (Apr. 25, 2007).
[4] *In the Matter of The First National Bank of Lindsay, Lindsay, Okla.*. OCC No. 2007-080 (June 19, 2007).

adopt policies and procedures to protect against similar harm, to make a $8.9 million contribution to consumer education, and to pay $10 million in penalties.[5]

The OCC was, in fact, the first FBA to bring an enforcement action based on unfair or deceptive practices within the meaning of the FTC Act. In a groundbreaking case involving Providian National Bank, the OCC asserted violation of Section 5 of the FTC Act as well as California state law – together with our general enforcement authority under the FDI Act – as a basis for issuing a C&D for affirmative remedies including customer restitution, against a national bank. Use of this authority led to a consent order requiring the bank to provide over $300 million to consumers in restitution for deceptive marketing of credit cards and ancillary products; to cease engaging in misleading and deceptive marketing practices; and to take appropriate measures to prevent such practices in the future.[6]

In 2005, the OCC, in joint enforcement actions with HUD, OTS and state insurance regulators, brought an action to enforce Section 4 of RESPA against Chicago Title Insurance Company for misrepresentations in its real estate settlement procedures. Chicago Title was ordered to change its real estate settlement procedures and pay a $5 million civil money penalty.[7]

And also in 2005, the OCC entered into a Formal Agreement requiring Laredo National Bank and its subsidiary, Homeowners Loan Corp., to establish a $14 million fund to reimburse various categories of consumers harmed through their dealings with the bank's mortgage lending subsidiary.[8]

In the area of mortgage fraud, the OCC has issued Orders requiring the payment of millions of dollars in restitution and civil fines as well as prohibition and C&Ds to prevent future

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[5] *In the Matter of Wachovia Bank, N.A., Charlotte, N.C.*, OCC No. 2008-028 (Apr. 24, 2008). At the same time, the OCC also issued guidance to banks on the proper handling of payment processor relationships. Bulletin 2008-12.
[6] *In the Matter of Providian National Bank,* Tilton, N.H., OCC No. 2000-053 (June 28, 2000).
[7] *In the Matter of Chicago Title Insurance Company,* OCC No. 2005-12 (Feb. 24, 2005).
[8] *In the Matter of Laredo National Bank, Laredo, Tex.*, OCC No. 2005-142 (Nov. 3, 2005).

misconduct.[9] Additionally, the OCC has used its enforcement tools against individuals in banks who attempt to benefit from confidential customer data, such as those who steal from bank customers or take customer lists with them when they leave the employment of a bank.[10] Since 2002, the OCC has taken over 100 consumer-related enforcement actions.

II. ENFORCEMENT ACTIONS CONCERNING PROBLEM BANKS

"Problem banks" warrant special special supervisory attention. The OCC has used a combination of enforcement tools to address deteriorating financial conditions at problem banks. Our efforts, and the type and scope of the enforcement actions taken, are designed to remedy various unsafe and unsound practices and violations. The principal problems we encounter here include inadequate capital, illiquidity, inappropriate growth, inadequate loan underwriting, a lack of appropriate internal policies and controls, and ineffective management. The various corrective measures incorporated into our enforcement actions have included requiring the bank to raise additional capital, restrict borrowings, eliminate certain activities and even entire business lines, adopt appropriate underwriting standards and policies to govern lending activities, replace senior officers and members of the board of directors, limit the transfers of assets, and eliminate payments of bonuses or dividends.

As of February 17, 2009, there were 139 3-rated national banks, 35 4-rated national banks, and eight 5-rated national banks -- a total of 182 problem banks. Since February 2008, in only 12 months, there has been a 136 percent increase in the number of problem banks (77 in February 2008 to 182 in February 2009). However, 3-rated banks are not preordained to fall to a

[9] *See, e.g., In the Matter of Tracie B. Hunter, LaSalle Bank Midwest N.A., Troy, Mich.*, OCC No. 2007-098 (Aug. 15, 2007), and related Orders.

[10] *See, e.g., In the Matter of Robert Stevenson,* OCC No. 2008-010 (Feb. 21, 2008).

4 or 5 rating. The supervisory goal, which is achieved for most problem banks, is rehabilitation and return to non-problem status. Deterioration from a 3-rating occurs when the volume and severity of problems increase to a critical level or where the bank, through its board and management, fails to take the appropriate corrective actions. In the present stressed economic conditions, it is not surprising that those stresses are affecting more banks or that some banks are deteriorating more quickly than in more normal times. And it follows that OCC enforcement activities are increasing with the number and severity of problem banks.

The OCC has taken more than 300 informal and formal enforcement actions against banks that, during the past 18 months, have been designated for special supervisory attention as problem banks:

Outstanding OCC Enforcement Actions Against Problem Banks, September 19, 2007, through February 17, 2009

Type of Enforcement Action	**Number of Enforcement Actions**
Cease and Desist Orders	54
Bank Civil Money Penalties	8
Formal Agreements	131
Bank Individual Minimum Capital Ratio Letters	47
Memoranda of Understanding	50
Commitment Letters	23
Prompt Corrective Action Directives	1
Safety and Soundness Plans	11
Total	**325**

As shown in the above chart, we have used a variety of enforcement tools, including Formal Agreements, MOUs, IMCRs, and C&Ds. Each action has been crafted to deal with the specific problems existing at each bank. In some cases we have issued multiple enforcement actions to a single bank. Where a bank's problems have proved insurmountable, as when the

bank has been unable to attract additional capital from private investors, our enforcement actions are designed to prepare the bank for resolution through receivership.

In some problem bank cases, we have used PCA authority in addition to other enforcement tools. PCA categories and the restrictions associated with those categories, including the use of PCA Directives, are driven primarily by a bank's capital levels. Because depletion of capital usually occurs as a result of other deficiencies, capital is often a lagging indicator of problems. Consequently, the OCC generally places a problem bank under an enforcement action well in advance of a decline in capital that would trigger either the issuance of a Notice of Intent to Issue a PCA Directive, or a PCA Directive. In addition, enforcement actions often contain more restrictions and affirmative obligations than would be prescribed under the bank's PCA capital category.

PCA does not eliminate bank failures nor does it ensure such failures result in zero cost to the FDIC insurance fund. However, this doesn't mean that PCA is not working. The OCC has used its PCA authority to dismiss officers and directors from problem banks and to fill gaps between what is contained in the enforcement action and problems that may have developed subsequently. Most important, PCA ensures that problems at banks are addressed earlier, which can sometimes help them avoid failure, and which can also reduce the cost to the deposit insurance fund if failure does occur.

In a number of cases, problem bank enforcement actions have led to our commencing investigations concerning the conduct of bank officials that caused the bank's financial deterioration. The OCC has issued many formal enforcement orders against bank managers and directors who breached their fiduciary duties by failing to effect appropriate and necessary

actions to halt unsafe or unsound activities that resulted in significant risk of loss or actual loss to the bank.

III. OCC COORDINATION WITH OTHER REGULATORY AND LAW ENFORCEMENT AGENCIES

The FBAs regularly share supervisory information and undertake coordinated enforcement actions. As an example, when the OCC issues a remedial enforcement action against a national bank, the Federal Reserve Board will often take a complementary action with respect to the bank's holding company. Pursuant to an interagency sharing agreement, the FBAs regularly exchange documents and information concerning fraudulent activities, including suspicious activity reports that involve suspected illegal activities at multiple financial institutions, and notify each other of enforcement actions against banks and individuals.

We also coordinate extensively with other regulatory agencies and with law enforcement authorities. OCC has entered into similar information sharing agreements with most state banking agencies and all 50 state insurance departments, and we regularly share information with the SEC. We make enforcement referrals to all of these regulators, as well as to state licensing boards and state professional ethics and responsibility boards, with respect to misconduct by attorneys, accountants, real estate agents, appraisers, and other professionals. We also make enforcement referrals and cooperate in investigations conducted by several federal agencies, including, for example, FinCEN,[11] the Department of Labor, IRS, HUD, FEC, and the Federal Trade Commission, with whom OCC recently entered into an information-sharing agreement to

[11] Pursuant to an interagency agreement, OCC provides information to FinCEN concerning all significant violations of the Bank Secrecy Act ("BSA") detected during our examinations. In addition, the two agencies coordinate enforcement efforts, and often take simultaneous actions against a bank to impose appropriate civil money penalties for BSA violations.

enhance the ability of both agencies to pursue activities of fraudulent payment processors and telemarketers.

When we find suspected criminal violations, including evidence of fraud, we refer such matters to the DoJ. We often coordinate with and assist the DoJ, the FBI, and the Secret Service in their investigations and prosecutions of fraud, as appropriate, by providing OCC examiners to serve as special agents to the grand jury and as expert banking witnesses for the prosecution at trial. As just one example, in addition to our own enforcement actions involving unsafe and unsound practices by senior officials at Hamilton Bank, N.A., Miami, Florida, we provided information to assist the SEC in its taking several of its own enforcement actions, and OCC examiners testified for the DoJ in the criminal trial that resulted in fraud convictions and a 30-year sentence against the former Chairman of the Board – one of the longest sentences ever imposed for a white-collar crime.

OCC is an original member of the National Interagency Bank Fraud Working Group ("BFWG"), which is chaired by DoJ, participates in BFWG subcommittees on Mortgage Fraud and Payment Processor Fraud, and belongs to the President's Corporate Fraud Task Force, all of which serve to coordinate the government's response to fraud in the financial services industry.

IV. OCC SUPERVISORY AND ENFORCEMENT ACTIVITIES REGARDING MORTGAGE LENDING PRACTICES

Abusive lending practices by mortgage lenders and brokers and the current foreclosure crisis understandably have raised questions about the role and effectiveness of bank regulators in anticipating and preventing mortgage lending abuses. This area represents a good example of how we apply our comprehensive approach to supervision and enforcement.

First, it is important to be clear about who did what. The OCC extensively regulates the mortgage business of national banks and their subsidiaries. As a result of the standards applied by the OCC, national banks were not significant originators of subprime loans. The vast bulk of such loans were originated by non-depository institution mortgage lenders and brokers that were subject to a significantly less rigorous system of oversight and examination. Non-depository institution mortgage providers originated the overwhelming preponderance of subprime and "Alt-A" mortgages during the crucial 2005-2007 period, and the loans they originated account for a disproportionate percentage of defaults and foreclosures nationwide, with glaring examples in the metropolitan areas hardest hit by the foreclosure crisis. It is these lenders and brokers that have been widely recognized as the overwhelming source of abusive subprime mortgages resulting in waves of foreclosures. Reflective of the practices used by those non-bank lenders, nearly one-half of the mortgages they originated in some major markets are in foreclosure. As the 2007 Report of the Majority Staff of the Joint Economic Committee recognized, "[s]ince brokers and mortgage companies are only weakly regulated, another outcome [of the increase in subprime lending] was a marked increase in abusive and predatory lending."[12]

The OCC has been aggressive in combating abusive lending practices and in preventing national banks from engaging in such activities. The OCC was the first FBA to issue comprehensive anti-predatory lending guidance and regulations. In 2000, we issued advisory letters on payday loans, title loans, and abusive lending practices designed to prevent national banks and their subsidiaries from engaging in lending practices that were unfair and deceptive. In 2002, we issued comprehensive guidance on unfair and deceptive practices, and separate guidance instructing our examiners to address risks associated with subprime mortgage products.

[12] MAJORITY STAFF OF THE JOINT ECONOMIC COMMITTEE, 110TH CONG., REPORT AND RECOMMENDATIONS ON THE SUBPRIME LENDING CRISIS: THE ECONOMIC IMPACT ON WEALTH, PROPERTY VALUES AND TAX REVENUES, AND HOW WE GOT HERE 17 (OCTOBER 2007).

In 2003, we issued two advisory letters outlining our expectations for conducting mortgage lending free from predatory or abusive practices. Among other things, these advisory letters provided detailed recommendations for establishing policies and procedures to help ensure that national banks do not become involved in predatory practices in any of their mortgage lending activities, including in loans made through brokers.[13]

In 2004, the OCC issued a rule prohibiting national banks from making loans based on liquidation of a borrower's collateral rather than the borrower's ability to repay.[14] And in 2005 the agency issued "Guidelines Establishing Standards for Residential Mortgage Lending Practices,"[15] based on the anti-predatory lending principles of our 2003 supervisory guidance. These formal Guidelines may be enforced under provisions of the FDI Act.

In October 2006, the OCC and the other FBAs each issued final guidance on nontraditional mortgages, targeting "interest-only" mortgages, in which a borrower makes no principal payments for the first several years of the loan; and "payment option" adjustable-rate mortgages, in which a borrower has several payment options each month, including one with the potential for negative amortization, which results in a portion of the interest due being deferred and added back to a rising loan balance. In conjunction with this guidance, the FBAs also issued illustrations of the type of information that should be provided to consumers regarding these nontraditional mortgages, emphasizing the importance of providing the information in a concise manner and format.

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[13] OCC Advisory Letter 2003-2 (Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices), February 21, 2003; and OCC Advisory Letter 2003-3 (Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans), February 21, 2003.

[14] 12 C.F.R. 34.3. *See also* 12 C.F.R. 7.4008 (establishing similar limitations on other lending activities by national banks).

[15] 12 C.F.R. Part 30, Appendix C.

In April 2007, the FBAs jointly released a statement encouraging all financial institutions to work with borrowers who may be unable to meet contractual payment obligations on loans secured by their primary residences. The agencies encouraged financial institutions to consider prudent workout arrangements that increase the potential for financially stressed residential borrowers to keep their homes.

Further, in July 2007, the FBAs issued detailed guidance on subprime mortgage lending, developed to address underwriting and consumer protection issues and questions related to certain subprime mortgage products and lending practices. The agencies were particularly concerned with so called "2/28", "3/27", and similar ARMs that expose borrowers to significant payment shock once introductory interest rates expire. The statement sets forth the regulators' expectations for sound lending practices and clear communications with borrowers. It also emphasizes that institutions should verify and document a borrower's income, assets, and liabilities, and that reduced documentation should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. The statement provides regulators' expectation that an institution should evaluate a borrower's ability to repay a debt by its final maturity at its fully-indexed interest rate. It further provides that prepayment penalties should not extend beyond initial interest-rate reset periods, and that borrowers should have a reasonable period prior to the reset date to refinance their loans without penalty. As with the agencies' guidelines on nontraditional mortgages, we provided illustrations of consumer disclosures related to subprime ARMs. Further, in May 2008, the OCC issued a Consumer Advisory warning homeowners how to avoid foreclosure "rescue" scams perpetrated by con

artists who take advantage of people who have fallen behind on their mortgages and face foreclosure.[16]

While these statements were issued as agency "guidance," compliance with their provisions is not optional for national banks. The OCC examines banks for compliance, including the numerous interagency statements and advisory letters issued concerning subprime and non-traditional mortgages. Such guidance helps define for the banking community what are considered to be safe and sound banking practices. Thus, deviation from agency guidance, depending on the scope and severity, will result in a range of supervisory and enforcement responses by the OCC.

As previously noted, the OCC has also taken many formal enforcement actions to combat mortgage fraud. Most recently, these included a prohibition Order and civil money penalty assessed against a bank vice president who facilitated the use of a straw borrower and false documents to obtain a mortgage;[17] a C&D against a bank loan officer and a bank manager who participated in a scheme to make false representations concerning the financial condition of loan applicants;[18] prohibition Orders, civil money penalty assessments and a requirement to pay $460,375 in restitution against a bank loan officer and a mortgage processor who submitted false applications on behalf of 64 low-income, first-time homebuyers to purchase homes from a property "flipper";[19] and, in conjunction with actions taken by DoJ and the Federal Housing Administration ("FHA"), various enforcement Orders, including a $6.25 million civil money penalty, against a bank, its mortgage subsidiary and ten former employees, for submitting loans to HUD for FHA insurance without proper review and certifications by appropriate

[16] "OCC Consumer Tips for Avoiding Foreclosure Rescue Scams," CA 2008-1, May 16, 2008.
[17] *In the Matter of David S. Eisenberg,* OCC No. 2008-128 (Oct. 20, 2008).
[18] *In the Matter of Gregory Bobb,* OCC No. 2009-009 (Feb. 4, 2009).
[19] *In the Matter of James Serratore,* OCC No. 2007-051 (Feb. 26, 2007).

underwriters.[20] OCC continues to be active on mortgage fraud issues, through our own enforcement processes and in conjunction with inter-agency efforts in this important area.

CONCLUSION

As a result of the financial crisis, national banks large and small are grappling with many different types of stresses and challenges. At the OCC, we will continue to use the broad range of supervisory and enforcement tools we have available to remedy problems and appropriately sanction abuses.

[20] *In the Matter of ABN AMRO Mortgage Group, Inc., LaSalle Bank Midwest, N.A., Troy, Mich.*, OCC No. 2005-162 (Dec. 12, 2005).

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Statement of

Elizabeth A. Duke

Member

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

March 20, 2009

Chairman Frank, Ranking Member Bachus, and members of the Committee, I want to thank you for the opportunity to discuss the Federal Reserve Board's ongoing efforts to address and prevent mortgage-related fraud and abusive lending practices in the institutions we supervise.

While the expansion of the subprime mortgage market over the past decade increased consumers' access to credit, too many homeowners and communities are suffering today because of lax underwriting standards and other unfair or deceptive practices that resulted in unsustainable loans. The Federal Reserve is committed to improving consumer protections and promoting responsible lending practices through each of the roles we play as supervisor for safety and soundness and consumer compliance, and as rulewriter.

I will discuss the Federal Reserve's ongoing efforts as a banking supervisor to ensure that the institutions we supervise are managing their mortgage lending activities in a safe and sound manner and in compliance with laws and regulations. I will also discuss the rules and guidance that have been issued over the past several years that address many of these issues. In addition to our own examination and enforcement activities, I will talk about our ongoing efforts to coordinate with other law enforcement agencies to hold those who are involved in criminal activities in our supervised institutions accountable.

The Federal Reserve's enforcement efforts begin with the examination of its supervised institutions. The Federal Reserve conducts regular examinations of state member banks for both safety and soundness and compliance with consumer protection laws. We also conduct regular inspections of bank holding companies. We examine the mortgage businesses of these institutions, including subprime residential portfolios, as applicable.

Institutions with weaknesses are expected to take corrective actions that include improving their risk management and underwriting practices in the future. In those rare instances where the bank is not willing to address the problem, we have and use a full range of powerful enforcement tools to compel corrective action. To ensure that banks with performance deficiencies give appropriate attention to supervisory concerns, we may require them to enter into nonpublic enforcement actions, such as memoranda of understanding. When necessary, we use formal, public enforcement actions, such as Written Agreements, Cease and Desist Orders, or civil money penalties.

Mortgage Fraud and Investigations

In recent years, there has been a significant increase in suspected criminal activity with respect to mortgage fraud and other mortgage-related criminal activity. Mortgage fraud occurs in various ways. In many cases mortgage fraud is perpetrated against the financial institution by brokers, appraisers, and other third parties. In other situations fraud is perpetrated by insiders of the institution. As I will discuss further, there are other abusive practices that occur in mortgage lending that harm borrowers and the safety and soundness of financial institutions.

The Suspicious Activity Reports (SARs) that banking organizations are required to file reveal significant suspected mortgage fraud activity. As recently reported by FinCEN, there is a continuing upward trend of SARs filed by depository institutions involving suspected mortgage loan fraud.[1] From July 1, 2007, through June 30, 2008, depository institutions filed a total of 62,084 SARs reporting suspected mortgage loan fraud. This represents an increase of 44 percent in SARs involving mortgage fraud compared with the prior year. During the reporting period, mortgage loan fraud was the third most reported activity in SARs. The top 25 filing institutions of mortgage loan fraud SARs submitted 82 percent of the total 62,084 SAR filings. SARs

[1] FinCEN, Filing Trends in Mortgage Loan Fraud, February 25, 2009

alleging mortgage fraud involve numerous varieties of conduct from large-scale multi-million-dollar "straw borrower" and property flipping schemes to single incidents of overstated income or assets by individual borrowers.

Federal Reserve staff regularly review SARs filed by the financial institutions the Fed supervises. When bank insiders may be involved, we initiate investigations, make referrals to law enforcement, coordinate with law enforcement and other regulatory agencies, and pursue enforcement actions against individuals, including seeking prohibition orders and, in appropriate cases, civil money penalties and restitution. We are pursuing numerous investigations involving insiders relating to possible mortgage-related fraud, both commercial and residential. The Federal Reserve has established a Federal Reserve System examiner group to share information on the detection of fraud and pending investigations. On the local level, Reserve Bank staff also interacts with representatives from law enforcement, the Federal Bureau of Investigation, the Internal Revenue Service, and other agencies in SAR "review teams" to review SARs and coordinate actions. These meetings provide an opportunity to share information about criminal activities, including mortgage fraud, occurring within the district.

The Federal Reserve regularly coordinates with law enforcement in a number of ways. Staff participates in monthly interagency meetings led by the U.S. Department of Justice (DOJ) Fraud Section and attended by other law enforcement and regulatory agencies. This interagency group, the "Bank Fraud Working Group," discusses and shares information on recent cases, trends, and other issues, including mortgage fraud.

Supervision Examinations and Enforcement

In the Federal Reserve's regular safety and soundness examinations of state member banks and bank holding companies, we evaluate risk-management systems, financial condition,

and compliance with laws and regulations. In assessing a bank's risk management systems for its mortgage lending activity, examiners evaluate the adequacy of the bank's practices to identify, manage, and control credit risk. This includes the appropriateness of the bank's underwriting standards, credit administration, quality control processes over its own originations and third-party originations, and appraisal and collateral valuation practices.

To assist institutions in understanding our supervisory expectations, the Federal Reserve has supplemented its long-standing guidelines on safe and sound real estate lending practices by joining the other federal bank regulatory agencies in issuing additional guidance on mortgage lending practices.

Specifically, starting in 2005, the Federal Reserve and the other federal agencies observed that lenders were increasingly originating nontraditional mortgage loans that lacked principal amortization and had the potential for negative amortization. We were also concerned about the growing use of adjustable rate mortgage products with "teaser" rates that adjust to a variable rate plus a margin for the remaining term of the loan, in addition to other risky characteristics. These products could result in payment shock to borrowers, and present heightened risks to lenders and borrowers. Moreover, the easing of underwriting standards and the marketing of these products to lower credit quality borrowers, including those purchasing investment properties, held the potential to create significant risks for institutions and for borrowers.

To address those concerns and prevent supervised institutions from making unaffordable mortgage loans, the Federal Reserve and the other federal banking agencies issued the *Interagency Guidance on Nontraditional Mortgage Products Risks* in 2006 and the *Interagency Statement on Subprime Mortgage Lending* in 2007. The nontraditional mortgage guidance

highlights sound underwriting procedures, portfolio risk management, and consumer protection practices that institutions should follow to prudently originate and manage mortgage loans with payment option and interest-only features. A key aspect of both statements is the recommendation that a lender's analysis of repayment capacity should include an evaluation of the borrower's ability to repay debt. The subprime guidance emphasizes the risks of stated income or reduced documentation loans in the subprime sector. Further, the subprime guidance outlines certain practices that are considered predatory in nature and stipulates that institutions should not engage in these practices regardless of loan features.

Also, in 2005 the Federal Reserve and the other banking agencies issued the *Interagency Guidance on Independent Appraisal and Evaluation Functions*. This statement reinforces the importance of appraiser independence from the loan origination and credit decision process to ensure that valuations are fairly and appropriately determined. Independence has been a core principle in the Board's appraisal regulation and guidance, which have been in place since the early 1990s. When we examine a bank's real estate lending activities, examiners consider the adequacy of the appraisal function to ensure that it complies with the appraisal regulation and has appropriate risk management practices. A strong appraisal function is essential to combating the potential for mortgage fraud by protecting the collateral valuations from influence by individuals whose intent is to deceive the lender about the condition and value of the collateral. The agencies took steps to further strengthen their guidance in this area by proposing interagency appraisal and evaluation guidelines last November.

More recently, the collapse of the global credit market, triggered by the end of housing booms in the United States and other countries and the associated problems in mortgage markets, has led to a deterioration of asset values and credit conditions. As a result, financial institutions

have incurred losses that in and of themselves have caused financial institutions to tighten credit underwriting standards to ensure that borrowers have the capacity to repay. Furthermore, sweeping new rules issued by the Board under its authority in the Home Ownership and Equity Protection Act (HOEPA) will further ensure that mortgage lenders that offer high-cost mortgages have appropriate practices to ensure consumers can repay their loans.

Consumer Compliance Examination and Enforcement

The Federal Reserve conducts regular examinations of state member banks to evaluate compliance with consumer protection laws, the fair lending laws, and the Community Reinvestment Act. These examinations are conducted by a specially trained cadre of examiners for the approximately 875 banks we supervise. The Board has a long-standing commitment to ensuring that every bank it supervises complies fully with federal financial consumer protection laws, including the fair lending laws. The scope of these examinations includes a review of the bank's compliance with the Truth in Lending Act, the Real Estate Settlement Procedures Act, the Home Mortgage Disclosure Act, the Equal Credit Opportunity Act (ECOA), the Community Reinvestment Act, and other federal consumer protection laws.

One objective of our consumer compliance examination program is to identify compliance risks at banks before they harm consumers and ensure that state member banks have appropriate controls in place to manage those risks. In conducting a consumer compliance examination at a state member bank, examiners review the commitment and ability of bank management to comply with consumer protection laws as well as the bank's actual compliance with such laws. Examinations follow a risk-focused approach tailored to fit the risk profile of the bank. This approach directs supervisory attention and resources to the products, services, and areas of the bank's operations that pose the greatest risk to consumers. Our examiners

prepare a stand-alone consumer compliance examination report bearing a distinct consumer compliance rating for each state member bank we supervise. These confidential reports include an evaluation of the bank's compliance management program, a summary of the fair lending review, and a discussion of violations of consumer laws and regulations.

When examiners identify banks with weak and ineffective compliance programs, they document the weaknesses in the examination report and take appropriate supervisory action. Banks with a poor record of compliance are examined more frequently than those with favorable records. When necessary to obtain compliance with consumer protection laws, we can, and do, use our enforcement tools, ranging from nonpublic actions to public Cease and Desist Orders. However, most banks voluntarily address any violations and weaknesses in consumer compliance management programs that our examiners identify so we find public formal actions are not typically necessary.

Important tools for examiners and financial institutions are guidance and examination procedures for enforcing the Federal Trade Commission Act's prohibition of unfair or deceptive acts or practices. The *Unfair or Deceptive Acts or Practices by State-Chartered Banks* issued by the Board and the FDIC in 2004 outlines strategies for banks to use to avoid engaging in unfair or deceptive acts or practices, to minimize their own risks and to protect consumers. Among other things, the guidance focuses on loan servicing and managing and monitoring creditors' employees and third-party service providers.

The Federal Reserve's consumer compliance supervision authority extends to bank holding companies as well as to state member banks. In recent years, banking organizations have greatly expanded the scope, complexity, and innovation of their business activities. At the same time, compliance requirements associated with these activities have become more complex.

To assist financial institutions in addressing these challenges, the Federal Reserve recently issued guidance in 2008 clarifying its expectations regarding firm-wide compliance risk management and oversight for both prudential and consumer protection supervision in *Complex Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles*. Further, Federal Reserve consumer compliance examiners routinely participate in the review and assessment of the adequacy of large bank holding company compliance risk management programs.

In addition to its own supervisory efforts related to bank holding companies, the Federal Reserve, along with the Office of Thrift Supervision, the Federal Trade Commission, and a number of state authorities, recently completed a pilot consumer protection compliance review as part of an interagency project to enhance the supervision of subprime mortgage lenders. Under the pilot project, the agencies coordinated to conduct consumer-protection compliance reviews at selected entities with significant subprime mortgage operations. The reviews included independent state-licensed mortgage lenders, nondepository mortgage lending subsidiaries of bank and thrift holding companies, and mortgage brokers doing business with or serving as agents of these entities. These reviews included targeted evaluations of mortgage underwriting standards, risk management strategies, and compliance with certain consumer protection laws. We are currently assessing the results of the pilot project. The results will guide the Board's decisionmaking as to how it may supervise these entities in the future.

Focus on Fair Lending Enforcement

Although the Federal Reserve's fair lending enforcement program is not intended to detect mortgage fraud, it is a vital component of the Federal Reserve's efforts to ensure fair access to responsible credit. The Federal Reserve is committed to ensuring that every bank it

supervises complies fully with the federal fair lending laws, the ECOA and the Fair Housing Act. Every consumer compliance examination includes an evaluation of the bank's fair lending compliance program, as well as an assessment of the bank's fair lending risk across all types of lending, including mortgage lending. Examiners also test the institution's actual lending record for specific types of discrimination, such as pricing discrimination in mortgage lending. A specialized Fair Lending Enforcement Section on the Board's staff works closely with staff at the 12 Reserve Banks across the country to provide guidance on fair lending matters and to ensure that the fair lending laws are enforced rigorously.

When examiners find fair lending violations, the Board takes appropriate supervisory action. If we have reason to believe that an institution has engaged in a pattern or practice of discrimination under the ECOA, the Board, like other federal banking agencies, has a statutory responsibility under the Act to refer the matter to the DOJ, which reviews the referral and decides if further investigation is warranted. A DOJ investigation may result in a public civil enforcement action or settlement. The DOJ may instead return the matter to the Federal Reserve for administrative enforcement. When this occurs, we ensure that the institution takes all appropriate corrective action. If a fair lending violation does not constitute a pattern or practice, we similarly ensure that the bank takes all appropriate corrective action.

In carrying out our supervisory responsibilities related to fair lending, Federal Reserve examiners perform many reviews to detect pricing discrimination, redlining, and steering in mortgage lending. These illegal practices can limit fair access to responsible credit, and make it more likely that minorities will fall prey to potentially abusive lending practices. Several of these reviews have resulted in referrals to the DOJ. In the past three years, we have referred

fifteen matters to the DOJ and four of these matters have involved illegal discrimination in mortgage lending based on race or ethnicity.

The Board referred two nationwide mortgage lenders to the DOJ because we determined that Hispanic and African-American borrowers paid more for their loans than comparable non-Hispanic white borrowers. These reviews resulted from a process of targeted reviews for mortgage pricing discrimination that the Federal Reserve initiated when the mortgage pricing data became available under the Home Mortgage Disclosure Act. We also referred a lender for imposing a restriction on rowhouse lending that resulted in discrimination against African Americans. Finally, we referred a lender for redlining. The lender's marketing strategy was based on negative racial stereotypes and, as a result, excluded a cluster of minority neighborhoods from its lending activity.

Rules Banning Unfair and Deceptive Practices

In addition to our supervisory activities, the Federal Reserve Board in 2008 finalized sweeping new rules for home mortgage loans to better protect consumers and facilitate responsible residential mortgage lending. The rules, which amend Regulation Z (Truth in Lending), were adopted under HOEPA, and prohibit unfair, abusive or deceptive home mortgage lending practices and restrict certain other mortgage practices. Importantly, the rules apply to all mortgage lenders, not just depository institutions supervised by the federal banking and thrift regulators. These rules resulted from a series of field hearings conducted by the Board in 2006 and 2007 and a review of approximately 4,500 comment letters representing a broad spectrum of views that were received in response to the Board's proposed rule issued in December 2007.

The final rule adds four key protections for a newly defined category of "higher-priced mortgage loans" secured by a consumer's principal dwelling. The higher-priced thresholds

adopted by the Board would cover all, or virtually all, of the subprime market and a portion of the Alt-A market. For loans in this category, these protections will prohibit a lender from making a loan without regard to a borrower's ability to repay the loan from income and assets other than the home's value. Second, lenders are prohibited from making "stated income" loans and are required in each case to verify the income and assets they rely upon to determine borrowers' repayment ability. Third, the rules restrict the use of prepayment penalties in cases where the borrower could encounter payment shock. Finally, creditors are required to establish an escrow account for property taxes and homeowner's insurance for all first-lien mortgage loans.

In addition to rules for higher-cost loans, the Board adopted other protections that apply to all mortgage loans secured by a consumer's principal dwelling, regardless of the cost. The rules prohibit lenders or brokers from coercing, influencing or otherwise encouraging an appraiser to misstate or misrepresent the value of the property. The rules also prohibit, among other things, servicers from engaging in certain unfair practices.

I note that the Board is working on another important rulemaking action with other federal agencies and state organizations to implement the registration requirements for residential mortgage loan originators employed by federally supervised institutions, as required by the S.A.F.E. Mortgaging Licensing Act of 2008 (SAFE Act). The SAFE Act, when implemented, will provide for increased accountability and tracking of loan originators in a publicly accessible database. Under the SAFE Act, an individual is prohibited from engaging in loan origination without obtaining and maintaining annually a unique identifier and either a license and registration as a state-licensed loan originator or a registration as a federal loan originator.

Prevention and Future Challenges

The Federal Reserve will continue to take actions against institutions that violate consumer protection or fair lending laws, engage in unfair or deceptive practices, or otherwise engage in unsafe or unsound lending practices. We will continue to focus on strong supervision to prevent the occurrence of these practices and violations. In addition to our own examination and enforcement activities, we will continue our efforts to coordinate with other law enforcement agencies to hold those who are involved in our supervised institutions accountable for criminal activities related to mortgage lending.

Again, I want to thank you for the opportunity to discuss what the Federal Reserve does to address and prevent mortgage-related fraud and abusive lending practices in the institutions we supervise.

Testimony before the House Financial Services Committee
William F. Galvin, Secretary of the Commonwealth Of Massachusetts
March 20, 2009

Chairman Frank, Ranking Member Bacchus, members of the Committee, I am pleased to have this opportunity to testify on the crucial role of state securities regulators in financial regulation and investor protection.

As Secretary of the Commonwealth of Massachusetts, I am an elected constitutional officer, and as head of the Massachusetts Securities Division, I am the chief securities regulator for Massachusetts.

The Securities Division regulates to protect investors and promote confidence in the securities markets. The Division carries out these goals through a vigorous program of investigations and enforcement.

In the United States, securities are regulated by the Securities and Exchange Commission and by states securities agencies in a system of complementary regulation. This is consistent with our federal system. Concurrent state and federal regulation over securities allows regulators at different levels of government to work together, and it permits each regulator to serve as a backstop in case the other regulator is not acting to protect investors.

THE STATES HAVE A STRONG RECORD OF EFFECTIVE SECURITIES REGULATION

Massachusetts, along with other states, has been at the forefront in bringing enforcement actions to protect investors. These include:

- Actions against brokerages using bogus stock analyst reports to entice customers to buy low-value stocks and debt securities;[1]

[1] *In the Matter of Credit Suisse First Boston Corporation*, Docket No. E-2002-41 (Mass.

- Cases against mutual fund companies that illegally facilitated "market timing" trades;[2]
- Actions against abusive sales of variable annuities;[3]
- Actions against the use of spurious "senior credentials" to sell inappropriate investments to older investors;[4]
- Actions against unsuitable sales and fraudulent practices in the sale of auction-rate securities to retail and municipal investors;[5]
- Investigations and actions against pyramid schemes, including the Madoff scheme, and their feeder-funds; and
- Several hedge fund cases.[6]

The Massachusetts Securities Division has acted promptly and decisively to protect the interests of investors, particularly retail investors. While the Division does not have criminal enforcement powers, we use civil enforcement to implement strong and effective remedies against violators.

Sec. Div. 2002). *In the Matter of Merrill, Lynch, Pierce, Fenner & Smith Inc.*, Docket No. 2008-0058 (Mass. Sec. Div. 2008). The *Merrill Lynch* matter involved the use of research reports to inappropriately misstate the nature of auction rate securities and the overall stability of the auction market. Massachusetts, with the assistance of the North American Securities Administrators Association and the SEC, negotiated a refund to investors in excess of $10 billion.

[2] *In the Matter of Putnam Investment Management, Inc., et al*, Docket No. 2003-061 (Mass. Sec. Div. 2003); *In the Matter of Prudential Securities, Inc.*, Docket No. 2003-0075 (Mass. Sec. Div. 2003).

[3] *In the Matter of Citizens Investment Services Corp.*, Docket No. E-2004-0050 (Mass. Sec. Div. 2005).

[4] *In the Matter of Investors Capital Corp.,* Docket No. E-2005-0190 (Mass. Sec. Div. 2006).

[5] *In the Matter of UBS Securities, LLC and UBS Financial Services, Inc.*, Docket No. 2008-0045 (Mass. Sec. Div. 2008) *In the Matter of Merrill, Lynch, Pierce, Fenner & Smith Inc.*, Docket No. 2008-0058 (Mass. Sec. Div. 2008).

[6] *See*, for example, *In the Matter of River Stream Fund & Michael Carroll Regan*, Docket No. E-2008-0034.

Fines and Restitution

Massachusetts and other states have negotiated substantial refunds for investors and imposed significant fines against violators. Massachusetts was the lead state in three auction-rate securities cases that ended with settlements that will return $33.9 billion to investors. The states' combined efforts in these cases will bring back $61.3 billion, to date, to investors across the country.

The Securities Division also participated in cases that saw investors receive $10,697,004 in 2008. In fiscal year 2008 the Securities Division imposed fines of $4,776,323.

Other state settlements include:

- Over $50 billion in customer refunds, including over $19 billion paid by UBS Securities, LLC, in settlements with state and federal regulators of auction-rate securities cases ;[7]
- Over $150 million in restitution nationwide, and a fine of $50 million, paid by Putnam Investment Management in the settlement with state and federal regulators of a major case on market timing of mutual fund shares;[8]
- A global settlement by state and federal regulators of cases involving tainted stock ratings and research analysts. The firms involved paid a total of $875 million in penalties and disgorgement, over $432 million to fund independent research, and $80 million for investor education.[9]

Other Sanctions

State enforcement powers go beyond monetary sanctions. The Securities Division has revoked the licenses of serious violators in order to drive them out of the

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[7] *In the Matter of UBS Securities LLC and UBS Financial Services, Inc.*, Docket No. 2008-0045 (Mass. Sec. Div. 2008)

[8] *In the Matter of Putnam Investment Management, Inc., et al.*, Docket No. E-2003-61 (Mass. Sec. Div. 2003).

[9] See, SEC Fact Sheet on Global Analyst Research Settlements, May 28, 2003, www.sec.gov/news/speech/factsheet.htm

securities business. When appropriate, we refer cases to local, state, and federal prosecutors.

Even in enforcement cases that have been settled, Massachusetts has, in appropriate instances, required financial firms admit to the facts alleged against them, instead of merely reciting that the firm neither admits nor denies the facts alleged. This prevents such firms from treating violations of law as simply business as usual.

GIVE STATE REGULATORS THE TOOLS TO PROTECT INVESTORS

I ask this Committee and the Congress to give the states the tools we need to maintain and enhance our ability regulate effectively and protect investors.

The Impact of NSMIA Preemption

The National Securities Markets Improvements Act of 1996 ("NSMIA")[10] removed state regulatory authority over mutual funds, most private offerings of securities, and over large investment advisers. However, the states retain enforcement jurisdiction over fraud in those areas.

Restore Full Enforcement Authority over Federally Registered Investment Advisors

Since the adoption of NSMIA, jurisdiction over investment advisers has been split between the federal government and the states, with the SEC regulating large investment advisers and the states regulating the smaller advisers (which have less than $25 million to $30 million under management). As a consequence of this split in

[10] Public law 106-102, 113 Stat. 1338, enacted November 12, 1999.

jurisdiction, the states can only pursue federally registered advisers for fraud, and not for other violations of regulatory rules. I ask that the Congress restore the states' power to act against federally registered investment advisers for other types of violations, including for "dishonest and unethical business practices."

Reverse Limitation of State Rescission Remedy Under the Federal Arbitration Act

The state securities acts permit the states to impose a range of remedial sanctions against violators, including, civil fines, license suspensions, and requiring that violators make rescission (repayment) to investors for violations of law.[11] These sanctions give the states the tools they need to punish and deter violations, and to recover money for defrauded investors.

The rescission remedy is particularly important because it hits violators in the pocketbook, and it helps make investors whole. Unfortunately, several court decisions have held that the Federal Arbitration Act (the "FAA") preempts the states' ability to order rescission for securities law violations.[12] These cases hold that the rescission remedy is preempted under the FAA because arbitration is the sole mechanism for investors to recover their losses.[13]

We strongly dispute these decisions, which ignore the remedial and deterrent

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[11] See, for example, Section 407A(a) of Mass. General Law, Chapter 110A, the Mass. Uniform Securities Act.

[12] See, *Olde Discount v. Tupman*, 1 F.3d 202 (3d Cir. 1993) In *Olde Discount*, the court enjoined the Delaware Securities Commissioner from seeking rescission for investors in an administrative case because the investors had agreed to seek such relief exclusively through arbitration; the court held that the state of Delaware was preempted even though it was not a party to the arbitration agreement between brokerage and its customers.

[13] Virtually every investor in the United States signs a customer agreement that requires the customer to take any dispute with the brokerage –including allegations of fraud –to securities industry arbitration, rather than to court.

purpose of state-ordered rescission. We urge Congress to amend the Federal Arbitration Act to clarify that it does not preempt the states from ordering securities law violators to make rescission to their victims.

Make Broker-Dealer Firms Subject to Fiduciary Standards, Not Just Arm's-Length Dealing with Customers

Under current law, broker-dealer firms deal with their customers on an arm's-length basis, subject to an obligation of fair dealing.[14] This means that customers cannot rely on their brokers to meet fiduciary obligations of loyalty, care, and competence. In contrast to brokers, investment advisers work solely for their customers, and have an acknowledged fiduciary duty to them.

Brokerages like to have this issue both ways --among other practices, they frequently give their salespeople the title "financial advisor." This term blurs the nature of the firm's relationship with its customer by making the broker appear to be an investment adviser. However, when a dispute arises between the customer and the broker, the brokerage will strongly assert that it does not work for the customer, but instead has only an arm's-length relationship with that customer.

The Securities Division has seen examples of brokerages dealing unfairly and improperly with customers. Unfortunately, we have also witnessed customers who recover little or nothing for their losses due to the pro-industry arbitration system, and due to the fact that brokers are not considered fiduciaries. This system must be changed. I urge the Committee and the Congress to require that brokerages be in a fiduciary relationship to their customers, at least with respect to individual retail customers.

[14] See, for example, FINRA Manual, IM-2310-2, Fair Dealing with Customers.

PROBLEMS ON THE HORIZON

- With several large brokerages going bankrupt and industry-wide layoffs, many former agents of broker-dealer firms are likely to become affiliated with brokerages that have a decentralized structure. Such firms treat each office, which may be as small as one person, as a branch office of the firm. We have seen instances where the firm's office of supervisory jurisdiction is far from the branch offices, sometimes in a different state. Such brokerage firms have a history of inadequately supervising their selling persons, and they have a track record of sales practice violations. Any such change in the industry will require federal and state regulators to be vigilant about these firms.
- Layoffs in the securities industry may lead some brokers to act as unregistered securities salespeople, sometimes called investment "finders." Many fraudulent private offerings have involved finders. It has been suggested that the SEC should exempt finders from federal jurisdiction, and then leave the issue to the states. Such an approach would inappropriately saddle the states with this widespread problem. Instead, state and federal regulators should work together to police this area and assure that anyone acting as a broker is properly licensed.
- Layoffs in the securities industry may be accompanied by cuts in brokerage firms' compliance budgets. We are concerned that such cuts will lead to a lack of adequate oversight at financial firms.
- Many hedge funds are liquidating because their investment strategies did not work and because the advisors anticipate they will not receive an incentive share of fund profits for years to come. We can expect many of the people who ran and

advised the last generation of hedge funds to set up new funds and start again. Unless regulation of hedge funds is significantly improved, we can expect to see a replay of past problems, which include: high fees, a general lack of transparency, anonymity of the principals of the funds, and a disturbing level of trading and sales practice abuses. I ask the Committee and the Congress to take steps to make hedge funds more transparent and their activities more visible.

- American households now rely on mutual funds to help fund retirement costs. Because so many retail investors have their savings in mutual funds, I urge the Committee and the Congress to give mutual funds appropriate scrutiny. No topic or type of investment should be off the table as the Congress enacts regulatory reform and improvements to investor protection.

Thank you for this opportunity to testify on these important issues. I welcome your questions.

Department of Justice

STATEMENT OF

RITA GLAVIN
ACTING ASSISTANT ATTORNEY GENERAL
CRIMINAL DIVISION
UNITED STATES DEPARTMENT OF JUSTICE

BEFORE THE

UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

HEARING ENTITLED

"FEDERAL AND STATE ENFORCEMENT OF FINANCIAL CONSUMER AND INVESTOR PROTECTION LAWS"

PRESENTED

MARCH 20, 2009

Good morning Mr. Chairman and members of the Committee. Thank you for your invitation to address the Committee concerning mortgage and securities fraud enforcement. It is an honor to appear before you today.

The Nation's current economic crisis has had devastating effects on mortgage markets, credit markets, the banking system, and all of our Nation's citizens. Although not all of our current economic ills are the result of criminal activity, the financial crisis has laid bare criminal activity – such as Ponzi schemes – that may have otherwise gone undetected for years. The Department of Justice (the Department) is committed, during these difficult times, to redoubling our efforts to uncover abuses involving financial fraud schemes, mortgage lending and securitization frauds, foreclosure rescue scams, government program fraud, bankruptcy schemes, and securities and commodities fraud. We are committed to adopting a proactive approach for better detecting and deterring fraud in the future. Put very simply, where there is evidence of criminal wrongdoing – including criminal activity that may have contributed to the current economic crisis or any attempt to criminally profit from the current crisis – the Department will prosecute the wrongdoers, seek to put them in jail, work tirelessly to recover assets and criminally derived proceeds, and strive to make whole the victims of such crimes.

Historically, the Department has had tremendous success in identifying, investigating, and prosecuting massive financial fraud schemes. Last year, for example, the Department secured the convictions of five former executives, including the owner and president of National Century Financial Enterprises – one of the largest health care finance companies in the United States until its 2002 bankruptcy – on charges stemming from an investment fraud scheme

resulting in $2.3 billion in investor losses. Similarly, last year, the Department obtained a conviction of a former AIG executive who engaged in corporate fraud by executing two false reinsurance transactions to conceal a $59 million decrease in the loss reserves of AIG. From the Department's prosecution of executives of Enron to Worldcom to Adelphia to AIG, to the prosecutions of mortgage fraudsters and architects of Ponzi schemes across the country, the Department has considerable institutional experience and knowledge upon which it can, and will, draw in fighting crimes that relate to the current crisis.

Indeed, in recent weeks, the Department has made clear that its commitment to prosecuting financial crimes will not abate. In the last few weeks, the Department has secured a guilty plea from Bernard Madoff for securities fraud and mail fraud violations, among other charges; filed a criminal charge against Laura Pendergest-Holt, the chief investment officer of Stanford Financial, which allege that she obstructed an Securities and Exchange Commission (SEC) investigation into the activities of Stanford Financial; and arrested Charles "Chuck" E. Hays, who is alleged to have engaged in a large Ponzi scheme operation in Minnesota. These are but a few examples of the Department's ongoing, vigorous enforcement efforts.

Although there are many causes and effects of the current financial crisis, one of the most often cited is mortgage fraud and, indeed, mortgage fraud continues to be an escalating problem across the country. The U.S. Department of the Treasury recently reported that depository institutions filed over 62,000 Suspicious Activity Reports (SARs) on mortgage fraud between June 2007 and June 2008. That is a 44 percent increase over the prior year. To address this growing problem, the Department has been waging an aggressive campaign. We have deployed a

broad array of enforcement strategies to ensure the best use of our investigative and prosecutorial resources. Today, I want to address some of the steps the Department has taken to combat mortgage fraud.

Law Enforcement Coordination

Effectively combating mortgage fraud requires coordination among various law enforcement agencies and close cooperation between law enforcement and industry representatives. The Federal Bureau of Investigation (FBI), Department of Housing and Urban Development (HUD) Office of Inspector General, Internal Revenue Service (IRS) Criminal Investigative Division (CID), U.S. Postal Inspection Service, SEC, Federal Reserve Board, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Office of Thrift Supervision, and other federal, State and local agencies are among the many agencies that monitor, investigate and pursue mortgage fraud. Prosecutions are then brought by both federal and State prosecutors. Because this problem touches neighborhoods across the country, coordination and the sharing of intelligence and investigative resources are critical to our collective success in addressing mortgage fraud.

The Department is leading these coordination efforts through the Corporate Fraud Task Force and the Mortgage Fraud Working Group. Through these groups, law enforcement officers and regulators work to develop strategies to investigate and prosecute wrongdoers and their enterprises engaged in systemic mortgage fraud. In addition, there are 18 regional Mortgage Fraud Task Forces and 47 mortgage fraud working groups in which the FBI, and other federal, state, and local enforcement agencies are working together to address this problem. These

efforts continue to grow. For example, within the last several weeks, the United States Attorney's Office in Maryland announced the formation of the Maryland Mortgage Fraud Task Force linking federal, state and local agencies in an effort to better coordinate civil and criminal enforcement actions relating to mortgage fraud, recover more money for victims, and more effectively communicate information to the public about common schemes in an effort to prevent them from becoming victims of mortgage fraud in the first place.

In addition, the FBI has established a National Mortgage Fraud Team at FBI Headquarters. This unit, working closely with the Department's Criminal Division, U.S. Attorneys' Offices and other law enforcement partners, encourages proactive investigations of mortgage fraud and related crimes and employs an intelligence-driven case targeting system to identify mortgage fraud "hot spots" around the country and to promote real-time enforcement operations. This model has achieved initial success in the Southern District of Florida with the Department's Health Care Fraud Strike Force, which is also based on intelligence-based investigations. We hope to learn from these experiences and disseminate the lessons learned to other districts around the country.

In addition to inter-agency coordination, law enforcement is working with industry representatives to identify key processes that can be established to help prevent or more quickly identify potential mortgage fraud scams. Law enforcement agencies have reached out to industry representatives, including the Mortgage Bankers Association, Mortgage Asset Research Institute, Fannie Mae, Freddie Mac and others, thus increasing the access that these mortgage bankers have to FBI Mortgage Fraud Supervisors.

The sharing of information and ideas is essential to a coordinated approach to the mortgage fraud problem. Accordingly, the Department has encouraged, and led by example, a comprehensive information sharing effort within the Department and among our partner agencies.

Investigation and Prosecution of Mortgage Fraud

When criminals go to jail, we deter similar conduct by others. The Department has, over the last several years, aggressively prosecuted mortgage fraud cases, and the Department's efforts have yielded nationwide sweeps, resulting in hundreds of convictions, and sending hundreds of criminals to jail. As just one example, in partnership with the FBI, the Department has conducted three nationwide mortgage fraud and other banking crime sweeps. In Operation "Malicious Mortgage", conducted last year, U.S. Attorneys' Offices brought charges against more than 400 defendants across the nation, largely as a result of the work of local and regional task forces and working groups currently targeting mortgage fraud. Operation "Malicious Mortgage" was the most recent coordinated sweep in an ongoing law enforcement effort to combat mortgage fraud, which also included Operation "Quick Flip" in 2005 and Operation "Continued Action" in 2004. These operations spanned the country and involved the participation of U.S. Attorneys' Offices and over forty of the FBI's 56 field offices.

Operation "Homewrecker" is yet another example of our aggressive enforcement efforts. Operation Homewrecker was a case brought last year by the United States Attorney's Office for the Eastern District of California and investigated by the FBI and the IRS CID, which resulted in

the indictment of 19 individuals on mortgage fraud-related charges. The case stemmed from a scheme that targeted homeowners in dire financial straits, fraudulently obtaining title to more than 100 homes and stealing millions of dollars through fraudulently obtained loans and mortgages. *See United States v. Charles Head et al.*, 08-cr-116 (E.D. Cal. Feb. 2, 2008); *United States v. Charles Head et al.*, 08-cr-116 (E.D. Cal. Mar. 13, 2008). This is just an example of the hundreds of mortgage fraud cases prosecuted by the Department over the last several years.

In addition to criminal enforcement activities, the Department has addressed mortgage fraud through vigorous civil enforcement, including under the False Claims Act (FCA). The Department's recoveries under the FCA, with the assistance of private whistleblowers, have reached record levels. In eight of the last nine years, the Department's recoveries under the FCA have exceeded $1 billion and, since 1986, the Department's recoveries have exceeded $22 billion. The Department has used the FCA to protect a broad range of government programs and contracts, including matters relating to mortgage fraud. For example, the Department recently obtained a $10.7 million settlement from RBC Mortgage Company to resolve allegations that it sought FHA insurance for hundreds of ineligible loans. Additionally, the Department obtained two recent judgments, totaling $7.2 million, against a California real estate investor and a Chicago-based mortgage company, for defrauding HUD's direct endorsement program. *U.S. v. Eghbal*, 475 F.Supp. 2d 1008 (C.D. Cal. 2008), aff'd 548 F.3d 1281 (9th Cir. 2008); *U.S. v. Dolphin Mortgage Corp.*, 06-c-499, 2009 WL 153190 (N.D. Ill. 2009). The Department will continue to vigorously utilize the FCA to hold accountable those who engage in all types of housing related fraud.

Identifying and Helping Victims

In addition to detecting, deterring, and prosecuting crimes, the Department is always mindful of our obligation to help victims of mortgage fraud and, to the extent possible, attempt to make them whole. To this end, the Department's prosecutors and law enforcement partners work to locate and recover assets from the criminals and to provide restitution to their victims. Recovery of assets from criminals, however, is challenging and prosecutors have, in some instances, sought creative solutions. In one particularly egregious mortgage fraud case prosecuted in the North District of Georgia, for example, the court ordered the defendant to pay restitution of almost $6 million. To secure the restitution money for the victims, the government obtained a forfeiture judgment of $6 million, access to the defendant's book and movie rights, and the right to sell the defendant's paintings on eBay. The Department also effectively uses asset forfeiture as an important law enforcement tool and, last year alone, returned over $435 million to victims of financial crimes.

Because some financial frauds involve the victimization of hundreds of people, the Department also expends considerable resources finding the victims in the first instance. The Department's many victim-witness coordinators and law enforcement officials work tirelessly to identify the victims in mortgage fraud cases and to help ensure that what money is recovered reaches them. The Department uses traditional methods of investigation to identify victims but also is proactively trying to reach and alert potential victims. For example, in the Stanford Financial matter, the FBI recently issued a press release about the investigation and provided a telephone number for potential victims to call. Ultimately, identifying victims is a significant

and time-consuming task especially when, for example in the Bernard Madoff case, this undertaking can involve thousands of victims around the globe.

The Department's Intentions for Future Prosecutions

As I have attempted to outline for the Committee, the Department has had a long history of vigorously prosecuting financial crimes and mortgage fraud cases. In light of the current financial crisis, we are redoubling our efforts.

In addition to prosecuting crimes that have already been committed, the Department must work to prevent crimes from occurring in the first place. Among other things, we must ensure that the funds that Congress authorizes to rejuvenate and stimulate the economy are used as intended. Where these taxpayer funds are not used appropriately or where misrepresentations are made in order to obtain such funds, we are committed to investigating and prosecuting the wrongdoers. The protection of the public funds is now more important than ever.

From past experience – including the many prosecutions we have brought relating to the Hurricane Katrina recovery funds and the funds used as part of the Iraq reconstruction efforts – the Department is well aware that when large investments of taxpayer money are doled out over a short period of time, people will try to exploit the system and criminally profit. In anticipation of the need to protect the moneys that have been and will be provided as a part of the Troubled Assets Relief Program (TARP) and other economic stimulus packages, the Department has forged a working relationship with the Special Inspector General for TARP and is working to help identify ways to prevent fraud and abuse. Furthermore, we are continuing to assess whether

additional working groups or taskforces should be created or whether resources should be focused to augment the existing working groups.

Potential Improvements for Law Enforcement Efforts in the Future

Although the Department believes it has the tools it needs to continue to vigorously combat financial fraud, there are legislative steps that can be taken to close existing gaps and strengthen the statutes that prosecutors use to bring these cases. The Fraud Enforcement and Recovery Act of 2009 (FERA), which was introduced in the Senate on February 5, 2009 and approved by the Senate Judiciary Committee on March 5, 2009, and which the Department supports, contains a number of legislative modifications that would greatly benefit law enforcement. For example, the legislation would amend the definition of "financial institution" to include "mortgage lending business" in Title 18, United States Code. The new definition would ensure that private mortgage brokers and companies are both protected by, and held fully accountable under, federal fraud laws.

The legislation would also expand the prohibition regarding false statements to financial institutions under of Title 18, United States Code, to cover false statements made to mortgage lending businesses. Currently, section 1014 applies only to federal agencies, banks, and credit associations and does not extend to private mortgage lending businesses. This new provision would ensure that private mortgage brokers and companies are held fully accountable under this federal fraud provision by providing prosecutors with an important tool to charge those who make false applications and appraisals.

In addition to the proposals in FERA, the Department respectfully submits there are additional areas that could be addressed through legislative action, and we welcome the opportunity to work with this Committee and others to develop such proposals. For example, a law mandating that persons who provide real estate settlement services must maintain the settlement statements and related loan documents would give law enforcement an important tool to investigate mortgage fraud. Half of the top ten subprime mortgage originators in the second quarter of 2006 had either gone out of business or been sold by the second quarter of 2007 – only one year later. The Department has found that the records we need to investigate or prosecute mortgage fraud would have been in the possession of those providing settlement services (such as lenders, mortgage brokers, and title companies), but that they are frequently unavailable or difficult to obtain. All too often, such entities go out of business, and their records are either abandoned or destroyed. Requiring those who provide real estate settlement services to maintain appropriate records for ten years following the original date of a loan would significantly assist in the investigation of mortgage fraud.

The Department would welcome the opportunity to work with this Committee to provide additional information about proposed legislative modifications that would assist our prosecutors and investigators.

Conclusion

The financial crisis demands an aggressive and comprehensive law enforcement response, including vigorous fraud investigations and prosecutions of individuals who have defrauded their customers and the American taxpayer and otherwise placed billions of dollars of

private and public money at risk. The Department is committed to this effort and will ensure that we look at all allegations of fraud closely, follow the facts where they may lead, and bring our resources to bear to prosecute those who have committed crimes. Thank you for the opportunity to provide the Committee a brief overview of the Department's efforts to address the current financial crisis.

I would be happy to answer any questions from the Committee.

EMBARGOED UNTIL DELIVERY

STATEMENT OF

MARTIN J. GRUENBERG
VICE CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

FEDERAL AND STATE ENFORCEMENT OF CONSUMER AND INVESTOR PROTECTION LAWS

before the

FINANCIAL SERVICES COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

March 20, 2009

2128 Rayburn House Office Building

Chairman Frank, Ranking Member Bachus and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding federal and state enforcement of consumer and investor protection laws.

Earlier this month, in a speech before the National Association of Attorneys General, FDIC Chairman Bair stated that many of the current problems in the economy were caused by a widespread failure to protect consumers. It is essential that those whose actions contributed to the current crisis and who are engaging in practices harmful to consumers be held accountable. In addition, it is important to take steps to prohibit these practices from reoccurring in the future.

The FDIC has a strong commitment to the vigorous and effective enforcement of consumer protection laws and other statutes under our jurisdiction in order to ensure fair treatment of individuals, protect the safety and soundness of insured financial institutions, and carry out our core mission of maintaining public confidence in the banking system. The FDIC brings a unique perspective to this issue because of the variety of functions it performs including deposit insurer, federal supervisor of state nonmember banks and savings institutions, and receiver for failed insured depository institutions.

My testimony today will discuss how the FDIC conducts enforcement both with regard to failed institutions in our role as receiver, and with regard to open banks in our role as supervisor. In addition, I will touch on the efforts of the FDIC's Office of

Inspector General (OIG). I also will suggest a measure that would address a limitation on our existing authority.

Enforcement -- Failed Institutions

In addition to overseeing the national deposit insurance system and acting as primary federal supervisor for approximately 5,000 state chartered banks that are not members of the Federal Reserve System, the FDIC is responsible for resolving all failures of insured financial institutions in the United States. When a bank fails, and thus is unable to meet its financial or capital requirements (or both), the chartering authority closes the institution and appoints the FDIC as receiver. As receiver, the FDIC either pays depositors directly for their insured deposits, or arranges for a purchase of the failed institution by another insured financial institution.

Immediately following the closing of every failed institution -- regardless of size, circumstances or primary federal regulator -- our investigations staff and our attorneys who specialize in professional liability issues together begin an investigation. The purpose of the investigation is to determine, among other things, whether the failed institution's directors, officers, and professionals, such as accountants, appraisers and brokers, were responsible for its losses, and, if so, to hold them accountable.

At the closing, our investigators and attorneys will: determine the reason for the bank's failure; look for evidence of potential fraud that may have contributed to the

institution's failure; identify any cause of action against directors, officers or other professionals who contributed to the failure; preserve Bankers Bond and Director and Officer insurance coverage for any potential or existing claim; maintain and protect the integrity of the bank's records; and establish the chain of custody for such records.

Among the "assets" the FDIC as receiver acquires from failed institutions are the institution's pending or potential "professional liability claims," that is, legal claims against its officers, directors, bond carriers, independent accountants, attorneys, appraisers and others who provided professional advice to the institution. These are civil claims filed primarily in federal court. For each existing potential claim, our attorneys determine whether to seek authority to sue or terminate the investigation, weighing the merits of the claim, the cost of pursuing it, and the amount likely to be recovered. If a meritorious claim exists but is not likely to be cost-effective, we refer the claim to the appropriate primary financial regulator for administrative enforcement action.

For each insured bank or thrift that fails, our attorneys open 11 different types of professional liability investigations. The more important of these (in terms of required staff resources and potential recoveries) are investigations of directors, officers, attorneys, accountants, fidelity bond carriers, appraisers, perpetrators of mortgage fraud, securities brokers, and commodities brokers. Since 1986, the FDIC through its professional liability program has recovered a total of $6.1 billion and incurred expenses of $1.4 billion. To put this in context, recoveries in recent years are at a relatively low level because of the small number of financial institution failures from 2004 until the fall

of 2007. In 2008, for example, the FDIC recovered only $31.2 million from professional liability claims, a historical low. Professional liability activity – and recoveries – are expected to increase substantially now that institutions are failing and giving rise to significantly increased professional liability claims and investigations.

Recent failures of insured financial institutions – 3 failures in 2007, 25 failures in 2008, and 17 failures just since the start of 2009 – have resulted in a substantial increase in our investigations and professional liability workload. Since the beginning of 2007 through today, investigations of mortgage fraud claims have increased from 0 to 4375, investigations of professional liability claims other than mortgage fraud have increased from 34 to 427, and mortgage fraud lawsuits have increased from 0 to 113.

The 4375 mortgage fraud claims under investigation are expected to result in over 900 additional civil mortgage fraud lawsuits over the next three years. Defendants in civil mortgage fraud cases primarily are mortgage brokers, appraisers, closing attorneys and other closing agents, title companies, title insurance companies, and other third parties that participated in mortgage fraud against FDIC-insured banks and thrifts.

A case from our investigation of the failure of IndyMac bank is indicative of the kinds of mortgage fraud activities our investigators are discovering and pursuing. The case involves a fraudulent appraisal, fraudulent mechanics liens, a "straw" borrower who received $10,000 cash in a briefcase, and a $500,000 loss on two loans totaling $885,000. The appraiser valued the property at more than double its actual market value by using

inappropriate comparables, inflating the square footage, and omitting the fact that the house had been listed for sale at substantially less than the contract price. The closing agent recorded two false mechanics liens on the eve of closing as a means to skim off $200,000 cash. The borrower signed two loan applications falsely representing her employment, income and residence, in return for round trip first class airfare from Brooklyn to Houston and car service in Houston to attend the loan closings, in addition to the briefcase of cash. She never resided in the house or made a payment on the loans. In this case, fraud was committed against the FDIC-insured lender by the appraiser, the closing agent, and the borrower. The FDIC is seeking recovery of the full $500,000 loss.

Another consequence of an institution being placed in receivership is that the FDIC has the authority to terminate contracts upon an insured depository institution's failure. The FDIC routinely terminates compensation and other contracts with senior management whose services are no longer required. Through its repudiation powers, as well as enforcement powers, termination of such management contracts typically can be accomplished at little or no cost to the FDIC. Indeed, some compensation agreements are self-terminating in a receivership context. In addition, placing a failed institution in receivership usually results in its stock having little or no value. To the extent that the previous management was compensated in stock, they generally receive no value unless all depositors and general creditors have been made whole, which is rare.

The FDIC, through its Professional Liability Group, also has the ability to pursue claims in federal court for excessive compensation received prior to the receivership.

This includes cases in which the individual left the institution before it failed, as long as his or her departure date was within the period of the applicable state statute of limitations. These claims, at least when pursued directly as "excess compensation" cases, have been challenging to pursue as civil claims in federal court because of the difficulty of defining relevant peer groups and the inherent judgment involved in establishing what is excessive. Our attorneys are actively investigating potential excess compensation claims as part of each investigation of a failed FDIC-insured institution.

FDIC's professional liability attorneys also have pursued related claims that address excess compensation issues. For example, the FDIC filed director and officer liability claims out of Hamilton Bank, N.A., which failed in 2002, based on several theories. One of these theories was that the Chairman and Chief Executive Officer (CEO) of the Bank and other executive officers engaged in a series of secret asset swaps to prop up the price of the stock of Hamilton Bancorp, Hamilton's parent company, in order to increase their compensation among other things. The FDIC settled its claims in this case for $9.4 million. The FDIC now is pursuing a $15.5 million fidelity bond claim out of Hamilton, which is pending in federal court at this time, asserting, among other things, that between November 1998 and August 1999, during which time Bancorp's share price was artificially inflated due to the swaps fraud, the Chairman and CEO caused his personal Trusts to sell Bancorp stock for a gain of $2.3 million.

In addition to the development and support of civil claims brought by the FDIC with regard to failed institutions, our investigators also identify signs of possible criminal

activity in a closed financial institution. When appropriate, investigators will file a Suspicious Activity Report (SAR) regarding possible criminal activity. In criminal cases where fraud has been committed against the FDIC itself, this is done in coordination with our OIG. The investigation findings provide supporting documentation that subsequently can be used by the Department of Justice (DOJ) to pursue and prosecute the wrongdoers. Our investigators work with DOJ in the calculation of damages, serve as expert witnesses, and review and analyze financial information, as well as either direct or help with prosecutors' review of bank operations. Acting in our capacity as receiver for failed institutions, the FDIC also coordinates with other federal, state, international, and private sector agencies and groups to detect and deter bank fraud by supporting fraud prosecutions and collecting restitution and forfeiture orders from defendants convicted of fraud against FDIC-insured institutions.

To handle the substantially increased workload, the FDIC began to increase its legal staff in the Professional Liability Group, from 6 at the beginning of 2008 to 16 currently, and to 21 by mid-year 2009. We also have retained 16 outside law firms to perform professional liability investigations and litigation in connection with recently-failed institutions and will be retaining additional firms for this purpose, as well as firms to handle residential mortgage fraud cases specifically. FDIC also has added to both its civil and criminal investigations staff for a total of 67, including contractors.

Enforcement -- Open Banks

Under the Federal Deposit Insurance Act, the FDIC pursues enforcement actions against insured depository institutions, their directors and officers, employees and other institution affiliated parties, where warranted, including third parties and independent contractors such as accountants, attorneys and appraisers. The FDIC employs specialized examiners in fraud, risk management, consumer compliance and Bank Secrecy Act who regularly examine insured depository institutions to ensure compliance with state and federal laws and regulations, including all consumer protection laws, and the safe and sound operation of FDIC supervised institutions. When FDIC examiners find either violations of law, breaches of fiduciary duty, unsafe and unsound practices or mismanagement in banks' consumer protection responsibilities, the FDIC requires immediate corrective action.

During 2007 and 2008, the FDIC issued 142 Cease and Desist Orders and 102 Removal and/or Prohibition Orders, which ban individuals from banking. These enforcement actions were based on all types of harm or risks caused to an insured depository institution and include most frequently theft and embezzlement by an employee of the bank, poor lending policies or procedures, and fraudulent actions on the part of a lending officer.

The FDIC polices misconduct at open banks through enforcement actions targeting mortgage fraud and other abuses in all types of lending, such as improper

underwriting, record alteration, discriminatory practices, and nominee borrower schemes. A recent example involves a former financial center manager and loan officer, where the loan officer created or helped create false loan applications and accepted fraudulent property appraisals that he knew contained false information. The actions of the loan officer caused significant loss to the institution. When discovered, the FDIC successfully sought a prohibition action against this individual to assure that he would never be provided the opportunity to conduct these frauds against another institution. In addition, we worked with the Assistant United States Attorney's office to provide any necessary information in order for criminal actions to be pursued.

Removing from office and prohibiting from banking those who commit financial crimes is a primary goal of FDIC enforcement actions. The majority of the prohibition or removal actions taken by the FDIC were the result of theft, embezzlement or misappropriation on the part of Bank employees. Since 2007, 90 enforcement cases have arisen from these fraudulent concerns. The employees are removed from these positions of trust, and are often required to make restitution and pay a financial penalty to remedy their transgressions.

A recent enforcement case involving fraudulent activities began when examiners doing a routine bank examination discovered that bank management was illegally transferring past-due subprime loans from a related mortgage company to the bank. The FDIC instituted an enforcement action to ban further transfers, freeze the assets of the

bank principals involved, and require restitution to the bank for its losses in the illegal transaction. After these orders were issued, the bank recovered more than $10 million.

Open bank enforcement actions protect both the banking industry and consumers. The FDIC currently is working on several enforcement actions related to unfair and deceptive practices. The FDIC recently issued an enforcement order against a bank for providing deceptive marketing material related to its student loan products. The materials were confusing in that they appeared to be products offered from the educational institution's financial aid office and did not clearly state that they were being offered through a private company. The co-branded documents produced by the bank in coordination with the various colleges and universities were deceptive. The FDIC obtained a cease and desist order from the bank requiring that it would increase controls and oversight regarding these products to protect consumers in the future.

The FDIC also is working to assess substantial penalties and require consumer reimbursement where unfair and deceptive acts and practices were identified relating to credit cards, overdraft protection programs, ATM usage of debit cards, rewards accounts, and other lending practices. In late December 2008, the FDIC and the Federal Trade Commission won a major settlement against a credit card company for misleading subprime credit card users. As a result, the company will correct its practices and provide $114 million in cash and credits to consumers who were improperly assessed fees as a result of inadequate and misleading disclosures. We also have pursued enforcement actions against three banks that used this same firm's services. Two of the

banks have settled with the FDIC, are correcting their practices and substantially improving their compliance management systems and their oversight of third-party affiliates. In addition, the FDIC assessed civil money penalties in excess of $5 million. Our enforcement action against the third bank is currently pending, and we expect a similar resolution of that action.

A final example is a recent investigation of vendors and payment processors using banks to capture Social Security benefits for loan repayments or check cashing fees via direct deposit accounts. The FDIC is completing an investigation of three banks that were allowing their systems to be used by third parties to solicit customers for direct deposit of their Social Security benefits. The investigations discovered that some of the banks were not actively managing these third party relationships and were unaware of how customers were being treated when they attempted to get their money from the third parties. The FDIC discovered instances where check cashers, payday lenders, and small retail merchants were using a host of bad practices to keep consumers as customers, and worse yet, to keep them in perpetual debt.

As the FDIC completes this investigation, we will be seeking enforcement actions against these banks to require them to review their compliance programs and procedures and make the necessary changes to avoid these problems in the future. In addition, where we found the most egregious compliance violations that were beyond repair, we directed the bank to unwind these accounts, and help consumers find better ways of getting their benefits. The FDIC has worked with the Social Security Administration to understand

the benefit payment systems. In addition, the Social Security Administration has been instrumental as the banks seek to close these programs and transfer the consumers' benefit payments, without harming any consumers. Once our investigation revealed that there were other banks involved in these programs, we alerted the Federal Reserve to our concerns and shared our accumulated understanding of these programs so that they could begin their own investigations as to banks they supervise.

The Social Security benefit investigation is only one example of institutions failing to provide the appropriate oversight of third party relationships. The risks of third party relationships have been known in the industry for some time, and the FDIC updated our guidance on third parties in June 2008. We have taken open bank enforcement actions in cases where the bank used third parties to implement refund anticipation loan programs, credit card programs, reward programs, overdraft protection programs, and subprime and/or predatory loan programs.

The FDIC also has focused on utilizing the data provided under the Home Mortgage Disclosure Act or HMDA. It has been a significant effort to establish a program to allow us to analyze this statistical data provided by the banks to identify differences in pricing of mortgages along racial, gender or ethnicity lines. The FDIC is dedicated to investigating any instances of discrimination that the HMDA data or our examinations suggest. We have been working closely with DOJ in referring apparent instances of discrimination and in pursuing FDIC actions against institutions for

discrimination. The HMDA pricing data became available for the first time following collection of 2004 data, and we now have several cases that are in development.

As the current economic crisis continues, more and more institutions are suffering financial difficulties, which can lead them to look for higher returns and fee income wherever possible, including offering products that may not be advantageous for most consumers, or necessarily for the bank. Introduction of new products requires the FDIC's increased focus during examinations to assure that the institutions are not taking too much risk. When the FDIC discovers poorly devised products with the propensity to hurt consumers or provide opportunities for fraud, we pursue enforcement actions to revise the product or eliminate it completely.

The FDIC is very concerned about the excessive compensation and executive bonuses that have dominated the news in recent weeks with regard to financial institutions. As I noted in discussing this issue in the context of enforcement in failed banks, historically we have found bringing excessive compensation claims to be difficult but we do have enforcement tools available to us in cases where such schemes affect the safety and soundness of institutions or they involve a breach of fiduciary duty. These claims are highly fact intensive. Generally the FDIC's claim will be stronger in cases involving troubled or significantly undercapitalized institutions, and will also depend upon the extent to which the compensation at issue was manifestly unreasonable, and disproportionate to any legitimate business purpose. We continue to review these issues and expect to pursue claims on this basis.

Enforcement by the FDIC's OIG

The FDIC's OIG brings another level of enforcement that contributes to the FDIC's mission of maintaining confidence in the banking system. The OIG conducts investigations of fraud and other criminal activity in or affecting FDIC-regulated open financial institutions, all closed institutions and receiverships, and other FDIC-related programs and operations. Currently the OIG has about 170 active investigations, involving open and closed institutions. The work focuses on various types of fraud, including mortgage, securities, wire and mail, or bank crimes, such as embezzlement or money laundering. As an example, the OIG, together with the United States Attorney's Office for the Central District of California and the Federal Bureau of Investigation, is conducting an investigation to identify and prosecute any criminal activity that may have contributed to the failure of IndyMac Bank

The OIG investigates crimes against the FDIC as well as crimes against FDIC-insured institutions and receiverships. A staff of 41 federal law enforcement officers conducts these investigations throughout the country and operates a headquarters-based electronic crimes unit and computer forensic lab. The OIG's resources extend beyond its staff as it continues to work closely and partner with the other divisions of the FDIC, DOJ, Federal Bureau of Investigation (FBI), and other law enforcement organizations.

Investigations of financial institution fraud currently constitute about 88 percent of the OIG's investigative caseload. Over the last 2 years, the OIG has closed about 100 investigations, with the crimes occurring almost exclusively in open institutions. These investigations have resulted in over 230 indictments, 170 convictions, and over $530 million in fines, restitution, and monetary recoveries.

The OIG also is involved in stopping fraud schemes that rob depositors and FDIC-insured financial institutions of millions of dollars. The OIG has an ongoing effort to identify, target, disrupt, and dismantle criminal organizations engaged in such schemes that target financial institutions and prey on the banking public. These schemes range from identity theft to Internet scams, such as "phishing" and "pharming." By way of example, with the help of sophisticated technology, the OIG has recently been engaged in shutting down fraudulent emails, purportedly from the FDIC, which attempt to entice consumers to divulge personal information and/or respond to a request for money. In many of these cases, the OIG has been able to trace the schemes to locations outside of the United States, and then work with law enforcement of the relevant foreign country to shut down the scheme.

The OIG also works with other divisions of FDIC to identify individuals who have already committed financial institution crimes and are attempting to avoid their resultant financial obligations by concealing their assets.

In addition, section 38(k) of the Federal Deposit Insurance Act (FDI Act) requires that the Inspector General of a failed financial institution's primary regulator conduct a review if the Deposit Insurance Fund incurs a material loss as a result of a bank failure. A material loss exists when the estimated loss from the failure exceeds the greater of $25 million or 2 percent of the bank's total assets at the time the FDIC is appointed receiver. Once the FDIC calculates the estimated loss associated with an FDIC-supervised institution, the OIG begins its review. The review provides an independent analysis of why the institution failed and resulted in a material loss and evaluates the relevant regulators' supervision of the institution, and may provide additional information valuable for civil and/or criminal investigations into the failure. The OIG has six months to conduct and publicly report on the results of its review.

During the material loss review, the OIG team of auditors and/or evaluators reviewing bank and supervision records will coordinate with OIG investigators. If the team suspects or uncovers evidence of fraud, the investigators are immediately contacted. In these cases, fraud could have easily contributed to the bank's failure.

Authorities -- Current Restriction

Under the Federal Trade Commission (FTC) Act, only the Federal Reserve Board (FRB) has authority to issue regulations applicable to banks regarding unfair or deceptive acts or practices, and the Office of Thrift Supervision (OTS) and the National Credit Union Administration (NCUA) have sole authority with regard to the institutions they

supervise. The FTC has authority to issue regulations that define and ban unfair or deceptive acts or practices with respect to entities other than banks, savings and loan institutions, and federal credit unions. As FDIC Chairman Bair and other senior officials have noted before this Committee previously, the FTC Act does not give the FDIC authority to write rules that apply to the approximately 5,000 entities it supervises -- the bulk of state banks -- nor to the OCC for their 1,700 national banks. Section 5 of the FTC Act prohibits "unfair or deceptive acts or practices in or affecting commerce." It applies to all persons engaged in commerce, whether banks or non-banks, including mortgage lenders and credit card issuers. While the "deceptive" and "unfair" standards are independent of one another, the prohibition against these practices applies to all types of consumer lending, including mortgages and credit cards, and to every stage and activity, including product development, marketing, servicing, collections and the termination of the customer relationship.

In order to further strengthen the use of the FTC Act's rulemaking provisions, the FDIC has recommended that Congress consider granting Section 5 rulemaking authority to all federal banking regulators. By limiting FTC rulemaking authority to the FRB, OTS and NCUA, current law excludes participation by the primary federal supervisors of about 7,000 banks. The FDIC's perspective -- as deposit insurer and as supervisor for the largest number of banks, many of whom are small community banks -- would provide valuable input and expertise to the rulemaking process. The same is true for the OCC, as supervisor of some of the nation's largest banks. As a practical matter, these rulemakings

would be done on an interagency basis and would benefit from the input of all interested parties.

Conclusion

Thank you for the opportunity to address this important issue. The FDIC looks forward to working with the Committee to ensure fair and effective enforcement of consumer protection laws in financial services.

Testimony of

Illinois Attorney General Lisa Madigan

Testimony before the

House Committee on Financial Services

Friday, March 20, 2009
2128 Rayburn House Office Building
Washington, DC
10:00 A.M.

Hearing on

"Federal and State Enforcement of Financial Consumer and Investor Protection Laws"

Mortgage Fraud Enforcement Actions by State Attorneys General

I. Introduction and Background

Congressman Frank and members of the Committee, thank you for inviting me to testify at today's hearing regarding mortgage fraud enforcement actions brought by state and federal agencies. As the chief consumer advocate for the state of Illinois, I am pleased to share information about my efforts – and the efforts of my fellow attorneys general around the country – to prosecute the various forms of mortgage fraud that contributed to the home foreclosure crisis and the resulting economic recession.

Protecting Illinois homeowners from predatory mortgage lending has been a priority of mine since I took office as Illinois Attorney General six years ago. Like many state attorneys general, I recognized long ago the signs of a crisis in the making. I remember meeting with my consumer fraud lawyers and being told that this terrible wave of foreclosures was coming – years before it made the headlines. I also recall attending a meeting with federal regulators two years ago at which I voiced my concerns about the oncoming crisis. At that time, however, Wall Street was still making money on mortgage-backed securities. The federal regulators did not share my concerns.

In my role as Illinois' chief enforcer of consumer protection laws, I have brought enforcement actions against some of the largest mortgage lenders in the nation for engaging in the unfair, deceptive, and fraudulent lending practices, the same unlawful practices at the center of the housing crisis. Additionally, because I believe that homeowners are best protected by strong regulation and oversight of mortgage lending *at the point when loans are originated*, I have drafted and lobbied successfully for the passage of state legislation that provides significant protections at this stage, including requiring ability-to-pay underwriting standards for all mortgage loans, severely restricting the use of stated income or so-called "liar" loans, and creating a fiduciary duty between mortgage brokers and *borrowers*. But ultimately, my efforts and those of other state attorneys general were unable to fill the void created by what I view as an abdication of meaningful oversight at the federal level, and now we are all in the challenging position of pursuing the wrongdoers after the damage is done.

As a prefatory matter, I wish to point out that it is impossible to neatly unwind a single mortgage transaction, let alone millions of them. In an era when home loans are structured as complex financial instruments, residential mortgage loan transactions involve a bewildering array of different corporate entities and individuals. These participants range from appraisers, mortgage brokers, and title companies to loan funders, securitizers, and ratings agencies. Every step in a mortgage transaction is fraught with the possibility of fraud and wrongdoing. When things go wrong on a massive scale, as they have now, it is no simple matter to make every harmed homeowner whole again, or to hold every culpable party legally accountable for the damage they've done. A state attorney general – or any regulatory agency – has a myriad of potential wrongdoers to investigate and potentially prosecute, and thus it is critical that all of the agencies

testifying today develop an understanding of how we can better work together to address this crisis in a way that maximizes our respective regulatory and prosecutorial authority.

As we know, the home foreclosure crisis has profoundly affected not only homeowners but also taxpayers, cities, states, and the nation as whole. I have heard from citizens in my own state who can hardly believe the enormous sums of taxpayer dollars flowing into financial institutions to keep them afloat. In return for their trillion-dollar investment, these same citizens demand accountability, and, just as important, they demand that something be done to stem the swelling tide of home foreclosures in their communities.

As Attorney General, I believe that it is my obligation to pursue, within the boundaries of my authority, those who engaged in predatory practices that have adversely affected us all, and I can assure you that my fellow attorneys general are united in this belief. In the words of the Congressional Oversight Panel, "State regulators have a long history as the first-line of protection for consumers. . . .[S]tates first sounded the alarm against predatory lending and brought landmark enforcements against some of the biggest subprime lenders..." (*Special Report on Regulatory Reform*, January 2009, p. 32).

Indeed, state attorneys general have aggressively pursued enforcement actions against predatory lending practices since the 1990s, on both the civil and criminal levels. What has changed as a result of the current crisis are the remedies we seek. These days, not only do we seek monetary relief for consumers who have lost their homes as a result of these illegal practices, but – just as critically – we are crafting remedies that permit thousands of struggling homeowners to modify their mortgages so that they have a fighting chance of saving their home. As we discuss today the best ways to hold mortgage lenders accountable for placing millions of homeowners into loans they could not afford to repay, it is my hope that we do not forget the paramount importance of saving homes and stabilizing communities.

My testimony is divided into two parts. First, I will summarize the enforcement actions brought by my office and the other state attorneys general against participants in the mortgage lending market who have engaged in mortgage fraud and other violations of consumer protection laws and regulations. This part will include a summary of my office's investigation of and lawsuit against Countrywide Home Loans, and my eventual settlement with Countrywide's new owner, Bank of America. In the second part of my testimony, I will identify some of the key impediments to effective enforcement of fraud and other consumer protection laws and regulations by state attorneys general.

II. Attorneys General Prosecution of Predatory Mortgage Lending Practices

Civil Actions

The attorneys general are not newcomers to the arena of predatory lending. We have been pursuing these practices since as early as 1998, when the states of Illinois, Massachusetts and Minnesota initiated civil suits against First Alliance Mortgage Company ("FAMCO"), a non-depository state chartered mortgage lender based in California.

FAMCO was selling high cost loans to prime and subprime borrowers, and then bundling and selling those loans to the Wall Street firm Lehman Brothers. FAMCO's mortgage loans largely consisted of refinances into exotic 2/28 ARM products. As a result of the litigation – which was subsequently joined by other states and the FTC – FAMCO was forced out of business and into bankruptcy. Pursuant to a settlement agreement in 2002, the government entities recovered well in excess of $50 million in restitution for consumers' losses. Since those losses were sustained at the beginning of the housing bubble, when borrowers were still building equity in their homes, they were for the most part internalized by the borrowers themselves, in the form of higher monthly payments and lost equity. A homeowner placed in an abusive FAMCO loan could eventually refinance out of it. The losses had not yet spilled over significantly into the external marketplace.

While the FAMCO cases were still being settled, the attorneys general launched an investigation into the mortgage practices of the state chartered subprime mortgage lender Household Financial. That investigation targeted many of the practices that bring us to this room today: Household engaged in a wide scale pattern and practice of misrepresenting loan terms, selling loans with prepayment penalties and balloon payments without consumers' knowledge, packing credit insurance products into consumers' loans, refusing to give consumers loan payoff information, and writing loans that Household knew consumers could not afford. The multistate investigation of Household culminated in 2002 with a $484 million dollar restitution settlement and injunctive relief remedying the company's various fraudulent, deceptive and unfair lending practices.

Even while the attorneys general were finalizing the settlement with Household, it became clear to us that there were problems with the largest subprime lender in the country at the time, the California-based lender Ameriquest. Ameriquest also received its funding line from Wall Street firms. These same firms bought and securitized the subprime loans Ameriquest sold. For those of us on the state level, the Ameriquest investigation marks the moment when we began to see the underwriting practices of mortgage lenders erode at a disturbingly accelerated pace. In 2002, Ameriquest was originating loans with an average loan-to-value ratio of 74 percent. Two years later, the ratio had risen to 81 percent. Ameriquest had also ramped up its originations of stated-income loans, that is, loans that permit the borrower merely to state his or her income without further review. By 2003, Ameriquest was originating almost 30 percent of its loans – which were all subprime – as stated-income or limited-documentation loans.

Our multistate investigation of the nation's largest subprime mortgage lender revealed that Ameriquest engaged in the kinds of fraudulent practices that other predatory lenders subsequently emulated on a wide scale. These practices included: inflating home appraisals; increasing, at closing, the interest rates on borrowers' loans or switching their loans from fixed to adjustable interest rates; and promising borrowers that they could refinance their costly loans into loans with better terms in just a few months or a year, when these borrowers did not have any equity left to absorb another refinance. Ameriquest also locked borrowers into costly loans by including three-year prepayment

penalties on loans with a two-year introductory rate that reset to a higher rate at the end of two years. These penalties were added because Wall Street investors preferred and paid more for loans with prepayment penalties.

As a result of the multistate investigation, 49 states and the District of Columbia entered into a $325 million settlement agreement with Ameriquest in 2006. Just as important as monetary relief, the settlement contained extensive injunctive provisions that went to the heart of the industry's predatory lending practices. These provisions included: early disclosure of essential terms of the loan in an easily understood and concise manner, and the additional requirement that, if the terms changed, they would be re-disclosed prior to closing; scripts to he used during the sale of the loan setting out what borrowers would be told about the essential terms of their loan; provisions ensuring that Ameriquest would deal at arms-length with appraisers; restrictions on placing prepayment penalties on hybrid ARMs, so that borrowers would not be trapped in loans when their interest rates reset upward; restrictions on serially refinancing borrowers; and requiring Ameriquest to use a pricing system that would provide the same rate, including the same number of discount points, to similarly situated borrowers.

The intent of the Ameriquest settlement was to create a lender code of conduct that would stem the tide of abuses in the subprime mortgage market. However, shortly after the settlement was finalized, the subprime mortgage market began to contract. Ameriquest went under, and the lender code of conduct was never fully implemented. Despite its ultimate failure, Ameriquest's climb to the top of the market had paralleled an explosive growth in subprime lending that irrevocably changed the economic landscape. Due to the serial refinancing of their mortgages, many borrowers no longer had significant amounts of equity in their homes as of 2006. The days when borrowers could internalize the enormous costs of predatory mortgage lending were over, and equity-poor homeowners began defaulting in ever-increasing numbers.

By the fall of 2007, with the subprime mortgage market starting to crumble, my Office knew that Countrywide Home Loans merited a closer look. At the time, Countrywide was a state-licensed lender whose parent corporation also had a federal thrift subsidiary. Countrywide was also the largest prime and subprime mortgage lender in the nation. In September 2007, my office, in conjunction with the California Attorney General's Office, sent subpoenas to Countrywide pursuant to our authority under our states' consumer protection laws. What we found as a result of those subpoenas and interviews with former employees and mortgage brokers was that Countrywide, in relentless pursuit of greater market share over the last several years, had engaged in a wide range of deceptive practices. These practices included the inappropriate loosening of underwriting standards, particularly through the use of stated income loans to qualify borrowers for loans that they could not actually afford. We also found that Countrywide had engaged in a pattern and practice of qualifying borrowers at "teaser" interest rates, as opposed to the fully indexed and fully amortizing interest rate, setting borrowers up for an unaffordable payment shock. Countrywide also deceptively sold complex loan products with very risky features to borrowers who did not understand and could not afford them. The complexity of these products reached its peak in Countrywide's popular pay option ARM

prime product, which contained a negatively amortizing feature, providing a structure to put the borrower upside down on a loan by paying less than the interest owed on the loan. Additionally, we found that Countrywide structured unfair loan products with risky features, oftentimes combining several layers of risky features into one extremely risky loan – for example, a stated-income 2/28 hybrid ARM with a loan-to-value ratio of over 95 percent, for which the borrower was qualified only at the initial teaser rate.

Furthermore, our investigation revealed that Countrywide's explosive growth was paralleled by the demand from the secondary market for loans with nontraditional risky features. Through the securitization process, Countrywide extracted hefty over-head charges, then shifted the risk of the failure of these non-traditional loans to investors. Moreover, securitization allowed Countrywide to tap those investors for much needed capital to fuel its origination process and reach its goal of capturing more and more market share. To facilitate the increase in loan origination volume, Countrywide relaxed its underwriting standards and sold unaffordable and unnecessarily more expensive mortgage loans to millions of American homeowners.

On October 6, 2008, Illinois and several other states announced a settlement with Countrywide that established a mandatory loan modification program. To date, almost half of the states have signed on to this agreement. The settlement covers approximately 400,000 borrowers nationwide and, by our estimate, will provide 8.7 billion dollars in loan modifications to borrowers. Countrywide will also pay approximately 150 million dollars into a foreclosure relief fund for payments to distressed homeowners or for programs to help distressed homeowners.

Unlike previous settlements with subprime lenders, the Countrywide settlement did not contain mandatory injunctive provisions governing the company's future lending practices. There is a simple but disturbing reason for this: During our investigation, Countrywide transferred its mortgage origination business from its state-licensed subsidiary to its federally chartered thrift subsidiary.

The enforcement actions I have summarized are by no means fully representative of the extensive efforts undertaken by state attorneys general to combat predatory mortgage lending in the run-up to the foreclosure crisis and in its wake. As a measure of the vast scope of state-level enforcement actions against predatory mortgage lenders in recent years, I offer the following, non-exhaustive list:

In October of 2007, the Massachusetts Attorney General Martha Coakley filed a civil fraud suit against the large California based subprime lender Fremont General for predatory lending practices. In that case, a Massachusetts court granted General Coakley's request for injunction that prohibited Fremont from initiating or advancing foreclosures on loans that are "presumptively unfair." The Attorney General was then given the opportunity to review the loans and object to any future advancement of the foreclosures.

In June, 2008, General Coakley sued another large subprime lender, Option One Mortgage Company, and its parent H&R Block, for selling risky subprime products that were unaffordable and destined to fail.

In early 2007, the Ohio Attorney General filed a civil suit against the large California subprime lender New Century as it filed for bankruptcy. The Attorney General obtained a temporary restraining order prohibiting New Century from initiating any new loans or pursuing any foreclosure actions in Ohio. The injunction acted as a moratorium on New Century foreclosures in Ohio, thus giving the Attorney General's Office an opportunity to review the loans for evidence of predatory practices.

In December of 2007, the New York Attorney General filed a civil suit against the nation's largest mortgage and property services company, eAppraisalIT, for inflating the value of home appraisals. According to Attorney General Cuomo, the scheme was a response to pressure from Washington Mutual. The inflated appraisals would allow Washington Mutual to write more loans for more money than the collateral would justify.

In a continuation of its investigation of appraisal fraud, the New York Attorney General announced in early 2008 that the nation's two largest purchasers of home loans, Fannie Mae and Freddie Mac, had entered into cooperation agreements requiring them to only buy loans from banks that meet new standards designed to ensure independent and reliable appraisals. The agreements created a new organization to implement and monitor the new appraisal standards called the "New Home Valuation Protection Code."

In addition, numerous attorneys general have brought civil lawsuits against brokers, title companies and appraisers including the attorneys general of New York, Ohio, Iowa, Colorado, and Massachusetts. My Office has prosecuted a number of these individuals and companies in the past few years.

Criminal Actions

The attorneys general across the country have also begun pursuing mortgage fraud criminally. Targets have included dozens of mortgage brokers, loan processors, and bank officers. Additionally, in the first week of March there were guilty pleas in Minnesota, Delaware, North Carolina and Connecticut and sentences in Florida and Vermont for suits brought by the attorneys general in those states. Several states – including Texas, Colorado, Massachusetts, California, Washington, New Jersey, Ohio, Florida, and my own state – have brought criminal actions against various state participants in the mortgage arena, including attorneys, brokers, title companies and appraisers.

My Office and a number of other states participate in Mortgage Fraud Task Forces. These task forces are usually made up of federal, state, and local prosecutors who join forces to target the most egregious mortgage frauds. These task forces can be used to coordinate investigations and prosecutions of mortgage fraud and to promote inter-agency information-sharing.

III. Impediments to State Attorneys General Pursuing More Mortgage Fraud Enforcement Actions

State enforcement actions have been hamstrung by the dual forces of preemption of state authority and lack of federal oversight. The authority of state attorneys general to enforce consumer protection laws of general applicability was challenged at precisely the time it was most needed – when the amount of subprime lending exploded and riskier and riskier mortgage products came into the marketplace. For example, the Office of the Comptroller of Currency has taken the position over the past several years that it has authority to prevent state attorneys general from enforcing state fair lending and consumer protection laws against federal banks and bank subsidiaries. This position effectively created a void that was previously covered by state consumer protection and civil rights laws.

At the same time that preemption of state consumer protection powers gained ground, federal agencies failed to fill the gap in regulation with uniform market-wide standards that ensured lenders did not engage in fraudulent, deceptive or unfair lending practices. Our federalist system of government is premised on the notion that federal and state regulation can co-exist and are in fact complementary. Moreover, even if sufficient federal regulations had been promulgated, they are only effective to the extent that the administration in power is interested in enforcing them. Recognizing the important role of the state attorneys general will restore an effective check on banking and financial institutions.

The void created by preemption in the face of a failure of federal oversight added a number of impediments for state attorneys general in pursuing enforcement actions against predatory lenders. While it is too late to remove some of these impediments, there are some obstacles that can be eliminated to restore to state attorneys general the ability to successfully prosecute predatory lending in the future.

Preemption: Attorneys general have to make a difficult decision when we come upon lending abuses by federally chartered lenders; we have to weigh whether to expend our limited resources fighting the preemption battle or move on to pursuing the many other lenders engaging in the same practices. Many of the lenders who engaged in fraudulent, deceptive and unfair practices are no longer in business, and we are hamstrung in our efforts to pursue the remaining lenders, because most of them are now sheltering under the protections of federal charters. Such charters should not entitle lenders to a blanket exception from state prosecution for violating generally applicable state and federal consumer protection laws.

Failure to Include Consumer Protection in Federal Underwriting Standards: In the run up to the crisis, many federally chartered lenders were engaging in the same predatory lending practices as state-licensed entities, particularly through their subsidiaries. Federal regulators, however, in contrast to state attorneys general, did little to curb the abuses of those within their control. With the proliferation of increasingly sophisticated and complex loan products in the marketplace, the federal regulators should have taken steps

to ensure that lender underwriting standards protected consumers. Such standards should have included a requirement that lenders evaluate a consumers' ability to repay their mortgage loan. But instead of exercising their authority to protect consumers, federal regulators focused almost entirely on lender safety and soundness concerns. This focus was further narrowed by the federal regulators' limited metrics for assessing safety and soundness, which centered only on the viability of lending institutions. In essence, the federal government was sending the message to financial institutions that their profitability was the paramount concern.

In the absence of common sense underwriting standards on the federal level, states found it extremely difficult to enact underwriting standards and other lending reforms for state-licensed entities. As a result, states had to rely on state consumer protection laws to regulate lending abuses. This proved equally difficult. It was no easy matter to prove that questionable products and practices were illegal when there were no written federal rules or regulations specifically prohibiting them. Even as the first tremors were felt in the mortgage market, the perceived legality of the products and practices that fomented the oncoming crisis was reinforced by the federal regulators' failure to advance or support the states' arguments that certain products and practices were unfair and deceptive. When, with the issuance of Guidance, federal regulators finally weighed in on the appropriateness of these products and practices, it was too little, too late.

States continue to face enforcement issues caused by weak federal regulation. For instance, in 2007, Illinois passed legislation designed to protect consumers from the use – and abuse – of stated income documentation and to ensure that consumers were not placed in unaffordable mortgages. The stated income limitations in the Illinois statute apply to all loan products. By contrast, the Federal Reserve Board's recently announced limitations on stated income loans apply only to a certain category of loans. This is but one example of the many gaps between state and federal standards of protection. When these gaps occur, it is almost always the states that accord the greater level of protection. As a result, state-regulated entities are prohibited from engaging in certain practices that federally-regulated lenders can still do. This causes problems for the state attorneys general. Even with the housing market in ruins, mortgage brokers and others involved in the worst of the lending abuses are fighting to roll back consumer protections passed by state legislatures, and in service of this campaign, they invoke the "level playing field" argument. The attorneys general hear from state lenders and brokers that they simply want to offer the same products and use the same method of underwriting as do the federally chartered institutions. As one example, mortgage brokers in Illinois are currently arguing that the no documentation underwriting standards for the FHA streamline refinance product obviate any need to determine whether borrowers can in fact afford the new loan. Recent reports of rising default rates for FHA loans – including the FHA streamline refinance product – suggest that what is needed is not looser underwriting standards in Illinois, but stronger underwriting standards at HUD.

Resources: Investigation of the very large lenders requires an enormous investment of resources for the states. During the Countrywide investigation, for example, my lawyers

reviewed tens of thousands of documents and conducted numerous interviews of consumers and brokers. We also hired experts to assist us in this complex analysis.

While significant resources are required to prove lender liability, even more resources are required to prosecute individuals. To recover money from CEOs and executives of lenders who engaged in fraud, state attorneys general have to meet the high burden of proving individual liability for corporate activities. Despite these impediments, some states, including Illinois, have named Countrywide's former-CEO Angelo Mozilo in connection with their Countrywide lawsuits. These cases are still pending.

It is important to note that very large lenders are not the only targets of state attorney general enforcement actions. For the last few years, we have been investigating and prosecuting the many state-licensed participants in the market meltdown, especially mortgage brokers. These cases are so numerous that we could spend all of our time and resources pursuing them. State attorneys general simply do not have the resources to investigate every bad actor in the lending arena. Strong federal oversight of lender underwriting practices will go a long way toward decreasing the amount of abuse at the broker level.

TILA Disclosure Defense Used as a Shield: The lenders used TILA disclosures as a shield for extremely complicated mortgage products that very few consumers could understand. Pay Option ARMs that negatively amortize depending on the payment the consumer chooses is a good example. These products simply were not appropriate for the average homeowner and the TILA disclosures did not help the consumer to understand the product. Lenders point to compliance with TILA disclosures to immunize them from any claims that they violated state consumer protection laws.

Risk Shifting: The risk shifting caused by the largely unregulated securitization of mortgage loans causes two additional problems for state attorneys general. First, the risk shifting multiplies the number of potential targets that states may have to investigate. Second, the unchecked risk shifting incentivized imprudent underwriting at every level of the loan transaction and removed potential liability for that poor underwriting. If the incentives to engage in imprudent underwriting are not removed, then state attorneys general will fight a losing battle to regulate an ever-growing number of targets.

IV. Conclusion

To sum up, some state attorneys general have been predicting the current lending crisis for years, but few listened. Banks, lenders and mortgage brokers lobbied aggressively to prevent any regulation at either the state or federal level. It really was not until investors started losing money and Wall Street was impacted that it has been possible to get any significant legislative attention paid to these issues. There are lessons to be learned. First, to prevent a crisis of this magnitude from happening again in the future, greater and more rigorous oversight of lenders is needed at the federal level. That oversight must give as much weight to consumer protection as it does to safety and soundness. As we have all seen, these two goals are not mutually exclusive, but rather are inseparably

bound together. Second, the movement to erode state authority to enforce state and federal consumer protection laws must cease. Attempts to exclude state attorneys general from enforcing consumer protection laws have significantly contributed to the distress our residents have endured as a result of these difficult economic times. Finally, given the seemingly infinite number of bad actors responsible for this crisis, all of the agencies here today must maximize our resources by increased cooperation and coordination of enforcement efforts. Thank you for the opportunity to testify before the committee today.

Department of Justice

STATEMENT OF

JOHN PISTOLE
DEPUTY DIRECTOR
FEDERAL BUREAU OF INVESTIGATION
UNITED STATES DEPARTMENT OF JUSTICE

BEFORE THE

UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

HEARING ENTITLED

"FEDERAL AND STATE ENFORCEMENT OF FINANCIAL CONSUMER AND INVESTOR PROTECTION LAWS"

PRESENTED

MARCH 20, 2009

Good morning Mr. Chairman, Ranking Member, and Members of the Committee. I want to thank you for the opportunity to testify before you today about the Federal Bureau of Investigation's (FBI) efforts to combat mortgage fraud and other financial frauds. Much the same as the Savings and Loan (S&L) Crisis of the 1980s crippled our economy, so too has the current financial crisis. Many of the lessons learned and best practices from our work during the past decade, such as the Enron investigation, will clearly help us navigate the expansive crime problem currently taxing law enforcement and regulatory authorities.

In the late 1980s and early 1990s, the United States experienced a similar financial crisis with the collapse of the savings and loans. The Department of Justice (DOJ), and more specifically the FBI, were provided a number of tools through the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) and Crime Control Act of 1990 (CCA) to combat the aforementioned crisis. As stated in Senate Bill 331 dated January 27, 2009, "in the wake of the Savings and Loan crisis of the 1980s, a series of strike forces based in 27 cities was staffed with 1000 FBI agents and forensic experts and dozens of federal prosecutors. That effort yielded more than 600 convictions and $130,000,000 in ordered restitution."

However, today's financial crisis is vastly greater than the S&L crisis as financial institutions have reduced their assets by more than $1 trillion related to the current global financial crisis compared to the estimated $160 billion lost during the S&L crisis. Mortgage and related corporate fraud were not the main sources of the current financial crisis; however, it would be irresponsible to neglect mortgage fraud's impact on the U.S. housing and financial markets.

As the FBI's former Assistant Director for the Criminal Division testified in 2004 before the House Financial Services Sub-Committee: "If fraudulent practices become systemic within the mortgage industry and mortgage fraud is allowed to become unrestrained, it will ultimately place financial institutions at risk and have adverse effects on the stock market. Investors may lose faith and require higher returns from mortgage backed securities. This may result in higher interest rates and fees paid by borrowers and limit the amount of investment funds available for mortgage loans."

He also noted that the FBI supported new approaches to address mortgage fraud and its effects on the U.S. financial system, to include:

- a mechanism to require the mortgage industry to report fraudulent activity, and
- the creation of "Safe Harbor" provisions to protect the mortgage industry under a mandatory reporting mechanism.

What has occurred has been far worse than the Assistant Director predicted. The fraud schemes have adapted with the changing economy and now individuals are preyed upon even as they are about to lose their homes. But what is mortgage fraud?

Although there is no specific statute that defines mortgage fraud, each mortgage fraud scheme contains some type of material misstatement, misrepresentation or omission relied upon by an underwriter or lender to fund, purchase or insure a loan.

The FBI delineates mortgage fraud in two distinct areas: 1) Fraud for Profit; and 2) Fraud for Housing. Fraud for Profit uses a scheme to remove equity, falsely inflate the value of the property or issue loans relating to fictitious property(ies). Many of the Fraud for Profit schemes rely on "industry insiders", who override lender controls. The FBI defines industry insiders as appraisers, accountants, attorneys, real estate brokers, mortgage underwriters and processors, settlement/title company employees, mortgage brokers, loan originators, and other mortgage professionals engaged in the mortgage industry.

Fraud for Housing represents illegal actions perpetrated by a borrower, typically with the assistance of real estate professionals. The simple motive behind this fraud is to acquire and maintain ownership of a residence under false pretenses. This type of fraud is typified by a borrower who makes misrepresentations regarding the borrower's income or employment history to qualify for a loan.

The FBI compiles data on mortgage fraud through Suspicious Activity Reports (SARs) filed by financial institutions and through the Department of Housing and Urban Development (HUD) Office of Inspector General (OIG) reports. The FBI also receives and shares information pertaining to mortgage fraud through its national and regional working groups as well as complaints from the industry at large.

While a significant portion of the mortgage industry is void of any mandatory fraud reporting and there is presently no central repository to collect all mortgage fraud complaints, SARs from financial institutions have indicated a significant increase in mortgage fraud reporting. For example, during Fiscal Year (FY) 2008, mortgage fraud SARs increased more than 36 percent to 63,173. The total dollar loss attributable to mortgage fraud is unknown. However, seven percent of SARs filed during FY 2008 indicated a specific dollar loss, totaling more than $1.5 billion. Only seven percent of SARs report dollar loss because of the time lag between identifying a suspicious loan and liquidating the property through foreclosure and then calculating the loss amount. As of February 28, 2009, there were 28,873 mortgage fraud SARs filed in Fiscal Year 2009.

Based on past and current investigations, the FBI recognizes that the mortgage industry is susceptible to a number of vulnerabilities through industry insiders and other individuals involved in loan and finance transactions. However, the FBI recognizes that the term "industry insiders" can be interpreted very broadly, and many mortgage finance-related entities are either loosely or completely unregulated at the state or federal level. The Department of Justice would like to work with the Department of the Treasury's Financial Crimes Enforcement Network to expand the exercise of their statutory authority under the Bank Secrecy Act (BSA) to consider the implementation of SAR and anti-money laundering program requirements on some of the businesses and professions that currently fall outside the scope of SAR reporting. A vigilant industry combined with this

reporting stream, when made available to the FBI and HUD, would be a major step forward in addressing the practice of mortgage fraud.

Fraud Trends

The current financial crisis has produced an unexpected consequence: it has exposed prevalent fraud schemes that have been thriving in the global financial system. These fraud schemes are not new but they are coming to light as a result of market deterioration. For example, current market conditions have helped reveal numerous mortgage fraud schemes, Ponzi schemes and investment frauds, such as the Bernard Madoff scam. These schemes highlight the need for law enforcement and regulatory agencies to be ever vigilant of White Collar Crime both in boom and bust years.

The FBI has experienced and continues to experience an exponential rise in mortgage fraud investigations. The number of FBI mortgage fraud investigations has risen from 881 in FY 2006 to more than 2,000 in FY 2009. In addition, the FBI has more than 566 open corporate fraud investigations, including 43 corporate fraud and financial institution matters directly related to the current financial crisis. These corporate and financial institution failure investigations involve financial statement manipulation, accounting fraud and insider trading. The increasing mortgage, corporate fraud, and financial institution failure case inventory is straining the FBI's limited White Collar Crime resources.

Although there are many mortgage fraud schemes, the FBI is focusing its efforts on those perpetrated by industry insiders who are part of organized enterprises engaged in mortgage Fraud for Profit. Industry insiders are of priority concern as they are, in many instances, the facilitators that permit the fraud to occur. The FBI utilizes SAR data to help identify fraud schemes perpetrated by insiders. However, SAR data only captures suspicious activity identified by those industry actors who choose to voluntarily report it. Requiring the entire industry to report suspicious activity would give us a more complete data set to exploit. The FBI is engaged with the mortgage industry in identifying fraud trends and educating the public. Some of the current rising mortgage fraud trends include: equity skimming, property flipping, mortgage identity related theft, and foreclosure rescue scams.

Equity skimming is a tried and true method of committing mortgage fraud and criminals continue to devise new schemes. Today's common equity skimming schemes involve the use of corporate shell companies, corporate identity theft and the use or threat of bankruptcy/foreclosure to dupe homeowners and investors.

Property flipping is nothing new; however, once again law enforcement is faced with an educated criminal element that is using identity theft, straw borrowers and shell companies, along with industry insiders to conceal their methods and override lender controls.

Identity theft in its many forms is a growing problem and is manifested in many ways, including mortgage documents. The mortgage industry has indicated that personal,

corporate, and professional identity theft in the mortgage industry is on the rise. Computer technology advances and the use of online sources have also assisted the criminal in committing identity-related mortgage fraud. However, the FBI is working with its law enforcement and industry partners to identify trends and develop techniques to thwart illegal activities in this arena.

Foreclosure rescue scams are particularly egregious in that fraudsters take advantage and illegally profit from other individuals' misfortunes. As foreclosures continue to rise across the country, so too have the number of foreclosure rescue scams that target unsuspecting victims. These scams include victims losing their home equity or paying thousands of dollars in fees, and then receiving little or no services, and ultimately losing their home to foreclosure. The FBI is again working with our law enforcement and regulatory partners along with industry partners to target, disrupt and dismantle the individuals and/or companies engaging in these fraud schemes.

Proactive Approach to Financial Frauds

The FBI has implemented new and innovative methods to detect and combat mortgage fraud. One of these proactive approaches was the development of a property flipping analytical computer application, first developed by the Washington Field Office, to effectively identify property flipping in the Baltimore and Washington areas. The original concept has evolved into a national FBI initiative which employs statistical correlations and other advanced computer technology to search for companies and persons with patterns of property flipping. As potential targets are analyzed and flagged, the information is provided to the respective FBI field office for further investigation. Property flipping is best described as purchasing properties and artificially inflating their value through false appraisals. The artificially valued properties are then sold at a higher price to an associate of the "flipper" at a substantially inflated price. Often flipped properties go into foreclosure and are ultimately repurchased for a fraction of their original value.

Other methods employed by the FBI include sophisticated investigative techniques, such as undercover operations and wiretaps. These investigative measures not only result in the collection of valuable evidence, they also provide an opportunity to apprehend criminals in the commission of their crimes, thus reducing loss to individuals and financial institutions. By pursuing these proactive methods in conjunction with historical investigations, the FBI is able to realize operational efficiencies in large scale investigations.

In December 2008, the FBI dedicated resources to create the National Mortgage Fraud Team at FBI headquarters in Washington, D.C. The Team has the specific responsibility for all management of the mortgage fraud program at both the origination and corporate level. This Team will be assisting the field offices in addressing the mortgage fraud problem at all levels. The current financial crisis, however, has required the FBI to move resources from other white collar crime and criminal programs in order to appropriately address the mortgage fraud problem. Since January 2007, the FBI has increased its agent and analyst manpower working mortgage fraud investigations. The

Team provides tools to identify the most egregious mortgage fraud perpetrators, prioritize pending investigations, and provide information to evaluate where additional manpower is needed.

Partnerships

One of the best tools the FBI has in its arsenal for combating mortgage fraud is its long-standing partnerships with other federal, state and local law enforcement. This is not a new tool employed by the FBI. Collaboration, communication, and information-sharing have long been a proven solution to the nation's most difficult crimes. In response to a growing gang problem, for example, the FBI stood up Safe Streets Task Forces across the country. In response to crimes in Indian Country, the FBI developed the Safe Trails Task Force Program. In response to this new threat, the FBI stood up Mortgage Fraud Task Forces across the country.

Presently, there are 18 mortgage fraud task forces and 47 working groups nationwide. With representatives of federal, State, and local law enforcement, these task forces are strategically placed in areas identified as high threat areas for mortgage fraud. Partners are varied but typically include representatives of HUD-OIG, the U.S. Postal Inspection Service, the Internal Revenue Service, FinCEN, the Federal Deposit Insurance Corporation, as well as State and local law enforcement officers across the country.

While the FBI has increased the number of agents around the country who investigate mortgage fraud cases from 120 Special Agents in FY 2007 to 254 Special Agents, as of February 28, 2009, this multi-agency model serves as a force-multiplier, providing an array of resources to adequately identify the source of the fraud, as well as finding the most effective way to prosecute each case, particularly in active markets where fraud is widespread. We are pleased to report that the model is working.

Last June, for example, we worked closely with our partners on "Operation Malicious Mortgage" – a massive multiagency takedown of mortgage fraud schemes involving more than 400 defendants nationwide. That operation focused primarily on three types of mortgage fraud: lending fraud, foreclosure rescue schemes, and mortgage-related bankruptcy schemes. Among the 400-plus subjects of "Operation Malicious Mortgage", there have been 164 convictions and 81 sentencings so far for crimes that have accounted for more than $1 billion in estimated losses. Forty-six of our 56 field offices around the country took part in the operation, which has resulted in the forfeiture and/or seizure of more than $60 million in assets.

In addition to the effort placed in standing up mortgage fraud task forces, once a month the FBI is one of the DOJ participants in the national Mortgage Fraud Working Group (MFWG), which DOJ chairs. The MFWG represents the collaborative effort of multiple Federal agencies and facilitates the information sharing process across agencies, as well as to private organizations. Together, we are building on existing FBI intelligence databases to identify large industry insiders and criminal enterprises conducting systemic mortgage fraud. The FBI is also a member of the President's Corporate Fraud Task Force which is comprised of investigators from the Securities and

Exchange Commission, the Internal Revenue Service, the U.S. Postal Inspection Service, the Commodity Futures Trading Commission, and the Financial Crimes Enforcement Network. The purpose of the Corporate Fraud Task Force is to maximize intelligence sharing between membership agencies and to ensure the violations related to corporate fraud are appropriately addressed.

The FBI also participates in the Corporate/Securities Fraud Working Group, a national interagency coordinating body established by DOJ to provide a forum for exchanging information and discussing violation trends, law enforcement issues and techniques. In addition, since April 2007, FBI headquarters personnel have met with representatives from the Securities and Exchange Commission once a month to coordinate the respective Corporate Fraud inventories focused on the current financial crisis and to share intelligence.

Industry Liaison

In addition to its partners in law enforcement and regulatory areas, the FBI also continues to foster relationships with representatives of the mortgage industry to promote mortgage fraud awareness. The FBI has spoken at and participated in various mortgage industry conferences and seminars, including those sponsored by the Mortgage Bankers Association (MBA).

To raise awareness of this issue and provide easy accessibility to investigative personnel, the FBI has provided contact information for all FBI Mortgage Fraud Supervisors to relevant groups including the MBA, Mortgage Asset Research Institute, Fannie Mae, Freddie Mac and others. Additionally, the FBI is collaborating with industry to develop a more efficient mortgage fraud reporting mechanism for those not mandated to report such activity. This Suspicious Mortgage Activity Report (SMARt Form) concept is under consideration by the MBA. The FBI supports providing a "safe harbor" for lending institutions, appraisers, brokers and other mortgage professionals similar to the provisions afforded to financial institutions providing SAR information. The "Safe Harbor" provision would provide necessary protections to the mortgage industry under a mandatory reporting mechanism. This will also better enable the FBI to provide reliable mortgage fraud information based on a more representative population in the mortgage industry.

Lenders are painfully aware that fraud is affecting their bottom line. Through routine interaction with FBI personnel, industry representatives are aware of our commitment to address this crime problem. The FBI frequently participates in industry sponsored fraud deterrence seminars, conferences and meetings which include topics such as quality control and industry best practices to detect, deter, and prevent mortgage fraud. These meetings play a significant role in training and educating industry professionals. Companies share current and common fraud trends, loan underwriting weaknesses and best practices for fraud avoidance. These meetings also increase the interaction between industry and FBI personnel.

Additionally, the FBI continues to train its personnel and conduct joint training with HUD-OIG and industry on mortgage fraud. As a training model, the FBI seeks industry experts to assist in its internal training programs. For example, industry has assisted training FBI personnel on mortgage industry practices, documentation, and industry views of laws and regulations. Industry partners have offered to assist the FBI in developing advanced mortgage fraud investigative training material and fraud detection tools.

Conclusion

Mr. Chairman, the FBI remains committed to its responsibility to aggressively investigate significant financial crimes which include mortgage fraud. We will continue to work with the Office of Management and Budget, and the Congress to ensure that adequate resources are available to address these threats. To maximize our current resources, we are relying on intelligence collection and analysis to identify emerging trends to target the greatest threats. We also will continue to rely heavily on the strong relationships we have with both our law enforcement and regulatory agency partners.

The FBI looks forward to working with you and other members of this committee on solving this serious threat to our nation's economy. Thank you for allowing me the opportunity to testify before you today. I look forward to taking your questions.

Embargoed until
March 20, 2009, at 10:00 am

Statement of

Scott M. Polakoff
Acting Director, Office of Thrift Supervision

regarding

Federal and State Enforcement of Financial Consumer and Investor Protection Laws

before the

Committee on Financial Services
United States House of Representatives

March 20, 2009

Office of Thrift Supervision
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Statement required by 12 U.S.C. 250: The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent those of the President.

Testimony on Federal and State Enforcement of Financial Consumer and Investor Protection Laws
Before the Committee on Financial Services
United States House of Representatives
March 20, 2009

Statement of Scott M. Polakoff
Acting Director, Office of Thrift Supervision

I. Introduction

Good morning, Chairman Frank, Ranking Member Bachus, and Members of the Committee. Thank you for the opportunity to testify today regarding the scope and exercise of OTS's (Office of Thrift Supervision) enforcement authority over the institutions it supervises and regulates and institution-affiliated parties, and, in particular, OTS enforcement of consumer protection laws. My testimony presents an overview of OTS enforcement authority; discusses OTS enforcement policies; provides data showing a steady increase in OTS' formal enforcement actions continuing through the first few months of 2009; and presents examples of OTS formal enforcement actions addressing violations of consumer protection laws.

In addition, my testimony will explain the various ways in which OTS engages in enforcement efforts and initiatives on an interagency basis, making referrals to and coordinating with the Department of Justice (DOJ) and the Department of Housing and

Urban Development (HUD), and working with federal banking and state regulators to address fair lending and mortgage fraud matters.

II. Overview of Enforcement Authority

OTS has authority to take formal enforcement action under the Home Owners Loan Act (HOLA) and the Federal Deposit Insurance Corporation Act (FDIA) against OTS-regulated institutions, including savings associations, their operating subsidiaries and service corporations, and savings and loan holding companies and affiliates. OTS also has authority to take enforcement action against individuals and entities that are "institution-affiliated parties." This term is defined by the FDIA to include an OTS-regulated institution's employees, directors and officers, controlling shareholders, agents, consultants and other "persons participating in the conduct of the affairs" of an institution, as well as independent contractors, under certain circumstances.

OTS also has specific authority to enforce compliance by OTS regulated institutions and parties with various federal statutes. In the consumer protection area, for example, OTS examines for and enforces compliance by savings associations with the Truth in Lending Act (TILA) and the Real Estate Settlement Procedure Act (RESPA).

The Federal Trade Commission Act (FTC Act) provides OTS with authority to issue regulations, in addition to other OTS enforcement authority under the FTC Act, to prevent savings associations from engaging in acts or practices that are unfair or deceptive to consumers. The OTS began the interagency effort to protect consumers against unfair and deceptive acts in August 2007 by issuing an Advance Notice of Proposed Rulemaking to seek comments on a broad array of practices related to the marketing, originating and servicing of credit cards and other financial services products. Many commenters responding to the notice urged OTS to take an approach that would lead to uniform and consistent rules that would create a level playing field across the financial services industry.

The Federal Reserve Board and National Credit Union Administration joined the OTS for the next step in the federal rulemaking process and in May 2008, the agencies issued a Proposed Rule that generated 66,000 comments and led to the final rule published in January 2009. The final rule is intended to provide consumers with a reasonable time to pay credit card bills, fairly allocate payments to balances with different interest rates, establish certain restrictions on increasing interest rates, ban double-cycle billing, and limit the fees charged for opening an account. The OTS version of the rule will apply to savings associations, the FRB rule will apply to banks and the NCUA rule will apply to federal credit unions.

The regulation takes effect July 2010 and OTS will have authority to then enforce additional consumer protection regulations. Although the rule is not formally effective until 2010, the agencies have strongly encouraged institutions to implement them as soon as practicable. The OTS has issued a letter to savings association CEOs which asks them to do so. In determining the effective date, the agencies considered the broad scope of the operational changes that the rule will require for information systems and training. They were also mindful of the substantial improvements in disclosure requirements that issuers will have to implement in tandem due to the FRB overhaul of the portions of TILA rules that apply to open end credit. Although most commenters indicated that adapting to these changes would take two years, the agencies required that they be accomplished in about 18 months.

Types of Formal Enforcement Action

OTS's general enforcement power under the FDIA is the same as those of the other federal banking agencies (FBAs). OTS may issue an order to cease and desist (C&D order) to address unsafe or unsound practices, and violations of (i) any law, rule or regulation, (ii) a written agreement entered into with OTS, and (iii) conditions imposed in writing by OTS in connection with the granting of an application or other request by an institution. This includes formal enforcement action to address violations of consumer protection laws and regulations. OTS has authority to initiate formal enforcement actions, such as C&D orders, based on such practices or violations whether they are past,

ongoing, or if OTS has "reasonable cause to believe" that the regulated entity is likely to engage in such practices or violations. C&D orders may be issued by OTS, on consent or after a formal administrative hearing.

OTS may also require affirmative corrective action in C&D orders and other formal enforcement actions. If an association or affiliated party was unjustly enriched, or the violation or practice involved reckless disregard for the law, the formal enforcement action could require restitution or reimbursement by the OTS-regulated entity or affiliated party. OTS has required restitution and reimbursement for violation of consumer protection laws such as TILA and RESPA.

To deter violations of consumer protection and other laws and unsafe and unsound practices, OTS and the other FBAs also may assess civil money penalties (CMPs), on consent or after a formal administrative hearing. There are three statutory "tiers" of CMPs. CMPs can range in amount from $7,500 to $1,375,000 per day, per violation depending on the nature and severity of the violation and the amount of loss or unjust enrichment as a result of the violation or practice. OTS takes CMP action for violations of law and regulation, such as of consumer protection laws. In addition, OTS makes referrals to DOJ based on fair lending and other suspected violations.

III. Exercise of Enforcement Authority by OTS

OTS exercises its authority to enforce consumer protection and other laws and regulations, as well as safety and soundness, using the full range of formal and informal enforcement actions. OTS also coordinates with other federal and state banking regulators, functional regulators and DOJ in addressing civil and suspected criminal matters.

OTS examiners conduct compliance, as well as safety and soundness examinations every 12 to 18 months, based on the institution's asset size, condition and previous record of compliance. OTS also evaluates periodic financial condition reports filed by savings associations and conducts off-site monitoring and field visits to follow-up on issues of concern noted at previous on-site examinations. Examiners will evaluate an institution's compliance with applicable laws and regulation. This includes required disclosures and evaluation of the institution's compliance management program as a whole, including adequacy of its policies, procedures and staffing to determine adherence to consumer protection laws, regulations and OTS supervisory guidance. To the extent that noncompliance is found, formal or informal enforcement action is taken in accordance with law, OTS enforcement policy and supervisory considerations and goals.

Significant Considerations in Enforcement Decisions

The number and seriousness of the problems detected, including the extent of actual or potential damage or loss to consumers or the associations are other significant enforcement considerations. In addition, OTS considers whether the consumer violation or other problem was self-identified; whether and when any remedial action was taken by the institution; the ability and cooperation of management to address the problem; and whether the institution is a repeat violator.

In general, enforcement decisions, including those addressing compliance with consumer protection laws, are progressive -- moving from informal to formal action as needed or appropriate based on supervisory and legal evaluations. Consumer protection laws may also specify the type or amount of penalty or other enforcement action. Initiation, modification and termination of OTS enforcement actions, including those that enforce consumer protection laws, are required to be supported by documentation, such as examination findings and transcripts of discussions with management and the board of directors. In some cases, OTS will initiate a formal investigation as authorized by HOLA to obtain additional information, using subpoenas and sworn testimony, before making an enforcement decision. Robust and targeted fair lending examinations involving the review and analysis of underwriting and pricing factors, consideration of consumer complaints, and related factors precede a referral to DOJ or HUD.

Informal Action

OTS may use informal enforcement action when a savings association's overall condition is considered sound, but OTS deems it necessary to obtain certain written commitments from an association or holding company's board of directors or management to ensure correction of identified problems or violations of law or regulation, including consumer protection laws.

Absent unique circumstances, OTS enforcement policy presumes that informal action may be appropriate when an institution is well or adequately capitalized and has an effective compliance program. Examples of informal enforcement action are: an OTS request for board of director resolutions to address specific regulatory concerns or directions conveyed in a supervisory letter or presentation to the board of directors of a Memorandum of Understanding (MOU) requiring corrective action within a specified time frame.

Informal action is nonpublic and is not enforceable in and of itself. The effectiveness of informal action depends in large part on the willingness and ability of the regulated institution or its affiliated party to correct the identified deficiency or violation. If OTS subsequently determines there is noncompliance with informal action by the association or holding company, or finds additional problems, concerns or violations, or

finds that the association's condition has deteriorated, OTS will progress to formal enforcement action.

Formal Enforcement Action

OTS uses formal enforcement action to address violations of consumer protection and other laws, rules and regulations, and unsafe or unsound practices. Formal OTS enforcement actions are made public by OTS. Formal actions include Supervisory Agreements; C & D orders; Removal and Prohibition Orders; and orders that assess CMPs. In practice, nearly all formal enforcement actions taken by OTS are issued and become final on consent. In other words, the regulated institution or party stipulates to the action and waives a formal administrative hearing under the Administrative Procedures Act.

Violations of formal enforcement actions such as Supervisory Agreements and Orders may result in assessment by OTS of CMPs. OTS also may enforce all formal actions except Supervisory Agreements in federal district court.

OTS will use formal enforcement actions when an association has significant problems or violations, has an inadequate Compliance examination rating, or informal enforcement action is deemed inadequate or has been ineffective. In some cases, OTS is

legally required to take certain formal enforcement action, such as pursuant to the Bank Secrecy Act (BSA).

Sometimes OTS takes action jointly with other federal regulators. For example, in 2005, the OTS issued a joint C&D order with a civil money penalty in settlement of charges regarding mortgage settlement practices against Chicago Title Insurance Company. The other parties to the joint settlements were the Office of the Comptroller of the Currency (OCC) and HUD.

Requiring Disclosure, Restitution, Reimbursement and Other Affirmative Action

Formal enforcement action often requires an association or affiliated party to take affirmative action, such as independent audits and restitution or reimbursement and disclosures to customers. In a recent example, OTS entered into a Supervisory Agreement in 2007 with AIG Federal Savings Bank and two affiliates, Wilmington Finance, Inc. and American General Finance, Inc. that resulted from OTS's determination that AIG FSB had failed to manage and control the mortgage lending activities outsourced to an affiliate. Pursuant to this formal enforcement action, objectionable practices were prohibited and AIG FSB was required to establish a $128 million reserve to cover costs associated with providing affordable loans to borrowers whose creditworthiness was not adequately evaluated and to reimburse borrowers who paid

large broker or lender fees. The three AIG subsidiaries were required to implement a Financial Remediation Plan that included a mechanism for resolving consumer complaints and provided for a clear and accessible audit trail for tracking and verification to address the negative financial impact to certain borrowers from the insufficiently supervised lending activities. In addition the Agreement required the three AIG subsidiaries to donate $15 million to financial literacy and credit counseling programs.

Similarly, in 2008 OTS issued C& D and CMP orders against Domestic Bank of Cranston, Rhode Island and its subsidiaries to enforce compliance with consumer protection laws (RESPA, the FTC Act, TILA and the Home Owners Protection Act provisions governing private mortgage insurance and OTS regulations governing appraisals and real estate lending). The OTS C&D order required the Bank to prepare and implement a Remediation Plan for the benefit of the Bank's consumers who had been charged large lender or broker fees. In connection with this Plan, the Bank was required to establish a reserve of $5 million. Bank reimbursement to borrowers was also ordered based on the Bank's violations of the Real Estate Settlement Procedures Act and the Truth in Lending Act and the Bank was required to provide documentary evidence to OTS that such payments had been made. In addition, the order required improvements in the Bank's management and in oversight by the board of directors and the retention of an expert appraiser to prepare a required review and report on appraisals, including those criticized in the OTS examination.

Increase in OTS Formal Enforcement Actions

As the attached chart **[See Attachment A]** reflects, the overall number of OTS formal enforcement actions has increased significantly since 2006. C & D orders went from 13 in 2006 to 34 in 2008 and total enforcement actions rose from 53 to 68. The OTS Enforcement Division has already litigated one formal administrative hearing in 2009. Moreover, in just the first few months of 2009, OTS issued 15 C&D orders; 11 Civil Money Penalty Orders; four Prohibition Orders; and five PCA directives. Moreover, as of March 2009, the Enforcement Division has filed two Notices of Charges with the Office of Financial Institution Adjudication (OFIA) initiating the formal administrative hearing process.

More specifically, with regard to consumer protection, the OTS has taken the following formal enforcement actions: In 2006, OTS formal actions involving consumer protection issues included two C&D orders, two Supervisory Agreements, and four Civil Money Penalty assessments for violations of laws and regulations that contain flood insurance requirements. In 2007, there were four C&D orders, four Supervisory Agreements and three Civil Money Penalty assessments for flood insurance violations involving consumer protection issues. In 2008, there were six C&D orders, three Supervisory Agreements, five Civil Money Penalty assessments for flood insurance

violations and one Civil Money Penalty Assessment for safety and soundness violations involving consumer protection issues.

Several years ago, OTS began increasing the resources it devoted to enforcement. For example, from 2006 to 2009, OTS nearly doubled the number of its Enforcement Division attorneys from six (three in DC; three in Regions) in 2006 to 10 (six in DC; four in Regions) in 2009. OTS also revised its Enforcement Policies, established model document language to standardize enforcement documents, and is currently engaged in other initiatives to improve and enhance the efficiency and effectiveness of our enforcement process.

IV. Coordination with Other Agencies in Criminal and Civil Enforcement Fair Lending Referrals

OTS also makes referrals of suspected violations and coordinates with other regulators to facilitate other civil actions and criminal prosecutions. In the fair lending area, OTS has increased the number of referrals relating to the Equal Credit Opportunity Act and Fair Housing Act to DOJ (eight since January 1, 2007). OTS has seen a parallel increase in the number of Community Reinvestment Act ratings downgrades due to our findings of evidence of discrimination or other illegal credit practices related to the fair lending concerns. Included within these referrals are five cases based on "steering" consumers to more expensive mortgage products due to their race or national origin.

In 2006, OTS also began to expand staffing devoted to fair lending examination issues (including economists, specialists, experienced examiners and a Managing Director of Compliance and Consumer Protection) to oversee this important area of examination and supervision. OTS also revised and enhanced its fair lending referral process to provide guidance to field examiners and regional offices as they review savings associations with noted fair lending violations that may result in a referral to the DOJ or HUD.

Current, ongoing fair lending initiatives include revisions to OTS Nondiscrimination Examination Procedures and to the OTS' version of the Interagency Fair Lending Examination Procedures, which will be distributed shortly. Updates to the scoping and econometric tools to identify and analyze possible fair lending violations are also in development.

Criminal Prosecution of Consumer Fraud

OTS does not prosecute criminal matters but coordinates with DOJ and the various U.S. Attorneys Offices in the prosecution of criminal cases. OTS is an active participant in interagency working groups and task forces to identify various types of fraud in the financial sector and to determine the civil and criminal options available to hold responsible individuals and entities accountable for their actions. For example, OTS

is a member of the President's Corporate Fraud Task Force, the Bank Fraud Working Group, the Mortgage Fraud Working Group and the newly formed Payments Fraud Working Group.

In addition, law enforcement and the FBAs, including OTS, share relevant information. This provides OTS with a direct mechanism to bring matters it has discovered as likely involving criminal conduct to the attention of criminal enforcement authorities. OTS also supported the efforts of "Operation Malicious Mortgage," a joint collaborative law enforcement effort involving the DOJ, FBI, US Postal Inspection Service, IRS-Criminal Investigation Division, US Immigration and Customs Enforcement, US Secret Service, US Trustee Program, HUD-Office of the Inspector General, VA-Office of the Inspector General and FDIC-Office of the Inspector General. This joint effort resulted in 144 mortgage fraud cases in which 406 defendants were charged between March 1 and June 18, 2008.

OTS also works with federal and state prosecutors to obtain administrative prohibition orders concurrently with criminal convictions against institution-affiliated parties indicted for financial crimes.

In addition, savings associations are required by the BSA and OTS regulations to file Suspicious Activity Reports with Financial Crimes Enforcement Network (FINcen). As

part of our examination process, OTS monitors compliance by savings associations with the Suspicious Activity Report (SAR), and other BSA requirements. OTS uses enforcement actions to correct any failure by a savings association to file SAR and works closely with DOJ and other agencies to improve the handling and management of SARs.

V. Possible Areas for Improving Enforcement Closing the Regulatory Gaps

There are gaps in laws and regulations concerning mortgage lending that leave whole sectors of the financial market unregulated or under-regulated, including mortgage brokers and mortgage companies. Too many players in the housing debt and finance business do not fall under the reach of federal regulations. Therefore, we suggest that Congress consider establishing a level playing field with the same supervision and rules for all players, so the standards of the under-regulated segments of the market are raised to the level followed by the federally regulated segments.

Facilitating Prompt and Effective Regulatory Enforcement

Two other areas in which legislation may improve or facilitate prompt and effective regulatory enforcement of consumer protection and other laws and regulations are 1) expansion and enhancement of federal banking agency injunctive (temporary cease and desist) authority under 12 USC 1818(c) and 2) expansion or clarification of federal

banking jurisdiction over third parties to whom depository institutions have outsourced key reviews, activities or functions.

Under 12 USC 1818(c) OTS and the other FBAs have authority to take temporary and limited, immediate enforcement action for incomplete or inaccurate books and records and when the FBA determines that a violation or unsafe or unsound practice "is likely to cause insolvency or significant dissipation of assets or earnings of the depository institution, or likely to weaken the condition of the depository institution or otherwise prejudice the interests of depositors" prior to completion of a trial-type administrative hearing pursuant to 12 USC 1818(h). The temporary cease and desist order standard does not address the interests of consumers and is difficult to apply in consumer protection and certain situations affecting a depository institution's safety and soundness.

Clarification of the jurisdictional scope of the term "institution-affiliated party" in 12 USC 1813(u) (3) and (4), in particular with regard to certain third parties, would facilitate enforcement actions against mortgage brokers, appraisers and consultants who violate consumer protection laws and regulations while performing functions outsourced by a depository institution. At a minimum, legislation could add statutory examples of "participation in the conduct of the affairs" of the insured depository institution intended to be included with the definition of "institution affiliated party".

VI. Closing

Thank you Mr. Chairman. I would be pleased to answer any questions you may have.

ATTACHMENT A

Total numbers of OTS Formal Enforcement Actions (2006-3/2009)

	2006	2007	2008	2009 (01/01 – 03/11)
Supervisory Agreements:	15	7	8	1
Cease and Desist Orders:	13	20	34	15
Civil Money Penalties:	10	5	11	11
Prohibition Orders:	15	13	12	4
Prompt Corrective Action (PCA) Directives:	0	2	3	5
TOTALS:	**53**	**47**	**68**	**36**

TESTIMONY OF

SARAH BLOOM RASKIN

MARYLAND COMMISSIONER OF FINANCIAL REGULATION

On

"FEDERAL AND STATE ENFORCEMENT OF

FINANCIAL CONSUMER AND INVESTOR PROTECTION LAWS"

Before the

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

March 20, 2009, 10:00 a.m.

Room 2128 Rayburn House Office Building

Introduction

Good morning, Chairman Frank, Ranking Member Bachus, and distinguished members of the Committee. My name is Sarah Bloom Raskin, and I serve as the Commissioner of the Maryland Office of Financial Regulation. I also serve as the Chairman of the Legislative Committee of the Conference of State Bank Supervisors (CSBS). I am pleased to be here today to share my perspective as a state regulator and as a member of CSBS.

In addition to regulating banks, most state banking departments also supervise the residential mortgage industry. As the mortgage industry has evolved over the past two decades, CSBS has expanded its mission beyond traditional commercial bank supervision and has been working closely with the American Association of Residential Mortgage Regulators (AARMR)[1] to enhance supervision of the mortgage industry. States currently have regulatory oversight of over 77,000 mortgage company licenses, 50,000 branch licenses, and 410,000 loan officer licenses.

The states, the federal financial regulatory agencies, the Obama Administration, and Congress have all been very active in trying to restore confidence in the financial system. I commend you Chairman Frank, Ranking Member Bachus, and members of the Committee for your dedication to protecting consumers and for promoting the principles of responsible lending.

Let there be no doubt that fraud in financial services is a significant problem. Currently, there exists what could be called a "fraud spectrum" in the financial market place. At the less egregious end of the spectrum are compliance failures or "white lies"

[1] AARMR is the organization of state officials responsible for the administration and regulation of residential mortgage lending, servicing, and brokering. http://www.aarmr.org/.

that although absent malice, nevertheless result in harm to the consumer or the institution. At the other end of the spectrum are intentional fraud and criminal acts deserving of the most serious punishment our legal system can deliver. In between lays a vast array of acts that vary in both intent and ultimate harm, but are generally considered to be of an extremely serious nature.

State regulators address these incidents on a daily basis. As state regulators, we work in close proximity to the market, consumers, and troublesome practices. In particular, the mortgage industry is local in nature and has a tremendous impact upon local communities. The states, through CSBS and AARMR, have undertaken an array of initiatives to enhance supervision of the residential mortgage industry and have brought thousands of enforcement actions against mortgage loan originators to protect consumers.

At the same time, the financial structure underpinning the mortgage industry is national in scope. Securitization, wholesale funding, servicing, and other such functions are highly consolidated. Unfortunately, as a state regulator, my reach into these critical areas has been prohibited. My fellow state supervisors and I can only address part of the problem. We are largely unable to impact the underlying incentives that have contributed to the current economic crisis.

Given the structure of the financial industry, I submit the states play a critical role in regulation. The states are vital to restoring and promoting consumer confidence. The challenge Congress faces is to access the expertise and local knowledge of state supervisors and to leverage these resources to create a network of state-federal supervision that meets the needs of an industry that is both local and national.

Mr. Chairman, in my testimony I will discuss these state successes and initiatives to enhance supervision and enforcement of the financial system, particularly the mortgage

industry. I will also identify events or conditions that have hindered state actions. The states have made tremendous progress, but Congress must act to encourage more state and federal cooperation. Ultimately, Congress must facilitate a network of supervision, consumer protection, and enforcement that draws upon the resources and expertise at every level of government, ranging from local to national jurisdictions. Finally, I will offer the Committee suggestions for regulatory changes that should be considered as Congress debates reform of financial regulation, including offering our support for the Congressional Oversight Panel's recommendation to eliminate federal preemption of state consumer protection laws.

State Successes and the Future of State Supervision and Enforcement

States have long been recognized as leaders in the arena of effective, innovative, and comprehensive consumer protection. It is important to note the initiatives outlined in my testimony were either fully in practice or well under way prior to the most recent collapse of our markets. The significant enforcement cases I will outline in my testimony should have resulted in a dialogue between state and federal authorities about the extent of the problems in the mortgage market and the best way to address the problem. Unfortunately, that did not happen.

From the state perspective, it has been unclear for many years exactly who was setting the risk boundaries for the market. What is clear, however, is that the nation's largest and most influential financial institutions have been major contributing factors in our regulatory system's failure to respond to this crisis. The states have sometimes perceived an environment at the federal level that was skewed toward facilitating the business models and viability of our largest financial institutions rather than promoting the strength of the consumer or our diverse economy.

It was the states that attempted to check the unhealthy evolution of the mortgage market and apply needed consumer protections to subprime lending by passing state consumer protection laws and bringing enforcement actions against predatory lenders. Rather than thwarting or banning such protections, the regulatory system must incorporate the early warning signs and interventions that state laws and regulations provide.

States are leading the fight to reign in abusive lending through predatory lending laws, licensing and supervision of mortgage lenders and brokers, and through enforcement of consumer protection laws and standards of safety and soundness. In Maryland, for example, we have imposed a duty of good faith and fair dealing on the mortgage industry—refinancings must deliver a tangible net benefit to the borrower before they can be executed. Licensed entities now have a duty to report fraud to my office.

My fellow state supervisors and I welcome coordination with our federal counterparts to promote responsible lending across the residential mortgage industry, as well as the regulation of other types of financial institutions. Similar protections are in play at the national level as well. Last year, AARMR began developing national standards on a borrower's ability to repay; a crucial element of underwriting abandoned by the subprime lending market when it was needed most. In many instances, federal regulators are working closely with state authorities through the Federal Financial Institutions Examination Council (FFIEC) to develop processes and guidelines to protect consumers and prohibit certain acts or practices that are either systemically unsafe or harmful to consumers. These initiatives will begin to bear fruit in the coming months.

Broadly speaking, state efforts to enhance financial supervision are focused in two areas--contributing to the creation of an evolving network of financial regulation, or as addressing abuses through legislative and enforcement actions.

Evolving Network of Financial Regulation

- *CSBS-AARMR Nationwide Mortgage Licensing System.* In 2003, CSBS and AARMR began a very bold initiative to identify and track mortgage entities and originators through a national database of licensing and registration known as the Nationwide Mortgage Licensing System (NMLS). In January 2008, NMLS was successfully launched with seven inaugural participating states. Only 15 months later, 23 states are using NMLS and by January 2010—just two years after its launch—CSBS expects 40 states to be using NMLS.

The hard work and dedication of the states was recognized by Congress as they enacted the Housing and Economic Recovery Act of 2008 (HERA). I commend Chairman Frank and members of the Committee for introducing and passing through the House the Mortgage Reform and Anti-Predatory Lending Act in the 110th Congress. A significant portion of the Mortgage Reform and Anti-Predatory Lending Act was eventually incorporated in HERA as the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (S.A.F.E. Act). Special recognition must go to Ranking Member Bachus, who developed the S.A.F.E. Act and its state-federal model for regulation and supervision. The purposes of the S.A.F.E. Act are to increase uniformity, reduce regulatory burden, enhance consumer protection, and reduce fraud by requiring all mortgage loan originators to be licensed or registered through NMLS. Our best estimates today are that we will have licensed and registered 48,000 non-depository mortgage companies and 268,000 mortgage loan originators within the next 18 months.

As you well know, the law requires states to pass legislation to meet the minimum requirements established by the S.A.F.E. Act by July 31, 2009. While the implementation of the S.A.F.E. Act within the time period required is a monumental task, the states have

risen to your challenge and have unified under a Model State Law of implementing language and procedures.

Moving forward, regulators and the public will eventually have the opportunity to exploit the power of a vast data network designed to thoroughly screen mortgage companies and professionals. The system will:

1. Assist regulators in determining whether companies and individuals have the character and fitness to conduct business with consumers;
2. Establish a system of professional testing and education;
3. Assign a unique identifier for truly nationwide accountability; and
4. House consumer complaints, regulatory violations, and regulatory enforcement actions.

I cannot stress how important both the S.A.F.E. Act and NMLS are to the protection of consumers and in the battle against harmful business practices. Combined, these two initiatives create a system of accountability, interconnectedness, control, and tracking that has long been absent in the supervision of the mortgage market. By registering every loan originator with a unique identifier and requiring that identifier to be incorporated with loan origination documents, we have created the ability to associate the loan documents and business practices with the individual and company that negotiated the transaction. Further, NMLS is designed to track complaints and enforcement actions against companies and individuals. When combined with the required registration of loan originators operating within insured financial institutions, we have created an almost seamless connection that begins with practices and products and culminates with any record of consumer harm.

- *Nationwide Cooperative Protocol and Agreement for Mortgage Supervision.* In December 2007, CSBS and AARMR launched the Nationwide Cooperative Protocol and Agreement for Mortgage Supervision to assist state mortgage regulators by outlining a basic framework for the coordination and supervision of Multi-State Mortgage Entities (MMEs). The goals of this initiative are to protect consumers; ensure the safety and soundness of MMEs; identify and prevent mortgage fraud; supervise and examine in a seamless, flexible and risk-focused manner; minimize regulatory burden and expense; and foster consistency, coordination and communication among the state regulators.

To date, 48 states plus the District of Columbia and Puerto Rico have signed the Protocol and Agreement. In April, the first multi-state examinations will begin based upon examination procedures and methods redesigned to provide broader institution coverage, while focusing examiner resources where problems are most likely to reside.

- *Mortgage Examinations with Federal Regulatory Agencies.* Beginning in late 2007, the states, in partnership with the Federal Reserve System (Fed), the Federal Trade Commission (FTC), and the Office of Thrift Supervision (OTS) engaged in a pilot program to examine the mortgage industry. Under this program, state examiners worked with examiners from the Fed and OTS to examine mortgage businesses over which both state and federal agencies had regulatory jurisdiction. The FTC also participated in its capacity as a law enforcement agency. In addition, the states separately examined a mortgage business over which only the states had jurisdiction. This pilot is truly the model for coordinated state-federal supervision.

- *State Examination Programs.* Beyond investigations and enforcement actions, states regularly exercise our authority to investigate or examine mortgage companies for

compliance not only with state law, but with federal law as well. Unheralded in their everyday routine, examinations identify weaknesses that, if undetected, might be devastating to the company and its customers. State examinations act as a check on financial problems and sales practices gone astray. Examinations also stop a supervised entity from engaging in misleading, predatory, or fraudulent practices. In addition, examinations often result in the early detection of emerging harmful practices or trends.

Approximately 2,500 state financial institution examiners conduct thousands of on-site examinations each year of depository institutions, mortgage companies, consumer finance companies, payday lenders and other financial services providers. In Maryland, my agency alone will complete over 1,200 examinations this year. Taken as a whole, this system of state regulators is one of the largest financial institution regulatory bodies in the United States. This supervision mirrors the diffused industry it oversees. States are working in the same spirit that governs NMLS—a cooperative system that leverages local expertise and authority through joint examinations within the state system and with our federal regulatory counterparts.

To ensure our examiners are well-prepared, examiner training is an integral part of the state regulatory system. States have made a significant commitment in examiner skill sets that is continually broadened and improved to match the complexities of today's financial markets. For example, in 2007 state banking departments alone spent nearly $8 million on training for its examination staff.

Since 1984, CSBS has maintained a state banking department accreditation program to enhance the professionalism of departments and their personnel. In 2008, CSBS established the mortgage accreditation program to encourage state mortgage

regulatory agencies to enhance their capability to promote excellence in mortgage supervision.

- *Consumer Complaint Processing.* In financial supervision, regulator proximity to consumers, the entities they oversee, and the communities they serve matters. Nowhere is this more evident than with collecting and acting upon consumer complaints. State regulatory agencies are responsible for receiving, processing and resolving tens of thousands of complaints filed by consumers against financial institutions each year. My office in Maryland receives over 2,500 complaints per year. In 2008, the states of Connecticut, Pennsylvania, New Jersey, North Carolina, and Virginia alone processed over 9,000 complaints resulting in consumer refunds of over $7 million; an average return of $777 per household. States have developed policies and procedures to collect complaints, and are working with our federal counterparts through the FFIEC to ensure the complaints are channeled to the correct regulator in order to pursue further action if necessary. Complaint resolution will always be a primary function of state supervisors because the consumers are in some cases literally our neighbors and friends. We have focused our efforts in ensuring a high level of cooperation between state and federal regulators to develop a network of supervision and consumer protection to prevent abusive practices or fraudulent behavior from falling through the cracks.

- *Proactive Regulatory Guidance and Requirements.* Proximity to our supervised entities, examinations, and consumer complaints all help the states identify emerging threats, risks, and troubling products or practices. Our network of supervision must build upon this early-detection system and facilitate the development of supervisory tools that are proactive. State-federal coordination on regulatory policy has not always been

permitted or supported. An example of this disconnect is the development of the 2006 *Guidance on Nontraditional Mortgage Product Risks.* State officials were barred from contributing to the development of these guidelines, but then publicly chided for failing to have similar guidelines in place. The states did quickly develop parallel guidelines, and also developed AARMR/CSBS Model Examination Guidelines (MEGs) to facilitate implementation of the guidance. The process did improve by when Congress gave the states a voting seat on the FFIEC. This allowed us to participate in the development of the 2007 *Statement on Subprime Mortgage Lending.*

In an effort to stay ahead of market practices and innovation, and to ensure we are providing comprehensive consumer protection, state and federal authorities must strive toward developing coordinated guidelines and examination procedures. Through state involvement with the FFIEC, coordination between the states and our federal counterparts has greatly improved in the past two years, and continues to do so. As FDIC Chairman Sheila Bair recently told the states' Attorneys General, "if ever there were a time for the states and the feds to work together, that time is right here, right now. The last thing we need is to preempt each other."[2]

In early 2008, state regulators identified the reverse mortgage lending market as one of future concern and potential problems, not only to consumers, but to the safety and soundness of financial institutions as well. Despite the relatively small size of the market for reverse mortgage lending today, the states believe that it holds the potential, much like subprime lending, for explosive growth in the coming years. CSBS and AARMR held the first ever regulatory training school on reverse mortgages. By the end of 2008 we had

[2] Speech before the National Association of Attorneys General, March 3, 2009: http://www.fdic.gov/news/news/speeches/chairman/spmar0309.html.

developed and released a comprehensive set of Reverse Mortgage Examination Guidelines (RMEGs) at least two years prior to our projections of growth in the market.

The clarity provided by the MEGs and the RMEGs will greatly enhance industry compliance with regulatory guidelines. By providing the industry with clear expectations, regulators will be able to hold institutions accountable for compliance failures and monitor more precisely any unsound practices.

- *Regulatory Reporting.* Another CSBS/AARMR initiative underway prior to the passage of the S.A.F.E. Act is a system of mortgage data reporting similar to the Call Reports for depository institutions. Inadequate data means inadequate supervision. This is one more area where I would like to thank this Committee for having the insight to help us bring this initiative to the level of a national standard. In time, we will be collecting data and developing a much better understanding of the shape of the mortgage market as it returns to healthy and viable levels of business.

- *Technology and New Examination Methods.* Beginning in 2007, the states, through CSBS, began a year-long process of investigating available technology and in 2008 entered a public/private venture to bring the best of the available technologies to the examination process.

By extracting loan file data electronically for every loan originated or funded by the institution and running the data through specialized software built upon regulations and guidelines, we are able to conduct a pre-examination offsite review before the examiner ever leaves his or her desk. The idea is to identify apparent violations and problems before the examination begins, and then direct the examination resources exactly where they are needed the most. The use of technology eliminates the previous reliance upon random

sampling and educated guessing and replaces these with skilled resources focused where the problems are most likely to be found.

Legislative and Enforcement Actions

- *State Predatory Lending Laws.* Currently, 35 states—including Maryland—and the District of Columbia have enacted subprime and predatory mortgage lending laws.[3] The innovative actions taken by state legislatures have prompted significant changes in industry practices, as the largest multi-state lenders were forced to adjust their practices to comply with the strongest state laws. All too often, however, states are frustrated in our efforts to protect consumers by the federal preemption of state consumer protection laws. Preemption should not be used as a method to circumvent stringent consumer protection requirements.

I supported the Mortgage Reform and Anti-Predatory Lending Act in the last Congress, and I continue to support the creation of a federal minimum predatory lending standard that allows the states to address these predatory practices as they evolve. The federal standard must be a floor for all lenders that does not stifle a state's authority to protect its citizens through state legislation that builds on the federal standard. States should also be clearly allowed to enforce—in cooperation with federal regulators—both state and federal predatory lending laws over institutions that act within their state.

- *State Enforcement of Consumer Protection Laws.* State attorneys general and state regulators have cooperatively pursued unfair and deceptive practices in the mortgage market. Through several settlements, state regulators have returned nearly one billion dollars to consumers. In 2002, a settlement with Household Financial resulted in $484 million paid in restitution; a settlement with Ameriquest Mortgage Company four years

[3] Source: National Conference of State Legislatures. http://www.ncsl.org/.

later resulted in $295 million paid in restitution; and a settlement with First Alliance Mortgage Company resulted in $60 million paid in restitution. These landmark settlements included significant injunctive relief and monitoring programs setting new standards for fairness and further contributing to changes in industry lending practices.

While these cases have received most of the recognition, success is sometimes better measured by those actions that never receive media attention. Attached as Exhibit A is a chart of enforcement actions taken by state regulatory agencies against mortgage providers. In 2007 alone, states took almost 6,000 enforcement actions against mortgage lenders and brokers. But these cases do not include the unrecorded investigations and referrals for criminally punishable fraud and other crimes. To keep pace, state agency investments in resources combating serious crimes are a significant and growing portion of state agency budgets. Please refer to Exhibit B for a more detailed list of state-specific initiatives.

Challenges to State Supervision and Enforcement

Preemption

Foremost among the challenges to state supervision is the battle over federal preemption of a state's right to protect its citizens. Repeatedly states have stepped forward to implement new protections, investigate practices, or intervene with enforcement regardless of the chartering authority or institutional claims of federal protection. All too often, our efforts have been repelled by what Chairman Frank has referred to as "wildly over-pre-empted state law."[4]

Imagine if those who supported and continue to support the architecture of our origination and secondary market systems were held accountable in the manner of

[4] Source: Chairman Frank press briefing, March 5, 2009.

Household and Ameriquest, instead of enjoying preemptive policies that allowed them to operate outside of state law. I remind the Committee that the restitution dollars and fines in both these cases were only the penalty phase of the state enforcement. The injunctive relief and monitoring going forward is what caused a wake of positive lending reforms embraced by state chartered institutions, but disregarded by those under national authority.

Cloaked in preemption and unfettered by limitations on prepayment penalties, net tangible benefit or suitability requirements, extremely large institutions continued to originate, fund, and sell loans in a way that Household learned in 2002 would no longer be an acceptable practice under the mantle of state supervision. I ask you to re-imagine the current crisis in a world where the largest lending institutions would have been notified of unacceptable practices.

Resources Needed to Pursue Investigations

Investigating and prosecuting sales practice, fraud, and white collar crime cases—whether at the administrative, civil or criminal level—has always been a daunting and significant undertaking. A single case can dominate a large portion of a state agency's legal resources for an extended period of time. Simply put, these cases are difficult to make, requiring the will of the agency to engage in an elongated battle, a staff skilled with industry knowledge and investigative training, and the financial and legal resources to put it all together.

Investigations can literally take years to come to fruitful conclusion. Even landmark victories, such as the case against Household, are exhaustive and draining to every agency involved. Engagement in even the smallest of cases results in an enormous challenge and a significant distraction to core regulatory activities. Despite these challenges, states have achieved significant enforcement successes in recent years and we

continue to commit additional resources to pursue additional enforcement actions. These past successes and future initiatives have only been possible through a coordinated system of state agencies acting in unison. By necessity, states are nimble and innovative, and often able to react quicker and more aggressively than our federal counterparts. The states, through CSBS and AARMR, are working in concert to modernize supervision and enforcement and have taken the lead in many areas of regulatory development. More often than not it is the states who are setting the precedent and tone for verification and accountability through initiatives such as NMLS, MEGs for nontraditional and subprime mortgages, RMEGs, cross-agency examinations, multi-state examinations, and the use of advanced technology to detect and investigate what we have been unable to see through traditional methods and tools of supervision.

Insufficient Data

According to the Department of Treasury's Financial Crimes Enforcement Network (FINCEN), financial institutions filed 62,084 suspicious activity reports (SARs) reporting mortgage loan fraud in the one-year period ending June 30, 2008. This figure constituted nine percent of all SAR submissions for the period and a 44 percent increase over the preceding year. Mortgage loan fraud was the third most reported activity during this period. But these are only reports of suspicious activity made by depository institutions. Since such a large segment of the mortgage lending industry is not subject to these reporting requirements, I agree with the FBI that "the true level of mortgage fraud is largely unknown."

Therefore, we should explore the requirement to file SARs for transactions initiated by mortgage brokers and lenders. There are obviously benefits and challenges to doing so, but it is worth initiating a dialogue with FinCEN and the FBI.

Some statistics estimate the amount of annual loss related to mortgage fraud at $4 to $6 billion.[5] In 2008, the FBI conducted 560 indictments for mortgage fraud and achieved 338 convictions. But SARs and fraud serious enough to warrant criminal prosecution only tells part of the story. In the pursuit of improving industry information, data from the FBI's Criminal Justice Information Service, FinCEN's database, and the FTC's Consumer Sentinel database should be coordinated with NMLS and available to all regulators.

Recommendations and Suggested Congressional Action

The states are working to ensure legitimate lending practices, provide adequate consumer protection, and once again instill both consumer and investor confidence in the housing market and the economy as a whole. Enhanced supervision and enforcement tools can successfully weed out the bad actors and address bad assumptions that were made by the architects of our modern mortgage finance system. While much is being done to this end, more progress must be made towards the development of a coordinated and cooperative system of state-federal supervision and enforcement of comprehensive consumer protection provisions.

Forge a New Era of Federalism

The state system of chartering and regulating has always been a key check on the concentration of financial power, as well as a mechanism to ensure that our finance system remains responsive to local economies' needs and held accountable to consumers.

Consolidation of the financial industry, supervision, and preemption of applicable state consumer protection laws does not address the cause of our current economic crisis, and has in fact exacerbated the problem. Consumer confidence is dangerously low because

[5] Source: The Prieston Group.

the public feels largely cheated by financial service providers. The flurry of state predatory lending laws and new state regulatory structures for lenders and mortgage brokers were designed to protect consumers and preserve confidence. It would be incongruous to eliminate through preemption or regulatory restructuring not only these protections, but the early warning signs provided by state authorities. Just as checks and balances are a vital part of our democratic government, they serve an equally important role in our financial regulatory structure.

Most importantly, however, it serves the consumer interest that the states continue to have a significant role in financial supervision. State regulators must remain active participants in supervision because of our knowledge of local economies and our ability to react quickly and decisively to protect consumers.

Eliminate Preemption of State Consumer Protection Laws

Therefore, I urge Congress to implement a recommendation made by the Congressional Oversight Panel in their "Special Report on Regulatory Reform" to eliminate federal preemption of the application of state consumer protection laws to national banks. In its report, the Panel recommends Congress "amend the National Banking Act to provide clearly that state consumer protection laws can apply to national banks and to reverse the holding that state consumer protection laws of a national bank's state of incorporation govern that bank's operation through the nation."[6] I believe the same policy should apply to the OTS. To preserve a responsive system, states must be able to continue to produce innovative solutions and regulations to provide consumer protection.

[6] The Congressional Oversight Panel's "Special Report on Regulatory Reform" can be viewed at http://cop.senate.gov.

The federal government would better serve our economy and our consumers by advancing a new era of cooperative federalism. The S.A.F.E. Act enacted by Congress requiring licensure and registration of mortgage loan originators through NMLS provides a model for achieving systemic goals of high regulatory standards and a nationwide regulatory roadmap and network, while preserving state authority for innovation and enforcement. The S.A.F.E. Act sets expectations for greater state-to-state and state-to-federal regulatory coordination to prevent abusive lenders from falling through the cracks of supervision.

Establish Nationwide Predatory Lending Law

Congress should complete this process by enacting a federal predatory lending standard. A federal standard should allow for further state refinements in lending standards and be enforceable by state and federal regulators. Additionally, a federal lending standard should clarify expectations of the obligations of securitizers.

Information Sharing and Networking

The markets we regulate are a complex web of relationships and electronic connections. Supervision should be based upon an equally complex network of relationships, connected by a simplified means of communication and information sharing. But currently there is no efficient or formal mechanism for this type of information sharing. Congress should establish a mechanism among the financial regulators for identifying and responding to emerging consumer issues. This mechanism, perhaps through the FFIEC, should include active state regulator and law enforcement participation and should work to develop coordinated responses.

For too long, government at all levels has suffered from an insular type of confidentiality. The willingness to share information is often limited to an agency's inner circle, which results in simultaneous, but partially blind investigations.

Grass roots coalitions exist across the country, as do law enforcement task forces, state regulatory and attorneys general alliances, and federal agencies working in tandem with a variety of groups. My recommendation to Congress is to facilitate the linking of the information sources with the enforcement sources and the various enforcement sources with one another

Linking Information and Tracking Databases

Good enforcement begins with good information. The better the information, the easier the case to investigate, and the more likely it is to launch a successful prosecution. As designed, NMLS will be the principal source of data for mortgage companies and professionals. Under the S.A.F.E. Act Congress has encouraged state authorities to connect NMLS with the FBI's Criminal Justice Information Service by serving as a channeling agent to the states for criminal conviction records. Other significant data sources exist with FinCEN, the FTC's Consumer Sentinel database, the National White Collar Crime Center's Internet Crime Complaint Center, and information maintained by the federal banking authorities. At the state and local levels there is a myriad of data sources that are disconnected and inefficient to access. In today's world of technology, mortgage fraud cases are still investigated by a laborious and time-consuming process that fails to take full advantage of technological advancements.

Each of these databases should not only be connected to one another, but readily accessible to law enforcement officials. Where necessary, funding should be provided for the modernization and standardization of data formats with linking of the sources

facilitated at the federal level. Further, data should be upgraded and gaps must be closed. For example, felony conviction information currently exists in local jurisdictions that have failed to reach the FBI Criminal Justice Information Service. This means that NMLS—relying on the FBI for conviction data as required by the S.A.F.E. Act—could unintentionally allow the approval and registration of a convicted felon.

My recommendation to this Committee is to give enforcement officials the best available tools by upgrading the data and linking the sources.

Examination and Investigation Technology

I strongly believe that the use of technology is the only way to gain ground with the industries I regulate and to supervise them in an efficient and effective manner.

Through technology, specialized examination procedures and the information sharing I mentioned previously, regulators will begin to identify problems as they arise and even sometimes before the institution knows they have occurred.

The states are field-testing these new technologies now. But as you know, we are only part of the regulatory equation. I invite Congress to monitor our success and encourage you to consider our models when forging a new regulatory landscape.

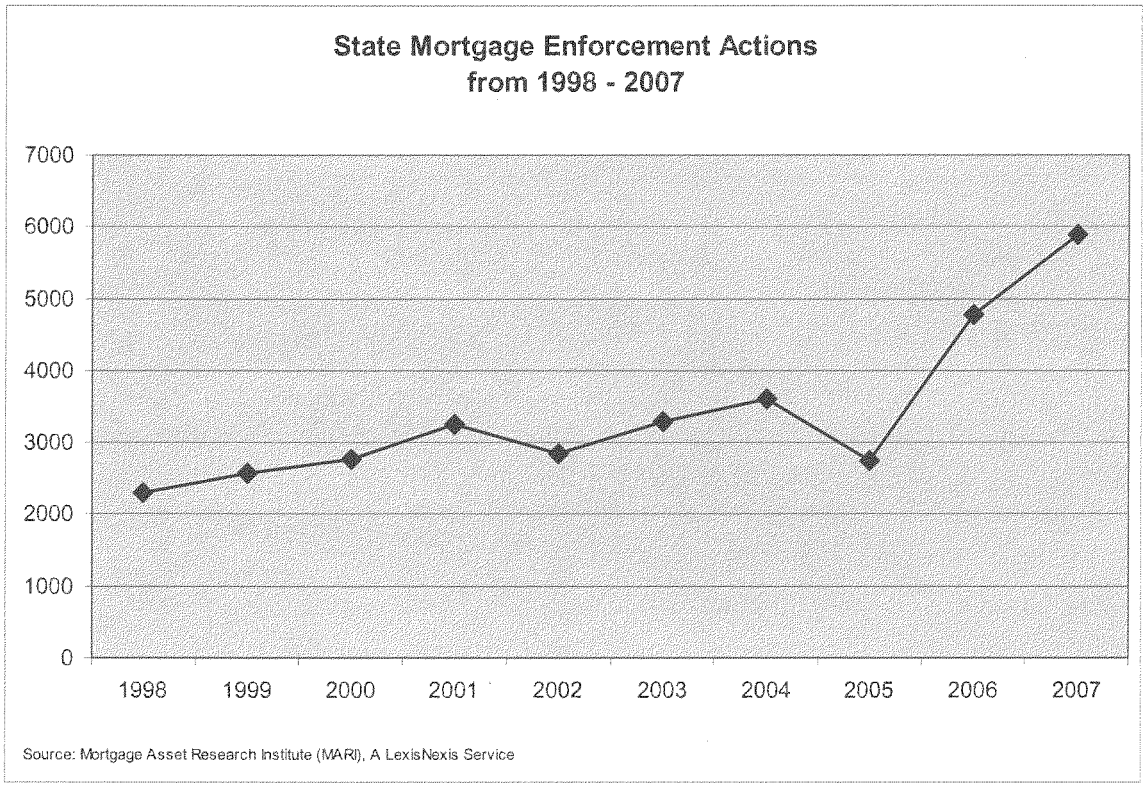
Conclusion

Chairman Frank, Ranking Member Bachus, and members of the Committee, I commend your work to protect consumers and the financial system. States have undertaken a number of initiatives to enhance supervision, protect consumers, and take action against predatory lenders. I urge you to work towards facilitation of a supervisory network that builds upon the strengths, resources, and expertise of state and federal regulators to effectively identify and react to emerging trends, develop comprehensive

consumer protection, and when necessary to take enforcement action that would deter future repetition of fraudulent actions.

Again, thank you for the opportunity to testify today. I look forward to answering any questions you may have.

Exhibit A: State Enforcement Actions Against Mortgage Providers



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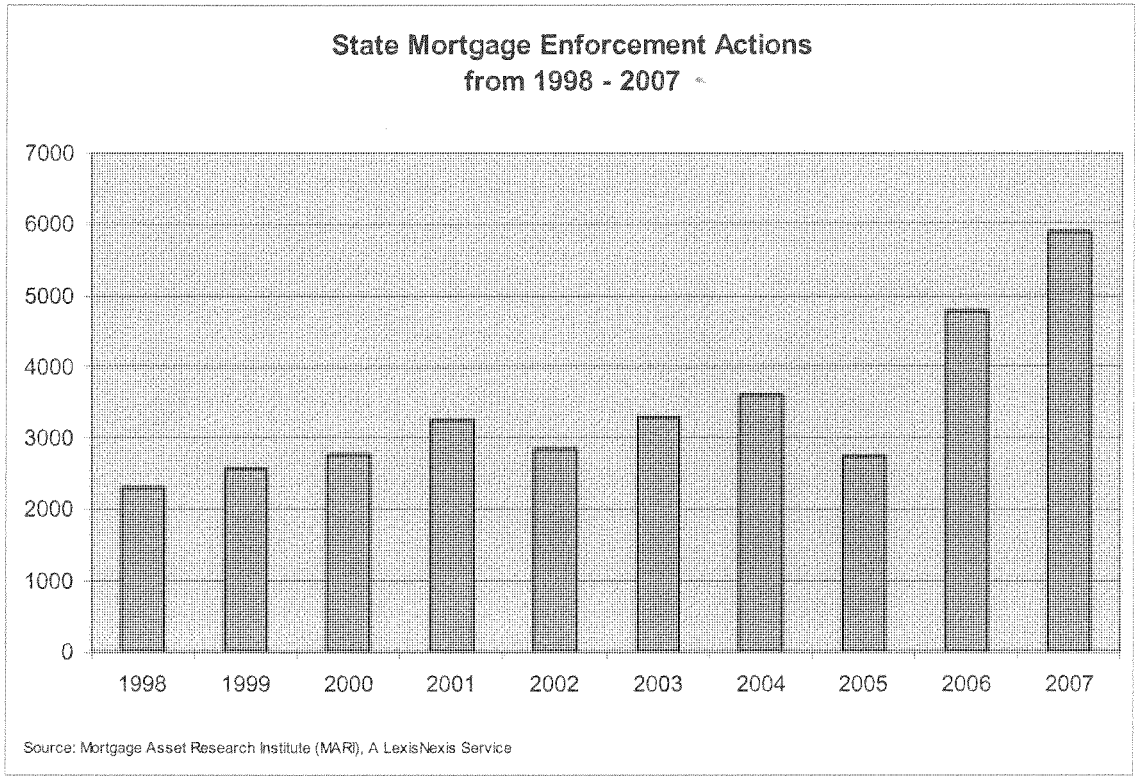

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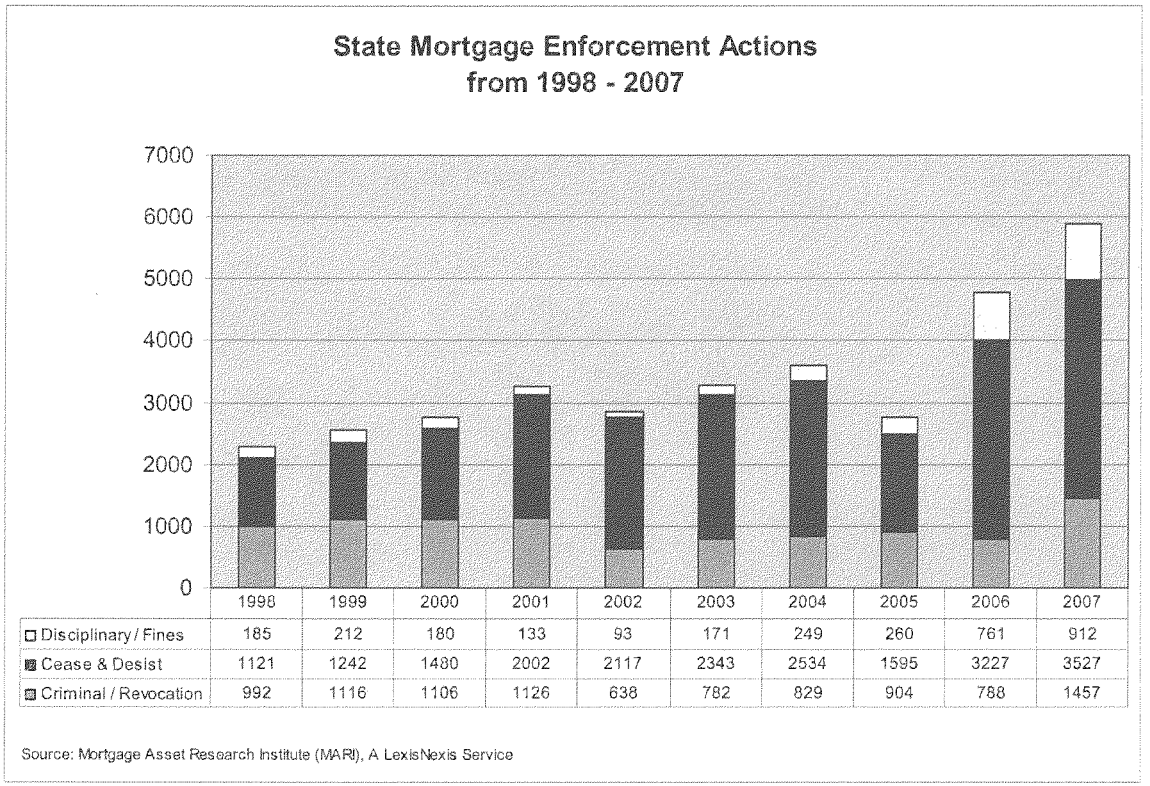

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Disciplinary / Fines	185	212	180	133	93	171	249	260	761	912
Cease & Desist	1121	1242	1480	2002	2117	2343	2534	1595	3227	3527
Criminal / Revocation	992	1116	1106	1126	638	782	829	904	788	1457

Source: Mortgage Asset Research Institute (MARI), A LexisNexis Service

Exhibit B: State-Specific Enforcement Efforts

In my state of Maryland we have moved aggressively to enhance statutory authority to address abusive practices. In 2008, the legislature passed the Maryland Mortgage Fraud Act, for the first time enumerating mortgage fraud as a specific crime. This statute addresses the responsibilities of all parties to a mortgage transaction and includes comprehensive penalties of incarceration and fines. Among other things, the Fraud Act provides for forfeiture and enhanced penalties for vulnerable victims. As Commissioner, I have also promulgated a regulation requiring mortgage brokers, lenders, originators and all other persons under my authority to report instances of fraud, theft, or forgery. We have already established a common form and begun to receive such referrals.

In addition, Maryland strengthened protections last year to address foreclosure rescue scams. Historically, these transactions have involved inducing homeowners to transfer title in an effort to save their homes. Instead, whatever remaining equity existed was stripped by the perpetrator. Maryland now prohibits transfer of title for these purposes and certain enforcement authority has been extended from the Attorney General to include the Office of Financial Regulation. Our Maryland investigators launched the investigation that uncovered one of the largest foreclosure rescue schemes in history – a $35 million scam involving the Metropolitan Money Store. Our team ultimately called in federal authorities and United States Attorney Rod Rosenstein issued a 25-count indictment last July.

The new statute expressly prohibits so-called foreclosure consultants from charging up-front fees for assisting borrowers as foreclosure consultants, which in many instances includes loss mitigation services. With vulnerable homeowners no longer having equity in their properties, these fee-based schemes have spread rapidly. To date, we have been

successful in recovering thousands of dollars for Maryland borrowers. President Obama's housing plan will incorporate work done at the state and federal levels to address potential abuses that will surely arise. Among other things, we have advocated extensive public outreach to inform borrowers that they do not need to pay these fees, support for additional counseling resources such as those already offered by the State of Maryland, and enhanced disclosure that identifies any third parties involved in the transaction. I understand that legislation similar to that in Maryland that bans up front fees has been introduced in Congress.

We are also working to coordinate our efforts at all levels. With limited resources, it is critical that we operate efficiently and cooperatively. Earlier this year, our agency took the lead in forming a Maryland mortgage fraud task force to concentrate its efforts on mortgage fraud cases not under the scrutiny of the federal authorities. The state task force consists of state regulatory agencies, the Office the Maryland Attorney General, local prosecutors, and investigators from the local police departments. The idea behind the state task force is to ensure that no cases of mortgage fraud will fall between the cracks.

At the same time, the Office of the United States Attorney for Maryland, in conjunction with the Federal Bureau of Investigation (FBI), recently formed a Federal / State mortgage fraud task force of which the Office of Financial Regulation is a member agency. Other agencies participating include representatives of all levels of federal law enforcement, other state regulatory agencies, representatives from the Maryland Attorney General's Office and local prosecutors. One of the goals of this task force is to provide a venue for information sharing so that each agency is aware of another agency's activities in order to allow for a coordinated, joint effort in conducting some investigations or for parallel investigations to proceed where appropriate.

Other states have reported similar successful efforts as well.

Arizona

Nov 17, 2008 - Cactus Cash Inc. and Rick Thomas McCullough. Charged with operating a residential mortgage scam. Sentenced to 3 ½ years in prison with 7 years probation plus $343,811 in restitution to victims. Additionally barred from employment with any financial institution or company regulated by the AZ DFI for making multiple misrepresentations, false promises, concealed material facts, disclosure violations, failure to maintain records, engaged in illegal or improper business practices and failed to comply with multiple federal requirements in conducting mortgage broker business activity.

Massachusetts

September 24, 2008 – American Advisors Group, Irvine, California. Commissioner issued a Temporary Order to Cease and Desist based upon information reflected in a consumer solicitation regarding reverse mortgage loans received by Massachusetts consumers from American Advisors which contained language that had the tendency to be false or misleading, that could collectively create the appearance that the solicitation was issued by a government agency.

Michigan

October 6, 2008 - Countrywide Financial - Settlement that must offer to refinance thousands of Michigan mortgages, provide millions in financial assistance and stop questionable loan practices. Those lending practices included misleading marketing techniques and incentives for selling loans with risky features, which may have contributed to the national increase in foreclosures. Must pay more than $9.8 million to assist Michigan homeowners who lost their homes to foreclosure. The funds will also be used for borrower education programs and neighborhood rehabilitation efforts.

Ohio

Sept 30, 2008 - APEX Mortgage Service, LLC – Revoked Mortgage Broker Certificate of registration and assessed $50,000 fine.

Washington

From 2007 through 2008, Washington State Department of Financial Institutions (DFI) made 32 criminal referrals for mortgage fraud under the state's successful Mortgage Lending Fraud Prosecution Account law passed in 2003. Creation of this unique piece of legislation has helped solve the dilemma of insufficient investigative and prosecution resources. Funds for the Account are generated by a $1 surcharge, assessed at the recording of a deed of trust. DFI can use these funds to reimburse county prosecutors for a variety of costs related to the investigation and prosecution of mortgage fraud cases. Reimbursable items include expenses related to investigation and litigation and may even include training costs for investigators and prosecutors. As a result of the credit crisis and the drop in home sales, the average amount of revenue raised by this fund per month has gone from $70,000 in 2006 to $44,000 per month in 2008. Nevertheless, this is over a half million dollars of prosecution resources solely dedicated to fighting mortgage fraud in one state alone.

Like my agency, Washington DFI participates in the state's Mortgage Fraud Working Group, which meets quarterly and involves the FBI, the King County Prosecutor, the King County Sheriff's Office, the Bellevue Police Department, the Kirkland Police Department, the U.S. Department of Housing and Urban Development (HUD), the Internal Revenue Service, the WA Department of Licensing, the WA Attorney General, and the U.S. Attorney General. Through this group the agency is working a number of large cases with the U.S. Attorney General and the FBI, as joint State/Federal prosecutions.

As with other states, administrative actions dominate the enforcement landscape for Washington DFI. Some recent examples of administrative enforcement include:

1. Countrywide Home Loans, Inc. dba America's Wholesale Lender. Charges include $1 million in fines, consumer restitution and a 5 year ban from the industry for lending discrimination, Home Mortgage Disclosure Act violations, disclosure failings and other administrative issues.

2. NovaStar Mortgage, Inc. Charges include $350,000 in fines, consumer restitution and a 5-year ban from the industry for disclosure violations, unauthorized fees, unlicensed activity and illegal prepayment penalties.

3. Paramount Equity Mortgage, Inc., Hayden D. "Hayes" Barnard, Matthew J. "Matt" Dawson, and John J. "Jason" Walker. Charges include fines of $500,000, restitution to consumers and a 5-year ban from the industry for unearned fees, bogus rate buy downs, deceptive disclosures and bait and switch advertising.

4. Dana Capital Group, Inc. and Dana H. Smith. Charges include a combined fine of $740,000, consumer restitution, corporate license revocation, and a 20-year ban from the industry for unearned fees, disclosure violations, unlicensed activity and failure to maintain records and make reports.

5. A+ Mortgage, Inc. and Gregory J. Nick. Charges include $250,000 in fines, $160,000 in consumer restitution and a 5-year ban from the industry for falsification of documents, unlawful fees, disclosure violations and conversion of borrower funds.

6. WCS Loans, Inc., d/b/a Advance Til Payday, and Loren C. Gill. Charges include $900,000 in fines, consumer restitution and a lifetime ban from the industry for illegal payday lending in Washington.

Testimony of James B. Ropp
Commissioner, Delaware Division of Securities and
Chair of the Enforcement Section
North American Securities Administrators Association, Inc.
Before the
United States House Committee on Financial Services

"Federal and State Enforcement of Financial Consumer
and Investor Protection Laws"

March 20, 2009

Chairman Frank, Ranking Member Bachus, and members of the Committee,

I'm Jim Ropp, Delaware Securities Commissioner and Chair of the Enforcement Section of the North American Securities Administrators Association, Inc. (NASAA).[1] I appreciate the opportunity to focus on the role of state securities regulators in the current economic crisis, and to provide you with recommendations to enhance our ability to pursue financial fraud and prosecute the perpetrators of those crimes.

Overview

The securities administrators in your states are responsible for enforcing state securities laws, licensing firms and investment professionals, registering certain securities offerings, examining broker-dealers and investment advisers, and providing investor education programs and materials to your constituents. Ten of my colleagues are appointed by state Secretaries of State, such as Secretary Galvin; five, like me, fall under the jurisdiction of their states' Attorneys General; some are independent commissions and others are appointed by their Governors and Cabinet officials. By nature, we are the first line of defense for Main Street investors and for us, enforcement is a top priority.

My own state of Delaware has a somewhat unique situation with regard to enforcement actions. Since it is a small state, historically all state criminal prosecutions are brought by the State Attorney General. There are no county District Attorneys. Since the Delaware Securities Division is part of the Delaware Attorney General's office, we have statutory jurisdiction over administrative, civil and criminal actions to address securities fraud. Unlike most state securities administrators, we do not have to refer our state criminal actions to an independent prosecutorial agency. This allows us more freedom to

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, the U.S. Virgin Islands, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

pursue offenders criminally and we do not shy away from bringing criminal cases. This is consistent with our philosophy that most Ponzi schemes are basically cases of criminal theft and securities fraud. We recently indicted a Ponzi scheme operator who was offering investments in fraudulent real estate deals. He was under investigation in a number of states and by at least one federal agency. Delaware was the first to indict. In another case, Delaware indicted a broker who had defrauded a senior citizen out of more than $200,000. The broker created a fictitious account at a different brokerage house and diverted funds from the client's account into the fictitious account. Shortly thereafter, the broker withdrew the money and left the country. Warrants are outstanding and we are attempting to locate him to secure his extradition to the United States. In short, criminal prosecution is an important tool for effective enforcement of state and federal securities laws.

Delaware obtains its cases from a number of sources. The primary source of securities cases come from investor complaints about either a financial professional or an unregistered fraud artist who has offered or sold them a fraudulent investment opportunity. We also obtain cases from branch office examinations, referrals from local law enforcement agencies, referrals from other states, NASAA working groups, the Securities Exchange Commission (SEC) and FINRA. Like my colleagues in all 50 states, I see what happens when dreams are destroyed by con artists who aggressively target senior citizens who have saved for retirement and families who are saving for college expenses.

State Securities Enforcement

State securities regulators have a century-long record of investor protection, and NASAA has long supported that effort. Within NASAA, for example, the Enforcement Section helps coordinate large, multi-state enforcement actions by facilitating the sharing of information and leveraging the limited resources of the states more efficiently. Members of this Section also help identify new fraud trends such as those promising high returns in today's down market, and they act as points of contact for other federal agencies and the self-regulatory organizations (SROs).

State securities regulators respond to investors who typically call them first with complaints, or request information about securities firms or individuals. They work on the front lines, investigating potentially fraudulent activity and alerting the public to problems. Because they are closest to the investing public, state securities regulators are often first to identify new investment scams and to bring enforcement actions to halt and remedy a wide variety of investment related violations. The $60 billion returned to investors to resolve the demise of the Auction Rate Securities (ARS) market is the most recent example of the states initiating a collaborative approach to a national problem.

Mr. Chairman, we appreciate your affirmation during last year's ARS hearing that ***"in a number of states, it has been the state securities officials and law enforcement officials that have taken the lead."*** Attached to my testimony is a chart, "*States, On the Frontlines of Investor Protection,*" which illustrates many examples where the states initiated investigations, uncovered illegal securities activity, then worked with federal regulators or with Congress to achieve a national solution.

These high profile national cases receive greater public attention, but they should not obscure the more routine and numerically much larger caseload representing the bulk of the states' enforcement work. Those cases affect everyday citizens in local communities across the country. In the past three months alone, the Washington State Division of Securities, working with the Federal Bureau of Investigation and the IRS Criminal Investigation Division, broke up a $65 million oil and gas investment Ponzi scheme; Hawaii's securities commissioner, with the assistance of the SEC and CFTC, shuttered a suspected Ponzi scheme targeting the deaf community in Hawaii, parts of the mainland and Japan; an investigation by the Texas State Securities Board resulted in a 60-year prison sentence for a Ponzi scheme operator who stole at least $2.6 million from investors; and the Arizona Corporation Commission stopped a religious affinity fraud ring and ordered more then $11 million returned to investors. Since January 1, 2009, the Alabama Securities Commission has announced the conviction of nine different individuals convicted of securities fraud. These convictions encompass cases of fraud and abuse ranging from a classic Ponzi scheme to violations of Regulation D, Rule 506.

All convictions and charges are felonies. Currently, in the State of Alabama, the Securities Commission has twenty-seven defendants awaiting trial for securities fraud in nineteen separate cases.

Our proximity to individual investors puts us in the best position, among all law enforcement officials, to deal aggressively with securities law violations. Just one look at our enforcement statistics shows the effectiveness of state securities regulation. During our three most recent reporting periods, ranging from 2004 through 2007, state securities regulators have conducted more than 8,300 enforcement actions, which led to $178 million in monetary fines and penalties and more than $1.8 billion ordered returned to investors. And, we are responsible for sending fraudsters away for a total of more than 2,700 years in prison.

In spite of the states' success, a series of large scale financial frauds have rocked the capital markets since 2000. We are grateful that you have called this timely hearing to determine what actions would strengthen the states' enforcement capabilities, assist defrauded investors, and deter this type of illegal activity in the future.

Impediments to State Securities Regulation

In thinking about the role of state and federal enforcement authorities, it is instructive to look back at the regulatory responses to the major financial scandals over the past decade. From the investigation into the role of investment banks in the Enron fraud, to exposing securities analyst conflicts, "market timing" in mutual funds, and the recent ARS cases, state securities regulators have consistently been in the lead. Indeed, in some cases, at the time the states began their investigations, it was unclear whether the federal regulators intended to pursue any investigation at all. There have been numerous accounts in the press and in academic journals detailing the criticism of the SEC for its failure to investigate fraud allegations as quickly as state regulators.[2]

[2] *See, e.g.*, Susan Antilla, *Bankers Would Love to Kneecap State Regulators*, Bloomberg News, Nov. 14, 2008 ("This year, regulators from Massachusetts and 11 other states brought cases against major banks and

State securities regulators are often first to discover and investigate our nation's largest frauds. When we bring enforcement actions pursuant to these investigations, the penalties states impose are more meaningful and the restitution component is significantly greater. In fact, it has been shown that in cases where state and federal regulators work cooperatively, the more aggressive actions of state securities regulators cause a significant increase in the penalty and restitution components of the federal regulator's enforcement efforts.[3]

And yet, over a number of years there has been a concerted industry assault on state securities regulation, with calls for the preemption of both state regulation and enforcement. For example, in 1996, the National Securities Markets Improvement Act (NSMIA) did preempt much of the states' regulatory apparatus for securities traded in national markets, and although it left state anti-fraud enforcement largely intact, it limited the states' ability to address fraud in its earliest stages before massive losses have been inflicted on investors.

A prime example is in the area of private offerings under Rule 506 of Regulation D. Even though these securities do not share the essential characteristics of the other national securities offerings addressed in NSMIA, Congress nevertheless precluded the states from subjecting them to regulatory review. These offerings also enjoy an exemption from registration under federal securities law, so they receive virtually no

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securities firms that had marketed auction-rate securities to investors as ``safe," only to see that market collapse. The states negotiated agreements that got customers' money back. The SEC hopped on those auction-rate cases after the tough work already had been done"); Gretchen Morgenson, *Call In the Feds. Uh, Maybe Not,*The New York Times, Feb. 29, 2004 (the SEC's failure to protect investors in Washington State is Exhibit A for why state regulators should stay in the oversight mix); Editorial, *Wall Street and the States*, The Washington Post, Wednesday, July 23, 2003 ("ANYONE WHO'S WATCHED the scandals that engulfed Wall Street over the past few years understands the importance of the role played by state officials in going after corporate wrongdoing. While the Securities and Exchange Commission snoozed, New York state Attorney General Eliot L. Spitzer led the way in cracking down on firms whose stock analysts simultaneously evaluated companies for investors and milked them for investment banking business."); Susanne Craig, *Local Enforcers Gain Clout on Street,* The Wall Street Journal, June 21, 2002 ("'States have stepped up to fill the void' left by what some perceive to be weak federal regulators, says John Coffee, a U.S. securities-law professor at Columbia University.")

[3] Eric Zitzewitz, *An Eliot Effect? Prosecutorial Discretion in Mutual Fund Settlement Negotiations*, 2003-7, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1091035.

regulatory scrutiny. Thus, for example, NSMIA has preempted the states from prohibiting Regulation D offerings even where the promoters or broker-dealers have a criminal or disciplinary history. Some courts have even held that offerings made under the guise of Rule 506 are immune from scrutiny under state law, regardless of whether they actually comply with the requirements of the rule. *See, e.g., Temple v. Gorman*, 201 F. Supp. 2d 1238 (S.D. FL. 2002).

As a result, since the passage of NSMIA, we have observed a steady and significant rise in the number of offerings made pursuant to Rule 506 that are later discovered to be fraudulent. Further, most hedge funds are offered pursuant to Rule 506, so state securities regulators are prevented from examining the offering documents of these investments, which represent a huge dollar volume. Although Congress preserved the states' authority to take enforcement actions for fraud in the offer and sale of all "covered" securities, including Rule 506 offerings, this power is no substitute for a state's ability to scrutinize offerings for signs of potential abuse and to ensure that disclosure is adequate *before* harm is done to investors. In light of the growing popularity of Rule 506 offerings and the expansive reading of the exemption given by certain courts, NASAA believes the time has come for Congress to reinstate state regulatory oversight of all Rule 506 offerings by repealing Subsection 18(b)4(D) of the Securities Act of 1933.

And, there have been more recent attempts to preempt state regulation, resulting in a strain between federal and state regulators. In some instances, state investigations into corporate abuses that federal officials missed resulted not in reform at the federal level, but in criticism of the states. Some federal agencies have responded by issuing regulations broadly preempting state law.[4] Federal agencies have also aggressively

[4] *See* Office of Comptroller of the Currency, Investment Securities: Bank Activities Operations; Leasing, 66 Fed. Reg. 34784, 34788 (2001); *see also* Office of Comptroller of the Currency, Notice: Preemption Determination and Order, 68 Fed. Reg. 46264 (Aug. 5, 2003) (declaring state Consumer Protection laws dealing with mortgage lenders preempted); *see also* Office of Thrift Supervision Opinion Letter No. P-2004-7, "Authority of a Federal Savings Association to Perform Banking Activities through Agents Without Regard to State Licensing Agreements" 10 (Oct. 25, 2004), *available at* http://www.ots.treas.gov/docs/5/560404.pdf.

moved to preempt state law by bringing suit against state officials.[5] It is troubling that states are now facing efforts to preempt state authority through federal rules and regulations that ignore clear statements of Congressional intent. States now find themselves engaged in a battle with certain federal authorities simply to retain the authority to protect the interests of investors and consumers.

These calls for preemption or for more SRO authority at the expense of state jurisdiction defy common sense, if only because the evidence clearly demonstrates that the state-federal regulatory structure actually works for the investor. State involvement drives the performance level of all participants upwards and provides protection against the possibility of regulatory capture.

Recommendations

Resources. There are a number of legislative proposals now pending to significantly increase funding for federal law enforcement agencies responsible for investigating and prosecuting financial fraud. NASAA supports these efforts, but, at the same time, urges Congress to consider establishing a federal grant program to assist State law enforcement agencies, including securities divisions, involved in the prevention, investigation and prosecution of certain financial crimes. State securities regulators have the determination, willpower and experience to pursue perpetrators of financial crime. We've learned how to accomplish more with less. However, there's little doubt that additional resources would enhance our ability to uncover and prosecute securities fraud during this economic downturn, which has resulted in vulnerable investors looking to recover their losses.

One innovative approach proposed last year is S. 2794, the "Senior Investor Protection Act of 2008." Introduced by Senator Herb Kohl (D-WI), it would make grant funding

[5] *State Farm Bank, FSB v. Reardon*, No. 07-4260 (Aug. 22, 2008), (Opinion Letter from the Chief Counsel for the Office of Thrift Supervision effective to preempt state law as it affects exclusive agents for a federal thrift) *See also, State Farm Bank v. Reardon,* --- F.3d ---, 2008 WL 3876196 (6th Cir. Aug. 22, 2008)

available to states that adopt NASAA's model rule prohibiting the misleading use of "senior designations," which are titles that unscrupulous agents often used to defraud senior investors. The bill addresses a serious form of elder abuse while at the same time making significant funding available to the states for enforcement.

The current levels of funding for law enforcement agencies is low, given the billions upon billions of dollars being used to shore up distressed banks and other institutions, some of which undoubtedly contributed to the current financial crisis through illegal or reckless behavior. Increasing enforcement and more effectively deterring fraud is vastly more cost effective than trying to compensate victims and repair the damage to our economy once the frauds have occurred.

Securities Prosecutions. In many states, the attorney general, county attorney or district attorney may request that a duly employed attorney of a state securities division be appointed a special prosecutor to prosecute or assist in the prosecution of criminal violations on behalf of the state. These special prosecutors have all the powers and duties prescribed by law for assistant attorneys general or assistant district attorneys, but they don't technically have full independent prosecutorial authority. As a practical matter, deputizing a state securities attorney gives the local prosecutors and the state Attorney General the ability to formally utilize the expertise of the state securities division attorney in prosecuting complex securities cases. This is a valuable leveraging of talent and resources and should be encouraged in all jurisdictions and at the federal level.

Remedies. The nature and extent of the unlawful conduct occurring in our financial markets today requires that Congress thoroughly review all of the civil and criminal remedies that apply in all sectors to ensure they more effectively deter misconduct.

In 1990, Congress granted the SEC its first comprehensive authority to seek monetary penalties in both administrative and civil enforcement actions for violations of the securities laws. For the most serious or "third tier" offenses, penalties for each violation

may be up to, but not more than, $100,000 for natural persons and $500,000 for entities.[6] It does not appear that these penalty amounts are high enough, at least relative to the scope of the fraud still evident in our markets.

In 2002, Congress substantially increased the criminal penalties under the 1934 Act.[7] Fines rose to a maximum of $5 million for individuals and $25 million for entities, and jail terms rose to a maximum of 20 years. These criminal penalties have not had the deterrent effect that one might expect.

The effectiveness of stronger sanctions hinges in large part on the willingness of regulators to use them. In 2006, the SEC issued a release explaining the factors that it considers when determining the appropriate monetary penalty to seek against a corporate wrongdoer. *See* "Statement of the Securities and Exchange Commission Concerning Financial Penalties," SEC Release 2006-4 (Jan. 4, 2006). While that release includes some helpful guidance, it also reflects an attitude of restraint in the use of monetary sanctions, especially where the impact on corporate shareholders may be adverse. If Congress provides federal regulators with better enforcement tools, then it is equally important that regulators use them aggressively.

State securities regulators have served a leading role in the fight against senior investment fraud since first focusing national attention on the issue in 2003. Given the number of baby boomers moving toward retirement who are watching their hard-earned investment portfolios decline in value, it is important that state securities regulators work together with Congress to protect those who will be the most vulnerable to investment fraud. We believe legislation to enhance penalties against perpetrators of securities fraud against seniors will assist law enforcement and regulators to ensure that those who take advantage of our nation's elderly will be held accountable. Fraudulent investment sales to seniors will remain a problem of epidemic proportions as long as the benefits to the perpetrators outweigh the costs. It's for that reason that NASAA supports the Senior

[6] *See* 15 U.S.C. Sec. 78u (codifying provisions of the Securities Enforcement Remedies and Penny Stock Reform Act).
[7] *See* The Sarbanes-Oxley Act of 2002, Sec. 1106 (codified at 18 U.S.C. Sec. 1513).

Investor Protection Act that was introduced in 2008 and will be working toward its introduction and passage in both the Senate and House during the 111th Congress.

Reexamine and Remove Hurdles Facing Private Plaintiffs. Private actions are the principal means of redress for victims of securities fraud, but they also play an indispensable role in deterring fraud and complementing the enforcement efforts of government regulators and prosecutors. Congress and the courts alike have recognized this fact. The Senate Report accompanying the Private Securities Litigation Reform Act of 1995 (PSLRA) described the importance of private rights of action as follows:

> The SEC enforcement program and the availability of private rights of action together provide a means for defrauded investors to recover damages and a powerful deterrent against violations of the securities laws. As noted by SEC Chairman Levitt, "private rights of action are not only fundamental to the success of our securities markets, they are an essential complement to the SEC's own enforcement program." [citation omitted][8]

The problem, of course, is that over the last 15 years, Congress and the Supreme Court have restricted the ability of private plaintiffs to seek redress in court for securities fraud. These restrictions have not only reduced the compensation available to those who have been the victims of securities fraud, they have also weakened a powerful deterrent against misconduct in our financial markets.

For example, in the PSLRA, Congress imposed stringent pleading requirements and other limitations on plaintiffs seeking damages for fraud under the securities acts. The intent of the Act was to protect companies from frivolous lawsuits and costly settlements. Many observers, however, believe that PSLRA has placed unrealistic burdens on plaintiffs with meritorious claims for damages.

The Supreme Court has compounded the problem by issuing decisions that further limit the rights of private plaintiffs in two important ways. The Court has narrowed the class

[8] *See* S. Rep. No. 104-98, at 8 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 687; *see also Basic Inc. v. Levinson*, 485 U.S. at 230-31 (observing that the private cause of action for violations of Section 10(b) and Rule 10b-5 constitutes an "essential tool for enforcement of the 1934 Act's requirements").

of wrongdoers who can be held liable in court, and at the same time, it has expanded the pleading burdens that plaintiffs must satisfy to survive immediate dismissal of their claims. As Justice Stevens lamented in his dissent in Stoneridge, the Court has been on "a continuing campaign to render the private cause of action under Section 10(b) toothless."[9]

In short, the pendulum has swung too far in the direction of limiting private rights of action. Congress should therefore hold hearings to examine whether private plaintiffs with claims for securities fraud have fair access to the courts. In that process, Congress should re-evaluate the Private Securities Litigation Reform Act and should furthermore consider reversing some of the Supreme Court's most anti-investor decisions. One case that undoubtedly deserves to be revisited is the Court's holding in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 114 S.Ct. 1439 (1994). The Court ruled that the private right of action under Section 10(b) of the Securities Exchange Act of 1934 cannot be used to recover damages from those who aid and abet a securities fraud, only those who actually engage in fraudulent acts. The Court's decision insulates a huge class of wrongdoers from civil liability for their often critical role in support of a securities fraud.

Other cases that warrant legislative re-evaluation include Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 779 (2008) (severely limiting the application of Section 10(b) in cases involving fraudulent conduct); and Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499 (2007) (establishing burdensome requirements for pleading scienter).

It bears repeating that removing excessive restrictions on access to the courts would not only provide more fair and just compensation for investors, it would also benefit regulators by restoring a powerful deterrent against fraud and abuse: the threat of civil liability.

[9] Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 779 (2008).

State/Federal Coordination

State securities regulators welcome the opportunity to work with our regulatory counterparts at the SEC and the SROs to collectively use our resources to protect investors. To facilitate communication and coordination on all financial services issues, NASAA believes the President's Working Group on Financial Markets should be expanded to include representatives from the state agencies that regulate banking, insurance, and securities.

Our current coordination and cooperation ranges from statutorily mandated meetings to working cases together to informal information sharing networks. NASAA and the SEC cosponsor an annual Conference on Federal-State Securities Regulation in accordance with Section 19(d) of the Securities Act of 1933. As part of the conference, representatives form the SEC and NASAA divide into working groups in the areas of enforcement, corporation finance, broker-dealer regulation, investment advisers, and investor education, Each group discusses methods to enhance cooperation in its subject area and to improve the efficiency and effectiveness of federal and state securities regulation.

As the NASAA Enforcement Chair, I have attended meetings of the Securities and Commodities Fraud Working Group, which is an informal association of law enforcement departments and regulatory agencies at the federal, state, and international levels. Organized under the auspices of the Justice Department in 1988, the Group seeks to enhance criminal and civil enforcement of securities and commodities laws through meetings and other information sharing activities that include discussions of current developments, and presentations on specific topics such as a major cases, sting operations, or policy initiatives.

NASAA is also a participant in the National Examination Summits. These are quarterly meetings attended by representatives from NASAA, the SEC, and FINRA in which complaint data and trends are shared and discussed. The information shared at these

meetings often results in cross-referrals for potential enforcement action or scheduling of joint examinations.

Several years ago, NASAA accepted an invitation from the U.S. Treasury Department to become a member of the Financial and Banking Information Infrastructure Committee (FBIIC), which is sponsored by President's Working Group on Financial Markets. As an active FBIIC member, NASAA helps coordinates public-sector efforts to improve the reliability and security of the U.S. financial system. FBIIC also develops procedures and systems to allow federal and state regulators to communicate among themselves and with the private sector during times of crisis.

NASAA also serves as a member of the Federal Reserve's Cross-Sector Group. The group's bi-annual meetings are hosted by the Federal Reserve and include representatives from the state and federal banking, insurance and securities regulators.

As you know, investment fraud knows no borders. That's why state and provincial securities agencies, through NASAA, have reached out to their colleagues in the international arena. NASAA plays an active role in the International Organization of Securities Commissioners (IOSCO) and the Council of Securities Regulators of the Americas (COSRA).

Conclusion

The unique experiences of state securities regulators on the front lines of investor protection have provided the framework for my testimony. As the regulators closest to investors, state securities regulators provide – and must be allowed to continue to provide – and indispensable layer of protection for Main Street investors.

States: On the Frontlines of Investor Protection	
PROBLEM: $2 billion/yr. Losses in Penny Stocks	
State Initiative	**1989:** States determined penny stock offerings by newly formed shell companies to be per se fraudulent. These "blank check" companies had no business plan except a future merger with an unidentified company.
National Response	**1990:** Congress passed Penny Stock Reform Act, which mandated SEC to adopt special rules governing sale of Penny Stocks (<$5.00 per share) and public offerings of shares in blank check companies (SEC Rule 419).
PROBLEM: $6 billion/yr. Losses in Micro-cap Stocks	
State Initiative	**1996-97:** 33 States participated in sweep of 15 broker-dealer firms that specialized in aggressively retailing low priced securities to individual investors. States found massive fraud in firms' manipulation of shares of start-up companies, most of which had no operating history.
National Response	**1997-98:** Congress held hearings on fraud in the micro-cap securities markets (shares selling between $5-10). **2002:** Congress passed Sarbanes-Oxley Act, which made certain state actions a basis for federal statutory disqualification from the securities industry.
PROBLEM: Risks of Securities offerings on the Internet	
State Initiative	**1996-97:** States issued uniform interpretative guidance on use of Internet for legitimate securities offerings and dissemination of product information by licensed financial services professionals.
National Response	**1998:** SEC issued interpretative guidance based on the States' Model on the use of Internet for securities offerings and dissemination of services and product information by licensed financial services professionals.
PROBLEM: Risks of Online Trading	
State Initiative	**1999:** In a report on trading of securities on the Internet, States found that investors did not appreciate certain risks, including buying on margin and submitting market orders.
National Response	**2001:** SEC approved a new NASD rule requiring brokers to provide individual investors with a written disclosure statement on the risks of buying securities on margin.
PROBLEM: Risks of Day Trading	
State Initiative	**1999:** In a report on individuals engaged in day trading, States found that day trading firms failed to tell prospective investors that 70% of day traders would lose their investment while the firm earned large trading commissions.
National Response	**2000:** SEC approved new NASD rules making day trading firms give written risk disclosure to individual investors. **2001:** SEC approved new NASD and NYSE rules governing margin extended to day traders.
PROBLEM: Research Analyst Conflict of Interest	
State Initiative	**2002-03:** States investigated and helped focus attention on conflicts of interest between investment analysts and major Wall Street firms.
National Response	**2002-03:** The SEC, NASD, NYSE, and states reached a landmark $1.4 billion global settlement and firms agree to reform practices.
PROBLEM: Illegal Mutual Fund Trading Practices	
State Initiative	**2003:** States uncovered illegal trading schemes that had become widespread in the mutual fund industry.
National Response	**2003-2004:** SEC, NASD and NYSE launch investigations; reform legislation introduced in Congress but fails to gain support; SEC initiates wide-ranging effort to reform certain fund regulations.
PROBLEM: Senior Investment Fraud	
State Initiative	**2008:** After calling attention to widespread fraud against senior investors, NASAA members approved a model rule prohibiting the misleading use of senior and retiree designations and numerous states have adopted the model through legislation or regulation.
National Response	**2008:** Sen. Herb Kohl, chair of the U.S. Senate Special Committee on Aging, introduced legislation that would provide grants to states to enhance the protection of seniors from being misled by false designations.
PROBLEM: Auction Rate Securities	
State Initiative	**2008:** Based on investor complaints, states launched a series of investigations into the frozen market for auction rate securities. The investigations led to settlements with 11 major Wall Street firms to return $50 billion to ARS investors.
National Response	**2006:** SEC looked into underwriting and sales practices of auction rate securities. While it did discover and try to remedy certain manipulative practices, the SEC failed to identify or correct fundamental conflicts of interest and self dealing that pervaded the auction rate market.

SOURCE: North American Securities Administrators Association

Updated: January 2009

Before the

United States House of Representatives
Financial Services Committee

Hearing on
Federal and State Enforcement of Financial Consumer and Investor Protection Laws
March 20, 2009

Merle D. Sharick, Jr., CMB
Vertical Solutions Consultant
LexisNexis Risk & Information Analytics Group, Inc.

On behalf of the
Mortgage Asset Research Institute (MARI)

Introduction

Good afternoon, Chairman Frank, Ranking Member Bachus, and distinguished members of the Committee. My name is Merle D. Sharick, and I serve in the LexisNexis Risk & Information Analytics Group as the Vertical Solutions Consultant for the mortgage industry. It is my pleasure to testify today on behalf of MARI—the Mortgage Asset Research Institute, a LexisNexis service. Mr. Chairman, I commend you and the members of the Committee for holding this hearing and for your dedication to protecting consumers and promoting the principles of responsible lending.

MARI manages and maintains the only cooperative contributory database – MIDEX (Mortgage Industry Data Exchange) – existing today in the mortgage industry specifically established by key industry participants over 18 years ago to keep track of mortgage professionals and companies. MIDEX includes public financial sanction information from over 200 government regulators and non-public incident reports provided by subscribers when fraud or misrepresentation is detected in a loan transaction.

MARI has become a "utility" in the industry whose subscribers use MIDEX and other solutions for credentialing new business relationships, quality control and quality assurance processes, and loan investigations. MIDEX is the only contributory database endorsed by the Mortgage Bankers Association. MARI became a key part of the LexisNexis suite of solutions in September of 2008. Our current focus is driving and supporting the installation of a loan fraud-prevention database for loan origination pipelines for all lenders to share and compare loans in-flight to prevent fraud early in the mortgage process, alerting lenders to suspect fraud in their current lending pipeline.

The goal of the LexisNexis Residential Mortgage Solutions is to identify, reduce, and prevent exposure to mortgage fraud risk by providing a broad suite of solution tools that focus on the application, the professionals, and the transaction.

MARI also is active in working with industry groups, regulators, and law enforcement to provide information and training to support the vital challenge of finding and stopping mortgage fraud and misrepresentation.

Congress, the states, the federal financial regulatory agencies, and the Obama Administration, have all been very active in trying to restore confidence in the mortgage market. I commend your collective efforts to protect consumers and promote the principles of responsible lending.

LexisNexis has positioned MARI to provide information and analytic tools to help restore the integrity so needed in the mortgage industry today. Many in the industry are using this crisis to review, evaluate, and make necessary changes in their processes. Mortgage fraud has been a crime of opportunity. However, as a result of what has happened in the mortgage industry coupled with the economic deterioration—mortgage fraud is now a crime of necessity or desperation for many.

Mortgage Fraud Case Report

This month, MARI released its Eleventh Periodic Mortgage Fraud Case Report to the Mortgage Bankers Association. This reports shows that reported mortgage fraud is more prevalent now than in the heyday of the origination boom. The increase in reported fraud incidents outlined in our report is a sign of better detection at the front end of the origination process and renewed commitment to reporting fraud cases; however, analysis of data by MARI reveals that fraud incidence is at an all-time high. Fewer loan originations coupled with increased

fraud incidence equals new times of desperation. Industry expertise and technological advancements, mixed with difficult economic conditions, are catalyst for the continuation of growth of fraud.

This is the eleventh annual report by MARI to the Mortgage Bankers Association members. This report examines the current composition of residential mortgage fraud and misrepresentation in the U.S. This report is based on data submitted by major mortgage lenders, agencies, and insurers on information describing incidents of alleged fraud and material misrepresentation to a central database know as MIDEX (the Mortgage Industry Data Exchange), in order to share their experiences with the mortgage industry.

The highlights of this annual report include:

- For the first time, Rhode Island is ranked first in the country for mortgage fraud. Future reports will tell if this is a statistical anomaly; however, current data suggests that the state has emerged with a problematic and heretofore unnoticed mortgage fraud problem. Its strong MARI Fraud Index (MFI), 315, indicates significant fraud activity.
- After improving its rankings in 2006 and 2007, Georgia has risen to fourth place for 2008 originations.
- Conversely, California's MFI has fallen to 111 for 2008, a significant drop from 2007's 175.

A complete description and analysis of our findings is included in the attached report.

Conclusion

Combating mortgage fraud is critically important to restoring integrity in the mortgage loan transaction, attracting the necessary capital to meet the needs of prospective homeowners and the industry; as well as rebuilding consumer trust in the industry's professionals when the real estate market segment begins to improve. Our lenders know the financial loss consequences of this growing problem in America and the same reported impacts in foreign nations with similar lending practices.

We believe that the mid to longer term systemic return of the real estate market segment must be anchored by improved fraud prevention and lending practices already being pursued by the lenders. This is essential to helping the country restore the economic foundation that the Obama Administration, your Committee and many others are currently working to achieve.

Mr. Chairman, we look forward to working with the mortgage industry, this Committee, the states, the federal financial regulatory agencies and other stakeholders to combat mortgage fraud, protect consumers, and promote the principles of responsible lending.

TESTIMONY OF ELISSE B. WALTER

COMMISSIONER

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Before the

United States House of Representatives

Committee on Financial Services

Concerning Securities Law Enforcement in the Current Financial Crisis

Friday, March 20, 2009

Good morning Chairman Frank, Ranking Member Bachus, and members of the Committee. I am Elisse Walter, one of the five Commissioners of the Securities and Exchange Commission, and I am testifying here today on behalf of the Commission as a whole. I appreciate the opportunity to discuss the United States Securities and Exchange Commission's enforcement program, and more specifically, the Commission's vigorous efforts to address violations of the federal securities laws arising out of the current financial crisis. The SEC is fully committed to pursuing wrongdoers and returning as much money as possible to injured investors.

The Commission's enforcement program is in a critical transition period. Our new Chairman, Mary Schapiro, joined the agency in January and has been taking a series of steps to bolster our enforcement efforts and restore investor confidence to our markets. She has hired a new Director of Enforcement, Robert Khuzami, an accomplished former federal prosecutor, who is scheduled to join the agency at the end of this month; began streamlining our enforcement process; and launched an initiative to improve the way we handle the hundreds of thousands of complaints and tips we receive each year.

The SEC's Law Enforcement Authority and Processes

The SEC is a capital markets regulator and law enforcement agency. We are charged with civil enforcement of the federal securities laws, primarily the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, and the Investment Company Act of 1940. The SEC's Enforcement Division is authorized to investigate any potential violation of the federal securities laws. In this regard, the anti-fraud provisions of the Exchange Act enable the SEC to take action against any form of fraud in connection with the purchase or sale of securities, regardless of the identity of the perpetrators and regardless of whether they are required to be registered with the SEC. The anti-fraud provisions also apply in areas of the financial markets that are not otherwise regulated by the Commission, such as hedge funds and credit default swaps ("CDSs").

The Enforcement Division initiates investigations based on information from many sources, including referrals from the Commission's examination program and other SEC Divisions and Offices, referrals from other regulators, complaints from investors and others, and tips from the public. In fiscal year 2008, the Enforcement Division received more than 700,000 complaints, tips and referrals. The Enforcement Division has delegated authority to initiate investigations, but, when needed, the staff obtains subpoena power by obtaining Commission approval of a formal order of investigation. In conducting investigations, the staff can take advantage of the full range of the SEC's resources, particularly the examinations conducted by the Office of Compliance

Inspections and Examinations ("OCIE"). OCIE conducts on-site inspections and examinations of broker-dealer and investment adviser firms that are registered with the Commission, and may do so on a periodic or random basis or "for cause". Enforcement Division staff may also consult with the SEC's Divisions of Corporation Finance, Trading & Markets, and Investment Management, as well as with the Offices of Economic Analysis, the Chief Accountant and the General Counsel, about matters within their respective areas of expertise.

The SEC's Enforcement Division has approximately 1100 attorneys, accountants and other staff located in the home office in Washington D.C. and in 11 Regional Offices nationwide who are committed to securities law enforcement and investor protection throughout the United States. In addition, the staff at each of the SEC's offices maintains close working relationships with their colleagues at the securities exchanges and other self-regulatory organizations ("SROs") and in the local, state and federal law enforcement communities.

If after an investigation, staff believes there has been a violation of the federal securities laws, the staff may recommend that the Commission take specific enforcement action against the alleged wrongdoer(s). On Commission approval of the recommendation, the Enforcement Division commences a civil enforcement action against the responsible parties—either by filing an injunctive action in federal court or through administrative proceedings. In most cases, the parties charged agree to settle the action on specific terms before the action is filed. If the Commission approves the settlement, the SEC's enforcement action will be filed and settled at the same time. If the

parties do not reach a settlement, the Enforcement Division files the action and litigates the matter to its conclusion.

In fiscal year 2008, the SEC filed a total of 671 enforcement actions, including 157 issuer reporting and disclosure cases (e.g., financial fraud); 121 securities offerings cases; 52 market manipulation cases and 61 insider trading cases. The total of 671 cases filed last year was the second-highest annual number of cases ever filed by the Enforcement Division in the agency's history.

The remedies available to the SEC in civil enforcement actions are disgorgement of ill-gotten gains,[1] permanent injunctive relief against violations of the federal securities laws, remedial undertakings, civil penalties, revocation of registration, and bars—which may preclude a wrongdoer from serving as an officer or director of a public company or from associating with any broker-dealer or investment adviser—either permanently or for a limited time period. In addition, professionals such as accountants and attorneys may be barred or suspended from appearing or practicing (broadly interpreted) before the Commission. This bar constitutes a substantial limitation on the conduct of any securities-related professional practice—as in practical effect it renders a professional unable to sign documents filed with the Commission and also carries a serious reputational stigma.

The SEC's enforcement actions last year resulted in orders requiring securities violators to disgorge illegal profits of approximately $774 million and to pay penalties of approximately $256 million. The Enforcement Division sought orders barring 132

[1] Disgorgement of a wrongdoer's ill-gotten gain may not be the same amount as the investor's damages, which may be greater. Because of this distinction and because assets are often dissipated in a fraudulent scheme, an SEC enforcement action usually cannot make investors whole for all of their losses. Nonetheless, the Commission seeks to maximize the amount of monies returned to investors in every case.

defendants and respondents from serving as officers or directors of public companies. In addition, the SEC halted trading in securities of 189 issuers about which there was inadequate public disclosure.

In order to halt an ongoing fraud or to prevent dissipation of investor funds, the SEC may seek emergency relief in federal district court, including temporary restraining orders, preliminary injunctions, asset freezes, and the appointment of a receiver to conduct operations during the pendency of the litigation, or to marshal and liquidate any remaining assets in order to make an equitable distribution of the proceeds among injured investors. Last year, the Enforcement Division sought temporary restraining orders to halt ongoing fraudulent conduct in 39 cases. During fiscal year 2009 to date, the SEC has obtained 20 temporary restraining orders to halt ongoing frauds.

Whenever possible, the Commission seeks to return monies to harmed investors under the Fair Funds provisions of the Sarbanes-Oxley Act of 2002.[2] In enforcement actions prior to Sarbanes-Oxley, only funds paid as disgorgement could be returned to investors. In order to make up for any short-fall in the amount going to harmed investors, Sarbanes-Oxley enabled the Commission to distribute to investors the amount obtained in civil penalties where there has been a related disgorgement of ill-gotten gains. In 2007, the SEC created a dedicated Office of Collections and Distributions in the Enforcement Division to facilitate the distribution of Commission recoveries, including Fair Funds, to injured investors. The Office is responsible for the Division's collections and distributions programs and also litigates to collect disgorgement and penalties imposed in Enforcement actions.

[2] *See* Sarbanes-Oxley Act of 2002, Section 308, codified at 15 U.S.C. §7246 (2009).

Since 2002, the Commission has authorized approximately 220 Fair Funds and disgorgement funds, with an estimated total value of more than $9.3 billion. In fiscal year 2008, the Commission distributed over $1 billion to injured investors, bringing total distributions since the passage of Sarbanes-Oxley to an estimated $4.6 billion. The Commission expects significant additional distributions this year from cases including: *AIG* ($800 million),[3] *Invesco*/AIM ($375 million),[4] and *Alliance* ($321 million).[5] In the current financial crisis, the benefits to investors from the authority Congress bestowed on the SEC in Sarbanes-Oxley are more valuable than ever.

Frequently, SEC enforcement actions are pursued and brought in cooperation with other law enforcement authorities. To illustrate, in conjunction with the filing of an indictment by the Attorney General of the State of New York, yesterday the Commission filed securities fraud charges against a former high level public official and a well connected political advisor.[6] These individuals allegedly used their positions and connections to extract kickbacks from firms that were seeking to do business with nation's third largest pension fund, the New York State Common Retirement Fund. The Commission's complaint alleges that the individuals schemed to enrich themselves and their friends at the expense of the Retirement Fund and thereby undermined the integrity of the state's investment decisions. They allegedly extracted millions of dollars of kickbacks from investment management firms seeking to be hired to invest and manage the Retirement Fund's assets.

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[3] *SEC v. American International Group, Inc.* Lit. Rel. No. 19560 (Feb. 9, 2006); .
[4] *SEC v. Invesco Funds Group Inc., et al.*, Exch. Act Rel. No. 50506 (Oct. 8, 2004).
[5] *SEC Announces Start of $321Million Fair Fund Distribution to Investors Harmed by Alliance Capital Market Timing*, Press Rel. No. 2009-21 (Feb. 6, 2009).
[6] These defendants are David Loglisci, New York State's former Deputy Comptroller, and Hank Morris, the top political advisor to former New York State Comptroller Alan Hevesi.

The SEC also has oversight responsibilities with respect to the enforcement and compliance programs of SROs, which are essential partners in the SEC's enforcement efforts. They conduct surveillance with respect to trading activities, make enforcement referrals to the SEC with respect to possible insider trading and other misconduct, and conduct their own examination and enforcement programs with respect to their member firms.

The SROs have a wide array of remedies to address misconduct by member firms and ensure investor protection. Disciplinary action against SRO member firms and individuals associated with SRO member firms may include suspension for a designated period of time, which may be either general suspension from any securities business or specific suspension from a particular aspect of the business (*e.g.*, underwriting suspension against a member firm or supervisory suspension against an associated person); revocation of registration; bars from future association with any SRO member firm, which may be absolute or limited to certain activities (*e.g.*, supervisory or compliance bars against associated persons); expulsion of member firms; and monetary fines that may be imposed against either individuals or member firms. In addition, FINRA handles customer complaints involving broker-dealers. In calendar year 2008, FINRA received 5,405 complaints from investors, filed 1,073 new disciplinary actions, and resolved 1,007 actions, in which 19 firms were expelled, 363 individuals were barred, and a further 321 individuals were suspended.

The Current Financial Crisis

From a regulatory and enforcement perspective, the current financial crisis is exceedingly complex and unprecedented in scope and impact. Our markets now attract a much larger and more complicated group of participants than ever before; feature a myriad of new products that have never before been subjected to such extreme market forces; and have become closely interrelated in complex ways.

In the current crisis, major U.S. financial institutions have played widely diverse and often simultaneous roles, including acting as investment banks, securities underwriters, lenders, prime brokers to hedge funds, investment advisers, executing broker-dealers and even as investors for their own accounts. Other market participants in the current crisis include mortgage lenders, securitizers, credit rating agencies, home builders, mutual funds and hedge funds. The crisis also involves a broad array of financial instruments, including subprime mortgage-backed securities, other collateralized debt obligations ("CDOs" and "CDO^2s"), auction rate securities ("ARS"), CDSs and an increasingly complex range of other derivative instruments,[7] some of which

[7] CDOs are securities based on a pool of underlying debt instruments. Financial firms known as "securitizers" create new securities based on distinct pools of mortgages or other debt instruments. The securitizers evaluate all the underlying debt instruments in a pool and then divide them into sub-pools or "tranches" of instruments bearing similar characteristics with respect to the risk of default. The debt instruments are divided into risk layers, ranging from the top layer tranches, which contain instruments having the least risk of default, to the bottom layer tranches, which contain instruments having the greatest risk of default. Securitizers then sell securities representing the right to a proportionate interest in the debt payments stream represented by each tranche. Because the different tranches are designed to represent different levels of risk of default, the securities based on each tranche are typically assigned a separate credit rating by a credit rating agency and priced separately. The securities are said to be collateralized because the homes or other assets associated with the mortgages or other debt instruments, respectively, serve as collateral in the event of default. A CDO^2 is a CDO based on a pool of underlying CDOs. ARS are bonds or preferred stock that have interest rates or dividend yields periodically reset through a process similar to Dutch auctions, typically every 7, 28 or 35 days. CDSs are analogous to insurance arrangements with respect to the risk of default on a corporation's debt. In exchange for one party's payment of a specific sum of money to a counterparty (similar to an insurance premium), the counterparty guarantees payment of predetermined amount ("face value") of a corporation's debt in the event of default. The amount paid as a "premium" for default protection is directly correlated with the perceived risk of default

are not, or may not be, subject to securities regulation.[8] Regulators and law enforcement authorities must confront problems that may include, among other things, lack of transparency, accounting fraud and irregularities, and inaccurate or inadequate disclosures regarding such matters as risk, leverage, credit limitations and investment strategies.

The SEC is fully committed to addressing this crisis: to finding out what went wrong, punishing any wrongdoers and returning as much money as possible to injured investors. There is no doubt that, under Chairman Mary Schapiro's leadership, the agency is moving with the utmost urgency to respond in the most effective manner. As described in greater detail below, we are taking action in a number of areas relating to the crisis. Also, we are committed to an extraordinary level of coordination and cooperation with other securities regulators, including the nation's stock exchanges and other SROs, state securities regulators and our foreign regulatory counterparts, as well as criminal authorities at the state, federal and international levels.

Subprime Enforcement Actions and Ongoing Investigations

The Enforcement Division formed a Subprime Working Group in March 2007 to coordinate its investigative efforts relating to subprime lending and credit market issues nationwide, to solicit assistance from various Divisions and Offices within the Commission, and to serve as a point of contact with the many other federal and state regulators and criminal authorities actively working in this area, including the SROs, the

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by the corporation. In general, derivative securities are securities the value of which is derived from the value of some other underlying payment obligation or asset.

[8] While the SEC has limited direct authority to regulate much of the OTC derivatives market, which includes CDSs, it nonetheless retains antifraud authority over security-based swap agreements including authority over insider trading.

Departments of Justice and Treasury, the Federal Reserve, the TARP program and numerous other federal and state regulators. Approximately 100 enforcement staff members throughout the country participate in this Group.

The Enforcement Division has already filed nine cases involving subprime issues and has many additional subprime matters under active investigation--which may or may not result in further enforcement recommendations. The subjects of these investigations fall primarily into three broad categories: (i) subprime lenders; (ii) investment banks and other large financial institutions; and (iii) others, including securitizers who packaged and resold slices of subprime mortgage debt in the form of various types of derivative securities, credit rating agencies, home builders, and companies that provided mortgages to investors to enable them to finance securities purchases.[9]

With respect to subprime lenders, the SEC is investigating, among other things, improper accounting, disclosure issues, and insider trading. For example, with respect to accounting, the investigations involve improper accounting for loan loss reserves and impairment of asset values, as well as overvaluation of foreclosed property and other assets. The disclosure issues under investigation include false, misleading, inadequate or non-existent disclosures regarding loan quality and credit risks, amounts and types of subprime exposure, understatement of mortgage delinquency and default rates, false favorable predictions about payment of dividends or future financial performance in light of subprime exposure, false representations regarding lending practices and failure to disclose material negative regulatory actions. Several investigations regarding subprime

[9] Three of the nine subprime cases filed to date have been fully settled. Two of the actions have been partially settled with respect to one of defendants and the other defendants in those actions are litigating. In each of the remaining four subprime cases, all of the defendants are continuing to litigate against the SEC.

lenders also raise issues regarding possible insider trading, particularly before the announcement of negative news regarding the lender.

Investigations regarding investment banks and other large financial institutions raise another range of issues. Many of the investigations regarding major financial institutions such as investment banks involve massive write-downs of asset values and other losses related to subprime securities portfolios. The investigations typically involve questions concerning the timing and amount of write-downs and the nature and timing of related disclosures. The investigations also involve possibly false, misleading, inadequate or non-existent disclosures regarding subprime exposure or concentration, financial condition, future financial performance, valuation of assets, intended curtailment of business lines, misrepresentations regarding underlying mortgage quality in securitization prospectuses, failure to disclose material changes in performance of mortgage portfolios underlying certain securities, and failure to disclose negative regulatory actions. Other issues under investigation include possible intentional mispricing of securities and the knowing underwriting of securities based on collateral likely to default. Staff is also investigating the existence and implementation of internal control procedures regarding risk, internal control procedures specific to subprime securities, disclosure of known material weaknesses in such internal control procedures and the efficacy of transactions intended to reduce risk.

Investigations of other entities such as credit rating agencies, home builders and companies that provided retail mortgages to consumers to enable them to purchase securities vary considerably. In investigating retail brokers who assisted customers in obtaining subprime mortgages so they could invest in securities, staff might consider the

suitability of the securities for the customers and whether the broker received any undisclosed compensation in connection with either the mortgages or the securities transactions. Investigations of credit rating agencies might include whether it diverged from its rating methodologies for any particular issuers due to a conflict of interest. An investigation of a home builder might entail possible financial fraud, such as improper quarterly earnings management or improper recognition of revenue on model home sales and leasebacks, as well as possible improper related-party transactions.

Examples of subprime enforcement actions resulting from our investigations include the following:

- Allegation of Misrepresentations in Connection With 2007 Bear Stearns Subprime Hedge Funds Meltdown - In June 2008, the SEC charged two Wall Street portfolio managers with fraudulently misleading investors and institutional counterparties about the financial state of the firm's two largest hedge funds and the funds' exposure to subprime mortgage-backed securities prior to the funds' collapse.[10]

- Allegation of Broker Misrepresentations to Customers re Assets Backing Securities Purchased for Customer Accounts - In September 2008, the SEC charged two Wall Street brokers with making more than $1 billion in unauthorized purchases of subprime-related auction rate securities. The SEC alleges the brokers represented to customers that the securities purchased for their accounts were backed by guaranteed student loans, when in reality the securities were backed by subprime mortgages and other less creditworthy assets.[11]

- Allegation of Brokers Pushing Unsophisticated Investors Into Subprime Refinancings to Pay for Purchase of Unsuitable Securities - In October 2008, the

[10] *SEC v. Ralph R. Cioffi and Matthew M. Tannin*, Civil Action No. 08 2457 (E.D.N.Y. June 19, 2008) (presently in litigation; the defendants deny and dispute the allegations in the civil and criminal proceedings brought against them by the SEC and the U.S. Attorney's Office for the Eastern District of New York, respectively).

[11] *SEC v. Julian T. Tzolov and Eric S. Butler*, Case No. 08 Civ. 7699 (S.D.N.Y. Sept. 3, 2008) (In November 2008, U.S. District Court for the Southern District of New York stayed the Commission's civil action pending resolution of the parallel criminal matter, *U.S. v. Tzolov and Butler* (08 Cr. 370 (JBW)), which is being litigated by in the U.S. Attorney for the Eastern District of New York; Butler and Tzolov each deny and dispute the allegations in both the civil and criminal proceedings brought against them by the SEC and the U.S. Attorney's Office for the Eastern District of New York, respectively.)

SEC charged five Los Angeles-based brokers for putting their customers at risk by refinancing their homes with subprime mortgages they could not afford in order to fraudulently sell them unsuitable securities.[12]

Auction Rate Securities

Through the collective efforts of SEC Enforcement, state regulators and FINRA, over the past year tens of thousands of ARS investors have received, or will receive, over $67 billion of liquidity. In tandem with other regulators, the SEC's Enforcement Division has finalized settlements with three of the largest broker-dealer firms in the ARS market, UBS, Citigroup, and Wachovia,[13] and has entered into settlements-in-principle with three others, Merrill Lynch, Bank of America and RBC.[14] We expect that these scttlements-in-principle will be finalized shortly. The ARS settlements involve the largest settlement sums in the history of the SEC.

ARS are bonds or preferred stock that have interest rates or dividend yields periodically reset through an auction process, typically every 7, 28, or 35 days. ARS were first developed in 1984 and, as of 2008, it was estimated that the market had grown to $330 billion.[15] The ARS market is primarily comprised of three types of securities: (1) municipal ARS, bonds issued by cities, counties, and public entities and generally backed

[12] *SEC v. Kederio Ainsworth, Guillermo Haro, Jesus Gutierrez, Gabriel Pareded, and Angel Romo*, Case No. EDVC 08-1350 VAP (C.D. Cal. October 3, 2008) (presently in litigation; the defendants deny and dispute the allegations of the SEC's complaint).

[13] *SEC v. Citigroup Global Markets, Inc.*, Lit. Rel. No. 20824 (Dec. 11, 2008) (Citigroup and UBS settlements); *SEC v. Wachovia Securities LLC*, Lit. Rel. No. 20885 (Feb. 5, 2009).

[14] *SEC Enforcement Division Announces Preliminary Settlement With Merrill Lynch to Help Auction Rate Securities Investors*, Press Rel. No. 2008-181 (Aug. 22, 2008); *Bank of America Agrees In Principle To ARS Settlement*, Press Rel. No. 2008-247 (Oct. 8, 2008); *SEC Division of Enforcement Announces ARS Settlement In Principle With RBC Capital Markets Corp.*, Press Rel. No. 2008-246 (Oct. 8, 2008).

[15] Last year's trouble in the ARS market also affected the markets for tender option bonds ("TOBs"). TOBs are derivative variable-rate securities based on an underlying pool of insured, fixed-rate municipal securities.

by insurance; (2) student loan ARS, asset-backed securities with ratings based upon the credit quality of an underlying pool of student loans; and (3) auction preferred stock, perpetual preferred stock of closed-end funds. Until mid-February 2008, auction failures were extremely rare, and the market was highly liquid. In February 2008, the auction rate securities market froze, and many auctions have failed. While the underlying bonds on which the ARS were based continued to perform and pay periodic dividends or interest to ARS holders, the derivative ARS instruments themselves became illiquid and could not be sold. After the market froze, many of the municipal ARS and some auction preferred stock were refinanced, repaid or converted to different interest rate modes.

The SEC's investigations revealed that some ARS investors had been misled by securities professionals about the risks in the ARS market and were wrongly led to believe that ARS were as liquid as cash or money market funds. When the ARS market froze, these investors had no access to funds needed for pressing short-term obligations, such as a down-payment on a home, college tuition, or small business payrolls. To address these issues, the Commission's staff formulated a framework for settlement to restore and maximize liquidity in the ARS markets as soon as possible.

In the settlements, many of the aggrieved ARS investors, including retail customers, small businesses, and charitable organizations, will have the opportunity to receive 100 cents on the dollar on their investments within short time frames. (Many of these investors have already accepted these offers and received the full par value of their investments.) UBS and Wachovia have also agreed to provide liquidity to their large institutional customers over a slightly longer period of time. In connection with the ARS settlements, FINRA has established a special ARS arbitration procedure for customers

who suffered consequential damages resulting from the illiquidity of their ARS positions. In these streamlined arbitrations, the firms that sold ARS cannot contest liability, and arbitrators determine the specific amount of damages to be awarded to the customer.

The Enforcement Division is investigating other firms and individuals. FINRA and state regulators have entered into separate settlements with other firms. All of these efforts have significantly reduced the total amount of frozen ARS and has led to a increase in liquidity in the ARS market.

21(a) Rumor and Manipulation Investigation

The SEC filed its first case alleging the circulation of false rumors in combination with a scheme to profit by short-selling in April 2008. In *SEC v. Berliner*, the Commission charged that a Wall Street trader, Paul S. Berliner, intentionally spread false rumors about the Blackstone Group's pending acquisition of Alliance Data Systems ("ADS"), in 2007 while selling ADS short.[16] Through instant messages sent to numerous Wall Street professionals at brokerage firms and hedge funds, Berliner allegedly circulated false rumors that the deal between ADS and Blackstone was being renegotiated at a substantially lower purchase price because of credit difficulties in ADS's consumer banking unit, and that ADS's board was meeting to consider the revised proposal even as the messages were sent.

Berliner allegedly circulated these rumors to artificially depress the price of ADS' stock, in order to profit from short selling. The rumors initially had the intended effect. They were picked up by the media and resulted in heavy trading in ADS's stock. Within half an hour after Berliner's first instant message, ADS's share price plummeted 17%.

[16] *SEC v. Paul S. Berliner*, Lit. Rel. No. 20537 (April 24, 2008).

During the stock's precipitous decline, Berliner profited from short selling in ADS. In response to the unusual trading activity, the New York Stock Exchange ("NYSE") temporarily halted trading in ADS stock, which allowed time for ADS to issue a press release announcing the rumor was false. ADS's stock price recovered the same day. The SEC charged Berliner with securities fraud and market manipulation based on his circulation of false rumors in combination with short selling, and he settled with the SEC by consenting to a permanent anti-fraud injunction and disgorgement of his ill-gotten gains from short selling.

Among other rumors investigations, SEC also opened a group of related investigations into the possible manipulation of the securities of six large financial issuers involved in the recent market turbulence (collectively, the "21(a) investigation"). On September 19, 2008, the Commission approved a relatively uncommon order under Section 21(a) of the Exchange Act that required numerous hedge funds, broker-dealers and institutional investors to file statements under oath regarding trading and market activity in the securities of financial firms. The order covers not only equities but also CDSs and other derivative instruments.

In October 2008, the Enforcement Division formed a nationwide Rumors and Market Manipulation Working Group to analyze data obtained through the 21(a) Order, with particular focus on claims that CDSs were being used to manipulate equities prices. The SEC's 21(a) investigation has been split into six separate investigations, which are proceeding as expeditiously as possible. The SEC's Rumors and Market Manipulation Working Group is also coordinating its investigation with parallel investigations being conducted by FINRA and the NYSE regarding the conduct of their member firms and

marketplaces, as well as with another parallel investigation being conducted jointly by the New York Attorney General's Office and the U.S. Attorney's Office for the Southern District of New York.

Hedge Funds and Institutional Insider Trading

The SEC is focusing on several issues involving hedge funds and other institutional traders, including (i) possible manipulation, abusive short selling and collusion; (ii) valuation concerns with respect to illiquid assets; and (iii) potential insider trading in a host of circumstances, including prior to mergers and acquisitions and in the credit derivatives market. The Enforcement Division has formed a Hedge Fund Working Group to address these and other issues arising in investigations relating to hedge funds. The Hedge Fund Working Group works closely with examiners from OCIE, and also coordinates with outside agencies and foreign regulators. The SEC has dozens of active investigations involving individuals associated with hedge funds. During the current crisis, the SEC has become particularly concerned about possible hedge fund offering frauds, where fraudsters use the non-transparent and largely unregulated status of hedge funds to conceal large Ponzi schemes. The SEC is also concerned with possible misconduct by "funds of funds" and "feeder funds," which invested their own investors' funds with other hedge fund managers, but may have failed to exercise the due diligence and compliance oversight touted to investors regarding such investments.

The huge number of liquidations and suspensions of redemptions by hedge funds in the past year have created particular concern as to whether hedge fund advisers may be favoring their own interests above others and whether principals, employees or favored

investors of the hedge fund adviser may have received "preferential redemptions" from the fund at issue. In addition, to better detect any insider trading before material corporate events, the Hedge Fund Working Group is developing technological tools that will enable staff to more readily capture patterns of unlawful trading by hedge funds and institutional traders.

The Commission has brought a broad range of enforcement actions involving hedge funds and institutional traders. While hedge funds are not required to register with the SEC, the SEC retains limited authority over hedge funds under the anti-fraud provisions of the federal securities laws. Despite the relative lack of regulation in this area, the Commission has brought over 100 cases involving hedge funds in the last five years—primarily under its anti-fraud authority. On February 25, 2009, for example, the SEC filed three separate fraud cases involving unregistered hedge funds based in New York.

In the *Westgate* case, the Commission charged that James M. Nicholson and his company, Westgate Capital Management, an investment management firm based in Pearl River, N.Y., defrauded investors of millions of dollars by significantly overstating investment returns and misrepresenting the value of assets under management in 11 unregistered hedge funds.[17] The SEC's complaint alleges that Nicholson and Westgate solicited new investors with sales materials that claimed a nearly impossible record of investment success, including one Westgate fund that claimed positive returns in 98 of 99 consecutive months. Nicholson also allegedly created a fictitious accounting firm and provided some of his investors with bogus audited financial statements. By late 2008, the funds had sustained such losses that Nicholson and Westgate could no longer honor

[17] *SEC v. James M. Nicholson*, Lit. Rel. No. 20911 (Feb. 25, 2009).

redemption requests. They allegedly hid the losses from investors with misrepresentations, false sales brochures and other deceptive devices. Nicholson closed one fund that was heavily invested in bankrupt Lehman Brothers and folded its assets into another Westgate fund. He allegedly issued bad checks to some investors seeking to cash out, and ultimately suspended all investor redemptions due to what he called investors' "irrational behavior." Nicholson was already barred from the brokerage industry in 2001 for failing to reply or supplying false information in response to inquiries from NASD (now FINRA).[18]

In the *Greenwood* case, the SEC charged two New York residents and three affiliated entities with securities fraud involving the misappropriation of as much as $554 million in investor assets from an unregistered hedge fund.[19] The SEC's complaint alleges that Paul Greenwood and Stephen Walsh promised investors that their money would be invested in a stock index arbitrage strategy. Instead, Greenwood and Walsh allegedly used the investor funds to purchase multi-million dollar homes, a horse farm and horses, luxury cars, and rare collectibles such as Steiff teddy bears. The SEC obtained an emergency court order freezing the assets of Greenwood and Walsh as well as their companies: WG Trading Investors, L.P. ("WGTI"), an unregistered investment vehicle; WG Trading Company, a registered broker-dealer located in Greenwich, Conn.; and Westridge Capital Management, Inc. ("Westridge"), a registered investment adviser located in Santa Barbara, Calif. The SEC alleges that since at least 1996, Greenwood and Walsh solicited a number of institutional investors, including educational institutions and public pension and retirement plans, by promising to invest their money in an "enhanced

[18] *Id.*
[19] *SEC v. WG Trading Investors, L.P., et al,* Lit. Rel. No. 20912 (Feb. 25, 2009).

equity index" strategy that involves purchasing and selling equity index futures and engaging in equity index arbitrage trading. The Commission alleges, however, that Greenwood and Walsh misappropriated as much as $554 million of the $667 million that Westridge clients invested in WGTI to support their lavish lifestyles.[20]

The last of the three cases, *North Hills Management,* halted an allegedly fraudulent "fund of funds" investment scheme by Mark Bloom and his firm, North Hills Management, LLC, based in Manhattan.[21] According to the SEC's complaint, Bloom, through North Hills, raised approximately $30 million from 40 to 50 investors between 2001 and 2007 by representing that the assets would be invested in a diverse group of hedge funds. Instead, the complaint alleges that Bloom misappropriated more than $13.2 million of investor funds to furnish a lavish lifestyle that included the purchase of luxury homes, cars and boats. The remaining funds allegedly were invested in a single fund ("the Fund"), which itself turned out to be fraudulent.

Bloom and North Hills allegedly sent investors false monthly account statements that portrayed their investments as profitable when, according to the complaint, Bloom was systematically looting the Fund's trading account by making "loans" to himself. Bloom also alledgedly invested in contravention of the Fund's stated investment strategy in an investment known as the Philadelphia Alternative Asset Fund ("PAAF"), in exchange for undisclosed commissions he received from PAAF. PAAF itself was uncovered as a fraudulent scheme in June 2005. In November 2007, one of the Fund's largest investors, a charitable trust (the "Trust") that funds children's schools began to serve Bloom with redemption requests, which Bloom allegedly repeatedly evaded.

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[20] *Id.*

[21] *SEC v. North Hills Management LLC, et al.,* Lit. Rel. No. 20913 (Feb. 25, 2009).

Bloom allegedly failed to honor the Trust's redemption requests in full and claims that he does not have the means to do so. The Trust alone is owed more than $9.5 million on its investment and other investors are owed more than $20 million.[22]

In each of the three cases, the SEC sought and obtained asset freezes and other emergency relief to halt the alleged frauds. In the ongoing actions, the SEC also seeks permanent anti-fraud injunctions, disgorgement and civil penalties. In each instance, the SEC is coordinating its case with parallel criminal proceedings filed by the U.S. Attorneys' Office for the Southern District of New York. *Greenwood* and *North Hills Management* also involve related charges by the Commodity Futures Trading Commission ("CFTC"), as well as cooperation among the SEC, the CFTC and the National Futures Association. *Westgate* was filed with the cooperation of the Rockland County District Attorney's Office. These three cases illustrate the SEC's coordination with other law enforcement agencies, and *Westgate* also illustrates the cooperation between the SEC's regional offices, as it involves investigation of entities from coast to coast in New York and California.

The Commission has also pursued numerous cases involving "information leakage" within the financial markets, particularly with respect to large financial institutions that may possess material non-public information about numerous clients, including hedge funds and other institutional traders. These include cases in which the SEC has charged large broker-dealers with having inadequate information barriers or other internal controls that prevent misuse of confidential non-public information--such as allowing the firm's proprietary traders to have access to confidential information about

[22] *Id.*

upcoming research reports or about clients' upcoming mergers and acquisitions[23]--as well as cases involving alleged misuse of such information about clients' trading activities.[24]

For example, last week the Commission filed its most recent "squawkbox" case against a major broker-dealer for having inadequate policies and procedures to control access to institutional order flow, which allegedly resulted in misuse of that information by day traders who traded ahead of the firm's customers' orders.[25] According to the SEC's order instituting proceedings: retail brokers in three offices of the broker-dealer permitted day traders to listen to announcements broadcast over the firm's internal "squawkbox" regarding large unexecuted block orders placed by the firm's institutional customers; in exchange for compensation paid by the day traders, the brokers put their telephones near the squawkboxes, often for the entire trading day, to provide the day traders with access to information about the firm's institutional customer order flow; this allowed the day traders to trade ahead of the orders placed by the firm's customers. The broker-dealer agreed to a censure, to cease and desist from securities law violations related to the inadequacy of its policies and procedures to limit access to such information, and to pay a $7 million penalty.

Given the dramatic market volatility in recent months and the corresponding increase in major corporate announcements, the Commission remains particularly concerned about misuse of material non-public information of all kinds.

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[23] *In the Matter of Banc of America Securities LLC*, Exch. Act Rel. No. 55466 (Mar. 14, 2007); *In the Matter of Morgan Stanly & Co., Inc. et al.*, Exch. Act Rel. No. 54047 (June 27, 2006).

[24] *See, e.g., SEC v. A.B. Watley Group, Inc., et al.*, Lit. Rel. No. 19616 (Mar. 21, 2006) (alleged misuse of squawkbox information re orders by large institutional customers); *SEC v. Amore, et al.*, Lit. Rel. No. 19335 (Aug. 15, 2005) (same).

[25] *In the Matter of Merrill Lynch, Pierce, Fenner & Smith Incorporated,* Exch. Act. Rel. No. 59555 (Mar. 11, 2009).

Ponzi Schemes and Similar Frauds

The Commission has an enforcement program that seeks to combat Ponzi schemes. Our powers include the ability to seek temporary restraining orders, asset freezes and the appointment of receivers, as temporary relief. In addition, our enforcement and examination programs work closely together to detect Ponzi schemes that involve registered investment advisers and broker-dealers. For example, our examination staff currently is conducting a sweep examining the custody practices of investment advisers.

Over the past two years, the SEC has filed enforcement cases against more than 75 Ponzi schemes, including twelve such cases since December 2008.[26] Since 2002, the SEC has sued over 300 individuals in enforcement actions related to Ponzi schemes, including more than a dozen cases in which the alleged fraud involved $50 million or more.[27] In light of the SEC's ongoing enforcement efforts in this area, the defendants in one case recently filed by the SEC went so far as to tell potential investors that the

[26] *See, e.g SEC v. John M. Donnelly, et al.*, Lit. Rel. No. 20941 (Mar. 11, 2009) (alleged $11 million Ponzi scheme based in Charlottesville, Virgina); *SEC v. Anthony Vassallo et al.*, Lit. Rel. No. 20943 (Mar. 11, 2009) (alleged $40 million Ponzi scheme based in Northern California); *SEC v. Shelby Dean Martin, et al.*, Lit. Rel. No. 20935 (Mar. 6, 2009) (alleged $10 million Ponzi scheme based in North Carolina); *SEC v. Ray M. White et al.*, Lit. Rel. No. 20925 (Mar. 4, 2009) (alleged $11 million foreign exchange Ponzi scheme based in Dallas); *SEC v. Daren L. Palmer et al.*, Lit. Rel. No. 20918 (Feb. 26, 2009) (alleged $40 million Ponzi scheme based in Idaho Falls); *SEC v. Billions Coupons, Inc.*, Lit. Rel. No. 20906 (Feb. 19, 2009) (alleged Hawaii-based Ponzi scheme targeting deaf investors); *SEC v. Craig T. Jolly et al.*, Lit. Rel. No. 20890 (Feb. 9, 2009) (alleged $40 million internet Ponzi scheme based in Spokane); SEC *v. CRE Capital Corporation and James G. Ossie*, Lit. Rel. No. 20853 (Jan. 15, 2009) (alleged $25 million Ponzi scheme based in Atlanta); *SEC v. Gen-See Corp. et al.*, Lit. Rel. No. 20858 (Jan. 8, 2009)(alleged $0.5 million Ponzi scheme targeting clergy, Catholics and seniors based in Buffalo); *SEC v. Joseph S. Forte, et al.*, Lit. Rel. No. 20847 (Jan. 8, 2009) (alleged $50 million Ponzi scheme operating from Pennsylvania for 15 years); *SEC v.Creative Capital Consortium, LLC et al.*, Lit. Rel. No. 20840 (Dec. 30, 2008) (alleged Ponzi scheme and affinity fraud targeting Haitian-American investors).

[27] *See* J. Larson and P. Hinton, SEC Settlements in Ponzi Scheme Cases: Putting Madoff and Stanford in Context, NERA Economic Consulting, Mar. 13, 2009, available at www.securitieslitigationtrends.com/PUB_Ponzi_Schemes_0309.pdf; *see also SEC v. Joseph S. Forte, et al.*, Lit. Rel. No. 20847 (Jan. 8, 2009) ($50 million Ponzi scheme).

investment opportunity had been audited by an outside accounting firm, which had concluded that it was not a Ponzi scheme (which according to the Commission's complaint, it was).[28] State regulators have also been pursuing an increased number of Ponzi schemes, and their enforcement assistance in this area has been invaluable to investors.

On December 11, 2008, the SEC sued Bernard L. Madoff and his broker-dealer firm, Bernard Madoff Investment Securities, LLC ("BMIS"), for securities and investment advisory fraud in connection with a Ponzi scheme that resulted in substantial losses to investors in the United States and other countries.[29] The SEC's Enforcement Division is coordinating its ongoing investigation with that of the United States Attorney's Office for the Southern District of New York, which filed a parallel criminal action on December 11, 2008.

The SEC coordinated the filing of its action with Mr. Madoff's arrest. By the next day, the SEC staff had obtained full emergency relief against Madoff and BMIS, including the appointment of a receiver for Madoff-related entities, asset freezes, a temporary restraining order and other relief. The SEC staff later obtained a preliminary injunction order extending the emergency relief through the duration of the civil litigation. The SEC also is closely monitoring the liquidation of the Madoff broker-dealer firm by the court appointed trustee and the Securities Investor Protection Corporation ("SIPC").

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[28] *See SEC v. CRE Capital Corporation and James G. Ossie*, Lit. Rel. No. 20853 (Jan. 15, 2009).

[29] The scheme is outlined in the Commission's complaint filed in the United States District Court for the Southern District of New York, captioned *United States Securities and Exchange Commission v. Bernard L. Madoff and Bernard L. Madoff Investment Securities LLC*, 08 Civ. 10791 (LLS) (S.D.N.Y. Dec. 11, 2008).

On February 9, 2009, the SEC settled its civil action against Mr. Madoff with his consent. The Court entered an order permanently enjoining Mr. Madoff from further violation of the federal securities laws, and directing him to pay a civil penalty and disgorgement in amounts to be determined at a later time. On March 12, 2009, Mr. Madoff admitted to operating a Ponzi scheme in open court and pleaded guilty to 11 counts in the criminal indictment against him without entering into a plea agreement. He is presently in jail and faces up to 150 years in prison and billions of dollars in civil and criminal disgorgement, restitution and penalties.

On March 18, 2009, the SEC filed a complaint alleging that, from 1991 through 2008, certified public accountant David G. Friehling and his firm, Friehling & Horowitz, CPAs, P.C. ("F&H") violated antifraud and other securities laws in connection with their purported audits of financial statements and disclosures of BMIS. A criminal fraud case was also brought against Friehling on that date.

The SEC complaint alleges that Friehling enabled Bernard Madoff's Ponzi scheme by falsely stating, in annual audit reports, that F&H audited BMIS's financial statements pursuant to Generally Accepted Auditing Standards (GAAS), including the requirements to maintain auditor independence and perform audit procedures regarding custody of securities. In fact, the complaint alleges, the defendants did not conduct anything remotely resembling an audit of BMIS. F&H also allegedly made false representations that BMIS financial statements were presented in conformity with Generally Accepted Accounting Principles (GAAP). Finally, Friehling allegedly falsely stated that he had reviewed internal controls at BMIS, including controls over the custody of assets, and found no material inadequacies. If properly stated, the BMIS financial

statements, along with related disclosures regarding reserve requirements, allegedly would have shown that the firm owed tens of billions of dollars in additional liabilities to its customers and was therefore insolvent. The complaint alleges that Friehling and F&H obtained ill-gotten gains through compensation ($186,000 per year) from Madoff and BMIS, and also from withdrawing $5.5 million from accounts held at BMIS in the name of Friehling and his family members (with a balance of $14 million as of November 2008).

Since commencing its action in December 2008, the Commission has been probing all facets of Mr. Madoff's scheme to secure assets for investors. The SEC has committed considerable enforcement and examination resources to this effort, including 18 enforcement attorneys and investigators in the New York Regional Office, 30 examiners from New York and three other regional offices around the country, and additional staff from Chicago, the Home Office and the Office of International Affairs in Washington D.C.

We are also coordinating our investigations with numerous domestic and international agencies. In addition to the U.S. Attorney's Office, the FBI and SIPC, the SEC is coordinating its investigation with the Financial Services Authority and a court-appointed receiver in the United Kingdom; European securities regulators and other authorities with respect to the SEC's referrals regarding the location, identity and conduct of certain Madoff "feeder funds"; financial intelligence units in various other countries that have identified funds transferred to their respective countries from Madoff Securities; the Department of Labor with respect to ERISA plans that invested pension

funds with Mr. Madoff; FINRA and Attorneys General and regulators for various states that are also interested in investigating Mr. Madoff.

On February 16, 2009, the Commission took action in the *Stanford* matter, a different alleged Ponzi scheme involving up to $8 billion in fraudulent sales of bank "certificates of deposit" by Robert Allen Stanford.[30] The SEC's emergency action, filed in United States District Court in Dallas, alleges a massive Ponzi scheme by Stanford and three of his companies--Stanford International Bank ("SIB") based in Antigua; as well as Stanford Financial Group Company, a broker-dealer, and Stanford Capital Management, a registered investment adviser, both based in Houston. The Commission's complaint also alleges fraud by James Davis, Stanford's CFO, and Laura Pendergest-Holt, Chief Investment Officer of Stanford Financial Group. At the SEC's request, the Court issued a temporary restraining order and granted the Commission's request to place all Stanford defendants, and their related entities, into receivership, and to freeze their assets.

In addition to running a Ponzi scheme, the Commission alleges that Stanford and Davis misappropriated at least $1.6 billion of investor money through personal loans to Stanford. Despite SIB's contrary representations to investors, Stanford and Davis also allegedly "invested" an undetermined amount of investor funds in speculative, unprofitable private businesses, some of which they controlled. Stanford and Davis allegedly fabricated the performance of the SIB's investment portfolio to conceal their fraud and ensure that investors continued to purchase SIB's CDs. The Commission charges that, using the rate of return fabricated by Stanford and Davis, SIB's accountants reverse-engineered the bank's monthly financial statements to reflect investment income the bank had not actually earned.

[30] *SEC v. Stanford International Bank et al.*, Lit. Rel. No. 20901 (Feb. 17, 2009).

On February 26, 2009, criminal proceedings were commenced in the *Stanford* matter when the FBI arrested Laura Pendergest-Holt, Stanford's Chief Investment Officer, for lying to the Commission about her knowledge of SIB's investments. The SEC continues to work closely with the FBI and the Department of Justice's Fraud Section, as well as several other U.S. and international criminal and civil agencies in pursuing this matter.

The SEC Is Committed To Cooperation with Other Regulators and Criminal Law Enforcement Authorities, As Illustrated By Recent FCPA Cases

In nearly all the enforcement actions the SEC has taken in response to the current financial crisis, the SEC has cooperated with, and received substantial assistance from, its securities and criminal law enforcement counterparts at the SROs, in state and federal government, and at the international level. The SEC seeks to leverage its own resources through close coordination with other regulators and authorities in order to provide the broadest protection possible to investors, to avoid duplication of efforts, and to make the best possible use of its limited resources. Many of the SEC's enforcement actions in recent years would not have been as effective, or in some instances even possible, without the assistance provided by other law enforcement authorities.

The SEC's cooperation with other securities law enforcement authorities is perhaps best illustrated by the global fight against corruption under the Foreign Corrupt Practices Act ("FCPA"), which prohibits bribery of foreign officials to obtain business. For example, on December 15, 2008, the SEC announced a landmark $350 million settlement with Siemens AG charging worldwide bribery in violation of the FCPA—the

largest FCPA settlement in SEC history.[31] The SEC's settlement was part of a $1.6 billion global anti-corruption settlement between Siemens and the SEC, the U.S. Department of Justice and the Office of the Prosecutor General in Munich, Germany. The corruption alleged in the SEC's complaint was a bribery scheme of unprecedented scale and geographic reach, involving more than $1.4 billion in bribes to government officials in Asia, Africa, Europe, the Middle East, and the Americas.

Not only was Siemens the SEC's largest FCPA settlement ever, it also marked a significant advance in the SEC's cooperation with U.S. and international law enforcement authorities and a watershed in the SEC's global anti-corruption campaign under the FCPA. In Siemens, the investigation and resulting actions were jointly pursued by the SEC, the U.S. Department of Justice and the Munich Prosecutor General. These principals were also assisted by the U.S. Attorney's Office for the District of Columbia, the FBI, the IRS, the U.K. Financial Services Authority, and the Hong Kong Securities and Futures Commission.

The SEC Needs Additional Resources and Tools to Achieve its Mission in a Changing Marketplace

As part of our ongoing commitment to aggressively pursuing fraud against U.S. investors, the SEC wants to work in ways that will enable us to detect and stop securities law violations as soon as possible. To that end, the SEC has recently undertaken a number of significant initiatives to enable the staff to work more quickly and efficiently.

Within days after her appointment as SEC Chairman, Mary Schapiro repealed the Pilot Project under which Enforcement staff were required to seek pre-authorization from the Commission before negotiating civil money penalties against public issuers. In

[31] *SEC v. Siemens Aktiengesellschaft*, Lit. Rel. No. 20829 (Dec. 15, 2008).

addition, she streamlined the process of obtaining formal orders that grant the staff subpoena power. Under the revived procedure, such an order can be approved by a single Commissioner, rather than requiring a vote of the Commission as a whole.

Also, the SEC has engaged the Center for Enterprise Modernization, a federally funded research and development center, to begin working immediately with the SEC on a comprehensive review of internal procedures used to evaluate tips, complaints, and referrals. It is also our goal to establish a centralized process that will more effectively identify valuable leads for potential enforcement action, as well as areas of high risk for compliance examinations. It is our goal to leverage the information received from all sources for maximum efficiency in examinations and investigations of potential securities law violations.

But these steps are just the start. The Commission is re-examining its processes from top to bottom and carefully considering other ways to enable the SEC to work even faster and smarter. In this regard, however, it is important to acknowledge that while our job has grown substantially over the past several years, our staffing levels actually declined over that same period. The SEC's examination and enforcement resources are inadequate to keep pace with the growth and innovation in our securities markets.

The dramatic growth in the securities markets over the last decade can be illustrated with a few numbers. For example, the number of registered advisers has grown substantially. In 2002, there were 7,547 advisers registered with the SEC, and there are nearly 11,300 today, some of them advisers to hedge funds. In addition, there has been significant growth in structured financial products and credit derivatives in recent years. The dollar amount of outstanding asset-backed securities reached almost

$2.5 trillion in 2007, compared to just over $1 trillion in 2000. More dramatically, the issuance of CDOs globally reached a high of $521 billion in 2006, up from $157 billion just two years earlier.

The CDS market has experienced similarly dramatic growth in recent years. The explosive growth in these numbers is indicative of the sustained growth rate in our financial markets over the past few years. The Commission's resources have not kept pace with these developments.

Continued investment in technology is a top priority for the SEC's enforcement program in the coming years. To stay current in these challenging times, we need to modernize our technological tools. While we have started to leverage information by creating internal systems for sharing our investigative work nationwide, much more is needed. The SEC must be equipped with the same type of technology as the industry it regulates, and provided with tools similar to those used by the law firms it faces in investigations and litigation. In particular, the SEC's budget for forensic analysis of data produced in the course of its investigations must be increased by orders of magnitude.

We are also in the process at the Commission of considering what additional legislative changes may be needed to help our enforcement and examinations personnel combat fraud and wrongdoing in the market place. We look forward to working with the Committee on any potential legislative reforms we may recommend.

Finally, we need to focus on investor education and the creation of a strong compliance tone and culture in the securities industry. We need to encourage investors to be their own best advocates and to embrace basic safe investing principles, such as skepticism and diversification. And we need to encourage a tone and culture, especially

among those who make their livings from other people's investments, that mere compliance with the law, narrowly viewed, is not the highest goal to which we aspire, but the base from which we start. The securities industry as whole needs to embrace this compliance culture, and in each firm, the tone must be set at the top. We should all work toward a system where those who work in it are responsible stewards of the assets entrusted to them. As the agency uniquely charged with protecting investors, we are committed to restoring the confidence needed for our marketplace to thrive.

Questions for the Record Submitted by Representative Bill Posey

1. Please provide a one-page summary – not a book – but a one page summary describing what you think was the root cause of the crisis. To what extent is Congress to blame?

A number of interrelated factors contributed to the unprecedented turmoil that we have seen in the financial markets that has now spread to the general economy. In hindsight, it is clear that the benign economic environment of the late 1990s and early 2000s fostered an unwarranted sense of complacency among borrowers, creditors, investors, and regulators. The combination of steady growth, abundant liquidity, and minimal losses, coupled with interest rate reductions by the Federal Reserve Board, led to relatively low yields on safe assets, and reduced spreads on riskier assets as investor demand for new products that could deliver higher returns far outstripped supply. This environment, coupled with the continued globalization of financial markets that expanded the pool of liquidity and investors, spawned an array of new financial products and specialized firms to produce financial products for investors. Hedge funds and private equity funds became more prominent, expanding the range of activities and risk-taking in financial markets. Over time, increased competition led to a loosening of underwriting standards, prompted in part by capital market investors who were willing to accept higher levels of risk when purchasing credit instruments from loan originators or securitizers. Because of abundant market liquidity, many entities began following a so-called "originate-to-distribute" lending model, originating and packaging loans whose risk/return characteristics may not have met the bank's own internal investment hurdles but were sought or accepted by third party investors. In many cases, this led to loans with liberal repayment terms, reduced financial covenants, and higher borrower leverage.

Concurrent with these developments, and to some degree fostered by them, the U.S. and many other countries experienced rapid home price appreciation. Liquidity provided by investors searching for higher-yielding financial products helped support new types of mortgage products for consumers, who, under prior conditions, did not have access to mortgage financing. The rapid expansion of the mortgage and securitization markets attracted new mortgage lenders and brokers, many of whom had limited business experience or financial strength and operated with little regulatory oversight. These nonbank entities expanded their market share in part by extending credit on considerably less stringent terms than other, more regulated institutions. They originated the overwhelming preponderance of subprime and "Alt-A" mortgages during the crucial 2005-2007 period, and the loans they originated account for a disproportionate percentage of the defaults and foreclosures that we have seen. Increased competition led to loosened underwriting standards and ultimately resulted in over-leveraged borrowers. When house prices stopped appreciating, mortgage lenders began to experience sharply elevated levels of default, first in subprime and then in so-called "Alt-A" mortgages, that in turn precipitated broader concerns about, and "knock-on" effects to, the overall financial sector. As large financial firms reported losses on, and credit rating agencies began to sharply downgrade, CDOs and other securities backed by subprime mortgages, market liquidity abruptly shut down, resulting in the severe market dislocations we've seen over the past 18 months.

2. If your life depended on solving this puzzle, how would you do it, and what do all the indicators point to?

The OCC is actively working with supervisors from around the globe to identify and implement lessons learned from the recent market turmoil. Below are some of the key steps that I believe are necessary.

Regulatory Reform and Restructuring: As I outlined in my March 19th testimony before the Senate Committee on Banking, Housing, and Urban Affairs, I believe the recent turmoil highlights a number of gaps in our current regulatory structure that warrant careful examination.[1] First, recent events have highlighted the need for a systemic risk regulator who would have authority and accountability for identifying and addressing risks across the financial system, including those posed by systemically important financial institutions that are not banks. As I discussed in my written testimony, while the Federal Reserve Board may be the logical choice for such authority, care must be taken to address the very real concerns of the Board taking on too many functions to do all of them well, while at the same time concentrating too much authority in a single government agency.

Second, I support the establishment of a regime to stabilize, resolve, and wind down systemically significant firms that are not banks when necessary. The lack of such a regime this past year proved to be an enormous problem in dealing with distressed and failing institutions such as Bear Stearns, Lehman Brothers, and AIG. The new regime should provide tools that are similar to those the FDIC currently has for resolving banks, as well as provide a significant funding source if needed to facilitate orderly dispositions, such as a significant line of credit from the Treasury.

Third, Congress should establish a system of national standards that are uniformly implemented for mortgage regulation. While there were problems with mortgage underwriting standards at all mortgage providers, they were least pronounced at regulated banks, whether state or nationally chartered. Problems were extremely severe at the nonbank mortgage companies and mortgage brokers regulated exclusively by the states, accounting for a disproportionate share of foreclosures. Let me emphasize that this was not the result of national bank preemption, which in no way impeded states from regulating these providers. National mortgage standards with comparable implementation by federal and state regulators would address this regulatory gap and provide additional protections for consumers.

Fourth, while not as critical as the other three items, I believe the current environment provides an opportunity to consider whether the time has come to consolidate and streamline our current federal banking regulatory structure. The current system of four federal banking agencies and 12 Federal Reserve banks results in a structure with overlapping responsibilities. As noted in my testimony, if such an effort is undertaken, there are two principles that I believe should remain paramount. First, the Federal Reserve should maintain some role in supervision, perhaps in its role as a systemic risk regulator, due to the Federal Reserve's substantial role and direct experience with respect to capital markets, payments systems, the discount window, and international supervision. Second, but equally important, I believe we need to preserve a central role for a dedicated prudential supervisor, one whose only job is supervision and who is not distracted by other roles, such as monetary policy or deposit insurance. With a dedicated prudential supervisor, there is no confusion about the supervisor's goals and objectives, and no potential conflict with competing objectives.

[1] A copy of the testimony can be accessed at http://occ.gov/ftp/release/2009-24b.pdf

Enhanced Risk Management Practices and Capital Standards: As Senior Deputy Comptroller Timothy Long described in his March 18th testimony before the Senate Subcommittee on Securities, Insurance, and Investment, recent events have underscored the critical need for effective and comprehensive risk management processes and systems.[2] Such systems require, as their foundation, a strong corporate culture and corporate risk governance. Some of the key lessons we and the industry have learned are the following:

- Underwriting standards matter, regardless of whether loans are held or sold. We need to require lenders to have comparable and prudent underwriting standards for loans that they plan to sell and for loans that they plan to hold on their own books. Bankers must also guard against compromising their underwriting standards due to competitive pressures.

- Risk concentrations can accumulate across product and business lines. These risk concentrations must be identified and controlled. Larger financial institutions need to develop enhanced stress testing regimes that can help them identify risks that may be interconnected across product and business lines and corporate structures.

- Asset-based liquidity provides a critical cushion during periods of market disruption and must be maintained. Banks need to maintain a cushion of liquid assets and have robust liquidity contingency plans that evaluate liquidity needs over a range of scenarios.

- Capital standards and capital planning processes must be enhanced and strengthened to more fully incorporate potential exposures from both on- and off-balance sheet transactions across the entire firm. In addition, capital planning and estimates of potential credit losses need to be more forward looking and take into account uncertainties associated with models, valuations, concentrations, and correlation risks throughout an economic cycle.

- Current loan loss reserve accounting standards and practices accentuate pro-cyclical effects and should be made more counter-cyclical. The current "impaired loss" model effectively limits the amount of loan loss reserves that a bank can have when times are good, especially in a long period of economic growth when loss rates are low. This model constrains bankers from increasing reserves even though the level of risk embedded in banks' loan portfolios may be increasing substantially. Loan loss reserves need to be much more forward looking, so that banks can build bigger reserves when times are good and embedded credit risks are increasing.

We are taking steps to implement corrective actions in these areas. Our efforts have included working with the Basel Committee on Banking Supervision to develop and issue the September 2008 report on "Principles for Sound Liquidity Risk Management and Supervision" and the January 2009 consultative papers on enhancements to the Basel II capital framework, including the use of more robust stress tests. The Committee also plans to introduce standards to promote the build up of capital buffers that can be drawn down in periods of stress and to place greater emphasis on common equity as the core component of capital. As co-chairman of the Financial Stability Board's working group on Provisioning, I am leading international efforts to explore ways to make loan loss provisioning less pro-cyclical.

[2] A copy of the testimony can be accessed at http://occ.gov/ftp/release/2009-23b.pdf

At the OCC, we have enhanced our liquidity monitoring at the largest national banks through a monthly reporting template that collects information about balance sheet exposures, cash flow sources and uses, and financial market risk indicators. This information allows us to produce risk profiles for the largest banks that provide a forward looking assessment of liquidity mismatches and capacity constraints, both of which are considered early warning signals of potential future problems. We have also initiated loan level data collection from our major banks for residential mortgages, home equity loans, large corporate credits, and credit card loans. This enhanced data will improve our ability to monitor credit quality trends within and across banking organizations.

3. How often does the Comptroller of the Currency (OCC) find criminal misconduct, and to whom does the OCC refer such misconduct?

As part of its ongoing supervision of national banks, the OCC conducts periodic examinations of banks to ensure that they operate in a safe and sound manner. These examinations include determining whether the banks or insiders are engaged in violations of law.

Where the OCC finds indications of possible violations of law or regulations, e.g., "suspicious activities," OCC will file, or will require the bank to file, a "Suspicious Activity Report" (SAR) with the Financial Crimes Enforcement Network (FinCEN) of the Department of the Treasury. Federal and state law enforcement agencies, including the FBI and Secret Service, and state Attorneys General and state police, have direct electronic access to the SAR database administered by FinCEN, and review SARs on a frequent basis. SARs are one of the primary sources of information on which the FBI opens new criminal investigations. Law enforcement agencies conduct frequent SAR searches for indications of criminal misconduct in U.S. financial institutions. SAR reviews are often undertaken as part of joint regional task forces formed by law enforcement and federal and state banking regulatory agencies.

Federal banking regulatory agencies rarely make individual case referrals to law enforcement agencies because the law enforcement agencies have direct access to the SAR database. However, when the OCC becomes aware of immediate and particularly egregious misconduct, OCC will contact federal law enforcement agencies to alert them to the misconduct and to direct their attention to an individual SAR.

It is not possible to determine how often the OCC has discussed with or brought information concerning possible criminal misconduct to the attention of federal law enforcement agencies. However, the following chart shows the number of SARs filed by national banks during 2005-2008:

Number of SARs Filed by National Banks for 2005-2008

2005	2006	2007	2008
251,631	233,827	258,571	355,806

Banks file large numbers of SARs, because SARs are required not only when a bank detects or suspects a violation of federal criminal law, but also when a transaction has no apparent lawful purpose or is not the sort of transaction in which the particular customer would normally be expected to engage, and the bank knows of no reasonable explanation for the transaction. Thus, banks must report all "suspicious" transactions, even though many transactions do not actually involve criminal misconduct, and will not result in criminal investigations.

Further, the OCC frequently assists law enforcement agencies and the U.S. Department of Justice in its criminal prosecutions of individuals associated with national banks. Our assistance includes providing information and evidence for use in criminal prosecutions, and in some cases, assigning examiners to advise law enforcement agents and grand juries or to appear as a witness in criminal trials. By statute (12 U.S.C. 1829) individuals who have been convicted of any criminal offense involving dishonesty or breach of trust, or money laundering, may not thereafter

participate in the affairs of any insured depository institution. The OCC works with local, state and federal prosecutors to identify such individuals and notify them that they are barred from working for an insured depository institution as a consequence of their criminal conviction. The following chart shows the number of "Section 1829" notification letters issued by the OCC during FY 2005-2008:

Number of 1829 Notifications for FY 2005-2008

2005	2006	2007	2008
537	135	110	220

Insert to the Record: Governor Elizabeth Duke in response to Congressman Foster during March 20, 2009, hearing before the House Financial Services Committee.

During my testimony, you asked about the Federal Reserve's budget associated with enforcement activities, the total value of losses averted, and an analyses of the impact on enforcement capabilities if the budget were increased (e.g., by 10 percent).

The Federal Reserve makes its budget publicly available in the "Annual Report: Budget Review" and is available on the Board's website.[1] The Board allocates its expenses and employment through the Divisions of the Board. Divisions primarily engaged in enforcement are Banking Supervision and Regulation, Consumer and Community Affairs, and Legal. The budget for 2008-2009 for each of these divisions are as follows: Banking Supervision and Regulation $106 million, Consumer and Community Affairs $38 million, and Legal $29.4 million.[2]

The Reserve Banks also engage in enforcement activities. In total, the supervision and regulation budget, including legal and consumer affairs related activities for all the Reserve Banks in 2008, was $640 million.[3]

We do not have data to support a nonspeculative response to the question regarding total value of losses averted.

The Board carefully reviews the budget of the Federal Reserve System to determine whether resources are sufficient to allow the System to properly fulfill its responsibilities, including its enforcement responsibilities. The Board also considers the impact any budget increases have on reducing the Federal Reserve's payment to the U.S. Treasury. An increase in the budget of the Board or of the Federal Reserve Banks could allow for additional resources to be devoted to enforcement-related activities. There is not necessarily a correlation between the level of resources devoted to enforcement-related activities and an increase in enforcement actions. The Board will continue to carefully review its allocation of resources in light of all its responsibilities.

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[1] See http://www.federalreserve.gov/boarddocs/rptcongress/default.htm

[2] See Appendix D, Table D.1 Expenses and Employment at the Board of Governors, Operating Expenses of the Board of Governors, by Division, Office, or Special Account

[3] See Appendix D, Table E.3 Operating Expenses of the Federal Reserve Banks, FRIT, and OEB, by Operational Area

Insert to the Record: Governor Elizabeth Duke in response to Congressman Gohmert during March 20, 2009, hearing before the House Financial Services Committee.

1. During my testimony, you asked for recommendations for how mortgage underwriters and securitizers could be required to retain credit risk on the mortgages they underwrite and securitize, respectively.

A principal cause of the financial crisis was a significant erosion of market discipline by those involved in the securitization process, including originators, underwriters, credit rating agencies, and global investors, related in part to failures to provide or obtain adequate risk disclosures.

The Board staff, working with other members of the regulatory community both domestically and internationally, has analyzed a number of proposals that would require retention of risk by originators or underwriters and, while attractive in concept, significant issues were raised for consideration. First, it would be difficult to specify risk retention requirements in a complete and unambiguous manner in securitization processes that rely heavily on the use of a variety of financial instruments to apportion and transfer risk. There is concern that risk retention requirements would not be effective in these circumstances, and would provide only the illusion of addressing the issues. In addition, there is concern that applying retention requirements to one set of market participants would be perceived as absolving the various other institutions involved in the securitization "chain" which extends from originators to investors in mortgage-based securities of responsibility to adequately provide or obtain information. Furthermore, risk retention provisions could have unintended consequences, such as potentially creating incentives for increased mortgage underwriting outside of entities subject to capital requirements.

For all these reasons, a broader approach which focuses on the chain in its entirety rather than on one specific class of institutions seems more appropriate. As part of the President's Working Group ("PWG"), the Federal Reserve staff has participated in the development of a broad approach to addressing this situation, with specific recommendations relevant to each of the classes of market participants referenced above. This agenda is more clearly outlined in the PWG's October 2008 report, which describes increased oversight of rating agencies, mortgage originators and other financial institutions involved in the securitization process.

Governor Elizabeth Duke subsequently submitted the following in response to written questions received from Congressman Alan Grayson in connection with the March 20, 2009, hearing before the House Financial Services Committee:

For all witnesses:

Q1. According to the last 10-K filed by AIG, AIG's shareholder equity as of the end of 2008 was $54.7 billion (which is inclusive of $63 billion of government funds). According to that same document, on page 179, the company estimated that its exposure to the yield curve totaled $500 billion. What is your view of the prudence of such an arrangement and what should be done about it?

Exposure to yield curves is in keeping with the business model of an insurance company which collects premiums and deposits from policy holders and invests the proceeds in predominantly longer-term assets such as fixed-maturity securities and loans that are sensitive to yield curve movements. While the referenced "exposure" on page 178 of AIG's 10-K to yield curve shifts of $500 billion may seem significant relative to AIG's capital of $54.7 billion, it is important to note that AIG's use of the term "exposure" to the yield curve is used to describe a notional value or bond equivalent value reference. It does not reflect the amount that could be lost and charged against capital due to a change in the yield curve. In essence, the disclosure estimates that an exposure of $1 could lose 4.7 percent due to a potential one percent upward shift in the yield curve at a specific point in time (year-end 2008).

The documentation that AIG included in the 10-K filing demonstrates management's awareness of this issue. It is also important to note that continuing restructuring of the company's balance sheet will influence both the composition and sensitivity to yield curve movements going forward.

For Governor Duke:

Q.1. Have Federal Reserve officials looked at the loan tapes underlying any of the mortgage assets held by Maiden Lane I? What steps did the Federal Reserve take to ensure that these loan tapes have been examined for evidence of mortgage fraud?

In connection with its responsibilities as the investment manager for the assets held by Maiden Lane LLC, BlackRock Financial Management, Inc., reviews the data underlying the mortgage assets in Maiden Lane's portfolio. If evidence of possible fraud or other illegal conduct were detected, the relevant information would be provided to the appropriate enforcement authorities.

Q.2 JP Morgan Chase CEO Jamie Dimon was on the board of the New York Federal Reserve when the Fed brokered the Bear Steams deal with his bank, a deal that in all likelihood involved fraudulent loans being put onto the balance sheet of Maiden Lane. What steps did you take to manage that inherent conflict of interest?

Jamie Dimon, chief executive officer of JPMC, is one of nine members of the board of directors of FRBNY. Mr. Dimon did not participate in his role as a director of the Reserve Bank in the negotiations between the Federal Reserve and JPMC on any of the credit facilities authorized regarding Bear Stearns. Neither Mr. Dimon nor any other FRBNY director participated in the approval of the credit facilities regarding Bear Stearns. Rather, Mr. Dimon participated solely on behalf of JPMC. The Reserve Bank was represented at all times by its president at the time, Timothy Geithner, and staff in negotiations with JPMC. Mr. Dimon has recused himself from any role as a member of the board of directors of the Reserve Bank in any matter related to the Bear Stearns credit facility.

Insert to the Record: Governor Elizabeth Duke in response to Congressman Bill Posey during March 20, 2009, hearing before the House Financial Services Committee.

1. During my testimony, you asked for a summary of the root cause of and solutions to the financial crisis.

A precipitating factor to the current financial crisis is found in the global imbalances in trade and capital flows that began in the latter half of the 1990s. As a result of these imbalances, savings flowed from where it was abundant to where it was deficient, with the result that the United States, and some other advanced countries, experienced large capital inflows for more than a decade, even as real long-term interest rates remained low.

The responsibility to use the resulting capital inflows effectively fell primarily on the receiving countries, particularly the United States. The risk-management systems of the private sector and government oversight of the financial sector in the United States and some other industrial countries did not ensure that the inrush of capital was prudently invested. It is now clear that in recent years banking and financial markets experienced a period in which risk was generally under-priced and where credit was too freely available. The realization by many market participants that risks were larger than anticipated has contributed to the decline in prices for financial assets. There also has been a powerful reversal in investor sentiment and a seizing up of credit markets.

There are a variety of steps, both in the short and long term, that should be taken to address this crisis and help prevent a reoccurrence of similarly severe periods of stress. Broadly speaking, in the near term, governments around the world must continue to take forceful and, when appropriate, coordinated actions to restore financial market functioning and the flow of credit. Until we stabilize the financial system, a sustainable economic recovery will remain out of reach.

Looking down the road, we also must take a number of steps to address the potential for systemic risks to build up in the financial system. First, we must address the problem of financial institutions that are deemed too big--or perhaps too interconnected--to fail. This would involve (1) the extension of consolidated supervision beyond bank holding companies to all systemically important financial firms, and (2) a resolution regime for systemically important nonbank financial institutions. Second, we should consider whether the creation of an authority specifically charged with monitoring and addressing systemic risks would help protect the system from financial crises like the one we are currently experiencing. Third, we must strengthen the financial infrastructure--the systems, rules, and conventions that govern trading, payment, clearing, and settlement in financial markets--to ensure that it will perform well under stress. Lastly, we should review regulatory policies and accounting rules to ensure that they do not induce excessive procyclicality--that is, do not overly magnify the ups and downs in the financial system and the economy.

With respect to the Federal Reserve in particular, we have responded to the financial and economic crisis and will continue to do so. We have taken a number of actions related to our various roles as central banker, monetary policymaker, supervisor, and rulewriter. We have implemented new policies and programs with respect to monetary policy and provision of liquidity.

As a supervisor, the Federal Reserve is well aware that many of the current problems in the banking and financial system stem from risk-management failures at a number of financial institutions, including some firms under federal supervision. In our supervisory efforts, we are mindful of the risk-management deficiencies at banking institutions revealed by the current crisis and are ensuring that institutions develop appropriate corrective actions.

With respect to subprime mortgage lending, and mortgage lending in general, we recognize that practices in mortgage lending, in tandem with the sale of mortgage assets outside the financial industry, contributed to the current crisis. The Federal Reserve has already taken several steps to address identified problems. For example, in July 2008, using its authority under the Home Ownership and Equity Protection Act, the Board issued final rules that establish sweeping new regulatory protections for consumers in the residential mortgage market. Importantly, the Board's new rules apply to all mortgage lenders, not just depository institutions supervised by the federal banking and thrift agencies.

The Federal Reserve, together with the other federal agencies and a number of state authorities recently completed a pilot consumer protection compliance review as part of an interagency project to enhance the supervision of nonbank subprime mortgage lenders. The results will guide the Board's decisionmaking as to how it may supervise these entities in the future.

2. You also asked for the number of Federal Reserve employees and the number of prosecutions and convictions.

As of December 31, 2008, the Federal Reserve System employed a total of 20,826 staff (2,079 at the Board, the rest at the Reserve Banks) including official, professional, and support staff.[1] As I noted in my testimony, the Federal Reserve's enforcement efforts begin with the examination of its supervised institutions. Fifteen percent of the total (slightly more than 3,000) were employed in the supervision function, which includes safety and soundness, consumer and community affairs, and legal. The large majority of supervision staff are examiners and financial analysts. At the Federal Reserve Banks, about half of the supervision staff are field examiners, most of whom have undergone (or are undergoing) extensive examiner training within the Federal Reserve or another supervisory agency. Most of the balance of the supervision staff at the Reserve Banks are financial analysts and other supervisory professionals.

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[1] Federal Reserve Bank staffing is an average of employees throughout the year. Board staffing is the total positions authorized as of December 31, 2008.

The total number of staff who are involved in enforcement matters for the Federal Reserve System is 103 Full-Time Equivalents. Included in this number are staff who are involved in preparing formal or informal enforcement actions (e.g., cease and desist orders, written agreements, memoranda of understanding, board of director resolutions, civil money penalty assessments, and removal and prohibition actions); monitoring institutions' compliance with enforcement actions; or conducting investigations of alleged fraud, violations of law, or unsafe and unsound practices, and coordinating with law enforcement agencies and prosecutors. The total number includes staff from safety and soundness supervision, consumer compliance, and legal departments at the Board and at the Reserve Banks.

Below is a table describing the enforcement actions taken by the Federal Reserve against its supervised entities in recent years. To put this information in context, a brief explanation of the Federal Reserve's enforcement authority follows. The Federal Reserve has express enforcement authority over bank holding companies, state member banks, foreign banking organizations, and affiliated individuals. Enforcement actions may be taken to address unsafe and unsound practices, violations of laws and regulations, and breaches of fiduciary duty. The Federal Reserve issues "formal" enforcement actions under section 8 of the Federal Deposit Insurance Act and other banking laws. These are typically in the form of Written Agreements, Cease and Desist Orders, or civil money penalties. These actions are published on the Federal Reserve's public web site as required by law.[2] The Federal Reserve may also issue "informal" enforcement actions which are not enforceable in a court of law, requiring that the institution enter into memoranda of understanding or Board of Director Resolutions. Noncompliance with an informal enforcement action or a significant escalation of issues at an institution subject to an informal action would likely result in the Federal Reserve issuing a formal action.

The Federal Reserve also takes enforcement actions against individuals affiliated with institutions that we supervise. The remedies include prohibitions from the banking industry, assessment of civil money penalties, restitution, and imposition of cease and desist orders under section 8 of the Federal Deposit Insurance Act and other banking laws. In addition, since January 2007, the Federal Reserve has been posting on its website letters to individuals who have been convicted of certain crimes involving their affiliation with a banking organization. The letters notify the convicted individuals that they are automatically prohibited by statute from participating in the affairs of banking organizations without the consent of the FDIC or other banking agencies.[3]

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[2] See http://www.federalreserve.gov/boarddocs/enforcement/search.cfm

[3] 12 U.S.C. 1818

The Federal Reserve has also made referrals to the U.S. Department of Justice as required by the Equal Credit Opportunity Act when we have reason to believe an institution has engaged in a pattern or practice of lending discrimination.

FEDERAL RESERVE ENFORCEMENT ACTIONS

	2008	2007	2006
Formal Actions			
Actions Against Institutions	45	22	18
Actions Against Individuals	9	11	10
Informal Actions			
Remedial Actions Against Institutions	230	86	90
DOJ Referrals (Fair Lending)	3	8	4

Hearing before the Committee on Financial Services
United States House of Representatives
Entitled
"Federal and State Enforcement of Financial Consumer and Investor Protection Laws"

March 20, 2009

Questions Submitted to
Rita M. Glavin
Acting Assistant Attorney General
Department of Justice

Questions from Congressman Grayson

1. According to the last 10-K filed by AIG, AIG's shareholder equity as of the end of 2008 was $54.7 billion (which is inclusive of $63 billion of government funds). According to that same document, on page 179, the company estimated that its exposure to the yield curve totaled $500 billion. What is your view of the prudence of such an arrangement and what should be done about it?

   Response: This inquiry calls for an evaluation of the financial arrangement described. The Criminal Division is not in a position to provide expert advice on this matter or opine on the prudence of a commercial decision such as the one described. The Treasury Department and the Securities and Exchange Commission may be better suited to respond to this inquiry.

2. How many resources did the Justice Department dedicate to white-collar prosecutions relating to the Savings and Loan crisis in the 1980s?

   Response: At the height of the Savings and Loan crisis, the Department of Justice devoted the following resource levels:

   - FY 1991 Actual Obligations: 2,620 positions (978 agents, 523 attorneys, and 1,119 other); 2,141 FTE; and $239,520,000.

   - FY 1992 Actual Obligations: 2,926 positions (992 agents, 655 attorneys, and 1,279 other); 2,795 FTE; and $265,108,000.

3. How many resources is the Justice Department currently dedicating to the non prime mortgage situation?

   Response: Based upon an assessment of the mortgage fraud cases recently referred to the Department, an evaluation of the pending mortgage fraud investigations, and an estimation of cases that the current economic climate will continue to generate, the

Department is projecting that for FY 2009, approximately 500 positions and up to $100 million will be devoted to this type of fraud enforcement.

4. How many people have been indicted of mortgage fraud in the last five years? How many have been convicted?

Response:

Prior to July 18, 2008, the case records system for United States Attorneys' Offices did not track mortgage fraud cases separately from other cases of financial institution fraud. Statistics for federal mortgage fraud indictments and prosecutions prior to July 18, 2008 also may not be obtained by examining the statutes charged. There is no separate federal mortgage fraud statute. Instead, mortgage fraud is addressed under statutes generally addressing bank fraud, mail fraud, wire fraud and money laundering.

On July 18, 2008, United States Attorneys were instructed to begin tracking mortgage fraud cases separately using a new tracking code. In the brief period between July 18, 2008 and October 1, 2008 (the start of fiscal year 2009), United States Attorneys' Offices indicted 216 mortgage fraud defendants in 88 cases. Seventy-one defendants were convicted in that short period. In another brief period shortly before the new tracking code became effective, March 1, 2008 to June 18, 2008, United States Attorneys participated in "Operation Malicious Mortgage," a joint effort of the United States Attorneys, local prosecutors and federal law enforcement agencies which resulted in charges against over 400 defendants.

Preliminary statistics for the first half of fiscal year 2009 (through June 1, 2009) show an upward trend and the increasing number of open investigations presages a dramatic need for increased prosecutions. The number of open FBI mortgage fraud investigations has risen from 881 in FY 2006 to more than 2,000 today.

Prior to July 18, 2008, mortgage fraud cases were included in the case tracking system together with many other types of cases involving financial institution fraud. Overall statistics for financial institution fraud for the last five fiscal years include:

2004: 2,311 defendants charged with 2,169 convicted
2005: 2,028 defendants charged with 1,867 convicted
2006: 1,993 defendants charged with 1,905 convicted
2007: 1,806 defendants charged with 1,882 convicted[1]
2008: 1,771 defendants charged with 1,627 convicted

[1]Because cases frequently span more than one fiscal year, defendants convicted may have been charged in a prior fiscal year.

Questions from Congressman Posey

5. Please provide a one-page summary – not a book – but a one page summary describing what you think was the root cause of the crisis. To what extent is Congress to blame?

   Response: The Department of Justice is charged with enforcing the Nation's laws. As a law enforcement agency, the Department of Justice is not in the best position to analyze the root cause of the current financial crisis. We defer to the expertise of the Treasury Department, which has taken the lead in analyzing and addressing this complex issue.

6. If your life depended on solving this puzzle, how would you do it, and what do all the indicators point to?

   Response: Please see our response to the previous question.

7. Please provide a breakdown on how the 62,000 suspicious activity reports that were handled and how they were referred.

   Response: All federal law enforcement agencies review the Suspicious Activity Reports (SARs) filed by financial institutions, focusing on SARs that relate to crimes within their respective jurisdictions. During FY 2008, mortgage fraud SARs increased more than 36 percent from FY 2007 to 63,713. The FBI has primary investigative jurisdiction for mortgage fraud and, therefore, it reviews all SARs involving mortgage fraud and investigates them or refers them out, as appropriate. SARs are analyzed at FBI Headquarters and in each field office throughout the country. The FBI utilizes SARs to: (1) initiate new cases, (2) enhance on-going cases, and (3) evaluate the appropriate allocation of resources to address trends that are identified through the review of the SARs.

   In addition, the Asset Forfeiture and Money Laundering Section of the Department's Criminal Division created a National SAR Review Team within the past year. The National Team was created to pursue cases that fall outside the scope of a local SAR review team. Representatives from every federal law enforcement agency and FinCEN participate on the national team and meet monthly. The National Team reviews SARs that report on activities that are complex and/or multi-jurisdictional in nature, including complex mortgage fraud cases. While this team is not yet equipped to handle a large number of cases, it has already opened several mortgage fraud investigations.

8. Does your agency need an invitation to invite companies who received TARP money to be investigated under RICO, the racketeering statutes, and do you need Congress to ask you to do that or someone from the Treasury Department or someone else to ask for that?

   Response: No. There is no need for an invitation to investigate the facts and circumstances of a particular case. Federal law enforcement and investigatory agencies

conduct such investigations whenever reasonable cause exists to believe a racketeering crime has been committed. With regard to companies receiving TARP money, the Department is working closing with the Special Inspector General for TARP and will investigate and prosecute cases as appropriate.

9. To what extent are RICO laws useful to convict those committing white-collar crimes?

Response: The RICO statute is useful in convicting those committing white-collar crimes. Some of the recent RICO prosecutions involving white-collar crimes illustrate the scope of the RICO statute in this context:

United States v. Bell, et al., 09-cr-1209 (S.D. Cal.). The indictment was unsealed on April 7, 2009. The indictment charged 24 individuals with RICO conspiracy for an extensive mortgage fraud scheme based in San Diego, California, that involved 220 properties with a total sales price of more than $100 million dollars. The defendants were charged with RICO conspiracy based upon a pattern of racketeering activity consisting of wire fraud, bank fraud, and money laundering.

United States v. Reese, 08-cr-00034 (E.D. N.C.). On Feb. 25, 2009, a federal jury found Perry Reese, III, guilty of racketeering. Reese was a licensed medical physician operating a medical practice at Roseboro Urgent Care. According to the evidence presented at trial, he illegally distributed controlled drugs, such as Oxycodone, Fentanyl, Diazepam, and Alprazolam.

United States v. Rahal, 08-cr-566 (E.D. Cal.). On December 10, 2008, the defendant was charged with, and pled guilty to, racketeering charges. The defendant was the owner and president of Intramark USA Inc., a New Jersey based wholesaler of food ingredients, including processed-tomato products. He served as a sales broker for SK Foods, L.P., a grower of tomato products. The criminal information filed in the case alleged that the defendant routinely paid bribes to the purchasing agents of some of SK Foods' customers in order to ensure that those customers brought product from SK Foods, that the customers paid an inflated price for such product, and to induce the purchasing agents to turn over to SK Foods the bidding information of SK Foods' competitors.

United States v. Baudanza, et al., 06-cr-00181 (E.D.N.Y.). On April 17, 2007, seven members and associates of the Colombo and Luchese Organized Crime Families pled guilty to racketeering and extortion in connection with boiler room stock fraud schemes. The guilty pleas were the culmination of a four-year investigation and prosecution of the Colombo Family's infiltration of brokerage firms that specialized in selling penny stocks. The defendants admitted to exploiting their ties to the racketeering enterprise to further their financial interests in the criminal schemes, by using extortionate tactics to control brokers, cold callers, and others affiliated with branch offices of brokerage firms formerly located in Brooklyn, Manhattan, and Staten Island, New York.

10. I understand DOJ prosecutors do not use a RICO approach very often. How often is it used? Why not more often?

Response: The Department has and will continue to investigate and charge cases under the RICO statute when appropriate.

The Organized Crime and Racketeering Section (OCRS) in the Criminal Division reviews federal criminal racketeering cases, and in the last three years, OCRS has received the following number of RICO cases for review and approval:

Year	Number of RICO cases
2008	84
2007	81
2006	105

11. Are RICO statutes sufficiently broad to capture the kinds of activities white-collar criminals engage in?

Response: Yes. The RICO statute is sufficiently broad to capture the activities of white collar criminals. Section 1961 of Title 18, United States Code, lists the statutes that can form the predicate for federal racketeering activity. These federal crimes include mail fraud, wire fraud, bank fraud, securities fraud, bankruptcy fraud, and money laundering.

12. What are the limitations of a RICO approach in deterring and prosecuting financial white-collar crimes?

Response: All elements of the RICO statute must be satisfied in order to bring RICO charges. It is not sufficient to just establish that the defendant committed the underlying offenses that constituted the racketeering acts. Rather, the Government must prove beyond a reasonable doubt that a RICO enterprise exists, that the defendant was employed by or associated with the RICO enterprise, and that the defendant conducted the affairs of the enterprise through the commission of two or more racketeering acts.

13. How do prosecutors determine criminal intent apart from "recklessness" or general incompetence?

Response: In the criminal justice process, the fact-finder determines whether there is sufficient evidence to demonstrate criminal intent; the fact-finder in a criminal trial might be a judge or a jury. There are numerous ways for a prosecutor to prove criminal intent – for example, testimonial evidence, cooperating witnesses, confessions, recorded statements, documentary evidence, and other evidence and information. Criminal intent can be proved by both direct and circumstantial admissible evidence.

14. How best could Members of Congress strengthen criminal statutes to discourage some executives from running off with big bonuses while running their companies into the ground?

Response: There are already strong Federal criminal statutes that target and deter financial fraud, irrespective of whether the fraud is committed in connection with the taking of bonuses. The Department of Justice is pleased to continue to work with the Committee on ways of strengthening enforcement efforts against financial fraud.

Response to questions from the Honorable Bill Foster
by Martin J. Gruenberg, Vice Chairman,
Federal Deposit Insurance Corporation

Q1. What is your budget associated with enforcement?

A1. Closed Bank: The FDIC's Legal Division has budgeted $3.568 million for expenses of the Professional Liability and Financial Crimes Unit staff for 2009, and also has spent approximately $1.1 million on outside counsel to support enforcement efforts during the first three months of 2009. Our Division of Resolutions and Receiverships Investigations Unit has a budget for 2009 of $6.7 million for in-house investigations staff and an additional $16.5 million for assistance from outside contractors, for a total budget of $23.2 million.

Open Bank: The budget for our headquarters Legal Division enforcement section for open banks is $4.474 million. Employees of the legal departments of our six regional offices and two area offices also conduct investigations and pursue enforcement actions, and the overall budget for those employees is $17.952 million. In addition, the Division of Supervision and Consumer Protection (DSC) has approximately 1,730 examiners who regularly review the activities of insured depository institutions to ensure safe and sound operations and compliance with state and federal laws and regulations. Examination findings are the most common source of enforcement actions involving open institutions. The entire DSC budget is $503.5 million, of which $442.9 million represents regional and field operations, where all examinations and most enforcement actions are handled, and $5.4 million is the budget for the two groups in Washington that handle enforcement actions. It is not possible to separate the specific cost of handling enforcement actions from other supervisory activities as the same staff are involved in both.

Q2. What is your best estimate of losses under your purview?

A2. Our current best estimate of total losses from all civil residential mortgage fraud claims currently in investigation from the 25 institution failures in 2008 and 29 institution failures in 2009 to date is $1 billion. These losses are associated with over 4000 mortgage malpractice and mortgage fraud claims in investigation by the FDIC as Receiver. Most of these losses have arisen out of the failures of Washington Mutual Bank and IndyMac Bank, FSB, the two largest financial institutions to fail in 2008. Losses to the Deposit Insurance Fund (DIF) from the 25 banks and thrifts that failed and were placed in receivership during 2008 total $17.87 billion. Losses to the DIF from the 29 banks and thrifts that failed and were placed in receivership during 2009 to date (through March 20) total $3.8 billion.

Q3. What would be the effect of adding 10 percent to your budget for enforcement?

A3. Closed Bank: The FDIC has substantially increased its budget for the Legal Division's closed bank functions, specifically including the Professional Liability and Financial Crimes Unit. In 2008 and the first quarter of 2009, the Unit's staff has doubled, and we have plans to increase staff further during the remainder of 2009. We also have substantially increased the Division of Receiverships and Resolutions' budget and staff dedicated to closed bank matters, as noted previously.

Open Bank: The FDIC has been increasing the budget for the Legal Division's Enforcement Section in Washington and in the Regional Offices over the last two years. In 2008, the Enforcement Section added four new attorneys. Under the 2009 budget, the FDIC made provisions to further increase this staff by two additional term appointment attorneys.

In 2008, the FDIC added seven attorneys to the Regional Offices to assist in the increasing workload, including an increase in enforcement actions. The 2009 budget provides for an additional two attorneys hired in 2009, plus five more positions to be filled in the Regional Offices.

Finally, the Division of Supervision and Consumer Protection increased its budget and workforce in preparation for the additional work load. The budget increase of $86.8 million covers the hiring of 552 full-time equivalents.

Response to questions from the Honorable Louie Gohmert
by Martin J. Gruenberg, Vice Chairman,
Federal Deposit Insurance Corporation

Q. What do you personally recommend that Congress do legislatively to keep some of the financial risk with those who put people in mortgages and those who packaged and sold them as securities?

A. The FDIC is working with the other federal banking agencies and Congress to develop potential financial and regulatory reforms to address the financial crisis. One of the most important factors driving this financial crisis has been the decline in value, liquidity, and underlying collateral performance of asset-backed securities (ABS)—including mortgage-backed securities—that were initially highly rated.

One of the key changes we are discussing is the idea of "skin in the game." If originators and securitizers of mortgages, for example, were required to retain "skin-in-the-game" by holding some form of explicit exposure to the assets they originate and sell, the likely result would be more careful underwriting and better monitoring of the performance of mortgage-backed securities. Some have noted the implementation challenges inherent in this idea, such as whether we can or should prevent issuers from hedging their exposure to their retained interests. We need to evaluate these issues but correcting the problems in the "originate-to-distribute model" is very important.

In addition to "skin in the game," we also are looking at the role of disclosure. Many previously highly-rated ABS were never traded in secondary markets and were subject to little or no public disclosure regarding the characteristics and ongoing performance of underlying collateral. Additional disclosure might include, for example, rated securitization tranches, in a readily accessible format on the ratings agency websites. This could include detailed loan-level characteristics and regular performance reports. Over the long term, liquidity and confidence also might be improved if secondary market prices and volumes of asset-backed securities were reported on some type of system similar to the way that such data is currently captured on corporate bonds.

Finally, financial incentives for short-term revenue recognition appear to have driven the creation of large volumes of highly-rated securitization products. There was insufficient attention to due diligence, and insufficient recognition of the risks being transferred to investors. Moreover, some aspects of our regulatory framework may have encouraged banks and other institutional investors in the belief that a highly-rated security is, *per se*, of minimal risk.

We look forward to working with Congress to craft a comprehensive package of regulatory reforms that will address the short-comings of the regulatory framework for the "originate-to-distribute model" as well as the regulatory gaps in the overall financial regulatory system.

Response to questions from the Honorable Bill Posey
by Martin J. Gruenberg, Vice Chairman,
Federal Deposit Insurance Corporation

Q1(a). Provide a one page summary – not a book – but a one page summary describing what you think was the root cause of the crisis.

A1(a). The financial crisis was caused by a number of factors, but five key developments appear central. The first development was a dramatic shift in the U.S. mortgage market away from the traditional 30 year fixed rate mortgage toward subprime, Alt-A, and nontraditional mortgages, which include interest only and payment option adjustable rate mortgages. Prior to this decade, the 30 year fixed rate mortgage had dominated the U.S. mortgage market for years, but by 2006 its share had slipped to less than half of mortgage originations. Subprime mortgages, which accounted for less than 5 percent of mortgage originations in 2001, grew to account for over 20 percent in 2006. The rapid growth of these risky mortgages set the stage for the coming crisis.

The second development was the widespread deterioration of underwriting standards for mortgages that facilitated the rapid growth of subprime, Alt-A, and nontraditional mortgages. Lax underwriting standards were most apparent in subprime mortgages, where the most elementary notion of prudent lending – underwriting based on the borrower's ability to pay – was ignored. Most of the subprime mortgages originated during these years were 2/28 or 3/27 hybrid adjustable rate mortgages, characterized by a low fixed initial interest rate for 24 or 36 months followed by a significant increase in the monthly payment. Many of these loans were underwritten to the introductory rate, with prepayment penalties and no escrow for taxes and insurance. A significant share of subprime mortgages was also granted on a stated income basis, requiring no verification or documentation of ability to pay the loan.

The third development was the growth of mortgage-backed securities (MBS), particularly for the highly risky subprime, Alt-A, and nontraditional mortgages. Securitization of these mortgages largely took place in the private label MBS market which existed outside of the government sponsored enterprise securitization system. The private label MBS market led to new origination and funding channels that fell outside direct federal supervision and facilitated the expansion of risky lending. Securitization facilitated the poor underwriting since many institutions that underwrote the loans did not hold the loans. It further transmitted the poor underwriting of these mortgages to investors worldwide, many of whom, it is now clear, were unaware of the risk and failed to perform appropriate due diligence.

The fourth development was the growth of complex derivative instruments such as collateralized debt obligations (CDOs), through which subprime and nontraditional mortgages were bundled into senior and subordinate mortgage-backed securities, and credit default swaps (CDS) which were utilized by many investors to hedge the risk of these securities. The outstanding value of credit default swaps grew from less than $900 billion in 2001 to over $45 trillion in 2007. The complexity and lack of transparency of these structured finance vehicles, coupled with AAA

quality ratings by credit rating agencies, created a false sense of comfort among a wide range of sophisticated global investors and led to enormous counterparty risks.

The fifth development was the collapse of home prices in 2007. Much of the mortgage lending of recent years was based on the assumption that home prices would grow indefinitely. When home prices collapsed, the underlying mortgages became unsustainable. Borrowers with little to no equity in their homes became trapped in unaffordable mortgages and delinquency, default, and foreclosures began to rise substantially. This caused the secondary market for subprime mortgage backed securities to break down in 2007 and ultimately the collapse of the entire private label MBS market. When the impact of declining home prices and the spreading crisis began to affect the performance of CDS and highly leveraged financial institutions, it escalated and adopted truly global proportions.

Q1(b). To what extent is Congress to blame? If your life depended on solving this puzzle, how would you do it, and what do all the indicators point to?

A1(b). A number of measures will be required to address this crisis and prevent similar crises from occurring in the future. First is the need to restore proper underwriting to the mortgage market, particularly subprime mortgage lending. The federal banking agencies have taken a number of actions to address this issue, including the issuance in 2007 of a final *Statement on Subprime Mortgage Lending* that identifies prudent safety and soundness and consumer protection standards that institutions should follow to ensure borrowers obtain loans they can afford to pay. These standards include qualifying borrowers on a fully indexed, fully amortizing repayment basis.

In addition, in 2008, the Board of Governors of the Federal Reserve System approved a final rule for home mortgage loans under the Home Ownership and Equity Protection Act (HOEPA) that applies to all lenders, not just federally supervised institutions. The rule is designed to protect consumers from unfair or deceptive acts and practices in mortgage lending. It also establishes advertising standards and greater mortgage disclosure requirements. With regard to subprime mortgages, the rule prohibits lenders from making loans without regard to borrowers' ability to repay the loan, requires verification of income and assets relied upon to determine repayment ability, restricts the use of prepayment penalties, and requires creditors to establish escrow accounts for property taxes and homeowner's insurance for all first-lien mortgage loans.

Second, a review of securitization markets should be conducted to ensure that appropriate incentives exist for lenders to properly underwrite securitized loans and that securitizers of mortgages and other assets conduct adequate due diligence on the underlying risks of the securities. The review of securitization markets should include examination of credit rating agencies, the role they played in the crisis, and the extent to which banks relied on credit rating agencies to assess the risks associated with securitized mortgages.

Third, statutory change is needed to address gaps in supervisory oversight for Over-The-Counter (OTC) derivatives and credit default swaps. The proposed framework put forward by the Administration calls for requiring clearing of all standardized OTC derivatives through regulated

central counterparties, subjecting OTC derivatives dealers and other significant involved firms to a robust regime of prudential supervision and regulation; imposing recordkeeping and reporting requirements on all OTC trades; improving enforcement authorities for OTC market manipulation, fraud, and other market abuses; and providing greater protections for unsophisticated investors.

Finally, Congress and the Administration appropriately are undertaking a comprehensive review of the financial regulatory structure. Part of that effort will be focused on the need for a special resolution regime outside the bankruptcy process for large non-bank financial firms that pose a systemic risk, such as the regime that exists for insured commercial banks and thrifts. Unlike the special statutory powers that the FDIC has for resolving insured depository institutions, the current bankruptcy framework wasn't designed to protect the stability of the financial system. It will be important to create such a regime to avoid additional instability in times of economic crisis.

Q2. How many employees does the FDIC have–employees working on closed bank fraud, and employees working on open bank fraud?

A2. Closed Bank: In total, the FDIC has approximately 113 employees, as well as outside contractors, working on closed bank fraud. By mid-2009, the FDIC Legal Division will have increased staff in its professional liability and financial crimes unit from 21 in mid-2008 to 46. This includes 24 employees devoted to professional liability civil claims work arising out of recently-failed institutions (such as mortgage malpractice and fraud claims); 12 devoted to financial crimes work to support the United States Department of Justice in its prosecutions of criminal mortgage fraud claims; and ten employees having dual responsibilities in both these areas. We also have retained 17 outside law firms to date to assist with performing professional liability investigations and litigation as well as firms to handle residential mortgage fraud cases specifically. We anticipate retaining additional firms for both of these purposes during 2009. Our Division of Resolutions and Receiverships increased its civil and criminal investigations staff, bringing its total in-house investigations staff to 67, and also added contractors to support its investigations function.

Open Bank: In total, the FDIC has approximately 2,010 employees working on open bank fraud as part of their examination and enforcement responsibilities. In Washington, we have 22 employees in the Legal Division's open bank enforcement section. In addition, our regional legal offices have 58 attorneys and 32 other regional staff that assist with open bank enforcement and other open bank concerns. Our Division of Supervision and Consumer Protection includes both examination staff—responsible for identifying and investigating potential fraud—and supervisory staff who work with the Legal Division on enforcement actions. We have approximately 1,730 examiners who regularly review the activities of insured depository institutions to ensure compliance with state and federal laws and regulations, including all consumer protection laws and the safe and sound operation of FDIC-supervised institutions. Examiners are trained to identify situations in institutions where the risk of fraud is heightened and additional review procedures may be needed. Approximately 160 FDIC employees are

designated Bank Secrecy Act/Anti-Money Laundering/Fraud Subject Matter Experts, and these individuals each spend a portion of their time reviewing primarily insider fraud incidents.

Q3. How many successful convictions?

A3. The FDIC does not have authority to prosecute criminal cases directly. This authority resides with the U.S. Department of Justice. The FDIC actively supports the Justice Department in its criminal prosecutions of defendants who have committed bank fraud, but the FDIC does not maintain data on numbers of convictions separately from the data maintained by the Justice Department.

Q4. You state that you have had 4,375 mortgage fraud claims filed, and they are expected to result in 900 additional civil mortgage fraud lawsuits over the next three years. What do you think the success rate will be? What justice will come to the American people? What amount of money do you think we will be able to recover from the people involved?

A4. To clarify, the 4,375 mortgage fraud matters referenced at the March 20 hearing are investigations, and are not yet filed claims. The likelihood of success on the merits of these claims is very high since they are fraud claims. These have a high likelihood of success because fraud, by its nature, consists of dishonest acts that are not difficult to prove. For example, liability is rarely in question in the typical mortgage fraud case once the fraudulent scheme that makes up the case is uncovered, such as in mortgage transactions involving falsified loan documents and/or the theft of loan proceeds.

However, based on experience, we expect to find in many of the claims that there is not a viable recovery source to make the claim cost-effective, and thus we will not pursue those claims. Many others will be settled before the need to file suit. Our best estimate is there will be 900 remaining claims on which we will file suit. We anticipate that the estimated 900 mortgage fraud lawsuits over the next several years will result in more than $150 million in monetary recoveries.

In terms of justice for the American people, we would suggest that it is through these cases that mortgage fraud is addressed, perpetrators forced to make reparations, and future fraud deterred.

**Responses of the Federal Bureau of Investigation
to Questions for the Record
Arising from the March 20, 2009, Hearing Before the
House Committee on Financial Services
Regarding "Federal and State Enforcement of Financial Consumer
and Investor Protection Laws"**

Questions Posed by Representative Grayson

1. According to the last 10-K filed by AIG, AIG's shareholder equity as of the end of 2008 was $54.7 billion (which is inclusive of $63 billion on government funds). According to that same document, on page 179, the company estimated that its exposure to the yield curve totaled $500 billion. What is your view of the prudence of such an arrangement and what should be done about it?

Response:

The Federal Bureau of Investigation (FBI) is responsible for investigating criminal violations of Federal laws. The question posed concerns AIG's financial exposure based on fluctuations in the yield curve, which is beyond the FBI's investigative scope. The FBI believes this question would be more appropriately posed to those who regulate and audit AIG.

2. By year, how many FBI agents investigated financial fraud during the Savings and Loan crisis from 1986-1995?

Respouse:

FBI records from 1986 through 1989 did not delineate resource allocation by investigative program. Instead, agent staffing levels for the FBI's criminal investigative programs were simply classified in general terms as "criminal." Beginning in Fiscal Year (FY) 1990, the FBI maintained statistics regarding the resources allocated to the White Collar Crime Program, though even at that point the statistics did not capture assets devoted specifically to the Savings and Loan crisis as distinguished from other white collar crime. From FY 1990 through FY 1995, the agent Funded Staffing Level (FSL) for the White Collar Crime Program

as a whole (not limited to financial fraud investigations related to the Savings and Loan crisis) was as follows.

FY 1990	FY 1991	FY 1992	FY 1993	FY 1994	FY 1995
1778	1930	2198	2234	2322	2354

3. By year, how many agents have investigated mortgage fraud from 2004-2008? How many are investigating mortgage fraud this year?

Response:

The number of agents investigating mortgage fraud matters as of April 30, 2009, was approximately 260. The approximate number of agents investigating mortgage fraud from FY 2005 through FY 2008 was as follows.

FY 2005	FY 2006	FY 2007	FY 2008
15	44	120	180

The assignment of agents to investigate mortgage fraud cases was not tracked before FY 2005 because mortgage fraud was not identified as a sub-program for purposes of resource allocation until FY 2005.

To assist in comparing the assets devoted to the White Collar Crime Program more recently with those devoted to that program during the period in which the Savings and Loan crisis occurred, following are the agent FSLs for the White Collar Crime Program, as a whole, from FY 2004 through FY 2008.

FY 2004	FY 2005	FY 2006	FY 2007	FY 2008
2342	2178	2161	1995	2000

4. What can ordinary citizens do to help the FBI detect and investigate mortgage fraud?

Response:

The FBI asks all citizens to report suspected fraud to the appropriate local, state, or Federal authorities. Citizens can find information on mortgage fraud scams and submit tips regarding suspected mortgage fraud crimes through the FBI's Internet website located at www.FBI.gov. The FBI takes every opportunity to remind all

citizens to be vigilant and alert when engaging in mortgage transactions and to follow the following basic guidelines.

- Obtain referrals for real estate and mortgage professionals. Check the licenses of industry professionals with state, county, or city regulatory agencies.
- If it sounds too good to be true, it probably is. An outrageous promise of extraordinary profit in a short period of time signals a problem.
- Be wary of unsolicited contacts and of high-pressure sales techniques.
- Carefully review written information, including tax assessments and recent comparable sales in the area, to verify a property's value.
- Understand what you are signing and agreeing to. If you do not understand, re-read the documents or seek assistance from an attorney.
- Ensure that the name on your application matches the name on your identification.
- Review the property's title history to determine if it has been sold multiple times within a short period. If it has, it could mean the property has been "flipped" and the value falsely inflated.
- Know and understand the terms of your mortgage. Ensure the information in all loan documents is accurate and complete.
- Never sign any loan documents that contain blanks. This leaves you vulnerable to fraud.

5. Are you investigating the transactions that led to the AIG bailout?

Response:

The FBI is responsible for investigating corporate fraud along with other financial crimes, and is currently investigating 42 cases related to the current financial crisis. Longstanding Department of Justice (DOJ) policy generally precludes the FBI

from commenting on the existence or status of ongoing investigations. In addition to protecting the privacy interests of those affected, the policy serves to avoid disclosures that could provide subjects with information that might result in the destruction of evidence, witness tampering, or other activity that would impede an FBI investigation.

Questions Posed by Representative Posey

6. Please provide a one page summary - not a book - but a one page summary describing what you think was the root cause of the crisis. To what extent is Congress to blame?

Response:

The FBI is responsible for investigating criminal violations of Federal laws. As a law enforcement agency, rather than a regulatory agency, the FBI does not have the expertise, nor is it part of our mission, to speculate about the potential root causes of the current financial crisis, including whether Congress played any role. Rather, the FBI believes that this question would be more appropriately posed to those individuals or agencies that are subject matter experts on this issue.

7. If your life depended on solving this puzzle, how would you do it, and what do all the indicators point to?
Response:

Please see the response to Question 6, above.

8. Does your agency need an invitation to invite companies who received TARP money to be investigated under RICO, the racketeering statutes, and do you need Congress to ask you to do that or someone from the Treasury Department or someone else to ask for that?

Response:

The FBI has met with the Special Inspector General (SIG) of the Troubled Assets Relief Program (TARP), Neil Barofsky, and his staff on multiple occasions in order to coordinate efforts to combat crimes associated with the distribution of TARP funds. While it would be inappropriate for the FBI to comment on the existence or status of ongoing investigations, the Committee can be assured that the FBI

recognizes the potential for myriad crimes associated with TARP funding and is coordinating its investigative efforts in this area with the SIG-TARP on a continual basis.

9. What is your prognosis, what you forecast statistically, if necessary, to be the consequences and the results of the new fraud team that you put in place in 2008?

Response:

The National Mortgage Fraud Team (NMFT) was established at FBI Headquarters in December 2008 and is responsible for the management of the FBI's mortgage fraud program along with corporate fraud, financial institution failures, and other crimes associated with the current financial crisis. The NMFT was designed to leverage the tools and resources available to our agents and law enforcement partners in the field and, through information sharing and collaboration, allow us to apply the lessons learned and best practices gleaned from all of these parties.

Mortgage fraud, like other financial crimes, is in many respects a local and regional issue with national implications. As a result, the FBI has established 18 mortgage fraud task forces across the country and participates in 49 related working groups. With representatives of Federal, state, and local law enforcement, these task forces are strategically placed in areas identified as high-threat areas for mortgage fraud. Employing proven investigative tools and techniques, each task force is able to tailor its efforts to the individuals and enterprises engaged in mortgage fraud and related financial crimes in that area.

The success of the NMFT is also illustrated by its participation in the Washington D.C.-based National Mortgage Fraud Working Group (NMFWG), chaired by DOJ. The NMFWG represents the collaborative efforts of multiple Federal agencies and serves as a force-multiplying information-sharing hub of the Federal government's criminal, civil, and regulatory response to mortgage fraud.

Recently, the Financial Fraud Enforcement Task Force (FFETF), a new interagency task force led by DOJ, was established by Executive Order of the President to combat various types of financial fraud, including mortgage fraud. The goal of the Task Force is to improve efforts across the government and with state and local partners to investigate and prosecute significant financial crimes, ensure just and effective punishment for those who perpetrate financial crimes,

address discrimination in the lending and financial markets and recover proceeds for victims. The FBI is an active member and serves on the task force's Steering Committee.

10. To what extent are RICO laws useful to convict those committing white collar crimes?

Response:

The FBI investigates white collar crime under the Racketeering Influenced and Corrupt Organizations (RICO) statutes in close coordination with DOJ prosecutors. For example, in a San Diego mortgage fraud investigation in April 2009, 24 individuals were charged with "using a corrupt enterprise to conduct a pattern of racketeering activity" relating to wire fraud, mail fraud, and money laundering. This $100 million mortgage fraud scheme, one of the largest fraud cases in the Southern District of California, involved over 200 properties and was investigated jointly by the FBI and our partners at the Internal Revenue Service (IRS). Among those arrested were "industry insiders," including an appraiser, a real estate agent, and a licensed notary.

11. I understand DoJ prosecutors do not use a RICO approach very often. How often is it used? Why not more often?

Response:

The FBI defers to DOJ for a response to this inquiry.

12. Are RICO statutes sufficiently broad to capture the kinds of activities white collar criminals engage in?

Response:

As discussed in response to Question 10, above, the FBI uses RICO statutes very effectively to investigate appropriate white collar crimes.

13. What are the limitations of a RICO approach in deterring and prosecuting financial white collar crimes?

Response:

RICO is one tool among many that can be used to investigate and prosecute financial white collar crimes. While RICO can be used to investigate such offenses as embezzlement, money laundering, and securities fraud, other statutes are used to address other aspects of financial white collar crimes. For example, IRS statues can be used to investigate tax law violations and asset forfeiture laws can be used to remove the tools of these crimes from circulation and to recover property that may be used to compensate crime victims.

14. How do prosecutors determine criminal intent apart from "recklessness" or general incompetence?

Response:

In every criminal case, it is the prosecutor's responsibility to present evidence to the fact-finder, and it is ultimately the jury's responsibility to determine the intent of a criminal defendant. It is a basic principle of criminal law that people are not considered culpable if they do not possess the proper mental state to commit a crime. For example, people are treated differently when they engage in an intentional, premeditated act than they are when something bad results from an accident.

Investigators and prosecutors look to all the facts and circumstances of a case to assess the "intent" underlying a defendant's actions. Particularly illuminating are the defendant's own words and actions, including any evidence of consciousness of guilt, efforts to conceal conduct, attempts to direct others on how to respond to investigative inquiries, laundering or concealing of funds, unusual accounting methods, and the destruction of relevant documents. These are the types of evidence prosecutors use to differentiate between those who act criminally and those who are merely incompetent.

15. How best could Members of Congress strengthen criminal statutes to discourage some executives from running off with big bonuses while running their companies into the ground?

Response:

The FBI works with DOJ and the Office of Management and Budget to develop the Administration's position on matters such as this, and we would be pleased to do so in this case.

Committee on Financial Services Hearing on
Federal and State Enforcement of Financial Consumer and Investor Protection Laws
Follow up Questions to Office of Thrift Supervision
Acting Director Scott Polakoff
March 20, 2009

Question: According to the last 10-K filed by AIG, AIG's shareholder equity as of the end of 2008 was $54.7 billion (which is inclusive of $63 billion of government funds). According to that same document, on page 179, the company estimated that its exposure to the yield curve totaled $500 billion. What is your view of the prudence of such an arrangement and what should be done about it?

Answer: The exposure to yield curve is one of the sensitivity measures that AIG uses to monitor potential loss exposures from adverse fluctuation in interest rates on its assets and liabilities. For AIG, the asset-liability exposures are predominantly structural in nature. Typically, the structure consists of deposit and policy holder premiums and reserves (liabilities) that fund long-term credit based fixed and variable rate investments (assets). Investments and income earned on the investments fund claims, interest payable and operating expenses of the Company.

The $500 billion of yield curve exposures reported in AIG's December 31, 2008 10-K represents the portion of AIG's assets that are directly sensitive to interest rate movements. These include certain asset classes such as fixed maturity and finance receivables. AIG is estimating that the value of these assets would decline by $23.5 billion if the interest rates experience a sudden and parallel increase of 1% across the rate spectrum.

It should be noted that the disclosure relates only to the impact on assets and does not capture the impact of the economic gains that will be simultaneously experienced on the liability side of the balance sheet. We understand that the duration mismatch in the Asian markets (extended insurance liabilities vs. short term assets) may create significant economic gains in a rising rate environment for the Company, negating the value decline on the asset side.

Question: Why did an industry segment known as 'liar's loan' allowed to emerge?

Answer: Stated income loans are sometimes referred to as "liar loans" because borrowers had the opportunity to simply state their monthly income on a mortgage application instead of verifying the actual amount by furnishing pay stubs or tax returns. This simplified method was originally intended for self-employed borrowers, non-wage earners, or for those individuals whose incomes varied from year to year.

Initially, stated income loans often required a higher down payment, or more equity for loans being refinanced, a higher credit score, and carried a slightly higher interest rate than that for a fully documented loan as mitigants to the higher risk presented by the reduced documentation. Even with those additional requirements, while income may not have been verified in a stated income loan, employment typically would have been, and income that was significantly higher than the prevailing income for the occupation might have raised concerns.

Stated income loans were historically a very small percentage of originations and had performed well. However, according to one source, stated income loans increased from 18% of originations in 2001 to 49% in 2006, an increase unjustified by their original targeted use. The spreading use of stated income loans in 2006 raised concerns both here at OTS as well at the other banking Agencies.

It has been and remains OTS policy that savings associations use prudent underwriting and documentation standards for all loans they originate, both for those to be held in portfolio and those originated for sale. In early 2007, OTS, along with the other banking Agencies, published additional guidance concerning alternative mortgage products. In part, the guidance stated:

Reduced Documentation - Institutions increasingly rely on reduced documentation, particularly unverified income, to qualify borrowers for nontraditional mortgage loans. Because these practices essentially substitute assumptions and unverified information for analysis of a borrower's repayment capacity and general creditworthiness, they should be used with caution. As the level of credit risk increases, the Agencies expect an institution to more diligently verify and document a borrower's income and debt reduction capacity. Clear policies should govern the use of reduced documentation. For example, stated income should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. For many borrowers, institutions generally should be able to readily document income using recent W-2 statements, pay stubs, or tax returns.

In the past, a large down payment or substantial homeowner's equity combined with higher credit scores or other evidence of credit-worthiness had served well as risk mitigants in those limited cases in which stated incomes were permitted in the mortgage application process. However, relaxed underwriting standards encouraged by the voracious appetite for mortgage-related securities quickly eroded those safeguards, especially in the more lightly regulated or unregulated portions of the mortgage origination industry. As a consequence, stated income loans have over the last two years performed much worse than full documentation loans.

OTS and the thrifts we regulate are fully aware of the demonstrated limitations of stated income mortgages.

Question: What are the principles you would use to dispose of assets if the government formed a "bad bank"?

Answer: To address the challenge of legacy assets, Treasury - in conjunction with the FDIC and the Federal Reserve - has announced the Public Private Investment Program (PPIP) as part of its efforts to repair balance sheets throughout the financial system and ensure credit is available to the households and businesses, large and small, that will help drive us toward recovery.

The three basic principles of the PPIP are the principles we believe should be used to dispose of assets if the government formed a "bad bank".

- **Maximize the Impact of Each Taxpayer Dollar:** First, by using government financing in partnership with the FDIC and Federal Reserve and co-investment with private sector investors, substantial purchasing power will be created, making the most of taxpayer resources.

- **Shared Risk and Profits with Private Sector Participants:** Second, the PPIP ensures that private sector participants invest alongside the taxpayer, with the private sector investors standing to lose their entire investment in a downside scenario and the taxpayer sharing in profitable returns.

- **Private Sector Price Discovery:** Third, to reduce the likelihood that the government will overpay for these assets, private sector investors competing with one another will establish the price of the loans and securities purchased under the program.

The program should facilitate price discovery, enhance transparency, and should help, over time, to reduce the excessive liquidity discounts embedded in current asset prices.

This in turn should free up capital and allow U.S. financial institutions to engage in new credit formation. Furthermore, enhanced clarity about the value of these assets should increase investor confidence and enhance the ability of financial institutions to raise new capital from private investors.

If the government formed a "bad bank", the plan should help reduce the liquidity discounts contained in asset prices in the near-term. The most important way to protect taxpayers is to ensure that the government is not paying more for assets than their long-run value as determined by a fair and competitive market.

Committee on Financial Services Hearing on
Federal and State Enforcement of Financial Consumer and Investor Protection Law
Follow up Questions to Office of Thrift Supervision
Acting Deputy Director Scott Polakoff
March 20, 2009

Question: Please provide a one page summary describing what you think was the root cause of the crisis. To what extent is Congress to blame?

Answer: The root cause of the financial crises can be centered around two factors. A shift in underwriting standards to those that were investor driven as opposed to borrower ability to repay resulted in cascading consequences to the financial system. Secondly, inadequate and uneven regulation of mortgage companies and brokers led to inconsistent and sometimes careless lending practices that eroded consumers' confidence in credit providers and fostered an environment of distrust. Compounding the problem were a concentration of risks, extraordinary liquidity pressures, and weak risk management practices among banks and thrifts. While we believe the immediate liquidity pressures on the financial system have abated, the damage to the trust and confidence among consumers must be corrected to enable a sustainable recovery.

The growth of the mortgage securitization business encouraged the origination of loans based on the value of the loan in the capital markets as opposed to the ability of the borrower to repay the loan. The increased use of mortgage brokers and other unregulated entities in providing consumer financial services posed significant competition in the loan origination market and changed the way many mortgage lenders underwrote loans, and assigned and priced risk. Some banks and thrifts that had to compete with these companies also started originating loans with less than the standard underwriting guidelines associated with repayment. By the time the federal bank regulators issued the nontraditional mortgage guidance in September 2006, reminding insured depository institutions to consider borrowers' ability to repay when underwriting adjustable-rate loans, numerous loans had been made that could not withstand a severe downturn in real estate values and payment shock from changes in adjustable rates.

Unfortunately, independent mortgage companies and mortgage brokers were not subject to the same underwriting standards as banks and thrifts and therefore, continued to originate and underwrite loans based on the ability to sell into the capital markets. While loan terms were disclosed in a myriad of documents provided to potential borrowers, many borrowers did not have a clear understanding of the risks inherent in some of these nontraditional loan products while others obtained credit based upon aggressive assumptions with regard to price appreciation and the availability of future credit.

The velocity and magnitude of loan delinquencies and defaults resulted in significant losses in insured financial institutions. These losses were exacerbated by an equally shocking decline in liquidity available to fund existing loan commitments. The inability to sell loans and termination of short-term funding vehicles, such as asset-backed commercial paper and term repurchase agreements eventually led to the failure of some banks and thrifts. The lack of liquidity in the capital markets for asset-backed securities also led to the demise of large financial services companies. These failures damaged the public confidence in insured financial institutions and, in some cases, led to panic withdrawals of insured deposits with significant consequences to banks and thrifts.

Question: How can we solve this puzzle?

Answer: Consistent regulation and supervision of consumer and mortgage credit providers will level the playing field and help to minimize missteps driven by competitive forces. As the OTS has advocated for some time, one of the paramount goals of any new regulatory framework should be to ensure that similar bank or bank-like products, services, and activities are scrutinized in the same way, whether they are offered by a chartered depository institution or an unregulated financial services provider. The "shadow bank system," where bank or bank-like products are offered by nonbanks using different standards, should be subject to as rigorous supervision as banks.

Independent mortgage banking companies are state-chartered and regulated. Currently, there are state-by-state variations in the authorities of supervising agencies, in the level of supervision by the states and in the licensing processes that are used. State regulation of mortgage banking companies is inconsistent and varies on a number of factors, including where the authority for chartering and oversight of the companies resides in the state regulatory structure.

The supervision of mortgage brokers is even less consistent across the states. In response to calls for more stringent oversight of mortgage lenders and brokers, a number of states have debated and even enacted licensing requirements for mortgage originators. Last summer, a system requiring the licensing of mortgage originators in all states was enacted into federal law. The S.A.F.E. Mortgage Licensing Act in last year's Housing and Economic Recovery Act is a good first step. However, licensing does not go far enough. There continues to be significant variation in the oversight of these individuals and enforcement against the bad actors.

The current crisis in consumer confidence has highlighted consumer protection as an area where reform is needed. Mortgage brokers and others who interact with consumers should meet eligibility requirements that reinforce the importance of their jobs and the level of trust consumers place in them. Although the recently enacted licensing requirements are a good first step, limitations on who may have a license are also necessary.

Historically, federal consumer protection policy has been based on the premise that if consumers are provided with enough information, they will be able to choose products and services that meet their needs. Although timely and effective disclosure remains necessary, disclosure alone may not be sufficient to protect consumers against abuses. This is particularly true as products and services, including mortgages, have become more complex.

A consumer-and-community bank regulator would supervise depository institutions of all sizes and other companies that are predominately engaged in providing financial products and services to consumers and communities. Establishing such a regulator would address the gaps in regulatory oversight that led to a shadow banking system of unevenly regulated mortgage companies, brokers, and consumer lenders that were significant causes of the current crisis.

The consumer-and-community bank regulator would also be the primary federal regulator of all state-chartered banks with a consumer-and-community business model. The regulator would work with state regulators to collaborate on examinations of state chartered banks, perhaps on an alternating cycle for annual state and federal examinations. State-chartered banks would pay a prorated federal assessment to cover the costs of this oversight. In addition to safety and soundness oversight, the consumer-and-community bank regulator would be responsible for developing and implementing all consumer protection requirements and regulations. These regulations and requirements would be applicable to all entities that offer lending products and services to consumers and communities. The same standards would apply for all of these entities, whether a state-licensed mortgage company, a state bank or a federally insured depository institution. Non-compliance would be addressed through uniform enforcement applied to all appropriate entities.

Finally, regulators should consider promulgating requirements that are countercyclical, such as conducting stress tests and lowering loan-to-value ratios during economic upswings. Similarly, in difficult economic times, when house prices are not appreciating, regulators could permit loan-to-value (LTV) ratios to rise. Other examples include increasing capital and allowance for loan and lease losses in times of prosperity, when resources are readily available.

Question: It appears as though there are under 200 OTS formal enforcement actions. What number of employees does it take to get this many enforcement actions done? How many of the actions have been successfully criminally prosecuted, and how many do you expect to be successfully prosecuted of the actions outstanding?

Answer: Several years ago, OTS began increasing the resources it devoted to its Enforcement Division. For example, from 2006 to 2009, OTS nearly doubled the number of its Enforcement Division attorneys from six (three in DC; three in the Regions) in 2006 to ten (six in DC; four in the Regions) in 2009. OTS also revised its Enforcement Policies, established model document language to standardize enforcement documents, and is currently engaged in other initiatives to improve and enhance the efficiency and effectiveness of our enforcement process. Each Attorney is responsible for his or her own case load.

Total Number of OTS Formal Enforcement Actions.

The overall number of OTS formal enforcement actions has increased significantly since 2006 since the number of institutions with adverse exam ratings has increased. Cease and Desist (C&D) Orders went from 13 in 2006 to 34 in 2008 and total enforcement actions rose from 53 in 2006 to 68 in 2008. As of mid-March 2009, OTS reported 36 formal Enforcement Actions of which 13 were C&D Orders. As of April 22, 2009, OTS reports a total of 48 formal Enforcement Actions of which eight were C&D Orders. Formal actions include Supervisory Agreements; C&D orders; Removal and/or Prohibition Orders; and orders that assess Civil Money Penalties. In addition, the OTS Enforcement Division has already litigated one formal administrative hearing before the Office of Financial Institution Adjudication (OFIA) in 2009. Moreover, as of March 2009, the Enforcement Division has filed two Notices of Charges with OFIA initiating the formal administrative hearing process.

Coordination with the DOJ, Federal and State Prosecutors and Other Federal Banking Agencies in Pursuit of Criminal and Civil Enforcement.

OTS does not prosecute criminal matters but coordinates with DOJ, various U.S. Attorneys Offices, and state law enforcement in the prosecution of criminal cases. OTS is an active participant in interagency working groups and task forces to identify various types of fraud in the financial sector and to determine the civil and criminal options available to hold responsible individuals and entities accountable for their actions. In addition, law enforcement and the federal banking agencies, including OTS, share relevant information. This process provides assistance to criminal prosecution authorities and ensures that meritorious matters involving criminal conduct are adjudicated. OTS also works with federal and state prosecutors to obtain its own administrative prohibition orders concurrently with criminal convictions against institution-affiliated parties (IAPs) indicted for financial crimes. In 2007, thirteen administrative prohibitions were obtained. Of those thirteen, five also resulted in criminal convictions. In 2008, four out of eleven OTS administrative prohibition orders resulted in criminal convictions. As of April 22, 2009, six out of seven administrative prohibition orders issued in 2009

resulted in criminal convictions. In addition, there are currently four matters Enforcement is pursuing in tandem with federal or state prosecutors. Enforcement seeks administrative prohibition orders against these IAPs and recommends that these individuals are criminally adjudicated by prosecution authorities.

Question: What would you recommend we do legislatively to keep as least some financial risk with those who put people in mortgages and with those who package and sell them as securities? If your answer is, do away with mortgage backed securities, fine. But I am not looking for a treatise on what all is involved or who could – the question is very specifically: What do you personally recommend? Because if you don't have suggestions on something that nearly has brought down the financial system, then we are in bigger trouble than I thought.

Answer: The Office of Thrift Supervision believes Congress should create a level, scrupulous and well-regulated playing field so consumers and investors have confidence in the transparency, fairness and integrity of all mortgage originations. The standards of the under-regulated segments of the market must be raised to the level followed by the federally regulated segments. All entities that originate home mortgages should be required to comply with basic credit principles, such as conducting a reasonable assessment of each borrower's ability to repay.

Several key elements are: nationwide registration and licensing for all mortgage originators, because accountability is vital to avoid predatory and irresponsible lending; requiring all originators to have underwriting and origination expertise and utilize strict underwriting standards; requiring annual continuing education and biannual mandatory training; requiring mortgage brokers and companies to possess adequate financial resources to ensure a level of stability and commitment; and tying compensation for loan officers to responsible underwriting practices to assure that they offer loans only to borrowers who have a reasonable prospect of repaying the loan. Mortgage brokers could receive their commission over a three-year period based on the continued performance of the mortgage.

OTS believes that these elements would serve borrowers' interests, as well as those of lenders and investors. Equally important, it is critical to ensure that mortgage banks be forced to compete by the same set of standards as insured depository institutions. Establishing a partnership between the states and a federal overseer to set and enforce minimum mortgage funding standards would ensure accountability and consistency throughout the mortgage lending process. This could be similar to the partnership that exists between the FDIC and state banking commissioners in the oversight of state-chartered banks. Such a partnership need not involve establishing a federal mortgage banking charter, but rather a federal-state partnership to regulate these entities and ensure nationwide uniformity.

While it is not OTS's intention to expand its regulatory authority, the OTS is in a unique and skilled position to help level the playing field by acting as a backstop in a prudential federal-state supervision of state mortgage bankers who fund mortgages. If Congress determined that the OTS could provide the best solution by taking these responsibilities, we would assume these duties by applying a wealth of institutional knowledge and expertise supervising and regulating all aspects of the mortgage markets.

(In response to Mr. Gohmert's question on page 133 of the transcript relating to preventing problems with credit default swaps)

A significant issue regarding credit default swaps was that there was no clear legislative mandate concerning which Federal agency would regulate these financial instruments. As such there was a resulting gap in the regulation of these financial products. NASAA identified this problem in its 2008 Legislative Agenda, which contained five core principles. In paragraph four (4) of principal two (2) we stated as follows:

> The lack of regulation governing the over-the-counter derivatives market is a regulatory gap that Congress must close. The hands-off approach to these financial instruments can be traced largely to the Commodity Futures Modernization Act, passed by Congress in 2000, which specifically exempted swaps from regulatory oversight. This lack of oversight was a contributing cause of the financial crisis and must be addressed.
>
> NASAA believes that Congress, at a minimum, should pass legislation to subject derivatives to much more comprehensive regulation. NASAA believes legislation should be enacted to make the over-the-counter derivative markets more transparent and subject to effective oversight. NASAA supports recent efforts to provide clearing services for certain credit default swap contracts, but suggests that Congress explore the necessity of imposing a much broader range of regulatory safeguards over the derivative markets. Regulatory requirements that deserve careful consideration include mandatory exchange trading, licensing of market participants, capital requirements, recordkeeping obligations, conduct standards, enforcement remedies, and even prohibition, where appropriate.

(Response to Mr. Scott's questions regarding how Congress could assist the State's in their investigation.)

For the system to work properly all regulatory agencies (States, SEC and SRO's) must work together. They must communicate, cooperate, and share information. In 2008, NASAA promulgated a legislative agenda recognizing the importance of agency cooperation and stated as follows in the first "Core Principal" in that legislative agenda:

> Core Principle One: Preserve State/Federal Collaboration While Continuing to Streamline the Regulatory System Where Appropriate. Regulating our financial markets is an enormous challenge, one that can only be met through the combined efforts of state and federal regulators, working together to protect the integrity of the marketplace and to shield consumers from fraud and abuse. We must resist attempts to weaken this collaborative system. State securities regulators, for example, must not be preempted or marginalized as mere advisers to federal authorities. Particularly in the areas of enforcement, licensing, and compliance examinations, state regulators provide indispensable consumer protections. At the same time, we should look for opportunities within this collaborative framework to make regulation more streamlined and efficient.

In essence, anything that Congress can do to encourage federal agencies to cooperate with the states and share information would be really beneficial.

Questions Submitted by Mr. Foster

What is your enforcement budget? What are the losses in the area under your purview? What is the economic impact of allocating additional resources to enforcement?

ANSWER:

The Securities and Exchange Commission's Division of Enforcement budget for the current fiscal year is about $330 million.

One method to quantify the losses in the area under the Commission's purview, or at least set a floor on those amounts, is to look at the amount of disgorgement that has been ordered in Commission actions, as it provides an indicator of the amount of money that investors have lost. The average disgorgement amount ordered during the past five fiscal years was approximately $1.65 billion.[1]

To address the economic impact of allocating additional resources to enforcement, one method is to compare the Commission's enforcement spending to the monetary remedies (civil penalties and disgorgement) that it ordered. The Commission's average enforcement spending during the past five fiscal years was approximately $296 million, while the average total amount of monetary penalties ordered for that time period was approximately $2.6 billion.[2]

It is notable that recent research, based on international comparisons, has shown that allocating more resources to public enforcement is positively associated with robust capital markets, as measured by market capitalization, trading volume, the number of domestic firms, and the number of IPOs. This research also indicates that the United States is out-spent by other countries.[3]

Overall, increases in the Commission's budget would enhance the Commission's ability to aggressively—and strategically—pursue fraud and other regulatory misconduct that harm investors and the markets. There are at least two areas in which additional resources would significantly enhance the agency's ability to ferret out and prosecute

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[1] This method is not comprehensive and has a number of limitations. For example, the amount of disgorgement ordered by the Commission would by definition include only the disgorgement resulting from misconduct that the Commission has investigated and charged. Moreover, the Commission's theory of recovery is disgorgement, which reflects the amount of ill-gotten gain that a defendant has received. The amount of ill-gotten gain may not be the same as the amount of investor losses.

[2] This method also contains a number of limitations. For example, it does not include the prophylactic and other non-monetary forms of relief that the Commission achieves, including injunctions, cease-and-desist orders, officer and director bars, industry and supervisory bars, and undertakings to improve and/or maintain policies and procedures.

[3] *See, e.g.*, Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence* (Mar. 16, 2009).

misconduct: staffing and information technology. We have numerous ideas on how we would improve both staffing and information technology with additional resources.

Among them with respect to staffing would include the addition of persons with specialized financial industry experience to enhance the Commission's ability to quickly and strategically attack emerging areas of fraud and misconduct. With respect to information technology, although we have numerous potential needs to bolster our systems to detect and investigate wrongdoing, among our focuses include a new system to track, prioritize and act on tips and complaints, and a risk assessment tool to help us better analyze data and use our enforcement resources more efficiently and better protect investors.

Securities and Exchange Commission
Commissioner Elisse B. Walter
Response to Representative Gohmert Question for the Record
House Financial Services Committee
March 20, 2009, hearing on
Federal and State Enforcement of Financial Consumer and Investor Protection Laws

Question Submitted by Representative Gohmert

What would you recommend we do legislatively to keep at least some financial risk with those who put people in mortgages and with those who package and sell them as securities?

Commissioner Walter Answer:

In the "originate to distribute" model of lending, loans are packaged with many other loans and sold to third party investors through securitization vehicles. A retention of risk requirement could mandate that originators of the loans or sponsors of the securitization vehicles retain at least a portion of the risk that gets transferred to investors when the loans are sold off. Requiring lending institutions to retain a portion of that risk may better align their interests with those of investors. I personally believe that a retention of risk requirement aimed at improving the incentive structure merits serious consideration.[1]

Retention of risk requirements have recently garnered considerable support, and proposals with such requirements have come in several different forms. For example, under a bill recently introduced by Representative Brad Miller of the U.S. House Financial Services Committee, federal banking authorities would promulgate rules requiring any creditor selling off a non-qualified loan to retain an economic interest in a material portion of the credit risk for the loan.[2] The application of this provision would be limited, however, as risk retention would apply to only loans where, among other things, borrowers' income is not verified, and interest rates and debt-to-income ratios exceed prescribed amounts.

In addition, the Securities and Exchange Commission could incorporate the retention of risk concept into existing rules and form requirements for asset-backed securities. For example, shelf offering eligibility could be conditioned upon a requirement that sponsors retain a portion of the securities being sold in the offering.[3] As asset-backed securities

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[1] The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publications or statements by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission, other Commissioners, or the staff.

[2] 111th Congress: H.R. 1728, the Mortgage Reform and Anti-Predatory Lending Act.

[3] Some have suggested that originators be required to retain some portion of the subordinated tranche of the securities; on the other hand, similar to the EU proposed amendment, originators

typically are not held by a sufficiently large number of investors for the ongoing reporting requirements of the securities laws to apply, legislation amending Section 15(d) of the Exchange Act authorizing the Commission to require ongoing reporting by asset-backed issuers could improve monitoring of retained risks by the sponsor.

Retention of risk requirements also have been considered outside the United States. In October 2008, the European Commission announced proposals to amend the Capital Requirements Directive that effectively would prohibit a bank from investing in mortgage-backed securities unless the sponsor of those securities retains five percent of each tranche in a securitization that is sold to a credit institution. Also, in its January 2009 framework, the G30 recommended again that financial firms not be allowed to repackage and sell off debt instruments without holding any exposure.

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could be required to retain a certain piece of each tranche of the securities in an issuance. Any retention of risk requirement would necessitate careful consideration of its impact on the accounting of the retained securities and the treatment of the disposition of the assets under bankruptcy laws.

Questions Submitted by Mr. Grayson

According to the last 10-K filed by AIG, AIG's shareholder equity as of the end of 2008 was $54.7 billion (which is inclusive of $63 billion of government funds). According to the same document, on page 179, the company estimated that its exposure to the yield curve totaled $500 billion. What is your view of the prudence of such an arrangement and what should be done about it?

ANSWER:

American International Group, Inc. reported shareholders' equity of $52.7 billion at December 31, 2008, which includes $63 billion in government funds accounted for as equity. In addition, AIG had loans payable to government entities totaling $55.5 billion which it recorded as liabilities and did not include in shareholders' equity.

In the late 1990s, the Securities and Exchange Commission adopted Item 305 of Regulation S-K requiring public companies to provide quantitative and qualitative disclosure about market risk sensitive instruments in annual reports on Form 10-K. Companies may provide this disclosure in a tabular format, as a sensitivity analysis, or as value-at-risk disclosure. AIG chose to provide the required disclosure in the form of a sensitivity analysis. A sensitivity analysis should express the potential loss in future earnings, fair values or cash flows of the market risk sensitive instruments, resulting from one or more selected hypothetical changes in interest rates, foreign currency exchange rates, equity prices and other relevant market rates or prices.

The $500 billion amount in AIG's analysis represents its investments at December 31, 2008 that are market risk sensitive to changes in interest rates. In general, the growth over time of these investments appears to have resulted from AIG's normal insurance business activities, which include investment of premiums and deposits collected from policy holders into long term fixed maturity investments, and not from business activities such as those conducted by AIG's Financial Products unit. Most of these investments are held by AIG's insurance subsidiaries, which are subject to regulatory oversight by state insurance departments.

AIG's sensitivity analysis seems designed to show that in the event of a hypothetical 100 basis point parallel upward shift in all yield curves, the fair value of AIG's $500 billion of certain investments, consisting primarily fixed maturity securities, would decrease by a hypothetical $23.5 billion.

In adopting the Item 305 disclosure requirements, the Commission stated that the amendments were designed to "provide additional information about market risk sensitive instruments, which investors can use to better understand and evaluate the market risk exposures of a registrant." The federal securities laws require that public companies provide full and fair disclosure so that investors can make well informed investment and voting decisions.

Questions Submitted by Mr. Grayson

Who was most responsible for the destruction and turmoil in our financial markets and the broader economy? What should be done about it?

ANSWER:

Many commentators have expressed their views on the cause or causes of the current financial crisis. For example, lax lending standards relating to subprime mortgages are often cited, as is securitization. A growth in the size, complexity, and interconnectedness of the markets, overemphasis on the strength of market discipline, and regulatory gaps in areas such as credit default swaps are also discussed.

To my mind, the factors mentioned above played a contributing role in the crisis. The size and complexity of the market grew rapidly. Many institutions —including mortgage originators and securitizers—failed to exhibit sufficient prudence in carrying out both old and new businesses. They, like many other market participants, failed to anticipate the potential for a drop in the housing market as significant as the drop that occurred. They also failed to consider such scenarios in their risk-based analyses. Ultimately, market participants had insufficient understanding about the risks inherent in financial products and about the interrelated nature of financial products and various financial markets.

There are also factors on the regulatory side. Regulators didn't fully appreciate the interconnectedness of financial institutions as those businesses engaged in new and highly leveraged activities. Like the business world, regulators failed to take a broad enough view of possible future market events.

In addition, there are significant gaps and overlaps in our regulatory system. Credit default swaps ("CDS") and other financial derivatives are one good example. Despite the enormous size and importance of the CDS market, the Securities and Exchange Commission is explicitly prohibited from regulating much of the over-the-counter derivatives market.

To address concerns about CDS, efforts are currently underway to facilitate and encourage central clearing for CDS. While these efforts may result in increased transparency and accountability, I believe that changes to the regulatory framework are necessary to fully address gaps in the regulation and oversight of these instruments. Specifically, I believe that the most effective way to address the lack of transparency in the CDS market and the potential for CDS to be used to further fraudulent and manipulative schemes would be to provide the Commission with rule writing authority in this area. Such authority would permit the Commission to adopt reporting and recordkeeping requirements to increase transparency and to enable the Commission to fulfill its responsibilities to enforce the anti-fraud provisions of the federal securities laws. I also believe that Congress should consider whether to mandate centralized clearing for CDS.

Hedge funds are also a powerful illustration of problematic regulatory gaps. In recent years, hedge funds have played an increasingly significant role in our financial markets. They can contribute to liquidity and price discovery and provide investors with opportunities for portfolio diversification and capital protection in down markets. Hedge funds, however, also pose potential risks to investors and to the stability of the financial system.

The Commission currently lacks basic data about hedge funds and hedge fund advisers, and thus lacks significant knowledge concerning and important segment of the market. In addition, hedge funds and hedge fund advisers are not subject to our periodic examination program. This makes it much more difficult for the Commission to identify misconduct prior to significant losses occurring. As Chairman Schapiro has indicated, among other things, we are considering asking for legislation that would require registration of investment advisers who advise hedge funds, and possibly the hedge funds themselves.

In addition, the regulation of the securities markets and the futures markets is currently split between the Commission and the CFTC. I believe that Congress should merge the regulatory oversight responsibilities of the two agencies in order to provide more comprehensive oversight of the futures and securities markets.

The Commission is carefully considering whether to recommend legislation to address other gaps in regulatory oversight, such as those related to municipal securities and the statutory barriers requiring a different regulatory regime for investment advisers and broker-dealers, even though the services they provide often are virtually identical from the investor's perspective.

The Commission is also taking other steps to address the crisis to the fullest extent possible. For example, to target potentially abusive "naked" short selling in certain equity securities, the Commission tightened up the close-out requirements and adopted a new anti-fraud rule specifically aimed at abusive short selling when it is part of a scheme to manipulate the price of a stock. In addition, we recently sought public comment on whether short sale price restrictions or circuit breaker restrictions should be imposed and whether such measures would help promote market stability and restore investor confidence.

Also, Chairman Schapiro has indicated that the Commission will consider action in the near term relating to money market fund standards, investor access to company proxies, credit rating agencies, and controls over the safekeeping of investor assets. In addition, she has launched reforms in the enforcement and examination programs. For example, Chairman Schapiro has hired a new Director of Enforcement, Robert Khuzami, a longtime federal prosecutor who served as Chief of the Southern District of New York's Securities and Commodities Fraud Task Force, and begun to strengthen the agency's processes for handling tips and complaints, integrate new hires with deep industry experience into the agency's workforce, and enhance risk-based oversight of investment advisers and broker-dealers.

Increases in the Commission's budget would enhance the Commission's ability to aggressively—and strategically—pursue fraud and other regulatory misconduct that harms investors and the markets. There are at least two areas in which additional resources would significantly enhance the agency's ability to ferret out and prosecute misconduct: staffing and information technology.

Questions Submitted by Mr. Grayson

What can ordinary citizens do to help in detecting violations and enforcing investor and consumer protection laws? What kinds of steps is the commission taking to open up the process of detection and enforcement of these laws to citizens affected by these crimes?

ANSWER:

Ordinary citizens can play an important role in protecting themselves and others from fraud by understanding common fraud tactics and by reporting suspected fraud to regulators. The Securities and Exchange Commission's Office of Investor Education and Advocacy ("OIEA") provides a variety of services and tools to help investors with their problems and questions. OIEA encourages individuals to ask questions about financial opportunities and to check out the answers with unbiased sources before they invest. OIEA's materials also identify common "red flags," including common fraud persuasion tactics, to help investors avoid scams and other fraudulent schemes.

Since joining the Commission in January 2009, Chairman Schapiro has announced initiatives to strengthen the agency's processes for handling tips and complaints. Any member of the public may report tips to the Division of Enforcement by emailing enforcement@sec.gov, and send complaints to OIEA by emailing oiea@sec.gov. Complaints to OIEA that allege wrongdoing by registered or unregistered entities are referred to the Division of Enforcement for further action, if warranted.

Additionally, Chairman Schapiro has stated her interest in requesting legislation for a whistleblower program that would allow us to compensate whistleblowers for bringing well-developed fraud cases to the agency's attention.

Questions Submitted by Mr. Posey

Please provide a one page summary – not a book – but a one page summary describing what you think was the root cause of the crisis. To what extent is Congress to blame? If your life depended on solving this puzzle, how would you do it, and what do all the indicators point to?

ANSWER:

Many commentators have expressed their views on the cause or causes of the current financial crisis. For example, lax lending standards relating to subprime mortgages are often cited, as is securitization. A growth in the size, complexity, and interconnectedness of the markets, overemphasis on the strength of market discipline, and regulatory gaps in areas such as credit default swaps are also discussed.

To my mind, the factors mentioned above played a contributing role in the crisis. The size and complexity of the markets grew rapidly. Many institutions —including mortgage originators and securitizers—failed to exhibit sufficient prudence in carrying out both old and new businesses. They, like many other market participants, failed to anticipate the potential for a drop in the housing market as significant as the drop that occurred. They also failed to consider such scenarios in their risk-based analyses. Ultimately, market participants had insufficient understanding about the risks inherent in financial products and about the interrelated nature of financial products and various financial markets.

There are also factors on the regulatory side. Regulators didn't fully appreciate the interconnectedness of financial institutions as those businesses engaged in new and highly leveraged activities. Like the business world, regulators failed to take a broad enough view of possible future market events.

In addition, there are significant gaps and overlaps in our regulatory system. Credit default swaps ("CDS") and other financial derivatives are one good example. Despite the enormous size and importance of the CDS market, the Securities and Exchange Commission is explicitly prohibited from regulating much of the over-the-counter derivatives market.

To address concerns about CDS, efforts are currently underway to facilitate and encourage central clearing for CDS. While these efforts may result in increased transparency and accountability, I believe that changes to the regulatory framework are necessary to fully address gaps in the regulation and oversight of these instruments. Specifically, I believe that the most effective way to address the lack of transparency in the CDS market and the potential for CDS to be used to further fraudulent and manipulative schemes would be to provide the Commission with rule writing authority in this area. Such authority would permit the Commission to adopt reporting and recordkeeping requirements to increase transparency and to enable the Commission to fulfill its responsibilities to enforce the anti-fraud provisions of the federal securities

laws. I also believe that Congress should consider whether to mandate centralized clearing for CDS.

Hedge funds are also a powerful illustration of problematic regulatory gaps. In recent years, hedge funds have played an increasingly significant role in our financial markets. They can contribute to liquidity and price discovery and provide investors with opportunities for portfolio diversification and capital protection in down markets. Hedge funds, however, also pose potential risks to investors and to the stability of the financial system.

The Commission currently lacks basic data about hedge funds and hedge fund advisers, and thus lacks significant knowledge concerning an important segment of the market. In addition, although some hedge fund advisers register voluntarily, hedge funds and hedge fund advisers are generally not subject to our periodic examination program. This makes it much more difficult for the Commission to identify misconduct prior to significant losses occurring. As Chairman Schapiro has indicated, among other things, we are considering asking for legislation that would require registration of investment advisers who advise hedge funds, and possibly the hedge funds themselves.

In addition, the regulation of the securities markets and the futures markets is currently split between the Commission and the CFTC. I believe that Congress should merge the regulatory oversight responsibilities of the two agencies in order to provide more comprehensive oversight of the futures and securities markets.

The Commission is carefully considering whether to recommend legislation to address other gaps in regulatory oversight, such as those related to municipal securities and the statutory barriers requiring a different regulatory regime for investment advisers and broker-dealers, even though the services they provide often are virtually identical from the investor's perspective.

Questions Submitted by Mr. Posey

Your testimony mentions that you have 1,100 attorneys. Please provide for the record the number of convictions they have had, if any.

ANSWER:

The 1,100 figure reflects total Securities and Exchange Commission Enforcement staff, rather than only attorneys. The Enforcement staff is comprised of approximately 69% attorneys (including supervisory and nonsupervisory investigators and trial lawyers), 10% accountants (including supervisory and nonsupervisory accountants), and 21% other (including Market Surveillance, IT, auditors, and support staff). Each Enforcement attorney generally carries several cases, varying considerably in complexity.

The Commission as a civil agency is not empowered to file criminal charges or seek criminal sanctions that result in convictions. On a regular basis, however, our staff works closely with federal and state criminal authorities in securities-related criminal actions. The nature and extent of the cooperation varies from case to case and can include referrals, the sharing of information in parallel investigations, simultaneous actions, and staff assistance on criminal cases. In fiscal year 2008, for example, prosecutors filed indictments, informations, or contempts in 108 Commission-related criminal cases.

The Commission brings civil enforcement actions both in federal court and in administrative proceedings. In fiscal year 2008, it brought actions against 1,332 defendants. The Commission was successful against 1,222 of the defendants—a 92% success rate. A case is considered "successfully resolved" if it results in a favorable outcome for the Commission, including through litigation, settlement, or an issuance of a default judgment.

Questions Submitted by Mr. Posey

In regards to the Madoff case, the SEC did not investigate the claims made and evidence provided by Mr. Markopolos. What disciplinary measures were applied to employees who disregarded the best interests of the citizens of this country?

ANSWER:

The Securities and Exchange Commission takes very seriously the need to learn necessary lessons from the Madoff case and reform operations as needed. As you know, the Commission's Inspector General is continuing to investigate the handling of this matter and will take appropriate actions if warranted. The findings from this review are not expected for several months.

The Commission is not, however, waiting for the results of that review to implement policy changes. Since she joined the Commission in January 2009, Chairman Schapiro has already launched reforms in the enforcement and examination programs. She has hired a new Director of Enforcement, Robert Khuzami, a longtime federal prosecutor who served as Chief of the Southern District of New York's Securities and Commodities Fraud Task Force. The Chairman also has announced initiatives to strengthen the agency's processes for handling tips and complaints, integrate new hires with deep industry experience into the agency's workforce, and enhance risk-based oversight of investment advisers and broker-dealers.

Questions Submitted by Mr. Scott

Please comment on the need for assets to back what are essentially insurance products and the deviation from the need for an insurable interest before you can buy what is essentially an insurance product.

ANSWER:

Although I understand the rationale for requiring an insurable interest for credit default swaps ("CDS") participants—to avoid harmful speculation—it may be difficult to implement and may have unintended consequences. For example, it could impede legitimate hedging and risk-shifting strategies and could ultimately drive trading to foreign jurisdictions without such restrictions. Activities in foreign markets would continue to impact U.S. markets and market participants, but U.S. regulators would have less information to carry out their responsibilities. Thus, I believe we need to carefully examine further the benefits and downsides of such a requirement.

To address concerns about CDS, efforts are currently underway to facilitate and encourage central clearing for CDS. While these efforts may result in increased transparency and accountability, I believe that changes to the regulatory framework are necessary to fully address gaps in the regulation and oversight of these instruments.

Specifically, I believe that the most effective way to address the lack of transparency in the CDS market and the potential for CDS to be used to further fraudulent and manipulative schemes would be to provide the Securities and Exchange Commission with rule writing authority in this area. Such authority would permit the Commission to adopt reporting and recordkeeping requirements to increase transparency and to enable the Commission to fulfill its responsibilities to enforce the anti-fraud provisions of the federal securities laws. I also believe that Congress should consider whether to mandate centralized clearing for CDS.