



**SIGTARP**

OFFICE OF THE SPECIAL INSPECTOR GENERAL  
FOR THE TROUBLED ASSET RELIEF PROGRAM

ADVANCING ECONOMIC STABILITY THROUGH TRANSPARENCY, COORDINATED OVERSIGHT AND ROBUST ENFORCEMENT

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U.S. SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE  
SUBCOMMITTEE ON SECURITIES, INSURANCE AND INVESTMENT

**WRITTEN TESTIMONY SUBMITTED BY**  
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**FOR THE TROUBLED ASSET RELIEF PROGRAM**

BEFORE THE  
U.S. SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE  
SUBCOMMITTEE ON SECURITIES, INSURANCE AND INVESTMENT

June 18, 2014

Chairman Warner and Ranking Member Johanns, I want to thank you for holding today's hearing on "High Frequency Trading's Impact on the Economy." As the watchdog over the Federal bailout known as the Troubled Asset Relief Program ("TARP") which Congress passed in 2008 in response to the financial crisis, the Office of the Special Inspector General for the Troubled Asset Relief Program's ("SIGTARP") mission is to promote economic stability through transparency, robust enforcement, and coordinated oversight. SIGTARP protects the interests of those who funded TARP – American taxpayers – by conducting audits and other reviews of lessons learned from the financial crisis, and as a law enforcement agency, conducting criminal investigations to hold accountable perpetrators of crime related to a TARP program or TARP recipient.

Recovery from a crisis comes in two equally important stages. First, there is the immediate triage response. The second stage involves long-term planning and rebuilding to reduce vulnerabilities, strengthen infrastructure, mitigate future harm, and restore lost confidence. We are currently in that second stage. Our nation has made significant progress, but we are still recovering and our nation must continue to foster investor confidence so that history does not repeat itself. It is critical that Congress view high frequency trading through the lens of lessons learned from the financial crisis. This hearing is an important step to understand whether the financial system and investor confidence are vulnerable to the impact of high frequency trading.

High frequency trading raises important issues of transparency of market data, and one lesson of the financial crisis is that a lack of transparency can impact market stability and investor confidence. SIGTARP does not specifically audit or investigate the practice of high frequency trading, therefore whether or not any laws have been broken or what regulation

should be created over this practice is ultimately for Congress and the agencies that regulate or investigate high frequency trading to decide. However, through our work related to the financial crisis, we have learned lessons about how a lack of transparency can impact market stability, the effectiveness of regulators, and ultimately investor confidence, and are sharing that with you to foster your assessment of these issues.

Transparency is essential to restoring and maintaining confidence in the markets. In 1933, at the height of the Great Depression after a tumultuous run on the banks, President Franklin Delano Roosevelt closed all the banks, checked to see if each bank was healthy, and then opened up only the healthy banks and closed the rest. He did not act in the dark. He spoke directly to the public in radio broadcasts called, “fireside chats.” The result from his action and never-before-seen level of transparency was that he restored the confidence of the American people in its government and in the financial system. Transparency, then, was necessary for investor confidence.

Fast-forward to 2008, when Treasury asked Congress for TARP authority, then-Treasury Secretary Paulson explained that TARP was necessary to restore confidence in the financial system. Investors had lost confidence after learning that the system was controlled by institutions that had made risky gambles, including trades with mortgage-backed securities, an area that lacked full transparency to investors and regulators. The lack of transparency hindered the institutions and their regulators from understanding the true risk exposure of the institutions. Once again, transparency was necessary for investor confidence.

In addition to a lack of transparency, the practice of high frequency trading raises issues that echo other areas of concern learned from the financial crisis, including the interconnectedness of financial institutions that are counterparties to each other who lacked

risk management. Contributing to the need for TARP were institutions that falsely believed that they had zero exposure to their counterparties because they had hedged against that exposure by trading in complicated derivatives. However, they soon learned in the financial crisis that this false sense of security depended on the strength of their counterparties. If their counterparty was vulnerable to failure, they too, were exposed. They had not adequately managed against that risk, and their lack of risk management resulted in taxpayers bailing them out through TARP.

A significant legacy of TARP is moral hazard, the belief by institutions that did not adequately manage their risk that they can play by their own set of rules without regard for consequences. Moral hazard has left our nation vulnerable and must be eliminated. Those who engage in high frequency trading must appropriately manage their risk. *As regulators and policymakers assess the impact of high frequency trading, they should focus on transparency and risk management so that the investing public is not left in the dark or left exposed.*

SIGTARP has brought transparency to the moral hazard legacy of TARP and SIGTARP's law enforcement successes help end moral hazard by bringing to justice those who did not play by the rules, but instead broke the law. Full recovery from the crisis requires restoring confidence of the American people in our financial system through justice and accountability. As a law enforcement agency, SIGTARP holds accountable those who violated the law and thought they could act with impunity and turn to taxpayers for a bailout. SIGTARP works to restore confidence in the financial system by arresting individuals charged with committing crime at or involving TARP and TARP-applicant institutions or programs,

assisting in their prosecution and ban from the banking industry, and investigating and assisting in the prosecution of corporations for their violations of the law.

As of April 2, 2014, SIGTARP investigations have resulted in criminal charges against 188 individuals, and although it takes time for trials and criminal charges are not evidence of guilt until proven, 129 of those defendants have already been convicted. Already 80 of those convicted have been sentenced to prison, and others await sentencing. In addition, SIGTARP investigations can result in civil charges.

Two recent SIGTARP investigations related to securities trading in TARP's Public-Private Investment Program (PPIP) in which Treasury-hired fund managers bought and sold mortgage-backed securities using TARP funds. Crime or other violations of the law related to this non-transparent market in mortgage-backed securities harms the Government, hinders taxpayers' returns, hurts other investors, and could hurt the market as a whole.

- On January 29, 2014, as a result of SIGTARP's investigation, mortgage broker-dealer Jeffries LLC entered into a non-prosecution agreement with the U.S. Attorney for the District of Connecticut agreeing to substantial corporate changes and to pay a \$25 million penalty, after a jury convicted Jeffries trader Jesse Litvak for criminally defrauding customers, including PPIP funds, by overcharging them for residential mortgage-backed securities by more than \$2 million, which led to increased revenue for Jeffries and an increased bonus for Litvak. SIGTARP special agents arrested Litvak after conducting our investigation, which was the first criminal case brought under the President's Residential Mortgage Backed Securities working group.

- Violations of the securities laws by PPIP managers who were hired by Treasury for TARP also harm Treasury, and therefore, taxpayers. The Securities and Exchange Commission and the Department of Labor settled a civil lawsuit resulting from a SIGTARP investigation with those agencies that uncovered that PPIP fund manager Western Asset Management Co., (“Western Asset”), a Legg Mason subsidiary, engaged in illegal “cross trades” that favored some clients over others. Western Asset agreed to significant corporate changes and to pay more than \$21 million including \$1 million to be paid to Treasury.

SIGTARP’s law enforcement successes reduce vulnerabilities in the financial system and mitigate future harm by removing from the system those who have already shown a willingness to break the law. *This deters those who may contemplate breaking the law in the future.* These are the broader reasons why SIGTARP’s work matters: it instills and restores investor confidence in the financial system, and makes it stronger for the future; it matters to taxpayers who funded the bailout; and it matters to investors in TARP recipients, large or small, and the communities those institutions serve.

Ending moral hazard also requires important oversight and ongoing work by regulators on rules to strengthen the financial system and reduce vulnerabilities, and necessitates a change in culture by some institutions. SIGTARP has reported on cultures at TARP institutions that were vulnerable to moral hazard, including, for example, reports on the culture of profit-seeking and risk-taking at select large TARP companies that left them near failure.

Some confidence has been restored in the financial system but much work still needs to be done. It is important to carefully consider the extent that high frequency trading may present the potential for a lack of transparency, unfair practices, or possibly even fraud, and accordingly, result in a loss of confidence in our financial system and markets. Our nation can suffer from the domino effect from an interconnected financial structure and unrecognized risks. This second stage of recovery requires taking steps to manage risk, build transparency, level the playing field, and restore full confidence in our financial system. The lessons learned from the financial crisis cannot be ignored. Long term full recovery from the crisis depends on it.

If you are aware of fraud, waste, abuse, mismanagement or misrepresentations affiliated with the troubled asset relief program, please contact the SIGTARP Hotline.

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