

EXCLUSIVE

NEW TIPS MACHINE BRINGS SEC INTO 21st CENTURY

U.S. securities regulators are using technology and a partnership with the FBI to banish the ghost of Madoff



Thomas Sporkin is the chief of the office of market intelligence at The Securities and Exchange Commission (SEC) in Washington, June 24, 2011. REUTERS/JONATHAN ERNST

BY SARAH N. LYNCH AND
MATTHEW GOLDSTEIN
WASHINGTON/NEW YORK, JULY 27

FOR MORE THAN THREE YEARS, U.S. securities regulators investigated allegations of accounting fraud at a small

telecom firm called China Voice Holding Corp, but could not make a case.

Then last November, they got an unexpected break. A Texas-based tax consultant doing work for a firm affiliated with China Voice contacted the U.S. Securities and Exchange Commission

with information about suspicious money transfers she'd detected.

The call from Dee Dee Stone was quickly routed to a preliminary version of the SEC's new \$21 million "Tips, Complaints and Referrals" or TCR Database, which the agency later fully deployed in March. Within



BIG MISS: Bernard Madoff walks back to his apartment in New York on December 17, 2008. REUTERS/SHANNON STAPLETON/FILES

24 hours, Stone, a former Internal Revenue Service agent, got a call from an SEC attorney spearheading the China Voice inquiry.

Five months later, the SEC on April 29 sued several China Voice executives, claiming they had duped investors out of \$8.6 million in a Ponzi scheme. Agency lawyers say without Stone's help, regulators may not have even discovered the scheme, let alone made a case so soon.

The alleged fraud at China Voice was small in the annals of Wall Street sins. But the SEC's response to Stone is an indication that after dropping the ball on Bernie Madoff, the nation's top securities cops are trying to modernize the way they handle tips and complaints about potential wrongdoing.

The TCR Database is the SEC's most significant response to its well-documented fumbling of early tips about Madoff's \$65 billion fraud. The SEC's new Office of Market Intelligence, which last summer also forged a first-of-its kind partnership with the Federal Bureau of Investigation, is using the database as a key tool.

The changes are part of an effort by SEC Chairman Mary Schapiro to overcome the agency's reputation for being a step or two behind the bad guys. It is far too soon for the SEC to declare victory. But some of the agency's harshest critics notice a change.

Among them is Harry Markopolos,

REUTERS INSIDER



See interview with SEC critic Harry Markopolos:
<http://link.reuters.com/mad82s>

"EVERYTHING THEY SHOULD HAVE DONE IN THE MADOFF CASE THEY ARE NOW DOING."

BLOG

Find more Reuters special reports at our blog The Deep End here:
<http://link.reuters.com/heq72q>

the Boston-based financial analyst and fraud investigator best-known for trying to alert regulators about problems with Madoff's operation. Markopolos said since the database went into operation, he has submitted three of his own tips. In all three cases, he heard back from an SEC attorney within days, or in one case, a few hours.

"Everything they should have done in the Madoff case they are now doing," said Markopolos. "They have done a fantastic job of reforming themselves."

In February 2009, Markopolos told the House Committee on Financial Services that the SEC's "investigative ineptitude and financial illiteracy" permitted Madoff's crimes to go on for so long.

PAPER, PENCILS & FAXES

IT TOOK THE EMBARRASSMENT of the Madoff scandal to drag the SEC into the 21st century when it comes to tracking tips and complaints.

Tips used to come via phone calls, e-mails, faxes and even handwritten letters into the

SEC's 11 regional offices and Washington headquarters. Before the Madoff case, the SEC's Los Angeles office might receive a written complaint about a bad broker, for instance, and stuff the letter into a filing cabinet if it was deemed without merit. So, if later on a complaint about the same broker was sent to the SEC's Chicago office, staff there would have no easy way of knowing about the earlier tip and connecting the dots.

Sometimes, the only way an attorney could find out if someone had looked into a complaint would be to call all the other SEC offices.

"It was a sieve, basically," says Russ Ryan, a partner in the Washington law office of King & Spalding who spent a decade at the SEC before leaving in 2004. "It probably got better as I went along in my career, but I remember back when I first started there, it was a lot of paper and pencil type stuff."

Now with the TCR Database, once a tip or complaint is entered into the system, about 2,300 SEC employees can see it and add new information.

"All of the plumbing was brought into one place," said Thomas Sporin, a nearly 19-year veteran SEC attorney in Washington, who oversees the agency's new Market Intelligence Unit and its 41-member team.

The database is emerging alongside a new program by the FBI's criminal profiling group in Quantico, Va. that is creating a series

CRIME WAVE

FBI says active investigations of securities and commodities fraud are on the rise

2008	1210
2009	510
2010	1703

Source: FBI economics crime unit

of behavioral composites to help agents investigate white collar crime.

The more systematic approach by the SEC and FBI comes in response to the growth and complexity of financial crimes in recent years. In the U.S. government's 2010 fiscal year, the FBI's economics crime unit reports the bureau had 1,703 active securities and commodities fraud investigations, a 41 percent increase over the number of active investigations in 2008.

Over the past year, the amount of monetary penalties the SEC has imposed on wrongdoers has almost tripled, with high-profile cases against companies such as Goldman Sachs, Citigroup and Morgan Keegan for their roles in the crisis.

Sporkin's 41-member Market Intelligence Unit last month moved into new offices in Washington that look a little bit like a Wall Street trading floor, where they process more than 100 tips, complaints and referrals that come in each day.

The group's chief task is to ensure legitimate tips, like the one from Stone about China Voice, get routed to the right attorneys. The triage process begins with analyzing the information provided by tipsters, whistleblowers and self-regulatory organizations on an online questionnaire in the TCR Database portal.

The SEC is also trying to revamp the way it uses the raw data it gathers. Sporkin's team is working side-by-side with an FBI expert in financial crimes under a deal agreed to last August.

The FBI agent gets to look at all the tips about securities fraud as they come into Sporkin's team. For the FBI, the partnership offers the promise of faster criminal investigations. For the SEC, it's a chance to learn a trick or two from law enforcement.

Having an FBI agent embedded with the SEC "is really revolutionary," Sporkin said.

Other regulators are trying to set up their own FBI partnerships, including the Commodity Futures Trading Commission, which regulates the futures and over-the-counter derivatives market. The CFTC, which declined to comment, has also been closely



HOT TIPS: The SEC's new database is drawing positive reviews from critics.

Click here: <http://link.reuters.com/kad82s>

studying the operation of Sporkin's team.

THE FBI EMBED

JEFFREY HORNER, the FBI agent embedded with Sporkin's group, is an accountant who worked for audit giant PriceWaterhouseCoopers before joining the bureau in 2004.

Horner says he's not allowed to talk about specifics, but the nearly year-long partnership has led to new leads and bolstered existing FBI files.

"Some of the raw data that comes into the SEC, the (FBI) case agents may not be aware of," he said. "So plugging them in with the SEC and the information that the SEC has can be very valuable to an ongoing investigation."

FBI agent Horner is also sitting in on two SEC working groups examining micro-cap fraud and Chinese businesses that have done so-called reverse mergers with small U.S. shell companies. The FBI has opened its own broad investigation into reverse mergers and allegations of accounting irregularities.

Horner also uses the SEC's tips system to drill into areas of particular interest to the FBI. Right now, for instance, he is on the lookout for tips about high-yield investment scams as well as high-priority areas such as insider-trading and market manipulation.

"SOME OF THE RAW DATA THAT COMES INTO THE SEC, THE (FBI) CASE AGENTS MAY NOT BE AWARE OF."

The real test of the partnership -- and the effectiveness of the TCR Database -- will lie in the kind of cases the SEC and federal prosecutors file.

An independent analysis of the work of Sporkin's team could come when SEC Inspector General David Kotz conducts a planned audit of the Market Intelligence Unit's triage work. Kotz, who issued a scathing report on the SEC's failures in the Madoff affair, has called the new database an adequate response to ensure tips are "acted upon in a timely and appropriate manner."

Former SEC lawyers and securities attorneys wonder whether more agents need to be assigned to the SEC-FBI partnership.

"My sense is that there would be so many things going across that person's desk, I am not sure one person can manage it," said James Cox, a law professor at the Duke University School of Law.

Officials with the SEC and the FBI don't rule out an enhanced relationship. They note

SEC TRIAGE UNIT

The Market Intelligence Unit is the central clearinghouse for vetting all tips and referrals that come to Securities and Exchange Commission. Here's a sampling of the 41-member team's daily workload:

FRAUD
R_x

- 100 tips, complaints and referrals that come via a new database
- 80 reports filed by banks about suspicious money transfers
- 5 referrals from self-regulatory organizations
- work with embedded FBI agent to cross-check with criminal database
- route tips on active cases to the right SEC attorney
- weed out good tips from the bad

SIGNATURE

□ LABEL

SOURCE: SEC DATA

Designed by Alison Victor

that before Horner was embedded with the SEC, the two agencies coordinated on major investigations, such as the probe into insider trading by hedge funds.

At the same time, officials say they are sensitive to law enforcement protocols prohibiting prosecutors and the FBI from sharing investigative materials, such as wiretapped conversations, with securities regulators. They say it's easier for the FBI and SEC to work hand-in-hand before an investigation gets going to avoid any defense allegations of improper collaboration or information-sharing.

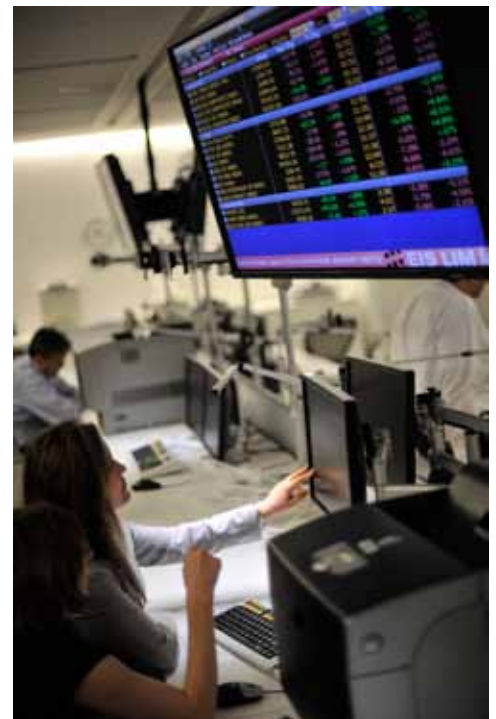
REWARDING WHISTLEBLOWERS

Sporkin's group is a work in progress and

the TCR Database has some limits. It can't yet be cross-checked against other internal databases. The system is not advanced enough to perform more sophisticated analysis or data-mining, such as cross-checks against trading activity, company filings or news feeds.

"It will be several years before we really see whether this new system is a success," said Bradley J. Bondi, a former SEC attorney who is now a partner with Cadwalader, Wickersham & Taft LLP. "But I think the new system is a step in the right direction."

It's a system Sporkin expects will become bigger and better over time, especially now that the SEC in May finalized rules for its own whistleblower program, rewarding



DATA MINING: Workers sit in a new Securities and Exchange Commission workspace for investigators with their recently-created Office of Market Intelligence, where they will be able to watch market traffic on computer terminals at SEC headquarters in Washington, June 24, 2011. **REUTERS/JONATHAN ERNST**

individuals who provide the agency with a high-quality tip that leads to a successful enforcement action.

Stone's tip about the potential Ponzi scheme at China Voice came in November 2010, after she says she grew concerned about the number of complaints she was hearing from investors in China Voice and related partnerships.

On May 31, Stone, testifying before a U.S. judge in Dallas in the China Voice case, said she learned about the new whistleblower rule only after hiring an attorney in advance of her court appearance. Her attorney, Misty Gutierrez, declined to comment. Stone didn't return telephone calls to her consulting business, Number Crunchers.

Stone told U.S. District Judge Reed O'Connor she started reviewing the bank statements for China Voice and those related companies after hearing the complaints, and quickly concluded, "something was wrong."

She talked about the money transfers with a friend who also once worked for the IRS and agreed the math didn't add up. The next day, Stone said she called the SEC.

(Editing by Bill Tarrant)



HOME BASE: A general exterior view of Securities and Exchange Commission (SEC) headquarters in Washington, June 24, 2011.
REUTERS/JONATHAN ERNST

FOR MORE INFORMATION CONTACT:

MICHAEL WILLIAMS,
GLOBAL ENTERPRISE EDITOR
+1 646 223 5462
michael.j.williams@thomsonreuters.com

BILL TARRANT,
ENTERPRISE EDITOR
+ 65 6870 3821
william.tarrant@thomsonreuters.com

MATTHEW GOLDSTEIN,
WALL ST INVESTIGATIONS EDITOR
+1 646 223 5773
matthew.goldstein@thomsonreuters.com

SARAH N. LYNCH,
+1 202 354 5831
sarah.n.lynch@thomsonreuters.com