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Legislation Won't Prevent The Next Madoff: SEC Needs Talent, Technology & Collaboration (Not New Laws)

The widespread pain triggered by Bernie Madoff is rife with potential for political posturing and legislative over-reaction. Sarbanes-Oxley taught us that laws passed in an emotional cauldron, while well-intentioned, frequently have significant adverse consequences. In the securities world, these consequences are disproportionately borne by smaller enterprises, public and private, and ultimately by all investors. We can't afford that.

Fraud is already fraud. Even without Sarbanes-Oxley, Enron-era corporate misdeeds were subject to adequate civil and criminal sanction. Dramatic new legislation isn't the answer. Early detection and effective enforcement that minimizes marketplace damage is.

Fraud is more likely to be prevented by sustainable operational changes in (and among) applicable government agencies rather than through sweeping rule-making. Day-to-day execution will be outcome-determinative.

A fair question is the SEC's historical role, and what it ought to be. The SEC has an almost inherently contradictory mandate: (1) protect investors, and (2) promote capital formation. Despite political pressure, increasing investor protection cannot come at the cost of impeding desperately needed capital formation.

The SEC requires fixing, not eliminating. Three straightforward changes that could be implemented quickly are:

1. Eliminate unnecessary branch offices.
2. Re-establish enforcement priorities.
3. Employ those best equipped to detect fraud.

With that accomplished, SEC leadership must be empowered to drive state and federal (intra-and inter-agency) collaboration and coordination.

Well-documented complaints about Madoff were reviewed by two of the SEC's 11 branch offices (Boston and New York). The system worked to the point that detection was possible, but ineffective follow-through failed to stop the fraud when investor losses would have been considerably less.

This may also be the time to ask whether the branches should continue or be eliminated. After all, the branches' historical role in registering securities has already been discontinued. Functions were consolidated at headquarters, cutting costs and improving quality. Better analysis and more uniform SEC responses resulted, reflecting stronger cumulative experience among SEC reviewers.

The lesson learned from this past success is to consolidate all future complaints and enforcement at headquarters reducing inherent inefficiencies. Madoff's recurring bad behavior might have been recognized and responded to more effectively if the same people had seen it.

Geographical consolidation alone is not a panacea; it must be coupled with enhanced information sharing and improved collaboration. Information is increasingly online; shared and stored using relatively inexpensive software combining robust search, collaboration, and networking functions. Physically separated workforces and social groups share and see the best information. Annotation software lets users benefit from the communities' collective memory and commentaries.

Technology permits physically dispersed individuals to comment at different times about a single investor complaint or investigation. Information silos need to be broken down. Institutional memory must be enhanced and maintained.

Since government agencies experience high personnel turnover, the practical ability to meaningfully retain the observations and experience of prior personnel is imperative.

Software tools alone cannot replace the advantages of proximity and personnel continuity. It's equally true that mere proximity cannot achieve all of the functionality of online collaboration.

The SEC's stated strategy for fraud enforcement appropriately emphasizes multi-disciplinary teams. A beneficial change may be to increase the number of forensic accountants who are specifically trained to detect fraud.

All long-term solutions, however, have to start with talent. The SEC needs to attract and retain the best and brightest. Psychic and economic compensation must be compelling. The SEC has to create an environment in which success and pride are possible. People need to believe that their efforts can make a meaningful difference.

No agency can uncover every fraud, nor can that be their mission. This is a percentage game. Securities regulators, state and federal, may be over-emphasizing investigating smaller businesses. Rampant fraud may exist there. More cynically, going after smaller fish creates better enforcement statistics. Some regulators clearly believe that big business is already subject to sufficient scrutiny and over-sight.

Massive fraud from India to New York doesn't support this. As famed bank robber Willie Sutton responded when asked why he robbed banks, "that's where the money is".

The same compelling logic suggests enforcement should emphasize those institutions whose raw size gives them the opportunity to significantly damage our marketplaces. Start with the companies who are "too big to fail", but whose failures have in fact necessitated a $750 billion bailout. Where there's that much money, there will be massive problems.

Since universal fraud detection will not occur, a risk-adjusted approach suggests allocating people and money to where success can minimize the most costly fraud and prevent the worst of disruptions. At $50 billion, Madoff would certainly have qualified.

To re-acquire our cherished reputation as the safest, most transparent, and liquid marketplace, we must detect, punish, and deter the inevitable future Madoffs. Greed is not disappearing.

Keep it simple. Give the SEC the budget, leadership, management, and technology to do their job. Agree on priorities, emphasize execution, and hold them accountable frequently. We need and are entitled to greatness from our regulatory bodies.