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ASSESSING THE MADOFF PONZI SCHEME AND REGULATORY FAILURES

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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ASSESSING THE MADOFF PONZI SCHEME AND REGULATORY FAILURES

Wednesday, February 4, 2009

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS,
INSURANCE, AND GOVERNMENT
SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:38 a.m., in room 2128, Rayburn House Office Building, Hon. Paul E. Kanjorski [chairman of the subcommittee] presiding.

Members present: Representatives Kanjorski, Ackerman, Sherman, Capuano, Hinojosa, McCarthy of New York, Baca, Lynch, Miller of North Carolina, Scott, Maloney, Bean, Klein, Perlmutter, Donnelly, Speier, Wilson, Foster, Kosmas, Grayson, Himes, Peters; Garrett, Castle, Manzullo, Royce, Biggert, Capito, Neugebauer, Posey, and Jenkins.

Ex officio present: Representatives Frank and Bachus.

Also present: Representatives Green, Maffei, and Arcuri.

Chairman KANJORSKI. This hearing of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will come to order.

I ask unanimous consent that Mr. Arcuri has permission to participate in today's hearing. Without objection, it is so ordered.

Pursuant to the agreement with the ranking member and to allow as much time as possible for testimony and members' questions, opening statements today will be limited to 5 minutes on each side. Without objection, all members may submit opening statements in writing that will be made a part of the record. Without objection, it is so ordered.

Good morning, everyone. We meet today to continue our review of the $50 billion Ponzi scheme allegedly perpetrated by Mr. Bernard Madoff. This is the second in our series of hearings on this topic. As my colleagues know, we are using the largest known instance of securities fraud as a case study to guide the work of the Financial Services Committee in reshaping and reforming our Nation's financial services regulatory system.

We preside at a crucial moment in our history, and our work on these matters in the 111th Congress will influence the securities industry for generations to come. After all, the Congress last undertook a wholesale rewrite of these laws in the wake of the Great Depression. We have only periodically tinkered with that regulatory engine over the last 75 years. The world, however, has now

changed, and the motor is broken beyond repair. We therefore need to invent a new engine to ensure that the securities regulatory system reflects today's realities and can respond effectively to tomorrow's innovations.

The low tide in our financial markets has exposed many individual frauds and many problems in our regulatory system. Since the Madoff scandal came to light in December, we have learned of other sizable schemes and frauds. Some of these cases which are now under investigation include the flight and capture of Arthur Nadel, a wayward hedge fund advisor in Florida, the $50 million con organized by Joseph Forte in Philadelphia, and the $370 million scam of Nicholas Cosmo in Long Island, who promised 48 percent annual returns.

During the last month, I have also heard from numerous victims not only of Mr. Madoff's swindle but many of these other cases. They want the help of their government. I have great sympathy for these individuals, including Mr. Goldstein, who joined us at our last meeting. They expected regulators to perform their jobs effectively. The Securities and Exchange Commission, the Financial Industry Regulatory Authority, the Securities Investor Protection Corporation, the Internal Revenue Service, the Justice Department, State securities regulators, and other appropriate authorities therefore must move quickly and do all they can to provide restitution, especially for retirees, charities, and pension funds.

Today, we will begin our proceeding by hearing from Mr. Harry Markopolos, an external whistleblower and conscientious citizen. We are pleased to welcome him to the subcommittee. I also greatly appreciate the effort he has put into preparing his testimony.

Unlike many others who suspected that something was wrong and amiss in Mr. Madoff's operations, Mr. Markopolos took the extra step of alerting authorities at the Securities and Exchange Commission about his concerns. As we will learn from his testimony, Mr. Markopolos was justifiably relentless in ringing alarm bells. Unfortunately, our regulators failed to follow his roadmap and heed his warnings. As a result, thousands of investors were hurt.

With today's second panel, we will hear from the frontline regulators at the Securities and Exchange Commission and the current leader of the Financial Industry Regulatory Authority. These individuals will help us to identify the loopholes that allowed the Madoff Ponzi scheme and other securities frauds to take place and offer recommendations for reform. These experts will additionally respond to the concerns raised by the victims of the Ponzi scheme and the observations of Mr. Markopolos.

Going forward, the committee has an enormous task ahead of itself. We need to pursue large-scale reforms by creating an effective method for monitoring systemic risk. While we have already begun work to craft wholesale regulatory reforms, I will also introduce legislation in the coming days that responds to one of the unique problems identified in the Madoff case. Specifically, my bill will close a legal loophole and permit the Public Company Accounting Oversight Board to conduct inspections and examinations of the auditors of broker-dealers.

In closing, I would like to welcome Scott Garrett as the Capital Markets Subcommittee's most senior Republican for the 111th Congress. I look forward to working with him to reach a bipartisan consensus and develop good public policy on the many matters under our jurisdiction.

And now, I would like to recognize the ranking member for his opening statement. Mr. Garrett.

Mr. GARRETT. Thank you. And before I begin, I just thank you and I look forward to working with you on this very important issue and, noting your comments on the air this morning, that I think I concurred on a number of the positions that we will be taking on this going forward. I am looking forward to it.

So thank you. I will yield myself 3 minutes for my comments.

Thank you, Mr. Chairman, for holding this hearing and also for the witnesses who are here today. I believe that there are three main points that need to be addressed.

First, there will be some talk that there are gaps in the current regulations that need to be filled. I don't know if that is actually the case. Each and every one of Mr. Madoff's relevant businesses were actually regulated by someone. There was not a gap in the sense that one sector was not covered by a regulator that needs a new regulator or more regulation.

Second, the failure at best, as we can see it today, came in part from a lack of coordination or basic information sharing between the agencies, specifically between the divisions within the SEC as well as FINRA. You know in 2006, Mr. Madoff was required to finally register his investment advisory business with the SEC. Traditionally firms such as Mr. Madoff's that had both an advisory business as well as a broker-dealer business had the broker-dealer arm process the trades made by the investment advisory arm. The SEC is well aware of this relationship between an investment advisory business and a broker-dealer business and how they work together when they are part of the same company. But over the last 10 years, FINRA has not conducted audits of his broker-dealer arm with the knowledge that Madoff's investment advisory unit even existed. So in light of the multiple infractions on his broker-dealer arm, it seemed incumbent upon the SEC that they should have ordered an internal audit when the investment advisory business registered in 2006. Unfortunately, I don't think we will learn today why that was not done. At the very least, they should have informed FINRA of the newly registered business advisory business and recommended to them to look back over their audits of the broker-dealer business with this new information and going forward to examine any other inconsistency.

Third, while I appreciate that the SEC cannot follow up on every single complaint—they say they get literally tens of thousands of them—with the specificity that we would like, I do not see that the failures were from a lack of funding or authority but in performing and executing the responsibility under the powers that they already had.

For example, we understand that there were recommendations for changes in the examination procedure and data collection in the various divisions. And for reasons not entirely clear, they were never implemented for over more than a 10-year period.

So in conclusion, we really cannot end all fraud nor guarantee that changes that we will be recommended or that the chairman will recommend to make sure that this never possibly happens in the future. But at least some of the things, had they been implemented earlier, at least in this case, it appears that the improprieties would have been discovered much earlier. It is sad when you think about but for the fact that Mr. Madoff came out and confessed this scandal, this scam would still be going on today.

And with that, I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Garrett. I now recognize Mr. Royce for 2 minutes.

Mr. ROYCE. Well, thank you, Mr. Chairman. And I really want to thank Mr. Markopolos for testifying here today. I can only imagine the degree of angst and frustration over the years that he felt going forward to the SEC with his analysis, repeatedly preparing that, preparing reports, showing the magnitude of the fraud. We are not discussing here how we stop all fraud. We are discussing the greatest fraud on record. We are talking about a systemic fraud here that has done untold damage really in terms of confidence of the system. And we are also talking about a fraud in which a few things surfaced. We will hear about some of it in your testimony later.

But I think that the concept of overlawyering, the fact that—and with we saw this in Britain, too, with the FSA. You have bureaucrats. You have people, you know, who are attorneys who don't understand the complexities of the market. And when somebody brings them and lays out for them that complexity—this was a discovery that was made in Britain actually after they missed Northern Rock. After they missed a number of things, they said, well, we have to reach out and bring into our FSA people who have experience in the markets to unravel some of the intricacies. And this was what I think was partly missing here.

But also what was missing was the type of discipline which would cause someone to sit down and try to walk through and understand. There was not the capacity on the part of many of these attorneys, I take it, to really follow what you were laying out for them. And what I guess hits all of us the most is that you didn't give up on these efforts. You tried repeatedly, and you tried to encourage others to look into this in order to protect investors not only here but around the world. And for that, we want to express our appreciation, our appreciation for you being here today.

I have read your testimony and look forward to the questions that we can ask you because we have to re-engineer the SEC in going forward so that these kind of systemic risks are presented, especially when a citizen like you comes forward and does their best in order to lay out the case.

Thank you very much, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Royce. And now I am pleased to introduce our first panel, our first witness. Without objection, your written statements will be made a part of the record. You will be recognized for a 5-minute summary of your written testimony.

We are pleased to have Mr. Harry Markopolos, an independent financial fraud investigator and a chartered financial analyst and

certified fraud examiner. Mr. Markopolos is joined at the witness table by his attorneys, Ms. Gaytri Kachroo and Mr. Philip Michael. His attorneys are here for advice only and will not be testifying themselves. Mr. Markopolos, it is all yours.

STATEMENT OF HARRY MARKOPOLOS, CFA, CFE, CHARTERED FINANCIAL ANALYST AND CERTIFIED FRAUD EXAMINER; ACCOMPANIED BY GAYTRI KACHROO AND PHILIP MICHAEL, COUNSEL

Mr. MARKOPOLOS. Thank you, Mr. Chairman. Good morning. Thank you for inviting me here to testify before your committee today regarding my 9-year long investigation into the Madoff Ponzi scheme. I would also like to recognize my Congressman, Stephen Lynch, who is a member of the committee. I look forward to explaining to Congress today and the SEC's Inspector General tomorrow what I saw, when I saw it, and what my dealings with the SEC were that led to this case being repeatedly ignored over an 8½ year period between May 2000 and December 2008.

First, I would like to extend my deepest sympathy to the many thousands of victims of this scheme. We know that many victims have lost their retirement savings and are too old to start over. We also know that others have lost medical services, community services, and scholarships provided by charities that were wiped out by the Madoff fraud. This pains me greatly and I will do my best to inform you, the victims, about my repeated and detailed warnings to the SEC. You, above all others, deserve to know the truth about this Agency's failings, and I will do my best to explain them to you today.

You will hear me talk a great deal about overlawyering at the SEC very soon. Let me say I have nothing against lawyers. In fact, I brought two of my own here today. As today's testimony will reveal, my team and I tried our best to get the SEC to investigate and shut down the Madoff Ponzi scheme with repeated and credible warnings to the SEC that started in May 2000 when the Madoff Ponzi scheme was only a $3- to $7 billion fraud. We knew then that we had provided enough red flags and mathematical proofs to the SEC for them where they should have been able to shut him down right then and there at under $7 billion. But unfortunately, the SEC staff lacks the financial expertise and is incapable of understanding the complex financial instruments being traded in the 21st Century.

In October 2001, when Madoff was still in a $12- to $20 billion range, again we felt confident that we had provided even more evidence to the SEC such that he should have been stopped at well under $20 billion. And again in November 2005, when Mr. Madoff was at $30 billion, 29 red flags were handed to the SEC. And yet again, they failed to properly investigate and shut down Mr. Madoff's operation.

Unfortunately, as they didn't respond to my written submissions in 2000, 2001, 2005, 2007, and 2008, here we are today. A fraud that should have been stopped at under $7 billion in 2000 has now grown to $50 billion. I know that you want to know why there was over $40 billion in additional damages, and I hope to be able to provide some of those answers to you today.

Just as there is no "I" in TEAM, I had a brave, highly-trained team that assisted me throughout the 9-year Madoff investigation. Let me briefly introduce the key team members to you. Neil Chelo, director of research for Benchmark Plus, a $1 billion-plus fund of funds, checked every formula, every math calculation, and every modeling technique, while also obtaining key financial statements and marketing documents from Madoff feeder funds. Mr. Chelo also interviewed senior level marketing staff and risk managers at these Madoff feeder funds.

Frank Casey, North American president for London-based Fortune Asset Management, a $5 billion hedge fund solutions advisory firm, closely tracked the Madoff feeder funds here and abroad, collected their marketing documents, and figured out Madoff's assets under management and his current cash situation.

The final member of this four-person team was Michael Ocrant, recruited into the team by Mr. Casey. Mr. Ocrant was then an investigative reporter at institutional investor who made key contributions to the investigation. Mr. Ocrant was the only member of my team who ever met Mr. Madoff or stepped inside the Madoff operation. He conducted a key interview in April 2001. On May 1, 2001, his publication, MAR Hedge, printed, "Madoff tops charts: Skeptics asked how." It was an expose. It contained several red flags that the SEC ignored.

These three gentlemen were my eyes and ears out into the hedge fund world, closely tracking who Madoff was dealing with and questioning the staff of the Madoff feeder funds to collect additional pieces of the puzzle. My Army Special Operations background trained me to build intelligence networks, collect reports from field operatives, devise lists of additional questions to fill in the blanks, analyze the data and send draft reports for review and error correction to my team before submitting them to the SEC. In order to minimize the risk of discovery of our activities and the potential threat of harm to me, my team, and to our families, I submitted these reports to the SEC without signing them. Only a few key trusted people at the SEC knew my name and my name only, not those of my team, in order to compartmentalize the damage if Mr. Madoff found out that we were tracking him. Mr. Madoff was already facing life in prison if he were caught, so he would face little to no downside to removing whatever threat he felt we posed. At various points in time throughout these past 9 years, each of us feared for our lives. Each time any of us collected information, we took risks, and fortunately for us we were not discovered.

I would also like to recognize Ed Manion of the Boston regional office of the SEC. He was my constant confidant throughout the past 9 years. If not for his encouragement and bravery, I would have quit the investigation after my second submission, which was in October 2001. Mr. Manion told me that his Agency had dropped the ball, but that I had a public duty to keep investigating because the Madoff Ponzi scheme was such a clear and present danger to the Nation's capital markets that if the SEC wasn't going to investigate, well, someone had to, and he didn't think there was anybody better qualified than me to lead the investigation. Mr. Manion kept taking the case to his superiors at the SEC and he kept getting ignored because he was not a securities lawyer, only a chartered fi-

nancial analyst with 25 years of trading and portfolio management experience in the industry. Sadly, the SEC distrusts anyone with industry experience. I am very surprised that the SEC did not fire Mr. Manion for his constant pestering about Mr. Madoff. The SEC to this day holds against him the fact that he kept bringing this case to their attention, and I believe he would be fired if he ever went public and told investors how strong an advocate he was on their behalf.

Boston Branch Chief Mike Garrity was the other SEC official who distinguished himself during the case. In October-November 2005 he examined my evidence, investigated and found irregularities, vouched for my credentials, and put me in touch with the appropriate SEC staff at the New York regional office. Since Mr. Madoff's operation was located in New York City, the New York regional office had jurisdiction.

In 2000, Mr. Manion warned me that relations between the New York and Boston regional offices were about as warm and friendly as the Yankees-Red Sox rivalry, and that New York does not like to receive tips from Boston. Truer words were never spoken. There was no centralized office of the whistleblower in Washington, staffed with industry professionals who knew how to determine if whistleblower complaints being submitted were credible and of sufficient quality to merit immediate investigation. Instead, I had to go through the Boston SEC regional office which had to forward me to the New York regional office. Unfortunately, these two offices did not get along, and I wasn't able to go directly to the SEC's headquarters in Washington and have them referee and lead this entire process. Regional turf battles definitely played a part, a determining factor in fact, in how disastrously this case was handled by the SEC.

In April 2008, I went to the SEC's Director of Risk Assessment with this case and got no response. I told the SEC exactly where to look, providing them with a long series of clear warnings that any trained investment professional would have immediately understood. Inexplicably, the SEC never acted upon those repeated multiple warnings on a 9-year time span. And as my formal written testimony makes clear, the SEC is overlawyered and has too few staff with relative industry experience and professional credentials to find fraud, even when a multi-billion dollar case is handed to them on a silver platter. Worse, my team and I kept collecting additional information and I kept sending it to the SEC and they kept ignoring it.

The SEC is also captive to the industry it regulates, and it is afraid of bringing big cases against the largest, most powerful firms. Mr. Madoff was one of the most powerful men on Wall Street. He owned a prestigious brokerage firm. He and his brother held numerous top-level positions on the most influential industry association boards. Clearly, the SEC was afraid of Mr. Madoff.

The SEC says it lives for the big cases, but the evidence shows that the only financial regulators bringing the big cases in the 21st Century are the New York Attorney General's Office and the Massachusetts Security Division. New York and Massachusetts brought the big cases against the market timing scandals and the auction rates securities scandals, while the SEC watched quietly from the

sidelines. Even today after Merrill Lynch paid out $6 billion in bonuses after losing untold tens of billions of dollars and is being propped up by government bailout money, only the New York Attorney General is investigating. The SEC continues to roar like a mouse and bite like a flea.

But what I find the most disturbing about the Madoff case is that no one from the SEC has stepped forward to admit personal responsibility. Instead, all we have heard is one senior official after another saying that they cannot comment about the Madoff investigation because it is ongoing. We have also heard senior SEC officials bemoan the lack of both staff and resources while telling us that they receive thousands of tips each year and that they have to conduct triage and can only respond to the highest priority matters. I gift-wrapped and delivered the largest Ponzi scheme in history to them, and somehow they couldn't be bothered to conduct a thorough and proper investigation because they were too busy on matters of higher priority. If a $50 billion Ponzi scheme doesn't make the SEC's priority list, then I want to know who sets their priorities.

The Troubled Asset Relief Program was funded to the tune of $700 billion by the previous Congress. Therefore, I can think of $700 billion reasons why the American public deserves answers from the SEC about its refusal to tackle the big cases and why all five major Wall Street investment banks under SEC supervision either failed, were forced by the government to merge with commercial banks, or became bankholding companies propped up by the Federal Reserve and the U.S. Treasury. When an entire industry that you were supposed to be regulating disappears due to unregulated unchecked greed, then you are both a captive regulator and a failed regulator. You have no excuses. But you darn well have a lot of explaining to do to the American taxpayers and you darn well better be apologizing to the Madoff victims.

The incoming SEC Chairwoman needs to come in and clean house with a wide broom. The SEC needs new senior staff because the current staff has led our Nation's financial system to the brink of collapse. They ignored the rating agency scandals. They allowed the investment banks to engage and package and sell toxic subprime securities to investors. They ignored auction-rate securities and allowed these toxic securities to be sold to investors. They ignored mutual fund market timing until embarrassed by State regulators into acting, and they ignored the Madoff Ponzi scheme. They haven't earned their paychecks and they need to be replaced.

This concludes my oral testimony. Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Markopolos can be found on page 101 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Markopolos. Now we will open for questioning, and I will take the first section.

Those are pretty tough charges you make against the SEC. At any time, do you feel that the Securities and Exchange Commission did perform its mission in the past and there was a weakening, or has this been a structural weakening since its very inception?

Mr. MARKOPOLOS. Mr. Chairman, I think leadership starts at the top. The tone at the top is very important. I think we have had

good SEC staff in the past. It all depends on who the Chairman is. I thought that William Donaldson was great. He was a fox who came to guard the hen house. He came from industry. He knew where the skeletons were buried, and he had his staff dig them up one at a time. And I think that is what led to his dismissal in 2006.

Chairman KANJORSKI. If you had to look at the need for reform and how it should be done, do you feel there is anything in the existing regulatory scheme that should just be corrected or do we have to start over from the bottom and reconstruct the regulatory scheme?

Mr. MARKOPOLOS. I think we need to start over at the top. I think you need an overarching department perhaps called the Financial Supervisory Authority, and I think it needs to have all of the security and capital markets and financial regulators underneath it. And I think you need to combine a lot of the existing regulators, just to simplify command and control to make sure that there is unity of effort and to eliminate expensive duplication of effort. And you also want to make clear the reporting lines to industry. They deserve to have better regulation, fewer regulators, and fewer different conflicting sets of laws to respond to.

I also think you need to start at the bottom, and you need to replace the staff that you currently have and replace them with industry professionals. If you have too many lawyers without industry experience, they really don't comprehend the frauds of the 21st Century. You need people who can take apart and put back together again the complex instruments of the 21st Century.

Chairman KANJORSKI. Do you think it is time to shoot the lawyers?

Mr. MARKOPOLOS. No. I actually think you need to spin them out of the regulatory agencies and have a separate enforcement unit where the lawyers can do both the civil and the criminal prosecutions that are dedicated just to securities and capital markets frauds. But you need to keep them separate because if you have them in the mix, it becomes toxic.

Chairman KANJORSKI. The revolving door problem that we all hear about; that is, people who work at the Agency and then end up on Wall Street and vice versa, is there something that can be done to prevent that? And is there any infection that is being carried from one entity to the other?

Mr. MARKOPOLOS. That is a great point, Mr. Chairman. There is an infection if the people coming to the SEC are too young and looking to make their bones and look at it as a steppingstone. And that is why I have a recommendation that you hire senior people from industry who have been there for a long time, who have gray hair or no hair. You would be perfect. You want them coming in, and this is the capstone to an already spectacular career. They have made lots of money in industry. They don't need any more money. They are not going to go back to industry. So I guess you want to have reverse age discrimination where you are looking to hire the old foxes to come in and police up the hen house. And that is what we really need.

Chairman KANJORSKI. Well, there have been now recently complaints about not having the staff and not having the funds available. But not too many years ago you may recall that the Agency

recommended to the Congress that certain fees be reduced or no charges made on those fees because there was an overabundance of revenue coming in to the SEC. And the Congress and this committee actually in the early 2000 period took that action to get rid of that fee schedule. I think it was as much as $1.5 billion a year that was anticipated was not necessary. Do you think that was a misjudgment, a misstatement? Or was that a purposeful act on the part of the Agency to follow in the ideology of deregulation?

Mr. MARKOPOLOS. I think it was ideological and idiotic because the industry only gets the message by the size of the fines. They know what a kick in the pants looks like, and they know what a slap on the wrist looks like. When you only slap them on the wrist, that sends a message that fraud is green lighted here. We don't do the big cases and we don't punish the big firms.

Chairman KANJORSKI. If you had your way, what would be your highest recommended action by this Congress to take in regard to the regulatory scheme in the country right now?

Mr. MARKOPOLOS. Combine regulators into one super financial organization with the departments underneath, like the SEC, some national insurance regulator, some bank regulator, probably the Fed, to handle all these market functions and have one super regulator above them so that there is no drop in coordination. I would centralize the databases so that an enforcement action by one agency gets noticed and picked up by the others. Mr. Madoff got caught in 1992, and no one apparently knew that in the New Millennium.

Chairman KANJORSKI. Very good. Thank you very much for coming forward. And now we will hear from our ranking member, Mr. Garrett.

Mr. GARRETT. Thank you. And again thank you for your work in this area. I will begin with what my last comment on my opening statement was, that but for the statement by Mr. Madoff to his two sons about what he had done, we may very well not be having this hearing today, that it would not have been uncovered officially at least. Do you concur with that assessment?

Mr. MARKOPOLOS. Yes. The SEC was never capable of catching Mr. Madoff. He could have easily gone to $100 billion if we hadn't had the financial crisis last year and run out of money to pay off existing investors.

Mr. GARRETT. So that is basically the end game, I guess, for any Ponzi scheme, right, is that you can keep on running until you have run out of investors. And had the market actually been continuing on the uptick bubbles that we had, we might be seeing him being able to continue for some time to come.

Mr. MARKOPOLOS. Correct. The SEC would never have caught him. He basically had to run out of money first.

Mr. GARRETT. You have indicated on the second or third page of your testimony in the statement that you have here how you were able to collect various different pieces of information along the line. You indicated three or four other people who worked alongside of you in doing this. Was there anything that you were doing—I actually know the answer to this but I will ask you—is there anything that you were doing that really was outside the purview of parameters or the authority of the SEC that had they committed the

time, attention, and resources, if you will, to it could have picked up on those things as well?

Mr. MARKOPOLOS. Everything that my team and I investigated was a matter of public record. It was basically marketing materials from the Madoff feeder funds and there were interviews collected of those feeder funds. We never had the access that the SEC had. We couldn't walk into his office, collect his documents. We never saw his smoking gun e-mails. We never talked to any of his staff. We did not have the inside smoking gun evidence available to us, but the SEC certainly did.

Mr. GARRETT. Is part of the problem, from your testimony, that the euphemism that we use here is, stovepipe conduct by an agency as far as the sharing of information? I referenced it in part as far as whether—just every aspect here, every part of Madoff's business was regulated by someone. The investment advisory arm, they are being regulated over here. FINRA is taking care of the broker-dealer section over here. And to use the euphemism, Washington stovepipe aspect, is that the crux of the issue here? And if the answer is yes, is that necessarily resolved by combining them under an umbrella organization? Because sometimes, as you already have indicated within the SEC, in the SEC you have one organization but different regions that are all within it. You have the Boston region, I believe it was, that was not sharing information. So would that be counterfactual, as the other chairman would say, some time to show that even when you are in one organization the information is not always being shared?

Mr. MARKOPOLOS. I agree. I think you need a super regulator to supervise all the different—and I would minimize the number of subregulators I had underneath there. But I want one centralized database of all enforcement actions so that the banking regulators know what the capital regulators are doing and also know what the insurance regulators are doing because right now you have these conglomerate firms that deal with all aspects of finance. They have insurance. They do banking. They do securities. And you need to combine the regulation database so that people are aware of all the infractions. You can't afford to be split into an army of ants. You need to be as giant as the conglomerates that you are regulating.

Mr. GARRETT. And part of the argument goes is that while until Madoff registered as an investment advisor, he really didn't appear on anybody's screen. Can you just comment on that?

Mr. MARKOPOLOS. He was operating and acting as an asset manager, as a hedge fund operator. But he was registered as a broker-dealer. He exploited the regulatory gaps and he fell through the cracks. And no one knew what he really was doing. Even though the regulators went in there multiple times, they never figured it out because they went in piecemeal. And you really need to have a combined task force of regulators to go after the big frauds. You need to have people from each agency in there at the same time.

Mr. GARRETT. I only have 10 seconds left. How did you know—you actually laid out the dollar figure in your testimony. It was this much here, this much here, this much here. How did you get that piecemeal information as to the size of it? Because we are still trying to get that question. Is it really $50 billion today? You seem to know that it was $7 billion here, $20 billion here, and so on.

Mr. MARKOPOLOS. My team was out there in the field, out talking to the Madoff feeder funds and identifying who they were. And we were tracking them very closely through Europe. We identified 14 feeder funds, only 2 of which have come public. There are 12 more out there hiding low in the weeds in Europe that you have not heard about yet. My team and I plan to meet with Mr. Kotz, the SEC's Inspector General, tomorrow and turn over this very critical list so that the French and Swiss authorities can attack these—can inspect these organizations. Because right now if they don't inspect them, if they don't know about them, that looks very bad for the United States of America.

Mr. GARRETT. I appreciate it. Thank you.

Chairman KANJORSKI. The gentleman from New York, Mr. Ackerman.

Mr. ACKERMAN. Thank you very much. Congratulations on your good work. What was the key tip-off that made you think that Bernie Madoff was a fraud?

Mr. MARKOPOLOS. The key tip-off—and it took me about 5 minutes to figure out that he was a fraud. So it took extensive time and research. I basically read his strategy description. And I knew that wasn't the source of his returns. I knew right away by looking at his performance chart. I wish I had a white board and an easel here, but I don't, so I will give you a hand signal. I am going to show you what his performance return line looked like. It was a 45 degree angle without any variation. It only went in one direction, up. It never had variation like the market does, like this. And that was the key tip-off because there is no such performance line as Bernie Madoff's that has existed—

Mr. ACKERMAN. Let the record show the witness said this—

Let me ask you this, were you commissioned to do this? Did somebody hire you to do this investigation?

Mr. MARKOPOLOS. No. I did it on my own.

Mr. ACKERMAN. How were you compensated? How much time has this taken out of your week, your year?

Mr. MARKOPOLOS. There was no compensation. We did it for the flag, the flag of the United States of America. We saw him as a clear and present danger to the capital market system and to our Nation's reputation. We were from the industry. I actually was in a competing firm. And when you have a bad player on the field, a dirty player, you want him removed from the playing field. I tried to remove him from the playing field, but the referee wasn't listening.

Mr. ACKERMAN. So how much time—I am trying to figure out how much time the SEC should have or could have invested to figure this out. How much time did you and your group put in this?

Mr. MARKOPOLOS. We never kept track. We are not lawyers. We don't do the billable hours thing. But I can tell you, this stack of evidence, you see over 311 pages of documents and exhibits that we provided to the Congress. We were missing the e-mails from 1999 through the third quarter of 2005. But I assure you that if we had access to those e-mails, which we do not, then the stack of evidence would have been this high. So it is however many hundreds of hours it took to do that. I am not sure.

Mr. ACKERMAN. Several hundred hours.

Mr. MARKOPOLOS. Yes.

Mr. ACKERMAN. So in several hundred hours, the SEC could have investigated this and come up with what you have come up with?

Mr. MARKOPOLOS. It took me 5 minutes, but I did about 4 hours of modeling just to prove the math and come out with the math proof. So in total, it took me 4 hours of work.

Mr. ACKERMAN. This is just because of the straight-up graphic of his success that led you to suspect—that is not evidence or proof of anything. That could be, you know—that could be just good luck for a long time, one would suppose. But it is not evidence. Did you have any hard evidence that this was a corrupt scheme, besides that it smelled bad?

Mr. MARKOPOLOS. Oh, definitely. I think the hardest evidence that we had right at the beginning was just opening up the Wall Street Journal to the options section, in the C section, the money and investing section, and just looking at how many options contracts were in existence. And you can clearly tell that Mr. Madoff was several times the size of the entire marketplace for those index options. And so clearly he was a fraud. That took about 20 minutes though.

Mr. ACKERMAN. The few statements that I have seen of victims of Mr. Madoff indicate that at the end of the reporting period he swept everything out of the account and put them in Treasuries. Was that his modus operandi?

Mr. MARKOPOLOS. It was.

Mr. ACKERMAN. Is that because then he had no need to report to the SEC because he had nothing at the end of the reporting period except Treasuries and they don't do Treasuries? Is that how I understand the deal?

Mr. MARKOPOLOS. You hit the nail on the head, Congressman. There was another reason why you do that. We did obtain the year-end financial statements for 2004, 2005, and 2006 of Greenwich Sentry, which is also known as Fairfield Sentry. That was the largest Madoff feeder fund. It was about $7.5 billion toward the end that they lost with Mr. Madoff.

Mr. ACKERMAN. I have only seen a couple of these statements and came to that conclusion pretty quickly that something—but that is not hard evidence. But it is indicative to me if that was the case across-the-board with everybody with whom he dealt, should there not be a regulation in place that allows the SEC or whatever entity that going forward is going to be investigating to look into accounts of people who sweep things into securities and then think they don't have to report to the SEC? Would that be an appropriate thing for us to tackle as a committee?

Mr. MARKOPOLOS. It would. If you are not holding any financial instruments that are reportable at year-end marking periods or quarter-end marking periods, especially if you are in Treasury bills, which are book entry form only, there are no physical securities there, there was nothing for the auditors ever to inspect. And what Greenwich Sentry was doing, they used 3 different year-end auditors in 2004, 2005, and 2006. That made me very suspicious that there was auditor shopping going on because why would you have three different auditors in three different countries?

Mr. ACKERMAN. Understood. Might I impose on the Chair for one final question? Could Mr. Madoff have done this himself with thousands of clients?

Mr. MARKOPOLOS. No. He had a lot of help. He had a robust information technology department that made sure the financial statements he sent out to clients each month footed because a lot of these retirees, they check those things and they make sure they match to the penny. He also had people taking in money, wire transfers from new victims, and sending out money to the existing clients, the old victims if you will. So he had a lot of help.

Mr. ACKERMAN. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Ackerman. Mr. Royce from California.

Mr. ROYCE. Yes, thank you. You pointed out that pretty early by analyzing this 45-degree return on investment, the absurdity of consistency of it and the unfailing nature of it that it was clear to you. I was wondering if there were some other flags there to the SEC beside what you brought them in the single entity custodial arrangement that existed, the one-person accounting firm that might have been a red flag, the lack of electronic account access, certainly the firm secrecy. I saw a piece in Investors Business Daily which early on, you know, that raised this issue that has been passed around. So there was some reporting in the financial press, too, that the SEC didn't pick up, the critical managerial compliance positions held by Madoff and people in his family who were in that position. Any number of these probably could have triggered an investigation.

What is your reflection on the totality of all of this on top of your analysis that you provided some 9 years ago to the SEC and maybe your thoughts on why this wasn't undertaken in a more deliberative manner by the SEC in terms of the investigation?

Mr. MARKOPOLOS. I think the overarching answer to your question is, they don't have financial professionals on the staff and they certainly don't have financial professionals on the staff who understand complex derivative instruments of the 21st Century. If you send out a team of lawyers to look at derivative transactions, you are not going to be able to find them. You need to have an experienced finance team in there that is highly compensated, highly trained, highly incentivized to find fraud. There are no incentives at the SEC to find fraud. That is why they shy away from the big cases.

Mr. ROYCE. As you speak of the overlawyering at the SEC and you reflect back on the years of dealing with the various officials at the Securities and Exchange Commission, do you believe that the reason for the inaction was a lack of understanding of the models that you presented to them? Or was it just a lack of desire to pursue this case? As you think about the personalities involved, how would you analyze that?

Mr. MARKOPOLOS. I think it was a mix of the two that you just described. I think they didn't understand the red flags, the 29 red flags that I handed them. They had no idea how to do the math. They were totally incapable of doing that math. They have no one on their staff probably systemwide who could do that math. And the other part was, they are a captive regulator. Mr. Madoff was

certainly one of the most powerful individuals on Wall Street. He had a respected broker-dealer arm. He traded a substantial percentage of over-the-counter and New York Stock Exchange listed stock volume every day. And they just looked at his size and said, he is a big firm and we don't attack big firms.

Mr. ROYCE. As we look at your original analysis as to what really struck you in terms of the magnitude of the fraud involved in this case, and looking at the macro level at the SEC, from your experiences over this last 9 years, what do you think needs to be changed to go after the systemic risk problem here, to make certain that in the future, if there are entities or frauds as deep as these, that the SEC would be at least guaranteed to look at them? What specific changes would you give us or policy prescriptions right now? And I imagine that within the SEC there would be people pushing for these types of changes for some time. Let's discuss what those would be.

Mr. MARKOPOLOS. I would attack it from three different areas. First, I would replace the senior staff at the SEC because they have the wrong senior staff right now. And then, I would go to the bottom of the organization. You need to change who the people on those teams are; they can't be young 20-somethings without industry experience. You need to get higher, senior, seasoned professionals. And the third thing you need to do, you need an Office of the Whistleblower to centralize these thousands of complaints that they get so they are not handled ad hoc by 11 regional offices. You need one centralized location, the Office of the Whistleblower. And you also need to compensate those whistleblowers for the risks that they are taking because once you turn a case in, you are blacklisted from industry and you had better make it worth their while. If you do those three things, I think we can solve this problem.

Mr. ROYCE. I hope we can revisit. After this case is closed on Madoff, I hope we can revisit here and look at the recommendations you have given, and at that point a lot more will have surfaced as this case goes forward. I thank you again for your efforts on behalf of so many investors and on behalf of honesty and transparency in the system. Thank you.

Chairman KANJORSKI. Thank you, Mr. Royce. The gentleman from Massachusetts, Mr. Capuano.

Mr. CAPUANO. Thank you, Mr. Chairman. Mr. Markopolos, first of all, thank you for being a good citizen. It is not often that we get too many people at that table whom I would consider necessarily good citizens. Second of all, more importantly, before my time runs out, I only have 5 minutes here. If you were offered a job at the SEC in charge of this whistleblower bureau, would you take it?

Mr. MARKOPOLOS. No. I have pressing family obligations at home that would prevent me from taking any SEC job for 2 years.

Mr. CAPUANO. So in 2 years, if you were offered the job, would you take it? We will talk.

Mr. Markopolos, my concern is a couple of things. The Madoff situation is one thing and it is one item. But I am just curious, I know how I feel. I want your opinion. Do you think that the problems you have encountered with this particular case are isolated in

this case or are they endemic throughout all of the regulatory structure, particularly the SEC but not just the SEC?

Mr. MARKOPOLOS. The SEC is overmatched. They are too slow. They are too young. They are too undereducated.

Mr. CAPUANO. So it is not just this case?

Mr. MARKOPOLOS. No. It is with all the regulators in the financial system. The Fed did an even worse job of regulating the banks than the SEC did of regulating the capital markets.

Mr. CAPUANO. I agree with you. And I like your concept about an overlawyered type of regulator with some substance below it. But I just want to make sure, are you just talking about fraud regulators? Because there are also regulators or an aspect of regulation that does not just deal with fraud, also deals with regular, ordinary, everyday capitalization requirements, etc., etc. We are all thinking about doing something about systemic risk as well in addition to fraud. And I would argue that some of those things may require us to have a little bit more complicated regulatory scheme. Is that something you have considered or not?

Mr. MARKOPOLOS. I wouldn't say more complicated. I would say more simplified, more streamlined because remember, American business wants as few regulators as possible. They are paying for the regulation. They want a value-added proposition. For every dollar they spend toward regulation, they want to receive that value back because right now without proper regulation, there is no trust in our capital markets, which raises the cost of capital or makes it unavailable to American businesses.

Mr. CAPUANO. That is the other thing we want to talk about. The one thing, for years I have never thought that "regulation" is a swear word. I don't think you would feel that way either. However, this country over the last 20 years has considered the word "regulation" as some sort of swear word.

I particularly want to talk about this case. My understanding is that most of this money was not lost by mom and pops. Most of this money comes from relatively sophisticated investors. Is that accurate?

Mr. MARKOPOLOS. It is. They were high net worth individuals who received no protection from the SEC. They are considered sophisticated investors, and I would argue that they deserve protection as well.

Mr. CAPUANO. I would agree with you. Thus far all I have heard from the SEC and others is that sophisticated investors somehow don't need anything. It doesn't cause—it doesn't run a systemic risk. And if some multi-billionaire wants to lose a billion dollars, why should we worry about it? I think this particular case, even what this case indicates beyond it, would argue just the opposite. I am hoping that is something you would agree with.

Mr. MARKOPOLOS. Because of the people who were involved and their wealth, a lot of charities were wiped out. Medical services are not being provided today to people in the communities, community services, scholarships, people have no retirement income left. They are wiped out. So I would—I think those wealthy people deserve protection as well.

Mr. CAPUANO. I agree with you. Again, and I just want to make sure that this is not—I have had my problems with the SEC in the

last couple of years because I think they have been asleep at the switch. Again, not just at the Madoff case. I didn't see this, but I think the entire problem we have right now is probably—you can't pick one item. But if you had to pick one item I think the lack of regulation is it. And I just want to hear from you, too. It is my understanding that if we had had aggressive or at least adequate regulation across the board, that first of all the Madoff situation might have been if not avoided—you always have criminals—at least minimized and maybe we wouldn't be in some of the economic problems we are having today. Would you find that statement agreeable or not?

Mr. MARKOPOLOS. To police up the capital markets, you have to increase the risk of detection of the frauds. Right now it is such a high reward, low risk equation to commit fraud, the markets feel a green light to do anything they want because they have gotten away with it for so long. And until you restore trust, the American investor isn't coming back into our markets and, worse, foreign investors won't either.

Mr. CAPUANO. Do you think that absent the structure of it and absent the adequacy of the individuals or the pay of the individuals, the laws relative to what is legal and what is not legal, if they were fairly interpreted do you think the laws we have now are currently adequate or are they totally inadequate? I am not talking about fine-tuning. I am talking about major adequacy.

Mr. MARKOPOLOS. You need a lot more laws because you are always going to be outdated as soon as you pass a new set of laws because of new financial instruments created to avoid whatever existing regulatory scheme there is. So you are always going to be behind the 8-ball. So you really have to look at the securities laws as the absolute bare minimum standard that you follow. And then you have to have regulators that enforce a much higher standard, which is good ethics, full transparency, fair dealing for all, and full disclosure. And if you do that, if you set ethics as a higher standard than the law, which it always is, then I think—and you have a regulator that is willing to attack bad ethics, you will get somewhere.

Mr. CAPUANO. Thank you, Mr. Markopolos. And think about that job, will you?

Chairman KANJORSKI. Thank you very much, Mr. Capuano. The gentleman from Alabama.

Mr. BACHUS. Thank you. Mr. Markopolos, thank you. Reading your testimony and having talked to you last month and to the staff, you called the SEC, you wrote the SEC, you pleaded with them, you badgered them. There are four pages of contacts with them; I mean, probably over 100 attempts on your behalf to lay out a case. You had extended telephone conversations, extended meetings with them, and you laid out chapter and verse, you know, handed them a case on a silver platter.

Was it incompetence? I am amazed that they could have ignored what you gave them. Was it incompetence? Was it a conflict of interest? Was it just a lack of willingness to take on Madoff?

Mr. MARKOPOLOS. I think it was a combination of incompetence and an unwillingness to take on a major player like Mr. Madoff. They fear the big cases.

Mr. BACHUS. The chairman has talked about more funding, more investigators. But you know that doesn't seem to be the case here. I mean it seems like they are not using the resources they have. Do you get any ideas on that? And there were all kinds of regulations. You laid out regulations, laws, there were all sorts of violations.

Mr. MARKOPOLOS. There were turf battles. You had regional rivalries between New York and Boston. And by the way, neither New York nor Boston likes Washington very much.

Mr. BACHUS. So dumping more money on it doesn't solve those problems, does it?

Mr. MARKOPOLOS. It doesn't solve the problems. They do need some more funding though. They need a lot more funding in certain areas. They need to increase the compensation levels so they can attract industry-experienced veterans on the team level because—

Mr. BACHUS. They have already been authorized to do that, I believe.

Mr. MARKOPOLOS. They need to have incentive compensation. Just like Wall Street, it is base salary plus incentive for what you bring in. So you are incentivized to bring—

Mr. BACHUS. In other words, if you catch people, if your job is to catch people, you catch them—

Mr. MARKOPOLOS. Yes.

Mr. BACHUS. —you are rewarded. If you don't, you are not?

Mr. MARKOPOLOS. Right. And what I like about that is, if someone tries to stop you from bringing a big case and you are incentivized to bring a big case, you will run over them with a bulldozer if you have to to get that big case in the door. And right now there is no incentive, no reward, for bringing those big cases in the door.

Mr. BACHUS. So it is not just throwing more money at it, it is doing it the right, smart way; and incentives are the way to do that.

How do you address those turf fights? How do you address sort of the sacred cows out there that they just sort won't take on?

Mr. MARKOPOLOS. I think that if you are in Boston and referring a case to New York, you get incentive credit for that as part of the bonus scheme for turning in a case to another region. You need to increase cooperation that way.

Mr. BACHUS. Thank you.

What would you ask us to do? What could we do differently?

Mr. MARKOPOLOS. As a Congress?

Mr. BACHUS. Yes.

And I will tell you this: You have heard the so-called "pay to play" in municipal bonds?

Mr. MARKOPOLOS. Yes.

Mr. BACHUS. Well, actually, 10 years ago we laid out a case to the SEC on what was going on. Again, 2 years ago, we laid out a case exactly what was going on in Jefferson County. They did nothing for a year. Finally, someone, a whistleblower, someone came, followed on something else and was caught. So, I mean your experience, you know, is very similar experience to one some of us on the Hill have had.

Mr. MARKOPOLOS. Congressman, I know what happened in Birmingham, Alabama, and it happened in my hometown of Erie, Pennsylvania, the same thing with municipal securities fraud.

It happened in Massachusetts as well. The Massachusetts Turnpike Authority lost $450 million on some over-the-counter swaptions that they never understood, that they were deceived into entering into a transaction with several Wall Street investment banks. And the SEC has been nowhere to be found regulating there, enforcing action for the crimes that occurred. As a result, Massachusetts plans on doubling our tolls. We are going to pay for that out of our own pockets.

Mr. BACHUS. Right. And that happened under the Clinton Administration, it happened under the Bush Administration. My letter was actually to the Clinton Administration.

But I would like, with permission of the committee, with unanimous consent, to introduce my letter to the SEC detailing a similar experience.

Now, the difference is, I was relying on other people. I actually had trusted them or relied on them to look at the information and tell me whether it was true or false. And they told me there wasn't anything to it, basically.

Mr. MARKOPOLOS. I think what you will see is that the SEC is busy protecting the big financial predators from investors. And that is their modus operandi right now.

Mr. BACHUS. I appreciate that. And I want to again just tell you how truly grateful we are to you. Unfortunately, if your warnings had been taken and if the warnings of other people had been taken 10 and 12 years ago, there would be literally millions of Americans who wouldn't be suffering today from losing their entire retirement.

So, thank you.

Chairman KANJORSKI. Thank you very much. And without objection, the letter of the gentleman from Alabama will be entered into the record.

The Chair hearing none, it is so ordered.

Mr. Sherman of California for 5 minutes.

Mr. SHERMAN. Thank you.

I build on the comments of Mr. Capuano. We need you in government service. And maybe that whistleblower office needs to be established in Boston for the next 2 years. I look forward to working with my colleagues to make the changes necessary in law so that we don't have a circumstance where today Madoff is on the streets and his accountant has not even been arrested or indicted.

You point out how you were able to use your professional skills in roughly 4 hours, if not 4 minutes, to convince yourself that there was probably fraud going on here. I am a CPA by training, and I would think it would take someone who is a CPA about the same amount of time—maybe even a little less. Because as I understand it, the financial statements filed by Madoff showed numbers as high as like $10- to $17 billion; is that right?

Mr. MARKOPOLOS. Yes. Let me explain.

I think there are going to be two numbers that the press will start reporting—$50 billion is what Madoff himself reported. And that was the notional amount of loss from all the investor statements combined of what they thought they had earned over many

decades of investment returns with Mr. Madoff. And it is a different number—probably a truer number is much lower—and that number is probably between $15- and $25 billion, which was actually cash received by Mr. Madoff.

Mr. SHERMAN. I am focusing on a different number. And that is, if you just looked at the financial statements filed by Mr. Madoff, they would show numbers well over $10 billion. And then they would be attested to by the Friehling accounting firm, which had one active CPA. So the first thing anybody looking at those financial statements would have done is say, well, this is a pretty big operation, $10-, $20-, $17 billion and the accounting firm isn't registered with the PCAOB. And what accounting firm is this? Oh, they have only one CPA.

Now, it is physically impossible for one CPA to audit a $17 billion firm. But even if it was possible, you are supposed to be an independent auditor. Independence includes not getting more than, say, about a fifth of your revenue from any one client. So unless you think that one CPA can audit a $17 billion operation and be done in a couple of months, you have a fraudulent financial statement in your hand. Not to mention your professional expertise focused on the fact that you cannot earn those kinds of continuously positive, even returns.

I think either of our two professions could have spotted this rather quickly. Did you have a chance to bring your accusations to FINRA or the NASD?

Mr. MARKOPOLOS. I would have never taken them to the NASD or FINRA. I had a lot of bad experiences as an over-the-counter trader in the late 1980's with the NASD. What I found them to be was a very corrupt, self-regulatory organization, that if you took a fraud to them, they would ignore it as soon as they received it. They were there to assist industry by avoiding stricter regulation from the SEC.

Mr. SHERMAN. Sir, you are using some strong terms. And from anybody else, you know, we would say, oh, that is the wild-eyed populist. But you have basically said that our two main securities regulatory agencies see their role as protecting the major institutions on Wall Street rather than protecting investors.

You have talked about some circumstances where the whistleblower is compensated. Have you suggested some private right of action? In a number of other statutes we have what we call private attorneys general, where the whistleblower doesn't just blow the whistle and hope that somebody takes action, but rather is able to bring an enforcement or civil case themselves, and if they win, do quite well.

What would you think of a proposal like that?

Mr. MARKOPOLOS. I would be wholly in favor of it. As you know, the False Claims Act already gives the right of private action on behalf of the government. The SEC has section 21A(e), of the 1934 Act, which does provide for a whistleblower bounty, but it is only for insider trading theory cases. I would like to see that expanded to include all financial fraud cases so that you incentivize the foxes out there in the field to come forward and bring cases against their firm with specific and credible allegations with inside books and

records, transaction reports, with smoking gun e-mails, and basically give the government a case on a silver platter like I did.

And if the government refuses it, give them a right of private action to take it forward.

Mr. SHERMAN. And finally, I don't think there is another $50 billion Madoff out there, but in your estimation, are there some mini-Madoffs and medium-sized Madoffs; could somebody do what he did and not be as powerful as he was?

Mr. MARKOPOLOS. There is. I plan on turning in at least a $1 billion, if not bigger, mini-Madoff to the SEC's Inspector General tomorrow. I hope this time they will actually listen to me.

Mr. SHERMAN. Oh, I think they will.

Chairman KANJORSKI. Thank you very much, Mr. Sherman.

The gentleman from Delaware, Mr. Castle.

Mr. CASTLE. Thank you, Mr. Chairman.

I also thank you, Mr. Markopolos, for your testimony here today, and I have a couple of questions. One I wasn't going to ask, but something you answered before calls me to.

Do you put FINRA and the NASD in the same camp of being ineffective because they are basically part of the entity that Madoff and others have come from? Or do you separate the two of them?

Mr. MARKOPOLOS. I would separate them. I would say that the FINRA is even less competent than the SEC. And I never thought that the SEC was corrupt. In fact, I am living proof here today that they are not. But FINRA definitely is in bed with industry.

Mr. CASTLE. And the NASD you sort of condemned in your previous answer. I assume that hasn't changed.

Mr. MARKOPOLOS. They are more like RICO.

Mr. CASTLE. Okay.

I may have this wrong, but I believe that the rules, as far as officials at the SEC, are that senior officials there can go to work for a firm, but for 1 year, they can't deal with the SEC, at least in the area in which they have previously worked.

Would we be wise to pass legislation expanding the limits on SEC employment transferring over to the firms which they have regulated—just a surmise—3 years or something of that nature?

And following up on your concept of trying to get people at adequate compensation with senior experience, my concern is, we have a lot of people at the SEC who are thinking, gee, at some point I am going to be going to work for these firms. I need to be a little bit careful about what I am doing.

If we had a greater prohibition about their ability to do that, perhaps we would limit that happening. I would just be interested in your thoughts about that.

Mr. MARKOPOLOS. That is why I would like to see incentive compensation for when you bring a big case you get a big bonus. Because that way they can make their bones, punch their ticket, and go to industry. If you prevent them from going to industry, you will never get them in the first place. That is why I like—

Mr. CASTLE. I was thinking in terms of those who have been in industry, as you indicated, with the gray hair—no hair, whatever it may be—coming to work for the SEC in their 50's perhaps or whatever with the experience. I mean, they may not be going back to Wall Street, is my point.

Mr. MARKOPOLOS. Yes, I would like to see a lot of gray hair in those senior positions tackle the big cases, because they have already made all the money on Wall Street that they will ever need. They are not going to be able to spend what they have already made.

But you want them on your team, and you want them as your best public servants; you want them leading the charge.

Mr. CASTLE. Mr. Capuano, who is here, and I introduced legislation called the Hedge Fund Adviser Registration Act to require all the hedge fund managers to register with the SEC, all of them, which I believe may be a good start in overseeing that particular industry.

Do you have other ideas about either registration or other things to make all this more transparent? Even though you made it very transparent to the SEC and they didn't respond, are there ways systemically that we can make all of this more transparent to the SEC, so there are no excuses as far as future activities are concerned?

Mr. MARKOPOLOS. Yes. One thing that Congress definitely needs to pass legislation regarding is the regulation of over-the-counter derivatives, because where there is no light and only darkness, that is where the financial criminals will tend to congregate. You see that in the over-the-counter markets. And that goes to Congressman Bachus's remarks about lack of regulation in the municipal securities area. You can't leave those dark corners.

Mr. CASTLE. The accounting firm that has been brought up here—and I don't know much about this, but I remember reading about it at the time—and that is, this accounting firm was apparently not of national note, was apparently doing just about this, and seemed to have disappeared when all the trouble began.

Is there something we should be doing with respect to accounting firms for large hedge funds and large security brokers?

Mr. MARKOPOLOS. I would like to think that there is, but when I looked at the Greenwich Sentry financial statements, they had a Big Four accounting firm, PricewaterhouseCoopers in the Netherlands, and PricewaterhouseCoopers in Toronto, Canada, as their auditor, and they didn't spot it either. All they saw were Treasury bills with those year-end financial statements, which are in book entry form. There were no securities positions in the inventory for the auditors to actually inspect. And as we all know, Mr. Madoff self-custodied.

So one thing you could do is make sure there are independent custodians, and I think that would go a long way toward solving this problem.

Mr. CASTLE. Thank you very much. And thanks for all your work in the area.

I yield back, Mr. Chairman. I yield back, sir.

Chairman KANJORSKI. Thank you very much.

We now have Mr. Hinojosa from Texas.

Mr. HINOJOSA. Thank you, Mr. Chairman.

Mr. Markopolos, I am very impressed with the evidence and the presentation that you have brought before our committee. And I want to say that here in Congress—and you probably know this—we have divided jurisdiction over our markets.

Considering all that has transpired, would you support transferring the jurisdiction over derivatives to this full Committee on Financial Services as one centralized location? And I might add to that question that I have no problem with leaving the commodities for the Agriculture Committee.

Mr. MARKOPOLOS. I would actually be against leaving the commodities and futures for the Agriculture Committee. I think all financial instruments—and even commodities are financial instruments—need to be under one central regulator and that the CFTC's function should be folded into the SEC.

American taxpayers deserve to have the lowest cost for the regulation, and they deserve not to have regulatory gaps between enforcement agencies.

Mr. HINOJOSA. Okay.

What changes, if any, would you recommend to FINRA, the Financial Industry Regulatory Authority, based upon your research into the Madoff Ponzi scheme?

Mr. MARKOPOLOS. I don't have any recommendations for FINRA. I never really considered them in my written testimony to you. I was just asked to diagram what the SEC needed.

I think what they could do is read my report and take the best ideas from there that would apply to FINRA and implement them.

Mr. HINOJOSA. I am very concerned, as you are, and my colleagues here, on the money lost by the investors. Is there any way to ensure that they will be made whole?

Mr. MARKOPOLOS. That is not my decision to make.

Mr. HINOJOSA. Mr. Chairman, I yield back.

Chairman KANJORSKI. Thank you very much.

The gentlelady from West Virginia, Mrs. Capito.

Mrs. CAPITO. Thank you, Mr. Chairman.

Thank you, Mr. Markopolos, for your contribution and your insight in today's hearing. I noticed over the course of 10 years you have conducted this investigation and reported, and with much frustration as well.

I am wondering—and obviously a lot of the folks who invested with Mr. Madoff were sophisticated fund managers and sophisticated investors, and certainly they—or let me ask you this:

Did you make your hue and cry—did you make them aware, the fund managers and other folks who were investing with Madoff, of your suspicions; and what was their reaction to you at the time? You know—and did you become sort of an I-don't-know-what on Wall Street where you were questioned, or did people look into this more deeply with you?

Mr. MARKOPOLOS. If you look at who the victims were not, that you would have expected to see but did not see as victims in New York, and certainly in Boston's financial district, I was warning the firms where I had close relationships, where the people were competent and understood financial mathematics and derivative securities; and those people all stayed away.

They were big investment banks here in the United States. They were big consulting firms. They were big private client offices. They were big funds of funds. And they all avoided Mr. Madoff because they knew me, and I warned them.

And there were people at the feeder funds that I—

Mrs. CAPITO. Could you explain to me what the theater funds, what that entails?

Mr. MARKOPOLOS. A feeder fund—

Mrs. CAPITO. Oh, feeder fund. I thought you were saying "theater fund."

Mr. MARKOPOLOS. A feeder fund.

Mrs. CAPITO. I understand a feeder fund. Thank you.

You know, in our notes it has that—and I might be pronouncing this incorrectly—Acacia LLC put out a statement the day that Mr. Madoff was arrested that they would no longer recommend the Madoff feeder funds. So obviously, this net had been cast pretty wide. People were becoming very suspicious.

What was the precipitating event to cause them to—was it people calling in their money and not finding satisfaction? Evasion by Mr. Madoff? What, in your book, happened that caused them to change their minds and others' right at the time that it became public—right before?

Mr. MARKOPOLOS. When this became public, anybody who had anything to do with Mr. Madoff went into hiding. You could ask people who were at the feeder fund staffs what their dealings with Mr. Madoff were, and they would run for the hills. No one wants to answer to the victims from the feeder funds.

I think they feel they will be answering in court very soon.

Mrs. CAPITO. All right. Well, I want to thank you too for your very in-depth analysis of the SEC and the regulatory environment.

I think—in my view, I think some of the problem is the complex instruments that develop so quickly over time and the lack of the ability of the regulatory agencies to move with flexibility and speed to be able to follow and track the instruments that they are tasked with overseeing. Would you agree with that statement?

Mr. MARKOPOLOS. Most definitely. I don't think the SEC had anyone who understood a split strike conversion except Mr. Manion in the Boston SEC regional office. I don't know how many people they have with 25 years of industry experience; I would say rather few.

Mrs. CAPITO. All right. Thank you.

I yield back.

Chairman KANJORSKI. Thank you very much.

The next member is Ms. McCarthy of New York.

Mrs. MCCARTHY. Thank you, Mr. Chairman.

And thank you, Mr. Markopolos. One of the things I want to touch on is the Ponzi schemes. When we had a hearing a couple of weeks ago, I asked the witnesses, you know, how many more of these schemes possibly could be out there? And obviously, we did have one on Long Island, where I come from.

Is there anything that we can do to go forward on basically trying to prevent these things? I know we can educate the public, but unfortunately the old adage, "If it sounds too good, it is probably not good," we keep saying that, but unfortunately people keep going through it.

And the other thing that I would like to ask you, because a lot of the questions that I was thinking of asking you have already been asked and answered:

One of the problems we are obviously going to be facing for probably a very long future is the confidence of the American public, whether it is in banking, whether it is in the financial institutions, obviously even in government, mainly because everything has failed. So, with that, if you have any ideas on how we build that trust up? I know you have offered some suggestions.

But one other thing, too:

With the SEC not responding to you—and you had mentioned the attorney general of New York, and then Massachusetts, obviously bringing charges forward, did the New York attorney general, did you think about going to them, or even the FBI, being that it was, you know, a criminal offense?

Mr. MARKOPOLOS. Yes. I didn't think I could go to the FBI after being rejected multiple times by the SEC, because with the FBI, I would have to make full disclosure. And if I told them I gave this to the SEC multiple times and the SEC did nothing to investigate, then I would have zero credibility with the FBI. They would automatically assume, and be wrong, but they would assume that the SEC was competent, when it was not.

As far as the New York attorney general, I actually did make an attempt to contact him. Mr. Eliot Spitzer was at the JFK Library a number of years ago. I went there with a package, with my submission to the SEC. I knew through the grapevine that he was a big hedge fund investor through his family trusts. And I figured the odds were high that he was a Madoff investor, which turned out to be the case. And to the staff of the JFK Library, I handed a packet. I made copies such that my fingerprints were never on that package. I handled it only with gloves, because I thought that he was an investor, and it turned out to be. I think the New York Times reported that he was.

So I did go there. And I don't know that he saw the envelope. I never saw him receive it. So I don't know what happened.

Mrs. MCCARTHY. When you were working with the SEC—and you had mentioned earlier in your testimony that only a few knew your name, obviously because you didn't want your name out there—do you think that might have hurt, with the SEC not responding to you?

Mr. MARKOPOLOS. No. Boston knew who I was. You know, I was the past president of the 5,000-member Boston Security Analysts Society. They knew my qualifications in derivatives. I managed billions of these as a chief investment officer at a very well-regarded firm in Boston.

So that definitely wasn't it. Boston vouched for me every step of the way.

Mrs. MCCARTHY. Well, with that being said, couldn't they have taken your case and pushed it a little bit more, even if they didn't have a good relationship with the New York or the Washington offices?

Mr. MARKOPOLOS. Not really. In fact, I made an offer to the SEC in my October 2001 submission. If you read it closely, you will see I offered to go undercover for the SEC under their command and control and have no one know where I was except my wife. And I would have no contact with my family during this time; I would have assumed a disguise, as I was trained to in the Army, and

gone undercover and led that team to a successful result very quickly.

I don't know what more I could do to put it on the line and bring this man to justice than I attempted to do in my October 2001 submission.

Mrs. MCCARTHY. I think what makes me nervous is obviously you never gave up on this, and there are probably many other people out there that are watching this testimony and saying, well, I know something, but what is the sense of me going forward if no one is going to pay any attention to me? Especially when you tried so many different avenues.

I thank you for your service. I am sorry that the government failed you and everybody else failed you.

With that, I yield back the balance of my time.

Chairman KANJORSKI. The gentleman from Texas, Mr. Neugebauer.

Mrs. Biggert. Not the gentleman from Texas, but the gentlelady from Illinois.

Mrs. BIGGERT. Thank you. Thank you, Mr. Chairman.

Thank you, Mr. Markopolos. Everybody seems to be pronouncing it differently, but I am not sure of the correct pronunciation. And thank you for all that you have accomplished. It is almost like reading a good book, I think all that you have gone through. I hope at some time this is all put down in your words, because it is fascinating.

You know, what we need now is for you to help us to restore confidence in the capital markets industry and the financial institutions and the economy. I mean, this is such a story that I think it has taken its toll on everyone. And I think what we are seeking really are what measures should Congress take to reform the regulations or the laws related to the case. What loopholes are left open that somebody is going to discover, and how can we close those to prevent something like this happening again?

But on the other hand, this market has always been innovative, creative; and we have brought—there have been a lot of ways that people use to make money legally and to advance different systems. So that—how could we maneuver through that without really stifling the creativity and innovation? And should we be looking at the regulations and the laws on the books and trying to decide whether they are adequate enough to address this issue, or is this more a failure, really, of enforcement?

Go ahead.

Mr. MARKOPOLOS. It is both, Congresswoman. It is, we need a few more regulations; we can leave no more dark spots unregulated and unguarded for financial predators to congregate in. There needs to be sunshine everywhere in our capital markets. Everybody deserves full transparency and a square deal when they are dealing with investments, to restore trust.

And the second part is, we need better people in the enforcement agencies. They really need to replace a lot of their staffs, especially at the senior levels.

Mrs. BIGGERT. Being a lawyer, I can understand that you need somebody who really is in the industry. And yet, this is difficult,

isn't it, as you said? And that concerns me. You talked about being a whistleblower; then you are blacklisted by the industry.

What is your position now?

Mr. MARKOPOLOS. I actually work full-time on fraud investigations, mainly involving cases where there is fraud against the government—Medicaid, Medicare, Department of Defense fraud, and IRS tax fraud.

Mrs. BIGGERT. That is great. Is this as an independent or with a regulator?

Mr. MARKOPOLOS. I am independent. I do work with attorneys, most of whom are former assistant U.S. Attorneys, Federal prosecutors who prosecute high-level white collar cases. Those are the people with whom I tend to work with most closely.

Mrs. BIGGERT. Thank you. I am sure that as this moves along we will be in touch with you for more specifics; and I think that you have given some of those in your testimony and to the members about what we should be doing.

But I think this is a very great hearing for us to have, you know, from somebody that has really delved into this so much. And I thank you.

With that, I yield back.

Chairman KANJORSKI. Thank you very much, Mrs. Biggert.

The gentleman from Massachusetts, Mr. Lynch.

Mr. LYNCH. Thank you, Mr. Chairman. I want to thank the ranking member as well.

Harry, thank you very much for coming forward and for your great work on that. And above all, for your persistence, having been rejected so many times. I am sure it must have been frustrating.

I also want to thank you for the power of your example. I know in my office we have received contacts from a number of former SEC employees and current SEC employees to raise a number of concerns similar in respect to what you have said here this morning.

I think, first of all, the former SEC Chairman Harvey Pitt had written an article, an editorial, I believe, entitled, "Overlawyered at the SEC." So I am not giving up his confidence in saying that he early on pointed to the same deficiency, and not having enough economists and accountants in play to be able just to analyze a lot of the data that was coming in and recognizing the problems. So that is a structural need.

Another structural need that you mentioned in passing with respect to the gentleman from Delaware's questions, a number of people that I have questioned at the SEC about the inability to discover this early on, they said that the way that Mr. Madoff had this structured was somewhat unusual in that he was executing the trade, but that he was also his own custodian bank. He didn't use State Street or another third-party custodial bank, as many of the legitimate firms do.

Do you see a need there? Is there a way that we can put a trip wire in if we separate that custodial responsibility versus the trading responsibility? Would that allow us to at least compare, or to have the SEC go in there and compare the books of both entities?

Mr. MARKOPOLOS. Yes. You need separate custodians. They can't be—one and the same organization was one of the big ways that he hid this fraud for so long.

But the SEC had enough. Even with Mr. Madoff being self-custody, all they had to do was go into his operation, take the road map I gave them, take those 29 red flags, and say, let me talk to your derivatives trading staff; and they would not have found one single derivatives trader there. Because the key mark of a Ponzi scheme is, there is no underlying product or service. It is all a fraud. There is nothing underneath it. The emperor wears no clothes.

The other thing they could have done was go to the Chicago Board Options Exchange, where these OEX Standard & Poor's 100 index options actually traded, and talk to the people trading them: "Have you ever received an order from Mr. Madoff?" And they would have told you he was a fraud.

Mr. LYNCH. All right. But you still think the separate custodial bank idea is a good idea?

Mr. MARKOPOLOS. It is a must-have. You really need to do this.

Mr. LYNCH. All right. That is what I wanted to get out of you.

The other thing that I keep hearing from some current SEC—and former—is that, well, there is a whistle—let me rephrase that. There is a hotline. I was told that senior SEC management had actually gone to an industry—a financial services industry conference and basically said to the firms out there, if you feel that you are being too aggressively investigated, then I want you to call this office. And that was a senior person, two senior people at the SEC. I know that these employees took that message as meaning, you know, we have to back off a little bit, in that the senior management at the SEC was actually captured by the industry and that it wasn't doing the intense investigating that we would expect from them.

Have you run into that sort of dynamic with the people of the SEC that you have been dealing with?

Mr. MARKOPOLOS. Yes, I did. In fact, I brought with me the Association of Certified Fraud Examiners 2008 Report to the Nation, and it lists in here that the best way to find fraud; 54 percent of the frauds get discovered by tips, whistleblower tips; only 4 percent by external auditors which—the SEC is an external auditor. Therefore, whistleblower tips are 13 times more effective than external auditing. So why wouldn't we want the SEC to be 13 times more effective? Lord knows, this Agency needs to be more effective.

Mr. LYNCH. Right. It just struck me, there was a hotline to stop an investigation or to slow it down at the SEC, but there wasn't one to speed it up or initiate it. It just seemed counterintuitive to me, given the mission of the Agency itself.

Again, I want to—my time is short, and I have run out, actually. I want to thank you again for your willingness to come here and help this committee with its work. Thank you.

I yield back.

Mr. MARKOPOLOS. Thank you.

Chairman KANJORSKI. Thank you very much.

Now the gentleman from Illinois, Mr. Manzullo.

Mr. MANZULLO. Thank you, Mr. Chairman.

Mr. Markopolos, could you draw any parallels between what happened in Madoff's case and those with the hedge fund operator, Arthur Nadel? And also whether or not you are familiar with any rules of distribution as to—in the event that money is recovered, whether or not those investors who had received distributions would be preferred over those—those investors who had not received distributions would be preferred over those who had received distributions, i.e., a clawback?

Mr. MARKOPOLOS. It is a God awful mess with the clawback. I know only what I have read. I am not a lawyer to make legal interpretations, so I prefer not to.

Mr. MANZULLO. The first part: the parallels between Nadel and Madoff?

Mr. MARKOPOLOS. There are parallels with every Ponzi scheme. And the SEC, you would have thought, would know these, but apparently they do not. They do not have the experienced staff at the junior levels, and they are even worse off at the senior levels. One of the things about a Ponzi scheme is, it is a cash-eating monster. It has a voracious appetite for cash. You need new cash to pay off the existing old investors. So that is always—that is there for every Ponzi scheme.

The other thing is, the numbers are always too good to be true. And the SEC has so little investment management experience that they don't know what the industry standards for good performance are and what the industry standards for unbelievable fraudulent performance are?

And there were other red flags. But those are the two main ones for the Ponzi scheme.

But they are so easy to recognize on the surface. If someone is advertising returns that are too good to be true and too smooth, you don't have enough down months, it is always up, up, up and away, how can you not see these if you are the SEC? And those are the questions you are probably going to be asking the next panel.

Mr. MANZULLO. Are you familiar with the hedge fund registration law that is being proposed by Mr. Castle and Mr. Capuano, and if that had been in effect, whether or not that could have saved investors at Nadel?

Mr. MARKOPOLOS. Registration always helps. But if the SEC doesn't send trained teams in to do the inspections and examinations, it is not going to really lead to a better result. Because the SEC already has jurisdiction over Ponzi schemes. If there is fraud out there, it doesn't matter if you are registered or unregistered, the SEC has the authority to attack it. They just don't have the ability or the willingness.

Mr. MANZULLO. In the Nadel case, he was disbarred as an attorney from the New York Bar. And there is some thought that if the investor into his hedge funds had had some knowledge of that, that obviously that could have been a deterrent.

In the registration that takes place presently, would that type of character flaw or legal issue come up in the registration that a person had been disbarred?

Mr. MARKOPOLOS. Oh, certainly in the SEC Form ADV, if you are a registered investment adviser, you would make disclosure

there. But I don't know how you are going to get these people to register if they are running a hidden Ponzi scheme. I don't know that investors know enough to go to the SEC's Web site and check for the ADV registration forms.

So I think these people aren't going to go on the map. I think they are going to remain hidden below the surface or underneath the rocks. So I don't know that registration is the be-all and end-all.

You certainly want them to register; and if they are not registered and the SEC receives a tip on them, well, that is a glaring red flag that fraud is taking place here. So it is an immediate red flag to the SEC that there is something here, they are not registered, we are getting a complaint about someone who is not registered. And they can go in expecting to find fraud, and chances are, they will find it. So I just think it is a great idea to make them register.

Mr. MANZULLO. I have a last question. That is—you obviously brought this to the attention of the SEC. Do you have any idea how many other funds, characters, had been brought to the attention of the SEC? Is it in the tens, the hundreds, the thousands?

Mr. MARKOPOLOS. I just know that you saw the example of my work that I turned in. I have seen several examples just like that of at least as high a quality that were turned into the SEC by people who have come to me asking for advice, how to go to the SEC, because they know—they knew that I was going to the SEC. And they submitted their complaints to the SEC that were at least as good as mine, and the SEC never bothered to pick up the phone or even show up to investigate.

So this is common and systemic. They ignore the big cases.

Mr. MANZULLO. Thank you.

Chairman KANJORSKI. Thank you very much, Mr. Manzullo.

Now Mr. Perlmutter of Colorado.

Mr. PERLMUTTER. Thank you, Mr. Chairman.

And, Mr. Markopolos, thank you for your testimony today and your persistence in this. I really appreciate sort of the forensic approach you took to this.

But first I have to make a statement, because you talked about it: It starts at the top down. And I want to take a shot at my friends on the other side of the aisle. When you vilify people who are regulating the system so that taxpayers don't have to pick up the pieces, or that the depositors of a bank don't have to pick up the pieces, or shareholders don't have to pick up the pieces, but you vilify those regulators and you make them out to be the bad guys in the system, then they become the bad guys in the system.

So there are philosophical differences between my side of the aisle and the need for regulation so that the taxpayer doesn't pick up all the pieces when everything goes to hell and wanting to keep the markets completely free so that the guy can make the last obscene buck. So that is my statement for the record.

Now let's just talk about a couple of things. I think you are right on the money with young people, inexperienced, ultimately wanting to go into the business, you know, to go to investment bankers, etc., being the regulators in the first place. They are going to be nervous. And you are right about picking some people who have seen

this stuff before. This is not rocket science, finding a Ponzi scheme. You found it in 4 hours, and I know you were looking for it. But when it is too good to be true, then you stop and you take a breath and say, what is going on here?

My questions are, you went to the media and you had stories written about this. You have, supposedly, sophisticated investment fund managers who were investing into this. What happened with them? Why didn't they see this?

Mr. MARKOPOLOS. I think one big reason is the feeder funds were preying on the people that they were close to. Ponzi schemes are, above all, an affinity fraud. We saw that in the United States, where Mr. Madoff was Jewish, he preyed on the Jewish community. But that is all he did here.

Overseas, he used different connections, and he actually took royal families to the cleaners, European aristocracy and high-born families and the nouveau riche. So I think the losses in Europe will actually be bigger than they are here in the United States; but they are going to be more hidden because a lot of that money invested from overseas was untaxed money in offshore jurisdictions, and they can't admit the losses or else their host nation authorities will come and investigate them.

So there are reasons for this failure.

Mr. PERLMUTTER. Here is my question. I mean, you were looking for this, I think. You know, I look at your timeline, your chart here, which is very good; and you were asked by Rampart Investment to try to figure out what this, you know, split strike strategy—which, in my opinion, is a bunch of baloney; you know, it is like the black box that everybody uses for a Ponzi scheme.

But you were asked and you discovered this. Shouldn't those investment managers have seen something that just didn't smell right?

Mr. MARKOPOLOS. But they were paid so much to look the other way.

Let me explain the fee scheme in the Madoff Ponzi.

Mr. PERLMUTTER. Please. Thank you.

Mr. MARKOPOLOS. Mr. Madoff was purporting to only be taking commissions from this product, even though he was a hedge fund manager who usually would take a 1 percent management fee and 20 percent of the profits. He was so generous a human being that he was offering those fees to the feeder funds to lure in new victims.

And so, let me explain the fee structure to you. To deliver 12 percent annual returns, he needed to be earning 16 percent gross, because there were 4 percent in fees. He was passing the 4 percent in fees along to the feeder funds and keeping only a smidgen for himself. And so those feeder funds were incentivized not to ask the questions, to be willfully blind, if you will, and not get too intrusive into the Madoff scheme.

Mr. PERLMUTTER. Okay.

What happened—you know, I noticed, in December of 2005, you went to the Wall Street Journal. What happened? Did they publish anything about this? It says you went to—I start to doubt New York SEC and contact WSJ. I assume that is the Wall Street Journal, Washington Bureau.

Mr. MARKOPOLOS. I did go to them, and I lost confidence quickly in the New York regional SEC to conduct this investigation. I lost it very quickly; it just took a couple weeks to lose confidence in them. I could see how bumbling they were.

And I was worried with my safety because the New York branch chief and the team leader knew my name. And if they were corrupt, I thought I was a dead man. And so to protect myself, I went to the Wall Street Journal's Washington Bureau; and that reporter, who was very senior and very good, was ready to come on a plane to Boston several times in 2006–2007. But I believe that senior editors at that publication respected and feared Mr. Madoff, and they never let him get on a plane, no matter how much he wanted to get on that plane.

Mr. PERLMUTTER. Thank you for your testimony. Thank you for your service on this.

Chairman KANJORSKI. Thank you, Mr. Perlmutter.

Mr. Donnelly of Indiana.

Mr. DONNELLY. Thank you, Mr. Chairman.

Mr. Markopolos, thank you for being here. You talked about respect and fear of Mr. Madoff. And in reading your document entitled, "The World's Largest Hedge Fund is a Fraud," you mentioned some pretty prominent financial organizations that basically said, oh, we don't touch this guy; we know it is a fraud.

Do you know if any of those organizations also contacted the SEC with their concerns, in effect putting more weight behind what you were saying?

Mr. MARKOPOLOS. I am not privy to all the complaints that the SEC receives, so I can't answer that question from their perspective. But I believe that I was the only one to investigate and do the math proofs. And my team were the only ones out there closely tracking Mr. Madoff every step of the way and building a voluminous volume of information against Mr. Madoff.

So I think my team was the only one out there tracking him. And we feared for our lives if he discovered that we were tracking him.

Mr. DONNELLY. And these very prominent Wall Street organizations that said, hey, Madoff is a fraud, we stay away, was it in effect a club-like atmosphere where, well, we are not going to say anything about Bernie because, you know, that might come back on our business?

Was that atmosphere rife throughout the people you were dealing with?

Mr. MARKOPOLOS. In Wall Street there is a code of silence. And when you live in a glass house, you do not throw stones.

Mr. DONNELLY. And with that code of silence, this is with the very same people that the American people are looking to trust, because they are giving every dollar of retirement savings or the funds they have accumulated, working hard every day at the shop, that they have been placing their trust in.

Mr. MARKOPOLOS. If it is misplaced trust in fraudsters, especially the white collar variety. These people are much more dangerous than any bank robber or armed robber because these people, the white collar fraudsters, are the most prestigious citizens, they live

in the biggest and best houses and have the most impressive resumes.

So when they commit a fraud scheme, they destroy companies and they throw thousands of people out of work, and they destroy confidence in the American system such that capital becomes unavailable at any price or it raises the price of capital. We cannot afford not to find white collar criminals out and punish them severely.

Mr. DONNELLY. And is there—you mentioned that so many of the companies knew Bernie was a fraud, Bernie Madoff was a fraud. Is there also, even today, within these organizations like a list of other companies that they look at and say, we stay away from these guys; it doesn't smell right, it is not working right? Is there a whole group that people are staying away from at this time?

Mr. MARKOPOLOS. Yes, there are. And they don't come forward.

There could be many reasons. I think the main reason is, if you are committing fraud yourself, you are not going to tell on somebody else's fraud scheme for fear somebody will do the same to you. And so they remain silent; there is a code of silence. They know who these people are, the fraudsters are.

They need to start coming forward. Otherwise, our Nation's system of finance falls apart, investors will stay away, and businesses won't have access to capital.

Mr. DONNELLY. So one of the things the SEC—it would be beneficial to do is, find out who else the organizations that are—that there are concerns about out there; and go through their books and find out how they are running their businesses and find out who has red flags out there.

Mr. MARKOPOLOS. Right now, there are no incentives for the SEC. Right now, the SEC exists to protect financial predatory organizations from investors. That seems to be their mission statement. And we need to change the whole focus.

The only way you can do that is to offer incentives to the staff such that anybody that gets in their way when they go after a fraud scheme, for whatever reason, they run them over with a bulldozer, because they have their own bonus on the line and they want their bonus.

Mr. DONNELLY. We asked the Inspector General of the SEC when he was here, or the question I asked him was, "How many red flags do you need before it sets off an alarm with a particular organization that you send the examiners in?" And he said, "It should only be one."

In the Madoff case, in your document, I think you were in the 20s on red flags; but certainly just in that testimony, we had four or five.

And so they should, the SEC, have a list of organizations that there are red flags that they can look at to make sure that investors, that Americans who are working hard every day, can have confidence again.

Mr. MARKOPOLOS. That is true. They have both an inability to find fraud, and they lack the willingness to attack fraud. And that needs to change. And I think the only way you are going to change that is, change the tone at the top. And you need to replace the

senior staff of the SEC, because right now the junior rank and file out in those regional offices has lost confidence in their senior staff.

Mr. DONNELLY. Mr. Markopolos, thank you very much for your time.

And, Mr. Chairman, thank you for having this hearing.

Chairman KANJORSKI. Thank you, Mr. Donnelly.

Now the gentlelady from California, Ms. Speier.

Ms. SPEIER. Thank you, Mr. Chairman. Maybe we should get it straight. Is it "Markopolos" or "Markopolos?"

Mr. MARKOPOLOS. I answer to all.

Ms. SPEIER. All right. Mr. Markopolos, I would like to just say for the record that I see you as a modern day Greek hero; and I want to thank you for the perseverance.

I was kind of amused a little bit to note that after all these years, you finally quit the investigation earlier last year. Why was that?

Mr. MARKOPOLOS. It was so much pent-up frustration. To that point, I had been on the SEC's doormat for 8 years and taken a lot of abuse from that Agency, and was ignored by that Agency.

I only had two champions within the SEC out of 3,500, so 3,498 people at the SEC were not helping me. I had two advocates, two champions, in Boston—Ed Manion and Mike Garrity. That was the only support I got. And Mr. Manion told me it was my public duty to keep leading the investigative team forward because if I didn't do it, no one would; and it was such a danger to our capital markets if this was left unchecked that I needed to step into the breach and do something.

But after my April 2nd submission of last year to the SEC's Director of Risk Assessment, Mr. Jonathan Sokobin, and I got no response back, at that point I lost all confidence in the SEC.

Ms. SPEIER. You spoke about not using your name, handing over documents with gloves on. You know, that is a bit of paranoia, one might say. And I want to know why you had that concern and if you suffered any recriminations.

Mr. MARKOPOLOS. I don't consider it paranoia. And the reason is Mr. Madoff was running such a large scheme of unimaginable size and complexity. And he had a lot of dirty money. Let me describe dirty money to you. When you are that big and that secretive, you are going to attract a lot of organized crime money and—which we now know came from the Russian mob and the Latin America drug cartels. And when you are zeroing out mobsters, you have a lot to fear. He could not afford to get caught, because once he was caught and once he knew—if he would have known my name, and he knew that he had a team tracking him, I didn't think I was long for this world.

Ms. SPEIER. All right.

In your testimony, you reference Ms. Cheung in New York as the Branch Chief. And you say, "She never grasped any of the concepts of my report, nor was she ambitious enough or courteous enough to ask questions of me. Her arrogance was highly unprofessional, given my understanding of her responsibilities and mandates.

"When I questioned whether she understood the proofs, she dismissed me by telling me that she had handled the multibillion-dollar Adelphi case. I then replied that Adelphi was a mere few-bil-

lion-dollar accounting fraud, and that Madoff was a much more complex derivative fraud that would easily be several times the size of Adelphi. She never expressed even the slightest interest in asking me questions.

"She told me that she had my report, and if she needed more information, she would call me. She should be fired."

Mr. MARKOPOLOS. She already left the Agency, but otherwise I would agree.

It is too late.

Ms. SPEIER. You referenced that you thought there needed to be housecleaning. And yet there are people, by your own reference, in the New York attorney general's office and in the Massachusetts Securities Division who are doing great work.

So it is not a lack of talent out there. It is a lack of really identifying the talent and bringing them in; wouldn't you say that?

Mr. MARKOPOLOS. I would agree. And I would urge the Congress to consider the fine examples set by the New York attorney general's office and the Massachusetts Securities Division. They give great regulation on the big cases that are nationwide fraud cases, and they get full restitution to the victims. They are aggressive.

But they are small. They don't do a lot of examinations. All they do is take in whistleblower tips and act upon them and act vigorously. They are pit bulls against financial fraudsters. And here we have a pip-squeak of a flea in the SEC.

So it is not the size of the dog, it is the size of the fight in the dog. And that is why I commend those two State regulators. They are very aggressive.

And if the SEC does not reform itself, you have an option. Just disband the SEC, zero out their budget, put all 3,500 of those people on the streets, because they are not protecting us right now; and just fund the New York attorney general's office and the Massachusetts Securities Division.

Ms. SPEIER. All right. My time is about to expire so let me ask you one final question: Fairfield Greenwich and Tremont, sophisticated investors, and yet they did not do their due diligence. Should we be going after them as well? Should someone be going after them because they ripped off the American people?

Mr. MARKOPOLOS. I would say they need to be looked into. If they didn't know, they were willfully blind, and they got paid a lot of money to be willfully blind.

Ms. SPEIER. Since I have opportunity for one more question, there was a reference made to the attorney in the SEC who later married Mr. Madoff's niece.

Do you know any more about that?

Mr. MARKOPOLOS. I am not privy to the SEC's investigation.

Ms. SPEIER. Thank you.

Chairman KANJORSKI. The gentleman from Ohio, Mr. Wilson.

Mr. WILSON. Thank you, Mr. Chairman.

Thank you, Mr. Markopolos, for coming forward today and for what you have done to this point to point out the greed and what is really going on. It always amazes me in America that we can lock up a single mother for stealing a can of spaghetti sauce at the convenience store, but we allow this kind of stuff to go on. It is just hard to understand.

Do you think that the size of the SEC—you said 3,500 people—is that they need 4,000; or do they need a little mission statement or maybe some integrity in there? What—in your own opinion, what do you think can be done with the SEC to make them effective?

Mr. MARKOPOLOS. First of all, I think 3,500 is a lot of people. You need 3,500 better people to start with. Before you get bigger, you need to get better. You need to replace the people that you currently have, upgrade them with industry veterans. And then you need to equip them adequately for the fight. Right now they do not use Bloomberg's. Every portfolio manager, every trader, every analyst on Wall Street uses a Bloomberg machine. And the SEC, they are lucky if they have one per regional office. If you are not equipped with the tools to do the fight, you are showing up at the gun fight without a gun, you are going to lose every time, and that is why they lose every time.

Mr. WILSON. So in other words, the quality of what they are doing, the equipment to work with, and the ability to move forward and actually make change is what really needs to be done.

Mr. MARKOPOLOS. Yes.

Mr. WILSON. My second question has to do with auditing, which I would think is one of the things the primary would focus when there are wrong things being done. Could it be a random assigned auditor rather than the same old same old that they have every time?

Mr. MARKOPOLOS. I would rotate the teams personally. You want a fresh set of eyes looking at the books and they want a fresh set of trained eyes. Right now those eyes are not trained. They are also not trained in human intelligence gathering. When they come in to inspect a firm, they are led to a conference room. They meet the compliance staff and they are fed controlled pieces of paper. That is what they do. They inspect pieces of paper because they are too untrained to realize what to look for on the financial end. All they are looking for is pieces of paper. If they see the pieces of paper, you are going to get a fine audit report back from the SEC.

What they need to be doing is talking to the portfolio managers, to the traders, to the marketing people, to the client service officers, the information technology people. And they need to be interacting with them and saying, is there any fraud here? Is there anything illegal or unethical happening here? And if you get a "no" answer, say fine, thank you. Is there any fraud anywhere else in any other organization that your firm deals with or that you know about? And then you hand them your business card. And you say if there is, if you ever discover a fraud, please let me know. And hand them the card. I think if you do that, you will increase audit effectiveness.

Mr. WILSON. It sounds like a pretty good commonsense way to approach it. I guess part of my question, too, is instead of having the same firm each time where a lot of times you know we could see just the cover pages change and the numbers reflect whatever happened that year. But are they really reaching in and interviewing with the people who are preparing those papers with them? As you said, are they really drilling down on it and saying, is there fraud? Is there anything that you are upset about or that

you are concerned about? And yes, here is my card. And contact me as soon as possible if there is anything you can help us with.

Mr. MARKOPOLOS. The SEC staff are afraid to ask those questions because they fear the answer would be yes, there is fraud.

Mr. WILSON. That is tough. What about the bounty hunter situation that has been mentioned? Is that any kind of a way to look to try to get a grip on this thing, to get a handle on it?

Mr. MARKOPOLOS. If you incentivize private parties who work at these firms that are committing fraud and you incentivize them enough, they will come forward with the books and records that solve the case quickly, easily, at low or no expense to the government. They would be your best source.

Mr. WILSON. That is good to hear. Sounds like some pretty good commonsense things could correct a lot of what is going on. Thank you, Mr. Markopolos.

Chairman KANJORSKI. Thank you very much, Mr. Wilson. The gentleman from Florida, Mr. Grayson.

Mr. GRAYSON. Thank you, Mr. Chairman. Mr. Markopolos, in the year 2000, the last year of the Clinton Administration, the SEC brought 69 cases of securities fraud and prosecuted them. In the year 2007, the 7th year of the Bush Administration, it brought 9 cases; that is 69 versus 9 cases. What is your experience in general with the enforcement of the securities laws in the Bush years?

Mr. MARKOPOLOS. There is a difference between zero tolerance for fraud and zero enforcement of fraud, and I think we have had zero enforcement.

Mr. GRAYSON. Zero enforcement for the past 8 years?

Mr. MARKOPOLOS. Correct.

Mr. GRAYSON. Now you have referred to this several times, the Ponzi scheme. Is that a rather newfangled thing?

Mr. MARKOPOLOS. It is rather old. It is from where I am, Boston, Massachusetts, 131 School Street in downtown Boston. These are rather old schemes. You would think that the SEC would be on to them by now, but apparently they are not.

Mr. GRAYSON. So when did Mr. Ponzi actually operate?

Mr. MARKOPOLOS. He operated in, I believe, the early 1930's, late 1920's.

Mr. GRAYSON. So this isn't a question of mastering some complicated derivatives, right?

Mr. MARKOPOLOS. No. Mr. Madoff was actually not using any derivatives whatsoever. That was just the hook, that was just the facade. Underneath it, there was nothing.

Mr. GRAYSON. I understand that in 2005 you wrote a letter regarding the scheme and the title was, "The World's Largest Hedge Fund Is a Fraud"; is that correct?

Mr. MARKOPOLOS. It is.

Mr. GRAYSON. Could you have possibly been more explicit?

Mr. MARKOPOLOS. I even drew pictures. So I don't know how I could have been more explicit. I gave them a roadmap and a flashlight to find fraud and they didn't go where I told them to go or ask the questions that I told them to ask or call the people that I told them to call.

Mr. GRAYSON. Who did you address that letter to?

Mr. MARKOPOLOS. I initially sent it to the SEC regional office in Boston, to Mr. Ed Manion. He put me in touch with Mike Garrity, an SEC Branch Chief in Boston, who actually believed me, and knew my credentials, he vouched for me, found several irregularities. In a week's time, he did more than the entire New York regional office and he said, there is something here. I am going to put you in touch with that New York regional office. And he did. But they refused to follow up.

Mr. GRAYSON. The year before you sent that letter in 2004, I understand the SEC convened a session and a gentleman made this statement at that session regarding what he proposed, the deregulation of Wall Street firms. He said, "You really have to start with the assumption that most of us in this industry really are our clients' interest coming first." Do you know who made that statement?

Mr. MARKOPOLOS. No.

Mr. GRAYSON. Mr. Madoff made that statement. Are you familiar with the concept of capture when you are talking about regulation? What is that? Do you know that concept?

Mr. MARKOPOLOS. Yes. It is basically when the regulator is in bed with the industry they purport to regulate and do not regulate the industry. In fact they consider the industry the clients, not the public citizens.

Mr. GRAYSON. And have you seen that in action?

Mr. MARKOPOLOS. Yes. At the Food and Drug Administration and at the SEC.

Mr. GRAYSON. As of now, Mr. Madoff was arrested and he is confined, correct?

Mr. MARKOPOLOS. He is under penthouse arrest.

Mr. GRAYSON. Penthouse arrest. Can you explain that further?

Mr. MARKOPOLOS. He is leading a life of luxury, and he does have serious complaints. He is not able to go out for his knosh.

Mr. GRAYSON. I understand that his luxury apartment costs $7 million. Does that sound about right?

Mr. MARKOPOLOS. It does.

Mr. GRAYSON. Where did he get that $7 million from?

Mr. MARKOPOLOS. From the victims.

Mr. GRAYSON. Now I also understand that he is confined and his confinement is regulated and guaranteed by security guards, is that correct?

Mr. MARKOPOLOS. Yes.

Mr. GRAYSON. And who hired those security guards?

Mr. MARKOPOLOS. I am not aware of who hired them.

Mr. GRAYSON. Actually he hired them. Isn't that correct?

Mr. MARKOPOLOS. I am not sure.

Mr. GRAYSON. I yield back the rest of my time. Thank you, Mr. Chairman.

Chairman KANJORSKI. The gentleman from Illinois, Mr. Foster.

Mr. FOSTER. You had mentioned that actually you are blacklisted from industry if you bring forth one of these cases. Are there more specifics that you can give us on that or examples where that has happened?

Mr. MARKOPOLOS. Yes, me. I have crossed the Rubicon. I can never go back.

Mr. FOSTER. Are you aware of other similar cases where people are basically not allowed to participate or are informally blacklisted?

Mr. MARKOPOLOS. Yes.

Mr. FOSTER. Like this?

Mr. MARKOPOLOS. Many.

Mr. FOSTER. I guess it is unreasonable to ask about details, but I may ask you privately about that.

You know, I am very interested in this issue of the principles from right sizing the SEC, that there be some sort of balance between the losses that are suffered from the SEC from securities fraud and the amount of money you put in. I guess that may have been handled recently, but I think that is the fundamental question that this committee has to deal with, to make it so that, you know, perhaps automatically the SEC is scaled as the industry expands so that it has the right level of staffing competence and, well, competence and manpower for these.

One of the things that troubled me was the whole issue of secrecy. I guess there is something that is absolutely necessary that these things have to be handled secretly because if nothing else, for the possibility of market manipulation. I was wondering if you are experienced with the necessity of secrecy during these investigations. Is that something that you view as an essential thing or something you have been frustrated with when you see it not operating properly or not operating properly in secret?

Mr. MARKOPOLOS. For me, I had to remain secret. We have feared for our health and safety. The government should have no fear, but it seemed all they did have was fear of Mr. Madoff and fear of the big cases.

Mr. FOSTER. And then another thing that struck me was the business of segmenting and compartmentalizing what the regulators were looking at. I was wondering if it was easier for the SEC to be overseeing a more compartmentalized interest, if there were not things like dual registration and self-custodians, if you had people whose job it was just to look at custodianship issues and they would just go through everyone that claimed to be a custodian and they would have a simple set of things to look at. If you are understanding what I am saying. Just putting up firewalls and very clear separations in the segments of the industry, that might solve part of the problem with the—sort of the competence issue that it is easier—you know, that is one of the young kids that you referred to that aren't really well trained could be taught, here is exactly what you look at for custodianship issues, and make the oversight more effective.

Mr. MARKOPOLOS. You can do that. You need subject matter experts who are very familiar with specific areas. But you need to have combined enforcement teams, where that is one person on your team. You also have the investment manager guy or gal who came from industry and knows exactly what to look for. You also need the accountant on the team who knows how to read the financial statements with a fine-toothed comb. So you need to combine those people on the same team and have them coordinate and communicate among themselves in order to attack the truly big frauds.

Mr. FOSTER. Okay. I just thought—probably reiterate my respect for what you have done. We need thousands more like you out there.

Mr. MARKOPOLOS. Thank you.

Mr. FOSTER. I yield back.

Chairman KANJORSKI. The gentleman from Texas, Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman. And I especially thank you because I am an interloper today. I am grateful you have allowed me the opportunity to ask Mr. Markopolos a few questions.

Mr. Markopolos, or Markopolos, by any name, you have done your country a great service. By any name, your country owes you a debt of gratitude.

Mr. MARKOPOLOS. Thank you.

Mr. GREEN. And by any name, I and many others can understand why you were in fear of your life. And I believe that fear to have been well-founded because you were dealing with a ruthless person who was in bed with other ruthless people. When you deal with the kind of characters that you were trying to bring to the bar of justice, you have to be concerned not only about yourself but about other family members who are near and dear to you.

I am not sure that the American people really know who you are. You are not just some person off the street. And while every person is important and all life is precious, you are not just a person off the street. You are a person with credentials. You are a person who has paid dues and who is respected. And I would like for you, if you would, to share some of your credentials with the public so that people can really understand who you are.

Mr. MARKOPOLOS. Thank you, Congressman. I am a Chartered Financial Analyst. I am a Certified Fraud Examiner. I have an undergraduate degree in business administration from Loyola College in Baltimore, Maryland. I have a masters in science in finance degree from Boston College. I used to manage billions and billions of dollars in equity derivatives and trade these securities as chief investment officer for a rather mid-sized firm in Boston. I have a military background. I served this Nation for 17 years as an officer. I commanded troops at every level from second lieutenant to major. My last 7 years were in Army Special Operations where my unit that I commanded had teams overseas. This was a reserve unit. This is part time. I had people overseas 24/7 every day of the year serving this Nation.

Mr. GREEN. Thank you. Two other points, and I will yield back the balance of my time. The first is, do you agree that the tone and tenor of the behavior of those who serve at the bottom is shaped by those who serve at the top?

Mr. MARKOPOLOS. I do. You lead from the front. If the SEC Chair is not aggressive and competent, the organization cannot succeed. Everything comes from the top.

Mr. GREEN. And do you also agree, sir, that we could have a million people in place to perform the investigative function. But if we don't have the will to perform that function, the number of people becomes to some extent inconsequential?

Mr. MARKOPOLOS. I would agree. Right now, the SEC staff consists of 3,500 chickens. We need to put some foxes in there and we need to compensate them. We need to give them incentives. We

need to get the right people. I don't think it is a matter of right sizing. It is a matter of right staffing. And right now we have the wrong staff, particularly at the senior levels.

Mr. GREEN. And finally, sir, in your quest for justice, did you happen to go by way of your own entry or by way of some sort of communication device, a communication to the Inspector General's Office? And I am asking, did you go personally or did you send some message to the Inspector General's Office which has some degree of oversight?

Mr. MARKOPOLOS. I did not.

Mr. GREEN. For edification purposes, if you had the chance to do this one more time, and I pray that you will never have to do what you have done again, would that be an office that you would consider taking your evidence to? Or were there reasons that you would like to share as to why the Inspector General's Office was not a part of the circle that you tried to get this intelligence to?

Mr. MARKOPOLOS. An Inspector General's Office is only as good as the Inspector General in the office. And with Mr. Cox, if he had been the Inspector General back then when I was doing this investigation, I would have gladly gone to him and trusted him to do the right thing. But the prior occupants of that office, I would have never gone to them.

Mr. GREEN. Thank you, Mr. Chairman. I yield back the balance of my time.

Chairman KANJORSKI. Thank you very much, Mr. Green. Now we have had a nonmember of the committee waiting for an awfully long time, Mr. Arcuri. And Mr. Maffei, who is a member of the committee, has kindly consented to passing over his right under the rules to be heard now to give it to you. So Mr. Arcuri, your 5 minutes.

Mr. ARCURI. Thank you, Mr. Chairman and Mr. Ranking Member, for allowing me to sit in on this hearing. It is very interesting. And thank you for holding the hearing. And Mr. Markopolos, thank you very much for what you have done.

You know, I think many people look at the Madoff scandal and they think that it is just the wealthy and sophisticated investors who have been hit by this. But I am here today to talk a little bit about some of the other people who have been hit by it. I just want to mention a few of the groups: The Bricklayers, Allied Craft Workers, the International Union of Operating Engineers, the United Association of Journeymen, United Association—a second group of journeymen, Local 267, 73 and 112 of New York, the Carpenter's Local 747 out of Syracuse, and the United Union of Roofers. All of these groups are from upstate New York. They were hit for pension and health care benefits between $300- and $400 million. These are not very wealthy people. These are hard-working people who have lost not only their health care benefits but also their entire retirement. There has been a long line outside of my office door. And I think I can speak for my colleague, Mr. Maffei, outside of his door as well, as we both represent upstate New York.

Obviously, my concern is this, many of these investors are not the very sophisticated investors. They are—they manage small pension funds. What can the small investors do to keep an eye out for the sharks that are out there like Mr. Madoff?

Mr. MARKOPOLOS. I am afraid that they may be on their own unless they hire consultants and trust those consultants, and hire only competent consultants because clearly the SEC is not out there guarding the hen house.

Mr. ARCURI. You know, and the point that you made when you held your arm out and showed the 45 degree angle curve. And you can't help but think, if it looks too good to be true, it probably is. Does the market itself, do they look at, you know, competitors who are out there, who are doing jobs that are too good to be true and say, hey, something must be wrong here; somebody needs to look into this?

Mr. MARKOPOLOS. Well, I am afraid not. They missed subprime. They missed the collateralized debt obligations, the collateralized loan obligations. They missed so much it is hard to just trust in the professionals. You need competent regulators as well, and you also need common sense.

Mr. ARCURI. My concern is this, if I am an investor and I am looking at the two prospective groups to invest my money in and one is doing everything legally and they are giving, let's say, 5 or 6 percent, and then you are looking at a Madoff who is giving a return of, say, 10 or 12 percent, the person who is giving the 5 or 6 percent has to be looking at Madoff and saying, something has to be wrong here, someone needs to look at that. Isn't there more pressure from the actual private sector itself to look into these?

Mr. MARKOPOLOS. I am afraid the private sector would look at the Madoff returns and say, he is getting more return, taking less units of risk, therefore I love Mr. Madoff better and I want to invest with him more. So greed often overrules common sense.

Mr. ARCURI. Now do you think there is a way to strike a balance between the SEC type of oversight and oversight from the private sector itself?

Mr. MARKOPOLOS. I am sorry.

Mr. ARCURI. Is there any way to strike a balance between actual oversight by the SEC type entities or the New York Attorney General and the private sector in terms of overseeing itself?

Mr. MARKOPOLOS. Regulators overseeing itself or private sector overseeing itself?

Mr. ARCURI. Private sector, yes.

Mr. MARKOPOLOS. That is why I recommended a whistleblower program to compensate people from within the industry who know about the fraud but fear blacklisting, to step forward anonymously—or the government would know who they are so that an investigation could be conducted immediately and put a quick halt to these frauds before they lure in too many victims.

Mr. ARCURI. And the last question I have for you is this: You talk about needing the SEC to be looking at bringing in the people who have been in the private sector for a while, who are the fox that you call them, and putting them in charge. But then you make references to the New York Attorney General, to the—I think it was the Massachusetts.

Mr. MARKOPOLOS. Securities Division.

Mr. ARCURI. Securities, thank you. And yet they don't have that type of people in their office. They have small, lean offices. How do they do it and the SEC is not able to do it?

Mr. MARKOPOLOS. It is easy. They rely on whistleblowers to come in with tips which they vigorously pursue. When the SEC gets a tip, it vigorously ignores it.

Mr. ARCURI. I want to thank you again very much and thank you on behalf of the hundreds, in effect thousands, of people in my district who have been ripped off and, hopefully more importantly, to thank you for the people that you have prevented from being ripped off because you were able to stop this and blow the whistle on Mr. Madoff. So thank you for what you have done.

Mr. MARKOPOLOS. Thank you.

Mr. ARCURI. Thank you, and I yield back, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Arcuri. Finally, Mr. Maffei of New York.

Mr. MAFFEI. Thank you, Mr. Markopolos. Thank you, Mr. Chairman. I, too, am not on the subcommittee, though I am a member of the full Financial Services Committee. As Mr. Arcuri pointed out, I do have a neighboring district and many of those same groups overlap in my district and then there are some additional ones. I wanted to ask you just a couple of questions that may be along roughly the same lines. It is interesting that you said that you worked for a competitor of the firm that Madoff had. And I actually worked until coming to Congress for a small locally owned broker-dealer that was actually a competitor of some of these feeding broker-dealers. I guess we weren't quite as smart as you. We couldn't figure out how in the world they were getting back these returns. But of course we didn't know enough about what they were doing to avoid that risk. But it is interesting. There are a lot of victims here in terms of the good players in the financial services industry who didn't do these practices, who have been missing out on business.

But what I would like to know, do you think, given that it took you 5 minutes and then 4 hours, do you think that any responsible broker-dealer or investment adviser should have known there was something wrong?

Mr. MARKOPOLOS. Yes. But I also think that they were so highly compensated—because a majority of the fees—and this is where Madoff was very clever. He left them 3 to 4 percent of the fees and took just a tiny bit for himself. So they became blinded by greed or willfully blind, if you will, and assiduously looked the other way.

Mr. MAFFEI. Thank you. Given the fact that, according to your testimony, the Securities and Exchange Commission so dropped the ball on regulating this, so dropped the ball on catching this, do you think that like in so many other areas that the Federal Government has dropped the ball on regulation, that we have some responsibility to not make these investors whole again maybe but to do something for them, do some sort of a program?

Mr. MARKOPOLOS. I will leave that to the Congress. I can't make those decisions for you. But clearly if the government had acted and acted responsibly, we wouldn't be dealing with these victims. So there is some obligation. We pay taxes. We want good government. We expect it to be provided. If we have regulators receiving paychecks, we want them to earn those paychecks and they did not in this case. So I think the victims would like some justice. I think

they want heads to roll at the SEC. They want someone to clean house with a very wide broom.

Mr. MAFFEI. Okay. Thank you. And I guess my last question is, who do you want to play you in the movie?

Mr. MARKOPOLOS. Well, it had better be someone who is a Red Sox fan. That is all I ask.

Mr. MAFFEI. I will avoid commenting on that. But I do appreciate your service to our country, Mr. Markopolos. Thank you very much.

Chairman KANJORSKI. Do you want somebody with hair?

Mr. MARKOPOLOS. Not necessarily. Michael Chiklis is Greek and from Massachusetts, so I think he would be perfect.

Chairman KANJORSKI. Let me follow up on one little question there regarding the SEC. Feeder funds have to disclose their fees and commissions paid to the SEC in some audited form, is that correct?

Mr. MARKOPOLOS. The feeder funds?

Chairman KANJORSKI. Yes.

Mr. MARKOPOLOS. The feeder funds that are registered with the SEC do make disclosures about fees in their ADV form, yes.

Chairman KANJORSKI. Examining this thing of appealing to the greed of the feeder funds, somebody at the SEC, if they are going over this, were passing over it, but think about a $7 billion fund that was being operated by Madoff from a feeder fund. And you are saying rather than a 1 percent fee going to them, he was allowing them to get 4 percent, which was huge. That is huge. It is $280 million. And somebody sitting down at the SEC should have looked at that, it seems to me, and said, that is quite a fee for just placing money, getting it from the client and placing it with the actual investment company. And so obviously they were not checking these audits or these reports. Or is that passed over and no one considers the difference in fees? It does not really matter?

Mr. MARKOPOLOS. I don't think the SEC staff came from industry and understood how unusual and absurd this relationship is. Why would the ultimate investment manager, Mr. Madoff, take just a smidgen for himself, just commissions, and why would he allow the 1 percent asset under management fee to be charged plus the 20 percent override of profits each year which, as you totally spoke about, $280 million a year is what Fairfield Sentry was getting in fees each year, and they weren't looking very closely, were they? No. But the SEC never spotted it. And that leads me to say that the SEC examiners are very, very underqualified. What is worse is the Wickford Fund, which came out in May of 2007, offered 3 to 1 leverage to the Fairfield Sentry Fund. And I sent that to the SEC, Meaghan Cheung, New York City Branch Chief, on June 29, 2007, with more glaring red flags. And again they ignored the evidence.

Chairman KANJORSKI. Now if I remember some of your earlier responses to some of the other members, you indicated that you felt that the FINRA you felt was corrupt but the SEC was just incompetent. That is correct?

Mr. MARKOPOLOS. That is correct.

Chairman KANJORSKI. Which is better, to be incompetent or to be corrupt?

Mr. MARKOPOLOS. I would say I would give an A-plus to the SEC for incompetence and I would give the same grade to FINRA for corruption. And fortunately, the SEC was not corrupt as far as I could determine in this case. I think I am living proof of that.

Chairman KANJORSKI. In what way? They saved your life in some way?

Mr. MARKOPOLOS. I am still standing. I don't think I would have been if they had taken money to look the other way and told Mr. Madoff my identity and, by the way, these are the SEC's submissions he has been giving us over the years. I don't think I would be here today.

Chairman KANJORSKI. Very good. Well, we are going to have the SEC's representatives testify on the next panel. So we are looking forward to some of their responses.

Mr. Garrett, do you have any further questions? Mr. Ackerman?

Mr. ACKERMAN. Thank you very much, Mr. Chairman. If I could address for just a moment what I generally would categorize as the cloak and dagger aspects of this, you have referenced, I think 7 or 8 times, about a fear for your life and handing documents over wearing gloves so that you didn't leave fingerprints and the fact that you are still alive, just a moment ago. Is that because the dollars are so big? Or was there some kind of threat that you actually perceived and reported or didn't report to lawful authorities? And following up on that, you made reference to, I believe in a question by one of our colleagues, that we now know that organized crime and the Russian mob were involved and investors. I am afraid we don't know that. Or at least I don't know that, and neither does any of the people that I have checked with on this side.

Could you explain the involvement of the Russian mob and organized crime investing in Madoff? And how do you know, as I would presume they don't register as the Russian mob and put it in that name.

Mr. MARKOPOLOS. We knew because of the offshore feeder funds and just the—

Mr. ACKERMAN. Offshore feeder funds.

Mr. MARKOPOLOS. The feeder funds that were offshore in tax-haven nations attract dirty money. The only reason you go offshore is if it is dirty money, and we knew a very high percentage of that was from organized crime in various locales.

Mr. ACKERMAN. How much of it is from organized crime?

Mr. MARKOPOLOS. When you are dealing with offshore, anywhere from 5 to 50 percent would be—

Mr. ACKERMAN. How much would Madoff in dollars, what percent was offshore?

Mr. MARKOPOLOS. I would say—

Mr. ACKERMAN. And how do you know that?

Mr. MARKOPOLOS. I knew that from my June 2002 trip to Europe where I was meeting private client banks in France and Switzerland. I knew many of them were operating offshore. And just given the size, it is a statistical conclusion. If 5 percent of the world's currency comes from organized crime, well, Mr. Madoff was going to be at least 5 percent organized crime for his investors. It is just common sense. But because it is a hedge fund that was so secretive

and the returns were so good, it was a great bet, a very high odds bet that it was a lot larger percentage for Mr. Madoff.

Mr. ACKERMAN. You are talking about all foreign investors from foreign countries?

Mr. MARKOPOLOS. Not all.

Mr. ACKERMAN. I am talking about when you talk about the Russian mob and organized crime. These are people who invested through European investors or European feeder funds?

Mr. MARKOPOLOS. Correct. And I didn't fear them. I didn't think they were going to come after me. I want to make this perfectly clear to all those Russian mobsters and Latin American drug cartels out there.

Mr. ACKERMAN. You are talking directly to them.

Mr. MARKOPOLOS. I was acting on your behalf, trying to stop him from zeroing out your accounts. I am the good guy here. Make that clear.

Mr. ACKERMAN. Yes. I think we registered that.

The final question, I represent a large number of people who invested with Mr. Madoff, recently impoverished former philanthropists among them. The question that we get asked, all of us all the time, is, why didn't people do due diligence? If the SEC didn't pick it up, if the feeder funds who, as you say, were disincentivized from picking it up and everybody else, how were others, even sophisticated investors or large investors, able to do due diligence? Why didn't anybody else pick this up? What could they have done?

Mr. MARKOPOLOS. The reason they didn't pick it up is that they looked at their friends at the country clubs—

Mr. ACKERMAN. Yes. We know what happened. It was, you know, fabled and you look pretty stupid if you didn't.

Mr. MARKOPOLOS. Correct.

Mr. ACKERMAN. In some of those circles. The question is, what should they have done to have picked this up besides calling you? Is there nothing they could have done to figure this out? They all, as you say, got their statements. They figured it out. It was to the penny.

Mr. MARKOPOLOS. I don't think that anybody had figured it out.

Mr. ACKERMAN. Could anybody have figured it out?

Mr. MARKOPOLOS. If you did not have a derivatives and quantitative finance background, it would have been very difficult to figure this out on your own as an individual investor.

Mr. ACKERMAN. The people who are blaming the victims for being stupid and not doing due diligence are off the mark?

Mr. MARKOPOLOS. A lot of the victims thought they were getting highly diversified portfolios. This is the beauty of Mr. Madoff's scheme. He was purporting to own 30 to 35 of the bluest chip stocks, the largest companies in America, and they would see that on their statement, and they felt very comfortable owning those companies and they considered it a very diversified basket because it really was a very diversified basket.

Mr. ACKERMAN. But there was nothing they could do to check it out, that he didn't actually buy it.

Mr. MARKOPOLOS. You could. As an individual investor, you could not. But as a feeder fund, you should have been able to go to the New York Stock Exchange and see that those volumes of

stock did not trade on that day at that price. They could have gone to the option price reporting authority that the Chicago Board Options Exchange offers, and you would have seen that no OEX index options traded at those prices that day. That is what you could have done and no one did that.

Mr. ACKERMAN. And the SEC could have done that, too?

Mr. MARKOPOLOS. If they knew how to do it, they could have done it. And if they had the willingness to do it, they could have done it. But they did not.

Mr. ACKERMAN. Thank you very much.

Chairman KANJORSKI. If they knew how to do it. Are you suggesting they do not know to do that?

Mr. MARKOPOLOS. I am suggesting that if you flew the entire SEC staff to Boston and sat them in Fenway Park for an afternoon, that they would not be able to find first base.

Chairman KANJORSKI. Well, one of the questions that struck me after they were forced to register in 2006—it is the usual custom that there is an audit performed within the first year after registration, and that was not done for whatever reason? But further, it did not have to be an extensive audit. Somebody just walked in and asked to see the securities, physically. That would have set off the alarm and there are not any, is that not correct?

Mr. MARKOPOLOS. That was Basic Auditing 101. And the SEC staff was incapable of even that level of due diligence.

Chairman KANJORSKI. Would you like to change places with us when we get the SEC up here next so you can ask some questions?

Mr. MARKOPOLOS. I would like that.

Chairman KANJORSKI. Thank you very much, Mr. Markopolos. We are delighted with your willingness to come forward. It is a compliment to the committee that you chose this committee to make this public disclosure of your long-term investigation, and we thank you for that. We want to work with you closely and hope that your services will be further available to the subcommittee and the committee as we move on toward regulatory reform.

Obviously we can see from the example in your testimony and in the interest of the membership that we have a long road to haul. But certainly you have made it in significant ways here in shining light on this particular problem. And of course as you know we are using the Madoff scandal as a platform to set the basis for regulatory reform, long-term regulatory reform. This is a major step in the right direction in my opinion.

So thank you very much. Your life may be in jeopardy, but I would say Mr. Madoff, if he took the mob and the Russian Mafia on, maybe he should stay in that $7 million apartment.

Mr. MARKOPOLOS. Thank you, Mr. Chairman. It has been a singular honor.

Chairman KANJORSKI. Thank you very much. Okay. We will now have the second panel. If they will step to the desk, we will start the introductions thereof.

I am pleased to welcome our second panel. First we have Ms. Linda Thomsen, Director of the Division of Enforcement at the Securities and Exchange Commission. Ms. Thomsen.

STATEMENT OF LINDA THOMSEN, DIRECTOR, DIVISION OF ENFORCEMENT, U.S. SECURITIES AND EXCHANGE COMMISSION

Ms. THOMSEN. Good afternoon. Chairman Kanjorski—excuse me. Let me start again, Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee, I appreciate very much the opportunity to appear today on behalf of the Securities and Exchange Commission to discuss the mission and mandate of the SEC, our critical work to protect investors, the work of the Division of Enforcement, and certain general information with respect to the alleged fraud perpetrated by Bernard L. Madoff and Bernard L. Madoff Investment Securities LLC.

I am Linda Thomsen, and for nearly 14 years it has been my privilege to serve on the staff of the SEC's Division of Enforcement. Let me assure the subcommittee that the Commission and every single member of the SEC staff takes the alleged Madoff fraud very seriously. The losses incurred by investors as a result of his alleged fraud are tragic. And we appreciate the impact of those losses on the lives of those investors. The activities and conduct of Mr. Madoff and others are under active and ongoing investigation by criminal authorities, by the SEC's Enforcement Division and, with respect to past regulatory activities, by the SEC's Office of Inspector General. We are not authorized to provide specific information about matters under active investigation or past regulatory activities in this matter. We simply cannot jeopardize the process of holding the perpetrators accountable.

On December 11, 2008, the SEC sued Mr. Madoff and his firm for securities and investment advisory fraud in connection with an alleged Ponzi scheme that allegedly resulted in substantial losses to investors in the United States and other countries. The Commission's complaint alleges that Mr. Madoff admitted to two senior employees of his firm that for many years he had been conducting the investment advisory business of his firm as a Ponzi scheme using funds received from new investors to pay returns to previous investors, and he estimated that the scheme had resulted in losses of approximately $50 billion. The complaint alleges that Mr. Madoff also informed these senior employees of his firm that he had approximately $200 to $300 million left which he planned to use to make payments to selected employees, family, and friends before turning himself in to authorities.

The SEC immediately sought and obtained a preliminary injunction and other emergency relief to prevent the dissipation of any remaining assets. 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, in connection with Mr. Madoff's alleged Ponzi scheme. These two actions, filed by the SEC and the United States Attorney's Office, could potentially result in billions of dollars in liability and decades of incarceration for Mr. Madoff.

As noted in our written testimony, which we have submitted to the committee for all witnesses on behalf of the Commission, the SEC's New York regional office commenced an investigation of Mr. Madoff and his firm in early 2006. Two years later, in January of

2008, that investigation was closed without any recommendation of enforcement action.

Returning if I might to the broader picture, the mission of the SEC is to protect investors, maintain fair, orderly, and efficient markets, and to facilitate capital formation. The Agency's staff is dedicated, hardworking, and committed to the mission of the SEC. Our investor protection mission is more compelling than ever. As investors turn to the markets to help secure their futures, pay for homes, and send children to college, they must have confidence that their interests are being protected.

Crucial to the SEC's effectiveness is its enforcement authority. Each year the SEC brings hundreds of civil enforcement actions against individuals and companies for violations of the securities laws. The Division of Enforcement investigates possible violations and enforcement lawyers, accountants, and investigators investigate these violations, recommend that the Commission bring civil action in Federal court or before an administrative law judge and prosecute those cases on behalf of the Commission.

Enforcement staff obtain information about possible violations of the securities laws from many sources, including market surveillance activities, investor tips and complaints, other divisions and offices of the SEC, the self-regulatory organizations, and other security industry sources and media reports. The SEC staff receives hundreds of thousands of tips each year from various sources with various levels of specificity and credibility. While the SEC does not have the resources to fully investigate all tips and complaints received, we use the staff's expertise, skill, and judgment to triage the complaints to devote attention to the most promising leads and the most serious potential violations.

Of the approximately 600 enforcement actions that are brought each year, many first came to the attention of the staff through a complaint or a tip. Yet SEC staff is now also working on ways to improve the handling of complaints, tips, and referrals to make optimal use of resources. This is just one of our efforts to improve the identification and assessment of risk. Collectively, together with Chairman Schapiro and the Commissioners, we are committed to reducing opportunities for fraud, to detecting it quickly, and to best protect investors from those who would seek to prey upon them.

In conclusion, let me reiterate our commitment on behalf of the SEC and its staff to the vigorous protection of the American investors. Thank you, and I would be delighted to take questions, as I think would my colleagues.

[The joint prepared statement of the SEC can be found on page 174 of the appendix.]

Chairman KANJORSKI. Thank you, Ms. Thomsen.

Next, we have Mr. Andrew Donohue, Director of the Division of Investor Management at the Securities and Exchange Commission.

STATEMENT OF ANDREW J. DONOHUE, DIRECTOR, DIVISION OF INVESTOR MANAGEMENT, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. DONOHUE. Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee, I am Andrew Donohue, Director of the SEC's Division of Investment Management. I appreciate the

opportunity to appear today on behalf of the SEC to discuss the mission and mandate of the SEC, our critical work to protect investors, the work at the Division of Investment Management, and certain general information with fraud perpetrated by Bernard L. Madoff and Bernard L. Madoff Investment Securities LLC.

As an initial matter, let me say that each member of the Division of Investment Management takes our role in protecting America's investors and the integrity of our markets very seriously. I deeply regret the losses suffered by Madoff investors. As you have heard, the activities and conduct of Mr. Madoff and others are under active and ongoing investigation by criminal authorities, by SEC's Division of Enforcement and, with respect to past regulatory activities, by the SEC's Office of Inspector General.

I am not authorized to provide specific information about past regulatory oversight of the regulatory firm. I am not participating in the current investigation or examinations involving the alleged Madoff fraud. I can provide the following general information concerning our work at the Division of Investment Management.

The Division of Investment Management conducts regulatory activities on behalf of the Commission with respect to investment companies, including mutual funds and investment advisers. The Division of Investment Management reviews investment company disclosures for the compliance with Federal securities laws, responds to no action requests and requests for exemptive relief, develops rulemaking recommendations concerning investment companies and investment advisers for Commission consideration, interprets laws and regulations for the public and for SEC inspection and enforcement staff, and assists the Commission and its staff in enforcement matters involving investment company and investment advisers.

The Division of Investment Management has approximately 150 staff members. The investment management industry is large and diverse, including approximately 11,300 investment advisers and 950 investment company complexes representing over 4,600 registered investment companies. The number of registered investment advisers has increased dramatically in recent years, going from 7,547 in 2002 to nearly 11,300 today.

As you know, Bernard L. Madoff Investment Securities LLC registered with the Commission in September of 2006. As described more fully in our written testimony, it is unlawful for an investment adviser to defraud clients or prospective clients. Investment advisers have a fiduciary duty to their clients to act in their best interest and to avoid conflicts of interest or to fully disclose them. The anti-fraud provisions apply to all persons and firms meeting the definition of an investment adviser whether or not registered with the Commission. In addition, investment advisers registered with the Commission are required, among other things, to have written policies and procedures designed to prevent violations of the law and rules, to designate a chief compliance officer responsible for administrating the adviser's compliance policies and procedures, to maintain and preserve specified books and records, and make them available to Commission examiners for examination, and to deliver to advisory clients and prospective clients a written

disclosure statement or a brochure describing the adviser's business practices and material disciplinary events.

Under the custody rule, registered investment advisers must maintain client securities and funds with a qualified custodian which includes regulated banks, registered broker dealers, registered future commission merchants, and foreign financial institutions that meet certain conditions. Investment advisers may have self-custody or use an affiliated custodian if the adviser or affiliate is also registered as a broker-dealer, futures commission merchant, or it is regulated as a bank.

The Division of Investment Management actively coordinates its functional responsibilities with staff of the Commission's other divisions and offices. For example, the Division of Investment Management staff often consult with the Office of Compliance Inspections and Examinations and enforcement staff, providing legal advice in connection with examinations or investigations involving investment management regulatory issues.

Finally, there are some ideas that the Division of Investment Management is considering recommending to the Commission to explore in light of the Madoff matter, including both changes and improvements to regulation and oversight which might make fraud less likely to occur and improve the ability to detect it. We are reviewing the adequacy of the custody rule to determine whether to recommend to the Commission any amendments that enhance the safety of client assets. We also are reviewing the adequacy of disclosures that advisers are currently making and required to make to the Commission—to determine whether additional required information would enhance the staff's ability to detect and prevent fraud by advisers.

In addition, the Division is looking at ways to improve the assessment of risk and at the adequacy of information required to be filed by registered firms and used to assess risk and whether the risk assessment process would be improved with routine access to additional information.

In a range of ways, we are thinking expansively and creatively about changes that could reduce opportunities for fraud as American investors deserve the best possible protection from Ponzi schemes and other frauds.

Thank you, and I would be happy to take any questions.

Chairman KANJORSKI. Thank you very much, Mr. Donohue. Next we have Mr. Erik Sirri, Director of the Division of Trading and Markets at the Securities and Exchange Commission. Mr. Sirri.

STATEMENT OF ERIK SIRRI, DIRECTOR, DIVISION OF TRADING AND MARKETS, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. SIRRI. Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee, I appreciate the opportunity to appear today on behalf of the Securities and Exchange Commission. I am the Director of the Division of Trading and Markets, which is responsible for administering statutes and rules designed to establish and maintain standards for fair, orderly, and efficient securities markets. Bernard L. Madoff Investment Securities was a registered broker-dealer. Given the focus of this hearing today, I will

briefly discuss two functions of the division related to broker-dealers: first, administering the broker-dealer financial responsibility rules; and, second, providing oversight of Securities Investor Protection Corporation, or SIPC.

Broker-dealers are subject to extensive financial responsibility rules designed to protect customers from a firm's illiquidity or misuse of customer funds and securities. These rules impose a system of requirements intended to reduce the likelihood of customer abuse, including requirements for capital, a safe keeping of customer cash and securities, the making and maintaining of books and records, and the filing of periodic financial statements and annual audits with SROs and with the Commission. The broker-dealer net capital rules is designed to ensure that a firm maintains sufficient liquid assets, such that if the firm fails it can promptly liquidate and pay all claims to customers and other creditors without the need for a formal bankruptcy proceeding. The rule requires an absolute minimum amount of net capital in order for the broker-dealer to conduct a securities business, below which it cannot operate.

In addition, a broker-dealer must immediately notify the Commission and the relevant SRO if its net capital falls below certain early warning levels. The broker-dealer's customer protection rule is designed to safeguard customer securities and consists of two parts.

First, firms are required to maintain possession and control of all fully paid and excess margin securities carried for customers. Second, all net cash owed to customers must be deposited in a special reserve bank account for the exclusive benefit of customers. The rule prevents a broker-dealer from using customer cash and securities for its own proprietary business, and it is designed to keep these assets available for prompt return to customers in the event a broker-dealer fails.

The Commission's books and records rules require broker-dealers to make and keep extensive written records on their business. These include stock records that show the amount and locations of the securities carried by the broker-dealer, ledgers showing cash positions and securities purchased sold, received or transferred to or from other customer accounts, the records of the net capital computation and the customer reserve fund computation.

The Commission also requires broker-dealers to file periodic financial reports with the SROs. These financial reports must contain a statement of financial condition, a statement of income, a statement of cash flows, a statement of changes in stockholders' partners or sole proprietors' equity, a statement of changes in liabilities subordinated to the claims the general creditors and supporting schedules, including the computation of net capital, a computation for the termination of the reserve fund requirement, and information related to the possession or control requirements under the customer protection rule.

With a few limited exceptions, broker-dealers registered with the Commission are required to follow similar information in annual audit reports with the Commission and with each SRO of which the broker-dealer is a member. The audit report also requires that the scope of the accountant's audit and review must provide rea-

sonable assurance that any material inadequacies existing on the date of the examination would be disclosed. If an accountant finds any material inadequacies on the part of its review, a special report must be provided to the Commission.

With respect to the matter of the registration of broker-dealer auditors with the Public Company Accounting Oversight Board, I note that while Sarbanes-Oxley requires auditors of registered broker-dealers to be registered with a PCAOB, the Act focuses on PCAOB's responsibility, specifically on the auditors of public companies. Most broker-dealers are not public companies either because they are privately held or are subsidiaries of public companies. The Commission gave temporary exemptions from registration while discussing with the PCAOB the treatment of these broker-dealer auditors. Subsequently, the PCAOB determined that the statute does not give it the necessary authority to examine auditors of nonpublic broker-dealers after they have registered or to discipline them for audit failures after which the Commission determined to let these exemptions expire.

Finally, I note that the Division is primarily responsible for administering the Commission's oversight of SIPC. This oversight includes examination authority as well as the authority to review the rules SIPC adopts with respect to the conduct of SIPC liquidations. Generally, all broker-dealers registered with the Commission must be SIPC members. SIPC must pay advances to compensate customers when the amount of securities and cash recovered from a failed firm are insufficient to make customers whole. These advances are limited to $500,000 per customer, including a maximum of $100,000 for cash claims. SIPC initially pays for customer advances and the administrative costs of liquidation out of the SIPC fund, which is funded through member assessments.

I would be happy to take any questions.

Chairman KANJORSKI. Thank you, Mr. Sirri.

Next we have Mr. Andrew Vollmer, Acting General Counsel at the Securities and Exchange Commission. Mr. Vollmer.

STATEMENT OF ANDREW VOLLMER, ACTING GENERAL COUNSEL, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. VOLLMER. Thank you for inviting me today. The Office of the General Counsel provides a variety of legal services to the Commission and the Commission staff, such as preparing all of the Commission's appellate briefs and providing legal advice and counseling concerning the Federal securities laws, administrative laws, and government ethics rules.

The SEC witnesses here today prepared a joint written statement on behalf of the Commission. I would like to ask that it be included in the record. To the extent questions seek information beyond the scope of the written statement, each of us will be expressing our own personal views that do not necessarily reflect the views of the Commission or other SEC staff.

This hearing is being held at the same time that several important investigations into matters related to Mr. Madoff are open and being actively pursued. Some of them are pending law enforcement proceedings and investigations.

In December 2008, the Commission filed a civil law enforcement complaint in the Southern District of New York against Mr. Madoff and his securities firm. The SEC's Division of Enforcement is both litigating that case and conducting associated investigations into possible violations of the securities laws by others. It is also coordinating its investigation with a criminal investigation being conducted by the United States Attorney's Office in the Southern District of New York, and that office filed a parallel criminal action also in December of 2008 against Mr. Madoff.

A third investigation is the one by the Inspector General of the SEC into past investigations and examinations of Mr. Madoff's firm by divisions and offices of the SEC. He is also looking into any SEC staff relationships with persons related to Mr. Madoff that might have affected those investigations and exams.

Questions that seek information that could bear on or be relevant to any of the Madoff investigations could affect the independence and integrity of the investigations and could harm law enforcement efforts. I want to express my appreciation to the subcommittee for its understanding of these concerns.

Chairman KANJORSKI. Thank you, Mr. Vollmer.

Next we have Ms. Lori Richards, Director of the Office of Compliance Inspections and Examinations at the Securities and Exchange Commission.

Ms. Richards.

STATEMENT OF LORI A. RICHARDS, DIRECTOR, OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, U.S. SECURITIES AND EXCHANGE COMMISSION

Ms. RICHARDS. Thank you, Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee. I am Lori Richards, Director of the SEC's Office of Compliance Inspections and Examinations, and I very much appreciate the opportunity to appear here today to discuss the important work of the SEC to protect American investors, the work of the Office of Compliance Inspections and Examinations, and to provide certain general information with respect to the alleged fraud committed by Bernard Madoff.

I want to assure this committee at the outset that the SEC takes the alleged fraud by Mr. Madoff extremely seriously, and that collectively, together with Chairman Schapiro and the other Commissioners, we are focused very hard on identifying possible improvements, both to regulation and to oversight, which might make fraud less likely to occur in the first place, and more likely to be detected.

I begin by noting that I have served as a member of the Commission staff for more than 20 years, and that the Agency staff are dedicated, they are hardworking, and they are keenly committed to the Agency's mission to protect investors.

As described more fully in our written testimony, the Office of Compliance Inspections and Examinations is the functional program at the SEC that administers the SEC's nationwide compliance examination program for firms that are registered with the SEC. So those include self-regulatory organizations, broker-dealers, transfer agents, clearing agencies, investment companies, investment advisers, and rating agencies.

As you have heard, the activities and conduct of Mr. Madoff and others are under active and ongoing investigation by criminal authorities, by the SEC's Division of Enforcement, and, with respect to past regulatory activities, by the SEC's Office of the Inspector General. I am not authorized to provide specific information about past regulatory oversight of the Madoff firm, and I am not participating in the current investigation or examinations involving the alleged Madoff fraud. I can, however, provide you with the following general information concerning examinations of the Madoff business.

The Madoff firm became registered as an investment adviser in September of 2006. The SEC staff did not examine the investment advisory operations of the firm. The Madoff broker-dealer operation was subject to routine examination oversight by the Financial Industry Regulatory Authority, and was also subject to several limited-scope examinations by the SEC for compliance with, among other things, trading rules that require the best execution of customer orders, the display of limit orders, and possible front running, most recently in 2004 and 2005. These examinations were focused on the firm's broker-dealer activities. The firm's investment advisory business, as I said, became registered in 2006, and was not examined by the SEC. For the reasons I noted, I must not detail or discuss these examinations in any greater detail.

By way of background, in a compliance examination, examiners, accountants or lawyers, and these people are not just lawyers, they are also examiners and CPAs and CFAs and other people with experience, they review the books and records and gather information that can indicate whether a firm is in compliance with the securities laws. Examinations also include often interviews with relevant personnel at a firm. These examinations are not audits. They are limited in their scope, and they are targeted to specific firms and to specific activities of a registered firm.

The firms that we examine vary in size and in type, and they include firms that are run honestly and in compliance with the law, and they also include firms that may be engaged in deception, dishonesty, falsification of records, and fraud of various kinds. I can assure you that examiners don't pull punches based on the type of firm that we examine or inspect. They are meant to identify deficiencies and violations of the law, and to ensure that those are corrected, regardless of the size or type or nature of the firm under examination.

Broker-dealers are under primary oversight by a self-regulatory organization that conducts periodic routine examinations. Investment advisers, mutual funds, and other types of registrants are not subject to routine examination by a self-regulatory organization. For these firms, the SEC provides primary examination oversight.

The SEC has about 425 staff people dedicated to examinations of all registered investment advisers and mutual funds, and about 315 staff dedicated to examinations of registered broker-dealers. Given the number of registered investment advisers today, over 11,000, and the fact that this population has grown significantly in recent years, the SEC cannot examine every investment adviser on a routine frequency. A small percentage of investment advisers are examined on a routine frequency.

The SEC also conducts cause examinations when we learn of a possible complaint or a problem that could indicate a violation of the law. We conduct random examinations of investment advisers, as well as sweep examinations focused on a particular risk issue.

Finally, I want to assure this subcommittee that at the SEC we are thinking expansively and creatively about changes that could reduce the opportunities for fraud. And we are committed to protecting investors from those who would prey on them in Ponzi schemes and other types of fraud.

Our testimony describes generally some ideas that the staff of the SEC are considering, and these are subject to refinement as more analysis is conducted and more facts are learned. But among the ideas that we are considering are the examination frequencies for investment advisers, the existence of unregistered investment advisers and funds, the different regulatory structures that surround broker-dealers and investment advisers, the existence of unregulated products, and the need to strengthen custody and audit requirements for regulated firms.

We are also looking very hard at ways that we can improve the assessment of risk and the adequacy of information that is required to be filed by registered firms and used by the SEC to assess risks, and whether the risk-assessment process could be improved with routine access to additional information.

In addition, we are targeting firms for examinations of their custody of assets, and we are expanding our efforts to examine investment advisers and broker-dealers in a coordinated approach to reduce the opportunities for firms to shift activities to areas where they may not be subject to regulatory oversight.

In conclusion, I want to assure this subcommittee that in a range of ways we are thinking expansively and creatively about changes that could reduce the opportunities for fraud, as American investors deserve the best possible protection from Ponzi schemes and other types of frauds.

Thank you. I would be happy to answer any questions you have.

Chairman KANJORSKI. Thank you, Ms. Richards.

And lastly, we will here from Mr. Stephen Luparello, interim Chief Executive Officer of the Financial Industry Regulatory Authority.

Mr. Luparello.

STATEMENT OF STEPHEN LUPARELLO, INTERIM CHIEF EXECUTIVE OFFICER, FINANCIAL INDUSTRY REGULATORY AUTHORITY

Mr. LUPARELLO. Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee, thank you for the opportunity to testify today. My name is Steve Luparello. I currently serve as interim CEO of the Financial Industry Regulatory Authority. Also known as FINRA, we are the primary nongovernmental regulator for securities brokerage firms doing business in the United States.

Unfortunately, we are all here today because the fraud that Bernard Madoff reportedly conducted has had tragic results for investors who entrusted their money to him. Investors are disillusioned and angry, and are rightfully asking what happened to the system that was meant to protect them. There was no doubt that Madoff

knew that system well, and perhaps that knowledge assisted him in avoiding detection and defrauding so many unsuspecting individuals and institutions. By all accounts, it appears that Mr. Madoff engaged in deceptive and manipulative conduct for an extended period of time during which he defrauded the customers who invested with him and misled those that had the responsibility to regulate him.

Mr. Madoff's alleged fraud highlights how our current fragmented regulatory system can allow bad actors to engage in misconduct outside the view and reach of some regulators. It is undeniable that in this instance the system failed to protect investors. Investor protection is the core of FINRA's mission, and we share your commitment to identifying the regulatory gaps and weaknesses that allowed this fraud to go undetected, as well as potential changes to the regulatory framework that could prevent it from happening in the future.

Bernie Madoff's broker-dealer was registered with FINRA and its predecessor organization, NASD, since 1960. Prior to 2006, Mr. Madoff also operated an unregistered money-management business. In 2006, the SEC required Mr. Madoff to register that money-management business as an investment adviser.

While Congress authorized FINRA to regulate broker-dealers in 1938, FINRA is not authorized to examine for or enforce compliance with the Investment Advisers Act. Only the SEC and the States have that authority. In fact, while we have the authority to bar broker-dealers and registered persons from the brokerage industry, FINRA is often powerless to prevent those persons from reentering the financial services industry as advisers.

Within Madoff's firms there were two discrete lines of business, the broker-dealer and the money-management business that ultimately registered as an investment adviser. Given the limitations imposed by Federal law, FINRA's authority over Madoff was and is limited to its broker-dealer operations, even though the Madoff-registered investment adviser was in the same legal entity.

For two decades, FINRA examined Madoff's broker-dealer operations at least every other year. We began a separate market regulation exam program in 1996, and conducted that exam at the Madoff broker-dealer each year since. The Madoff broker-dealer consistently reported to FINRA that 90 percent of its revenue was generated by market making and 10 percent by proprietary trading.

When examining the Madoff broker-dealer operations, FINRA found no evidence of trading for customer accounts, which is consistent with the market-making model, and no evidence of the kind of fraud that Madoff allegedly carried out through his advisory business. While we did receive a small number of customer complaints throughout the years, those complaints were filed by customers of other broker-dealers that had transacted business with the Madoff broker-dealer. FINRA did not receive any retail customer complaints that might have alerted us to the existence of the advisory accounts, and there were no complaints related to the investment advisory business as a whole.

FINRA also did not receive whistleblower complaints alleging either front running or Ponzi schemes at the Madoff money-manage-

ment business, nor did the SEC share the tip it received or alert FINRA to any concerns that it may have had with Madoff.

FINRA has long expressed concerns regarding a firm's ability to avoid our jurisdiction by keeping its customers outside the FINRA-registered broker-dealer. As early as the 1980's, NASD officials issued public statements urging reform. As recently as this past year, FINRA's former CEO, Mary Schapiro, personally raised these issues with the SEC Chairman. Unfortunately, the statutory limits of FINRA's jurisdiction did not allow it to be an extra set of eyes looking at the totality of the business. Any number of misrepresentations that can facilitate a fraud like this—the firm did have customers or it didn't, the trades ran through the broker-dealer or they didn't, the firm custodied the assets or they didn't—might have come to light much earlier. And one of the key parts of the FINRA exam program is that we confirm the existence and location of customer assets that are reflected in customer accounts on the broker-dealer. We follow the money to where the regulated firm says it is and ensure that those customer assets are properly segregated from those of the firm itself.

As I stated at the outset, what has happened to Madoff's investors is tragic. The fact is no regulator is perfect, and Ponzi schemes can be difficult to uncover. But that is all the more reason to give regulators the tools they need to ferret out fraud. As I have testified today, we take our mission very seriously. We have vigorous exams and enforcement programs, and have not hesitated to take actions against firms of any size for wrongdoing, or any individual, regardless of their position in the industry.

Mr. Chairman, investors should receive the same basic regulatory safeguards and protections no matter which investment product or service they choose. FINRA is committed to working with this committee as it considers how best to move forward on these important issues.

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

Chairman KANJORSKI. Thank you very much, panel. We have a vote on. It is a 15-minute vote, but if we take the break now, we will all be able to return, and I expect to take more than one round of 5 minutes. All of the members are welcome to participate in the additional round.

This is going to be a difficult panel to work with. As you know, they are asserting certain rights to not respond to certain questions. But I think this panel has the capacity to invade the self-restrictive protective devices of this panel.

With no other statements, we are going to take a break, recess the committee to get the vote, and then we will return for questions.

[Recess]

Chairman KANJORSKI. The committee will reconvene. Thank you for being here as a panel.

There was a little consternation before you arrived here, so I just want the record to be corrected, because, Mr. Vollmer, when you testified, you thanked us for our understanding of the limitations of this panel to the committee, and I think that was premature, because I do not recognize any right of the Agency to lay down limita-

tions as to what members of the SEC have to testify to or not testify to before the Congress of the United States. And unless I am mistaken, if there is any objection to be made, it will be raised either by the Department of Justice or others.

But that notwithstanding, I think we are going to try and be as amenable as we can and as civil as we can just with the idea that I want it clear to the members of this panel, and particularly to you, Mr. Vollmer, that in our discussions and prior preparations for the testimony of this panel, it became obvious to me that there seems to be a dysfunction between the Securities and Exchange Commission and this committee of the Congress in that there seems to be a misunderstanding as to who created whom and who is responsible to whom under the Constitution. And I hope we can disabuse ourselves of that misunderstanding. If we cannot, we should probably take any legal proceedings necessary to determine that, because I think we are involved in an extremely serious case that requires litigation. And from listening to the testimony of this panel, it appears to me that if these cases remain, as they very easily may, for years in trial and work, and it is the position of the SEC that they cannot discuss the matter, cannot be called upon to testify on the matter, and are completely removed from participating with the Congress in creating legislation that may be necessary to correct the matters.

And although I take great sympathy as a lawyer with the protection of cases to be prosecuted and not to compromise the same, we are obviously dealing here with two different situations. One is what laws have to be made or changed to protect the greater members of the public, and what kind of potential compromises would that cause to a particular case.

And in terms of hearing the testimony today of Mr. Markopolos, I have tentatively come to the conclusion that the Securities and Exchange Commission has been annointed by God to be all righteous. I hope I can disabuse the members of this panel of that fact, because, quite frankly, we are about to decide just in what nature and how the Securities and Exchange Commission should continue to exist. And the lack of cooperation shown in the last several weeks, and I think the abuse of authority, or the attempt to bring a protective shield over an executive agency or independent agency of this government is not acceptable. And if that is going to be the process, the easiest thing is to follow Mr. Markopolos's advice and just do away with the entire regulatory system as it is presently constructed and start anew.

I make that point obvious for a reason. There are several things that have happened in the last several years that should be embarrassing to the SEC. Let me ask that question. Are you embarrassed as members of the higher echelon of the SEC with how the Madoff case has been handled, or do you feel that embarrassment does not come into it, and it is unimportant, and that you are above all those things? Would anybody like to tell me that?

Ms. THOMSEN. Let me start. First of all, if we have in any way suggested a self-righteousness to you, I don't feel that. I don't feel it towards the Congress.

Chairman KANJORSKI. So it is understood, and I will break a confidence, one of the members of the panel here originally told me he

was not going to testify because he is exempt. And it precipitated a call, myself, to the Chairman, which I rarely make, although I know her very personally and have known all the Chairmen for 20 years. But it was so annoying to me that when that individual thought he did not have to testify before a committee of the Congress of the United States, I made it very clear that either he would be here today or appropriate subpoenas would be issued. And those subpoenas would have been issued to everybody who is here today. Quite frankly, we would not have accepted any excuse offered or request for lack of testimony on any facts and have structured a case. And let us just see what kind of protections you would have under the law for not testifying.

If we cannot have comity between two branches of government to handle the people's business, we have a serious problem. And right now as this panel is constituted, and as I have heard the testimony, I mean—you know, I like oatmeal, and that is about how I classify the testimony I heard today. And I do not know whether that testimony was written that way and presented that way in order to be a slap at this committee or the Chairman himself, but it is not appreciated. We did not call you up here for us to hear a traveler's guide of the Securities and Exchange Commission.

We are spending our time and effort, many of us, to get to the roots of how a Madoff scandal continues to occur for more than 10 years, when a rather credible expert in the field tries to do everything he can year in and year out to alert the appropriate regulator of the Federal Government that they should have handled or looked into that.

That is a little therapy on my part. Now let me hear your response of how good you intend to be.

Ms. THOMSEN. Mr. Chairman, we are here to help you in your effort. We think this is an important hearing.

As to your original question, I don't think—I think I speak for everyone when I say we hate fraud. We hate the fact that people are victimized by fraud. We wish it never happened. We wish we could get to every—

Chairman KANJORSKI. But your job is to prevent fraud, not to hate it.

Ms. THOMSEN. Well, in the Enforcement Division and the division that I know the best, our job is in part to prevent it, but only as a derivative effect of our enforcement actions, because we can only bring actions when a violation of the law has occurred. Now, we want to get to every violation the instant it happens, and we hope that by our actions there is less fraud to pursue. That is our mission. That is our passion.

I have heard today issues about wanting to avoid going after big players. There is nothing that makes a member of my staff happier than bringing a case. The only thing that makes them happier is a big case. And if it is against someone of some notoriety or fame, that makes them happier still. We live for bringing those cases. We hate the fact that people lose money. And we bring hundreds of them every year.

And I have to say that sitting here today, it is every law enforcer's worst nightmare to miss something, and yet it is something that we know is going to happen because there is—

Chairman KANJORSKI. How do you explain the fact that you not only missed this, but now that the Congress is attempting to close the loopholes and attend to it, you feel disposed not to cooperate 100 percent to see that we do that to protect other frauds that may be occurring and going on right now?

Ms. THOMSEN. Let me try to address it. And I understand your frustration, but when we talk about moving forward, what we can do to address it, the first and, to my mind, most important thing we can do to address it is to hold fraudsters accountable, to bring them to justice, to bring the full force of the law against them. That includes criminal prosecution, civil prosecution. And, for example, quite specifically, when you talk about what we did in the past, some of what happened in the past may in and of itself violate Federal criminal law. And the ability to pursue those cases to the full extent that we can is what we are here to protect. That does not mean that we should not examine what happened and even examine it theoretically to think what we could do, make assumptions about what the past was, and move from there.

Chairman KANJORSKI. Okay. Let me just say that justice delayed very often is justice denied. And if we are going to have cooperation, and we are going to have an effective enforcement tool of the Securities and Exchange Commission, we cannot have the culture or mentality that I sense over there that in examination and investigation, a process can go on forever. I mean, I have stories that will shrivel your ears with how long enforcement proceedings have just laid around with no action having been taken. I am getting the impression that is the culture now, that there is not an intent to do something.

So one of the things the committee will be considering in some of this legislation is whether or not we can impose a 180-day rule. You know, if we can get criminal prosecutions within 180 days in this country, it seems to me once we charge some corporate activity as being a violation of the SEC, let us move along; 180 days get to a trial, let us get it decided. Something like this.

I want to ask the question, how long do you need to resolve the problems that are causing you not to speak or cooperate with this committee? How long do you think these prosecutions are going to take before you can speak up?

Ms. THOMSEN. I honestly don't know the answer. And there are three things that are going on.

Chairman KANJORSKI. So if that is the case, you do not know the answer, it could be years; is that correct?

Ms. THOMSEN. I don't know.

Chairman KANJORSKI. Well, if it is years, and you do not intend to say anything, if I listen to how your statement and your counsel structured the statement, there are three things. You cannot help if it is a pending criminal investigation; you cannot help if the Inspector General is doing something; you cannot help if it is an ongoing violation. I mean, if there is a snowstorm in Washington, the SEC cannot help. That must be one of the conditions.

What I want to find out is, how long is it going to take for that to be vitiated? And when can we get together and cooperate in developing legislation that will protect the people other than Madoff?

Ms. THOMSEN. Sure. Let me suggest an approach that may help, because I understand your concerns about how much time it takes to get to specifics. But if you want to try to think about how we can help generally, we can make assumptions. So, for example, you could assume that—to my mind, I like to assume a case where I think the solution is the hardest, because if we find that solution, we will be considerably better off. So when I look at a potential investigation, let me hypothesize. The SEC gets a credible lead, a lead is followed up on to a certain extent, and the investigation is closed without action, as it can happen.

Now, when an investigation is closed, it seems to me there are one of two possibilities—well, maybe four. Either there was nothing to be found, and nothing was found; or there was something to be found, and it wasn't found—there are probably more. But in those circumstances, if we assume that something could have been found and wasn't, what are the reasons underlying that? And if it is complete and utter corruption, the answer is easy: You get rid of that which is corrupt.

If, on the other hand, the answer is that people of good will were trying very hard, the answer may be they lacked training. And so that is one of the issues that I know has been addressed. Or they lack expertise. So what do we do to provide additional expertise to people so that they have the expertise to look further? It could also be that it is a resource issue. That is you look, you find nothing, you keep looking, you find nothing, and then something else blows up somewhere else that is appearing to be more important at the time.

I mean, one of the issues that we are obviously struggling with is if we knew going into something that it was a fraud, a provable fraud, with evidence that we could present to a fact finder, it would be easy. When you don't know, that is what you pursue.

So I think we would be happy to have that conversation, that dialogue, to make the assumptions to make us better. We try every day to learn from our experience. And so among other things we are thinking about, as the committee has suggested, what can we do on risk? What can we do for expertise? What can we do to maximize our resources? And those are precisely the kinds of things that we are thinking about, even though we can't necessarily share the specifics with the committee.

Chairman KANJORSKI. Thank you, Ms. Thomsen.

I am going to call on my ranking member here, who obviously has some additional questions. I took more than enough time. Particularly I had to have therapy.

Mr. GARRETT. I thank you. And you know, Mr. Chairman, when I began my remarks, before I got into my remarks, I commended you on the statements that you made earlier today on CNBC with regard to the hearing with regard to what needed to be done. And it was actually by watching that program I learned a bit of other information. On there they were issuing—talking about an OIG, an Inspector General's report that was just listed on their Web site either today or yesterday with regard to a different issue, but still within the SEC. And it is regarding to uncollected disgorgement, what it is called.

That is not the point of this here, but after seeing that on, I guess it is Squawk Box, I had my staff go and we pulled out a copy of the report because it didn't really go to what we are talking about here, but after going through it, it does in two ways. One, it goes to—on the weed side or getting into it, it goes to the issue of enforcement and whether there is being enforcement done in general.

And as I assume the panel knows, this report raises a number of serious questions. There is about $177 million in uncollected disgorgement. And for those who don't know, disgorgement just means once you have a case, and you find the guy, and you get the guy who did the bad thing, and then you want to go after him and actually get back those revenues from him, the ill-gotten gains. I guess the OIG says there is at least $176-, $177 million in uncollected disgorgement. That would be one issue.

But the larger issue is in going through it, this goes back all the way through 1999, I believe it was at the very beginning, talking about that the OIG had done similar studies or reviews. And then if you go back at the very end to look to the Inspector General's responses to the management's comments, since the OIG gives their opinion, and then management is able to give the response, and then OIG gives a response to that, the very ending of it is—this is obviously OIG speaking—notwithstanding this effort—speaking to, in other words, the OIG saying over the last 1999, 2001, 2002, 2003, 2004, 2005, so almost 8 years, 9 years—notwithstanding the efforts of trying to address this situation, the language and the tone of the Enforcement's response leaves us unconvinced that Enforcement will take the OIG's findings seriously and implement tangible and concrete measures to improve its disgorgement waiver process.

I know, Mr. Chairman, we are not going into the issue of disgorgement. It just did raise a proverbial red flag that if there has been 7 or 8 years or more of OIGs saying—as an auditor basically saying, here is our recommendations to make changes, and 8 or 9 years later there are still those questions, it raises the flag here is that if this as a body comes up with our recommendations saying that we will just leave it to the SEC to act unilaterally to try to implement changes, that we may very well, as the chairman says, be waiting a long time. So it just raises those questions. I appreciate the fact I was able to learn that by watching the TV today, quite literally.

What I would like to learn a little bit more, though, is going into some of the issues that the first panel raised. And here is an easy one to start things out, to whomever can either address this right now or address it later on. And I see a lot of gray-haired people sitting in front of me, the gentlemen that is, which the previous panel was speaking to the issue of—

Ms. THOMSEN. There is gray here, too.

Mr. GARRETT. Well, I was never going to go there.

The issue was as far as the experience of the people who are conducting in the enforcement side and the examination side. Can you provide us with a response to that as to your number of employees, the salaries of your employees, the years of experience that they have within the Department?

Now, I noticed a number of you spoke to your experience here within the Agency, the SEC. First panel, Mr. Markopolos would probably indicate that he would be suggesting, as others would, that we look for experience outside of the Agency as well. So if you could provide that to us, a detailed summary of that as prior experience to address that issue. And if anybody would like to, I know you are not going to have that at your fingertips right now, want to address that general allegation, if you will, that the SEC is made up of folks who really come to the table without the adequate practical business experience necessary to get the job, and that they are simply government employees.

Ms. THOMSEN. Sure. I think we would probably all appreciate the opportunity to get specifics to you. Why don't I start, because my division is probably the division that has the greatest characteristic that was complained of. We do have a lot of lawyers in the Division of Enforcement, and that is because we have to prove our cases in court.

Mr. GARRETT. Can we just run through? I see my time has almost run out.

Ms. THOMSEN. Okay. Never mind. Let me stop. We have lawyers, accountants, and analysts, as well as market surveillance types. But I would let the others talk.

Ms. RICHARDS. Do I have time to supplement that?

Mr. GARRETT. Sure.

Ms. RICHARDS. In the examination program, we are mostly accountants and examiners. There are some lawyers, but the majority of the staff are examiners and accountants. They are CFAs and CPAs.

After the Congress adopted pay parity legislation, it gave the SEC the authority to pay our staff at higher salaries that were commensurate with other Federal banking regulators. It allowed us to bring in a greater number of staff that had experience; either experience in the industry, in auditing, in compliance. And so in the last, I would expect, 4 years, 5 years, our staff has become much more experienced, much more well-rounded than they were in earlier years, where they were more likely to be hired right out of school.

So that happened with the change that Congress gave us to pay our people a little bit more. And as a result, we began to keep people longer so they could gain experience in examinations, gain experience in dealing with complex products, complex strategies, and emerging types of compliance risks. So in the last 4 or 5 years, I believe it is a much better situation at the SEC in terms of the caliber and the experience of the examination staff.

Mr. GARRETT. With the chairman's permission to ask for elaboration on that, the suggestion was, and it is probably a good one, that if you were able to get some people who were in the industry, have worked in the industry most of their lives, and then come into the SEC to start doing enforcement, examination, rulemaking, etc., is that a practice to actually go out and seek that individual who has the 20-some-odd years' experience who is about to—well, whatever to go into this field later on in life?

Mr. SIRRI. Let me see if I can answer that question. We understand that such people are very valuable, they are very desirable.

It is simply hard to recruit them. We absolutely go out of our way to find people with industry experience. And we have such people in our division, Trading and Markets.

More to the point, within the Division of Trading and Markets, we have a group of people who are explicitly not lawyers who are collected together to supervise certain risk issues at broker-dealers. These are people with Ph.D.s in economics, accounting, statistics; master's degrees; exactly the kind of people you would think of you would want who have quantitative backgrounds to deal with just these kind of issues. And I will point out that some of them teach courses in derivatives on their own time, either before they came to the SEC or as they are at the SEC in the evenings to just those MBA students that were referred to on the prior panel.

Ms. RICHARDS. I also just want to add, just to supplement that, that we have in recent years hired former traders in the exam program, which is extremely beneficial to help us look at trading records and unscramble what could be violative trading patterns. And that expertise brought in from the industry has been extremely valuable to us.

One of the things we really want to do going forward is to expand that expertise to hire more quants, to hire more economists, to hire more former traders so that they can provide a resource, that expertise as a resource, to all the staff at the SEC.

Mr. GARRETT. I would just close on this. And let us say that the dilemma that I think that any government regulator is going to have was expressed to me by someone in the industry, and that is when they deal with you, that if they find somebody, whether he is a young guy out of school or somebody who has been around for a long time and can teach the course or do these other things, and he is a real top-notch guy, no matter what you guys are offering him, in the private market they are going to offer him a whole lot more. And so we are always going to have that dilemma of trying to get the best and the brightest, because the best and brightest are going to go where the pay is, and that may not be with the SEC. But I thank you for the latitude to expand.

Chairman KANJORSKI. Mr. Ackerman.

Mr. ACKERMAN. I am frustrated beyond belief. We are talking to ourselves, and you are pretending to be here. I really don't understand what is going on. The previous witness said that you guys as an Agency act like you are deaf, dumb, and blind. I figured you were coming here, and you were going to testify before Congress. Don't you dare tell anybody you testified before Congress. You are going to be subjected to violation of false advertising lawsuits. All right?

You have told us nothing, and I believe that is your intention. I figured you would leave your blindfolds and your duct tape and your earplugs behind, but you seem to be wearing them today. And instead of telling us anything, you read from the preamble of your mission statement and broke it up into five segments.

What the heck went on? You said your mission was to protect investors and detect fraud quickly. How did that work out? What went wrong? It seems to me a private—with all of your investigators and all of your Agency and everything that you all described, one guy with a few friends and helpers discovered this thing nearly

a decade ago, led you to this pile of dung that is Bernie Madoff, and stuck your nose in it, and you couldn't figure it out. You couldn't find your backside with two hands if the lights were on.

Could you explain yourselves? You have single-handedly defused the American people of any sense of confidence in our financial markets if you are the watchdogs. You have totally and thoroughly failed in your mission. Don't you get it? And now other people are investigating what you should have found out, and you are hiding behind, well, maybe we can't talk because someone else is looking at it. Well, you forfeited your right to investigate by not doing it, certainly not doing it properly or adequately. And now you are trying to tell us that because other people are looking at it, you are not going to tell us what is going on? Like hell you won't.

What happened here? That is a question. Do we start with hear no evil, see no evil, or do no evil? Take your pick. I only have 5 minutes.

Ms. THOMSEN. Let me start with Enforcement. As I said, we did an investigation—we began an investigation in 2006, and it was closed without action.

Mr. ACKERMAN. Why was it closed without action? What did you investigate? What methodology did you use?

Ms. THOMSEN. And in the interests—

Mr. ACKERMAN. Were you suspicious when the guy had a one-man accounting firm investigating a $50 billion empire? And you keep saying alleged, alleged. This guy confessed on national television, you might have noticed.

Ms. THOMSEN. And as I said, our objective is to actually hold him accountable in a court of law, bearing our burden of—

Mr. ACKERMAN. You missed your chance.

Ms. THOMSEN. We have a pending action pending in the Southern District of New York.

Mr. ACKERMAN. You took action after the guy confessed. He turned himself in. Don't give yourself any pat on the back for that.

Ms. THOMSEN. Congressman, every time—

Mr. ACKERMAN. Why didn't you find him, is the question?

Ms. THOMSEN. I understand your question, and we cannot answer as to the specifics. I can talk generally—

Mr. ACKERMAN. You know, if anybody made the case better than Mr. Markopolos, and I didn't think anybody could, about you people being completely inept, you have made the case better than him.

Ms. THOMSEN. Well, sir, I am sorry you feel that way, profoundly.

Mr. ACKERMAN. I think I am reflecting what the American public feels. How are they supposed to have confidence that if somebody goes to you with a complaint, gives it to you on a silver platter, with all of the investigation, with all of the numbers, with all the of the data, tell you exactly what he did, how he did it, and why he did it and how he knows that, and after a period of 6 or 8 years, you don't know anything.

Ms. THOMSEN. I can only talk about what we do overall.

Mr. ACKERMAN. No, no, we want to know specifically. I don't want to know what your general purpose in life is. I don't need you to come here to tell me that you hate fraud. I hate when that happens, don't you? You are supposed to find it out before it happens.

Ms. THOMSEN. In Enforcement, obviously we can't. And I understand that concern. In Enforcement we bring—last year we brought 670-some-odd cases. In the past 2 years, we brought 70 cases involving Ponzi schemes. In those 70 cases, close to half—

Mr. ACKERMAN. Listen, I am sure you have medals and ribbons—

Ms. THOMSEN. No, sir.

Mr. ACKERMAN. —and stuff like that. And congratulations on all the good stuff you have done. I don't want to belittle any of that. But this is huge. How do you miss that? And we know that there are many Madoffs out there. They are starting to surface. You missed all of those, too. But this one you were pointed at. And Mr. Markopolos says he is going to give you another one tomorrow. He is not even giving it to you. He is giving it out to someone else because nobody has confidence in you guys anymore.

Maybe the General Counsel, Mr. Vollmer, I believe you were the one who thought that your people didn't have to testify here today. I don't know where you got that, but some of us think otherwise. Maybe you could tell us. How did they miss all this?

Mr. VOLLMER. We are as committed as each of you—

Mr. ACKERMAN. That is not the question. We give you credit for being committed.

Mr. VOLLMER. Perhaps you could let me answer.

Mr. ACKERMAN. Perhaps you can try to answer.

Mr. VOLLMER. And what we are asking—

Mr. ACKERMAN. No, no, we are asking. You have to tell us things. You are forgetting what this procedure is. You aren't coming here to ask. We are asking you. How did you screw up?

Mr. VOLLMER. Let the process work. It is a process Congress set up to identify the facts that we all need to make these judgments. Let us let the system work that Congress created. There will be some recommendations. There will be time for this committee to look at the facts and to think of recommendations themselves.

Mr. ACKERMAN. Tell that to people who have lost their whole lives, that they have time.

Mr. VOLLMER. And that is the appropriate way to proceed in this matter.

Mr. ACKERMAN. People don't have time. We need you to tell us something instead of lecturing us, Mr. Vollmer.

Mr. VOLLMER. And the other thing that matters is that there are law enforcement proceedings going on, there are personal rights at stake, there is the integrity of the investigation.

Mr. ACKERMAN. We wouldn't be in this mess if you people did your job.

Mr. VOLLMER. And that is why we have asked the committee to bear with—

Mr. ACKERMAN. No, we are asking you. We are asking you.

Mr. VOLLMER. —these investigations to allow them to proceed.

Mr. ACKERMAN. Could you cite whatever authority you are citing and have cited?

Mr. VOLLMER. I would be delighted, I would be happy to do that. I would be happy to talk with your—

Mr. ACKERMAN. Because you have a right not to answer the Constitution's fifth amendment procedure.

Mr. VOLLMER. —your lawyer.

Mr. ACKERMAN. I am not a lawyer. I am a citizen.

Mr. VOLLMER. I would be happy to talk to your lawyer.

Mr. ACKERMAN. I am a frustrated citizen.

Mr. VOLLMER. Happy to give the references to you or to your lawyer.

Mr. ACKERMAN. I am listening. Give us the references.

Mr. VOLLMER. There is a very important opinion from Attorney General Robert Jackson in 1941, where he explained the need to discharge the constitutional and statutory obligations of the Executive Branch in connection with law enforcement and civil litigation—

Mr. ACKERMAN. Are you citing Executive Branch immunity, Mr. Vollmer?

Mr. VOLLMER. —in response to requests for information from the Congress.

Mr. ACKERMAN. Are you citing Executive Branch immunity, Mr. Vollmer?

Mr. VOLLMER. There are various protections—

Mr. ACKERMAN. Are you citing Executive Branch privilege, Mr. Vollmer?

Mr. VOLLMER. I would like you to allow me to answer your question.

Mr. ACKERMAN. It is a yes or no question, sir. Either you are or you are not.

Mr. VOLLMER. No, it is not. There are a variety of reasons and privileges and protections. One of them is Executive Branch protections. There is a deliberative process protection. They stem from the same desires that you have. And we are asking that you allow those processes to work.

Mr. ACKERMAN. We are out of patience. And the question, obviously, is a yes or no question. Either you are citing Executive privilege immunity or you are not doing that.

Mr. VOLLMER. I have just explained there are various doctrines.

Mr. ACKERMAN. You know, if you are citing your fifth amendment privilege, you don't make a speech.

Mr. VOLLMER. And that one of them was the Executive privilege.

Mr. ACKERMAN. Was that a yes, you are citing Executive privilege immunity?

Mr. VOLLMER. I said in part it is, yes.

Mr. ACKERMAN. I am sorry?

Mr. VOLLMER. I said yes, it is in part.

Chairman KANJORSKI. Have you inquired of the Justice Department or someone else that they have analyzed that position for this hearing today, and they found that the Securities and Exchange Commission, requested by Congress to discuss a very important pending piece of legislation that is being established to protect hundreds of thousands, perhaps millions, of people, that you have a right, representing the Executive Branch, the President of the United States, to stand on that authority? Have you posed that question to the Attorney General or—

Mr. VOLLMER. No.

Chairman KANJORSKI. Then this is on your interpretation?

Mr. VOLLMER. This is the position of the Agency.

Chairman KANJORSKI. And you are the General Counsel for the Agency. I assume you make the legal determinations for the Agency.

Mr. VOLLMER. No, the Commission makes the decisions for the Agency—

Chairman KANJORSKI. So this question—

Mr. VOLLMER. —after obtaining advice from a variety of sources, and the General Counsel's Office is one of them.

Chairman KANJORSKI. So this has been passed through the new Director or Chairman of the Commission, and the members of the Commission, and they agree and have instructed you to instruct this panel not to respond to the questions of Congress because of Executive privilege and maybe other privileges contained in the 1941 Supreme Court case; is that correct?

Mr. VOLLMER. The Commission supports this position.

Mr. ACKERMAN. That wasn't the chairman's question.

Mr. VOLLMER. The answer to that specific question is no.

Mr. ACKERMAN. The answer is no. So you are acting on your own volition.

Mr. VOLLMER. No, I didn't say that. No, and I would disagree with that.

Mr. ACKERMAN. You know, most of us speak English, and we are having a hard time getting an answer from you. This was not discussed by the Commission, but it is the Commission's position. Is that what you just said? Do you divine that?

Mr. VOLLMER. The Commission has approved taking this position.

Mr. ACKERMAN. The Commission has voted the position that you will cite Executive privilege in not testifying before this committee and answering its questions.

Mr. VOLLMER. I couldn't say that to you honestly, because the specific reasons—

Mr. ACKERMAN. Obviously.

Mr. VOLLMER. —weren't discussed and given by the Commission. But the basis is that we were—

Mr. ACKERMAN. Your value to us is useless.

Mr. VOLLMER. —in accommodation—

Mr. ACKERMAN. Your value to the American people is worthless. Your contribution in this proceeding is zero.

Mr. VOLLMER. We ask that you take into account the concerns that have been well settled over many years, and we would ask you to take those into account.

Mr. ACKERMAN. Our economy is in crisis, Mr. Vollmer. We thought the enemy was Mr. Madoff. I think it is you. You were the shield. You were the protector. And you come here and fumble through make believe answers that you concoct and attribute it to Executive privilege that you have not consulted with the Executive Branch on.

Mr. Chairman, I am through.

Chairman KANJORSKI. May I just add a second, were you all in the room when we had a prior witness? If I remember correctly, his testimony was that FINRA was corrupt, and the SEC was incompetent. Do you all not want to defend against that, or do you all accept that?

Ms. THOMSEN. Of course not.

Mr. LUPARELLO. Mr. Chairman, on behalf of FINRA, we take great issue with the representation that we as an organization are corrupt.

Chairman KANJORSKI. Are you going to break your—are you asserting the same Executive authority or—

Mr. LUPARELLO. I am not.

Chairman KANJORSKI. —privilege?

Mr. LUPARELLO. I am not.

Chairman KANJORSKI. So you are willing to break any rights or privileges you have in order to speak? I just want to make sure.

Mr. LUPARELLO. FINRA is not involved in the investigation. It is therefore a little bit less complicated for FINRA. But I am here to answer any question you would ask.

Chairman KANJORSKI. Very good.

Mr. Royce, we are going to give you a shot to see if you can get any responses.

Mr. ROYCE. Well, in order to try to do that, maybe what we could do is go back to Mr. Markopolos's testimony, and maybe we can try to get an answer to some of the points that he raised. Specifically, one was what he described as the overlawyering at the SEC. His argument was that it was the inability for some of the regulators to even comprehend the complicated investment strategies that he presented them. Is there a concurrence that perhaps that was indeed the problem, or can anybody speak to that?

Ms. THOMSEN. Well, I don't know if Erik wanted to start. I will start from the—

Mr. ROYCE. Why don't you start, because this would be Enforcement, right? And you are the Director for the Division of Enforcement. And I think that is the big question mark here. Was he right in that assertion? And then we can go to the next point he raised. Okay?

Ms. THOMSEN. Sure. I think without speaking specifically about whether he was right or not, let us talk about the issue of expertise, and I think that is a fair and important issue to discuss. As I said earlier, the Enforcement Division is largely lawyers, because our expertise is trying and winning cases. We have to comply with court rules. We have to meet burdens of proof. And that is traditionally a lawyer job.

Within Enforcement, we have lots of accountants who help us, lots of market specialists and investigators to help us on the core mission of the specific cases. Ours is a pretty micro job. Did this person commit a fraud? A "Can I prove it" kind of question. Now—

Mr. ROYCE. Right, but the complexity of the fraud is the problem. And you have a few people who had maybe 25 years experience as portfolio managers, but unfortunately they were on his side in this debate. They got shut out by the lawyers apparently. He had his allies in the SEC, but obviously—

Ms. THOMSEN. Again, let me not talk about the specifics—

Mr. ROYCE. Okay.

Ms. THOMSEN. —but talk about the expertise that we do have available to us within the Agency. And lots of them are represented to my left. We do go to our peers at the Division of Investment Management. We go to Trading and Markets, an enormously valu-

able resource for us when we are dealing with broker-dealers, broker-dealer issues. We have our Office of Risk Assessment, which is growing. It is a need we recognized some time ago. We have the Office of the Chief Economist.

Mr. ROYCE. Let me get to a question really quick then.

Ms. THOMSEN. Sure. Of course.

Mr. ROYCE. The percentage maybe, if you could give me an estimate in your division there, of broker-dealers or investment advisers or those who have that experience in the exchanges or rating agencies that also maybe are lawyers, but have that kind of experience—

Ms. THOMSEN. Within the Division itself?

Mr. ROYCE. —who are basically in a position to be key decision-makers on these kinds of cases.

Ms. THOMSEN. Within the division itself, very few.

Mr. ROYCE. I think that was his point, wasn't it?

Ms. THOMSEN. I understand the point. And I think the issue of expertise is one that I mentioned earlier we do need to address. We have—

Mr. ROYCE. Let me—because my time is limited, let me go to Erik Sirri really quick with a question, because the testimony this morning mentioned the vast difference in fraud cases uncovered from cases initiated by industry tips. And that then was explained against those from audits by regulatory bodies. And you must have been struck, as we were, by the discordant—by the extreme difference in terms of how many of these came from people in the industry that apparently knew more and discovered more in advance. Somehow the private sector was well aware of the Madoff Ponzi scheme before the SEC.

And so, you know, do you believe that is an accurate assessment? And do you believe the investigative priorities maybe of the SEC are properly set, given the outcome, that we are not just talking about one case here; he was taking in aggregate the number of cases brought because of whistleblowers, how much more effective that was than the experience of the auditing by the regulatory body.

Mr. SIRRI. I did understand the point that he made, and I, too, was struck by that point, though in many ways not surprised by it. People on the inside, of course, have knowledge, and they have their own motivation for releasing that information. When you are on the outside, of course, it is much more difficult to make those inferences and ferret it out.

The division I supervise is a policy division. We do not have examiners. We don't have an enforcement function, so I can't speak, I think, to the heart of what you asked. But I would like to follow up on a point that Linda Thomsen made.

The questions that you had asked were on expertise, and I think this event that has happened with Mr. Madoff has caused us to think about the way I think we deploy expertise. Chairman Schapiro, in her opening e-mail to us as a staff, said it is time to think about self-evaluation, and that we need to honestly take a look at what we are doing and how we are doing it. And I think we all as staff take that precisely to heart. When it comes to a point like expertise, nothing could be truer because that doesn't

cost more money. That is just a matter of working smarter. And I think we try do that as best we can.

We have resources within the SEC. The Office of Economic Analysis, almost exclusively economists with Ph.D.s; my division, mostly lawyers; but as I said, many, many other folks. I have a Ph.D. in finance, so I price derivatives for a living at times, so I am comfortable with that. Nonetheless, not all those people are brought to bear on the right problem at the right time. That is clearly something we need to work on. And when we see instructions like we got from Chairman Schapiro, I think it is a clue to all of us to figure it out so something like this doesn't happen again.

Mr. ROYCE. Thank you, Mr. Chairman.

Chairman KANJORSKI. Let me see, Melissa Bean from Illinois. Where did you appear from?

Ms. BEAN. I snuck in on you. Thank you, Mr. Chairman. And thank you all for your testimony here today.

I guess I would direct my questions either to Ms. Thomsen of Enforcement or Lori Richards of Compliance. I am not sure where this would fall, but clearly, the challenges that people feel we are facing as a Nation where there has been lack of compliance and enforcement isn't new to the SEC. Congress certainly provided additional funding. We all remember Enron and WorldCom and other situations where there needed to be greater scrutiny than has been provided.

I guess my question is how proactive is—and what level of best practices are in place to ensure that, number one, when people actually make complaints and suggest someone gets looked at, are lower-level staffers allowed to just dismiss those without a full investigation? And should that continue? Or should things have to be escalated automatically through at least several levels of authority before dropping further inquiry?

And where there haven't been any issues raised, what types of best practices are in place to go out there proactively in the industry to seek where there may be problems and investigate that at least on a sampling type of basis?

Ms. THOMSEN. Why don't I start with the complaint process, and perhaps Ms. Richards can talk about some of the examination process which is directed at proactively identifying issues.

On the complaint process, as we mentioned in our testimony, we literally receive hundreds of thousands of complaints every year, hundreds of thousands. So we simply—we can't investigate all of them. We take them all seriously. We try to respond to them. So the process for us is trying to triage them to identify those which have the greatest risk of the greatest harm, as well as the greatest likelihood of being accurate or verifiable. And all of you get all kinds of information, tips, mail, too. And the real challenge is you can get something that looks terribly credible with lots of detail and lots of exhibits, and it can be, for whatever reason, not true, not verifiable, etc.

Ms. BEAN. If I can interrupt only because we have limited time. Given that, and given the constraints of resources, what is the criteria when you get multiple complaints about the same organization year after year; how is it that this doesn't rise to senior-level attention?

Ms. THOMSEN. Let me just back up. So we are not being specific about this particular issue, but complaints get followed up. They get triaged, and they are worked. If someone decides to pursue it—it is not an on-off switch. You look at something, you do some work on it, you consult with your supervisors along the way. You may do a little investigation. If it looks promising, you may do more. How much more you do is a decision that gets made along the way, balanced against what you are finding.

Ms. BEAN. So there are no checks and balances within the SEC to say if someone has decided based on their—the degree of knowledge they have taken to pursue how big the risk or harm is—clearly if we look at the Madoff scenario, if we have met both of those criteria, what are the checks and balances in place to say that someone else decided that that was worth moving past?

Ms. THOMSEN. I am struggling with how to answer that because in the specifics—

Ms. BEAN. Does that have to happen, or can it just be arbitrarily dismissed by an individual?

Ms. THOMSEN. It is going to be assessed within an organizational group through—up through supervisors. And I think that is as far as I can go specifically.

Now, there are certain kinds of complaints that do have specific procedures. For example, if we get online complaints, there are very specific procedures that are followed in terms of responding. And which ones get picked up for further investigation also involve judgment calls. There are specific procedures with respect to SARS, suspicious activity reports, that we review. We try to—for example, depending on the nature of the complaint, if it is an accounting complaint, we have people with accounting expertise review them, all with an eye towards bringing expertise to those complaints.

Ms. BEAN. Let me interrupt again. So given that obviously this was a really big miss, and was dropped repeatedly, is it a lack of resources or a lack of skill sets among those who are in place who are making these decisions, in your opinion?

Ms. THOMSEN. What I would like—let us not assume—

Ms. BEAN. Well, I am not assuming, I am asking. So which is which?

Ms. THOMSEN. Well, first, there is a premise I would like to address first. I would not necessarily assume that a complaint was not addressed.

Ms. BEAN. The assessment was inaccurate. Is that a skill set issue?

Ms. THOMSEN. Not—and I am not trying to quibble, because the issue is, if the assess—assume there is a complaint with a very—which led to something, as you say, dramatic and specific. That complaint in a matter—as a matter of practice would be pursued in an investigative way. Then the question becomes, what happens in the investigation? And that depends on what you find by way of—

Ms. BEAN. My time is up. So I will yield back.

Ms. THOMSEN. Thank you.

Chairman KANJORSKI. Thank you very much.

Mr. Posey wishes to examine for 3 minutes and reserve 2 minutes.

Mr. Posey.

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

I was watching this on TV, eating my lunch, and it just occurred to me how shocked I would be if somebody dropped into my local police department and said, you know, there is a bank robbery going on down the street. Can you do something about it? And they said, yes, if we get around to it, we will. Or, well, we have done bigger robberies than that before. We are not going to worry about that.

It is amazing to hear the stories and the testimony that we have heard today, truly amazing.

A question for Ms. Richards at this point, and then I would like to reserve some of my time. You stated that you had been recused from the Madoff investigation, and I was just wondering why that was.

Ms. RICHARDS. Yes. Thank you for the question.

I am not participating in the current examinations or investigation due to the fact that a former employee who was under my chain of command married a member of the Madoff family, and I attended the wedding. So the SEC has established a process that would allow the staff to recuse themselves from any current or ongoing investigation or examination so as to ensure that no possible questions are raised about the objectivity or the impartiality of the examination or the inspection. So for those reasons, I am not participating in the current examinations of the firm.

Mr. POSEY. Could I follow up, Mr. Chairman?

Chairman KANJORSKI. Yes.

Mr. POSEY. So you asked to be recused?

Ms. RICHARDS. Chairman Cox in December decided that the SEC would establish a process for SEC staff to ensure that there were no questions—

Mr. POSEY. I understand. But you asked to be recused; is that correct?

Ms. RICHARDS. Yes. When guidance was provided by our ethics counsel, I then took that guidance and recused myself.

Mr. POSEY. Do you think had you not been recused, you could have added anything, any information at all whatsoever that would be at all pertinent?

Ms. RICHARDS. Add it to this testimony? To today's hearing, you mean?

Mr. POSEY. No, to the investigation. It is a question that begs for an answer. Is it innocuous that you recused yourself, and it would have no effect on it? Or do you consider your knowledge and insight and service to be of any value in this?

Ms. RICHARDS. I am sorry, sir. I didn't understand your question. There are very senior staff at the SEC, very experienced staff examiners who were working on the examination and on the investigation. So I don't believe that there will be any compromises to the quality of the work.

Mr. POSEY. Thank you.

I thank you, Mr. Chairman.

Mr. ACKERMAN. [presiding] The gentlewoman from New York, Mrs. Maloney.

Mrs. MALONEY. Thank you very much.

Mr. Markopolos in his testimony earlier testified that he brought complaints 5 times in writing to the SEC, and these were detailed complaints. It wasn't, "I think something's wrong." These were detailed complaints that this is wrong. They are not trading. They are not doing this. There is examples. And it was a very specific complaint, not once, not twice, not 3 times, but 5 times to the SEC. He said he had the support of some people in the SEC, professionals, saying that this needed to be investigated. And how many more times would a whistleblower have to bring complaints to the SEC for them to have investigated the Madoff case?

Ms. THOMSEN. As I think we have made clear, we did investigate in 2006, and the investigation resulted in no action—no recommendation of enforcement action. So the issue, I think, to a certain extent becomes in investigations—with any complaint, our job is to verify the information.

Mrs. MALONEY. But one of the things he said was that Madoff wasn't conducting trades. Now, if you went in and just asked for the trade slips or proved that they were doing trades when whistleblowers were saying they weren't doing trades, then you could have shut him down in one-half hour. You could have shut Madoff down in one-half hour by just following up on one of his allegations that they were not conducting trades.

So did the SEC ever use any tools to confirm that Madoff's trades could be confirmed in market transactions?

Ms. THOMSEN. As to the specifics of the investigation, I can't answer. As to what we do when we investigate, we try to confirm if we can—if there is a complaint, we try to confirm the elements of the complaint. Oftentimes a complaint takes us—

Mrs. MALONEY. Well, let me tell you something. I am not an SEC official, I am not an attorney, but I have common sense, and if I were sent in to find out whether or not he was trading, I would ask, where are your trade slips? Where is the proof that you are trading? It doesn't have to be classified information.

I find this absolutely outrageous, and if you won't answer it, I think I am going to appeal to the chairman to subpoena and find out what you did in this case.

He further testified today in very riveting testimony that in 2001, he offered to go undercover. He offered to risk his life to work with the SEC to prove this fraud. Why was that request turned down?

Ms. THOMSEN. Without talking about the specifics, let me say that we are a civil law enforcement agency and do not do undercover operations. They are exclusively the province of the—of criminal authorities. We don't do them.

Mrs. MALONEY. He also said, and I quote, and he wrote in his testimony, that Madoff was, "one of the most powerful men on Wall Street and in a position to easily end our careers or worse." He told me he was afraid for his life that he was bringing these allegations. He was afraid Madoff would have somebody kill him because he was bringing these allegations, and yet, they were brought in a very comprehensive way that would have been easy to prove. And you can't testify as to what tools you used or what results you got on looking at, whether or not he was conducting trades.

I mean, that is pretty basic. When people say, he is not conducting trades, it is a complete lie, that would have been able to be proved within a half hour if you looked at it. But maybe the SEC was afraid of—do you think the personnel were afraid of having their careers ended or worse if they looked at Madoff, as Mr. Markopolos said?

Ms. THOMSEN. On that one, again, without regard to Mr. Madoff, absolutely not. Absolutely not.

Mrs. MALONEY. Have any employees at the SEC ever gone to work for Madoff?

Ms. THOMSEN. I don't know the answer to that.

Mrs. MALONEY. Can you look into that?

Ms. THOMSEN. I think we can. I think we can. And I would say that the issue of revolving doors, the ethics rules are very seriously—we take them seriously.

Mrs. MALONEY. I know we have ethics rules. My question was, have any SEC employees gone to work for Madoff?

Ms. THOMSEN. I don't know the answer, but we will find out.

Mrs. MALONEY. The Madoff feeder funds were advertising unbelievably high sharp ratios. Can you tell us what a high sharp ratio is?

Mr. SIRRI. Yes, I can. A sharp ratio is the ratio between the expected return on the fund and the risk of the fund. So a high sharp ratio means that fund is returning a great deal of return for a unit of risk.

Mrs. MALONEY. And Mr. Markopolos testified about the sharp ratios advertised by Madoff and his feeder funds. Or do you agree that the sharp ratios shown by Madoff's equivalent to a baseball hitter hit 150 home runs a year, wouldn't you think that was a warning sign? His ratios were so successful; wasn't that a warning? No one else could get those numbers.

Mr. SIRRI. I have not seen those ratios, so I can't say anything specifically again about this case.

Mrs. MALONEY. Maybe it is something the SEC should have looked at.

Mr. ACKERMAN. The time has expired.

The Chair will next recognize the gentleman from Colorado, Mr. Perlmutter, and request of him if he would yield me 1 minute, I would be glad to extend his time by that amount.

Mr. PERLMUTTER. Mr. Chairman, I will so yield.

Mr. ACKERMAN. You will be made whole.

I just wanted to follow up on Mrs. Maloney's very important question to which the answer was neither opaque nor vague. It was just avoiding. But let me—inasmuch as you are not going to talk to us about specifics, which is why we invited you, could I ask you a hypothetical question? Hypothetically, if somebody came to you with evidence and a charge that somebody was committing a multibillion-dollar Ponzi scheme and said that person was not actually even making trades, would it not be standard operating procedure for you to go and see if he had trade slips?

Ms. THOMSEN. Our investigations would follow—

Mr. ACKERMAN. This is a yes or no question.

Ms. THOMSEN. There is no standard operating procedure other than if we took a complaint seriously, we would try to find out whether the facts were true or not.

Mr. ACKERMAN. If you took a complaint seriously, which obviously you did not, is that what you just told us?

Ms. THOMSEN. No, sir. That is not what I said.

Mr. ACKERMAN. Then if somebody brought you evidence and made a charge that somebody was committing this type of fraud hypothetically, would your procedure and investigation—I am asking you a procedural question now, having nothing to do with Bernie anybody. If somebody brought you this information tomorrow, would it not be reasonable to expect that you would ask to see their trade slips?

Ms. THOMSEN. I think it would be fair to say those are among the things that we would look at.

Mr. ACKERMAN. And if you did not, would you consider that malfeasance?

Ms. THOMSEN. Not necessarily, depending on what we saw.

Mr. ACKERMAN. Thank you very much.

Mr. Perlmutter.

Mr. PERLMUTTER. Thanks, Mr. Chairman.

I have to say just as an opening statement, the charges and the vehemence that Mr. Markopolos directed towards all of you, the only person who had any emotion in her voice in the initial opening statements was Ms. Richards. Cozy; captive; gullible; go along, get along; lazy; he couldn't have used any more adjectives to describe what he felt about this particular investigation.

We have heard about all the red flags. I don't want to talk about that. I would like to know, Mr. Donohue, what a split strike strategy is, if you know.

Mr. DONOHUE. First, I would start off by saying that I have only been at the Commission for 3 years. I started on Wall Street in 1975 and had many different positions in Wall Street prior to coming to the SEC.

Mr. PERLMUTTER. Do you know what a split strike strategy is?

Mr. DONOHUE. I understand what a split strike strategy is, that one creates a collar. You will buy either stocks or a basket of stocks and sell a call, which limits your upside opportunity, and you would buy a put, which would limit your downside risk.

Mr. PERLMUTTER. Had you in your experience ever used a split strike strategy?

Mr. DONOHUE. No, I had not.

Mr. PERLMUTTER. Mr. Luparello, what is your understanding of what a split strike strategy is?

Mr. LUPARELLO. Similar to what Mr. Donohue's is.

Mr. PERLMUTTER. In your experience, have you ever used split strike strategy?

Mr. LUPARELLO. I have not.

Mr. PERLMUTTER. Just so you two know, I asked Mr. Cox and Mr. Harbeck the same question a month ago. They didn't have any clue what a split strike strategy was. They had never used it. And it is classic Ponzi scheme doubletalk. Okay? You can call it whatever it is. And then there is, you know, secrecy and all that sort of stuff.

Let us drop back here for a second because I really wanted to give all of you the benefit of the doubt coming into this thing. But, Mr. Donohue, there actually was a guy named Jim Donohue, James Donohue, in Colorado with a little company called Hedged Investments. It had exactly the same Ponzi scheme in 1992, only $100 million was stolen, not $50 billion. My question is, when you are training your people, do you talk about; it is too good to be true, therefore, it has to be? What kinds of things do you ask your people to look for so they are sheriffs, they are cops, they stop this stuff from happening? Mr. Donohue?

Mr. DONOHUE. I will start off by saying that my division is a policy division. I don't have any examiners. I do ask folks when they are looking at registration statements and things of that nature that they look at things that might be abnormal, things that are too good to be true. And that is one of the things that we do ask people to look at. There is no free lunch, and that is one of the things I do try and impress on folks who are in my division.

Ms. RICHARDS. Can I answer that question, sir, with respect to examiners? It is the field office examination staff who go out and conduct examinations. The risk of Ponzi schemes, the risk of theft is foremost in their minds. So they are examining for compliance with lots of provisions of the Federal securities laws. But they are always alert to the possibility of fraud. So one of the things that examiners do is they verify records that are provided to them. They would never, for example, just simply ask, are you in compliance with the law, or are you engaged in fraud? That wouldn't be enough for an examiner. They want to see backup records. And one of the routine aspects of every routine investment advisory exam is to seek confirmation of the holdings of clients directly with a third-party custodian. It is a very basic audit step. And then the examiners will match that with the records that they see at the advisor—

Mr. PERLMUTTER. That sounds great.

Let me ask you the question point blank, and anybody can answer this, and then I am going to yield the balance of my time to Mr. Arcuri. The coziness, okay, those sound like very good precautions. Is the SEC too cozy with the industry? Are they captive by this industry, or are they looking out for us, looking out for the taxpayers? Ms. Richards, you answer that.

Ms. RICHARDS. Absolutely not. Examiners, as I said at the outset, they are taught to pull no punches. They are taught to communicate deficiencies in violations without regard to the type of firm, the influence of the person. They are blind to the type or the nature of the firm that they are examining. They truly have a "pull no punches" attitude.

Mr. PERLMUTTER. I would like, Mr. Chairman, to give my last minute to Mr. Arcuri if I could. I have 1 more minute, right, because I had given a minute?

Mr. ACKERMAN. Yes.

Mr. PERLMUTTER. I would yield that to Mr. Arcuri.

Mr. ARCURI. Thank you. I thank the gentleman.

Really quickly, Ms. Thomsen, how long were the Madoff actions allegedly going on?

Ms. THOMSEN. Well, I can't answer that as to the specifics.

Mr. ARCURI. The answer is, you don't know.

The next question is, you talked about credible lead. What do you consider a credible lead?

Ms. THOMSEN. Whether or not a lead is credible and how we assess it depends on the nature of the—

Mr. ARCURI. I understand the process. I am a former prosecutor. What do you consider a credible lead for the SEC?

Ms. THOMSEN. It depends on what is in it. It depends on the specificity and how important, how big it is.

Mr. ARCURI. I get it. Do you look at the person who is giving you the lead?

Ms. THOMSEN. Absolutely.

Mr. ARCURI. And obviously you weigh the credibility of the person who is presenting the lead to you; do you not?

Ms. THOMSEN. Yes.

Mr. ARCURI. You give certain greater credibility to people who you deem to be a credible person and less to someone you would deem to be noncredible?

Ms. THOMSEN. Generally speaking, yes, although I have to say that some people who appear incredible have credible leads.

Mr. ARCURI. That is true.

Now, when Mr. Markopolos came before you, did you consider that a credible lead?

Ms. THOMSEN. I can't answer that.

Mr. ARCURI. You can't answer that? How does that affect your ability to investigate or Mr. Madoff's investigation?

Ms. THOMSEN. Because that is subject of the Inspector General's investigation, and—

Mr. ARCURI. Ma'am, I have used that excuse a number of times, and I can't even fathom how this could in some way be affecting the investigation.

All right. Let me ask you this.

Ms. THOMSEN. Sure.

Mr. ARCURI. In 2006, when you investigated, did you make a determination of any wrongdoing on Mr. Madoff?

Ms. THOMSEN. We did not bring an enforcement action, and we did not—

Mr. ARCURI. That was not my question. Did you make a determination whether or not there was any wrongdoing?

Ms. THOMSEN. Again, I can't answer the specifics on the underlying investigation other than to say what is public was that there was no enforcement action.

Mr. ARCURI. Did you make a referral based upon your analysis in 2006?

Ms. THOMSEN. I can't answer that.

Mr. ARCURI. You can't answer whether or not you made a referral?

Ms. THOMSEN. I cannot. And again, this goes back to whether or not—it is to protect the criminal prosecution.

Mr. ARCURI. I understand. Thank you. I understand about a defendant's rights. But you can't answer whether or not you made a referral?

Ms. THOMSEN. No.

Mr. ARCURI. Okay. Now, my next question is this—do I have any more time, Mr. Chairman?

Chairman KANJORSKI. I don't know whether we should—

Mr. ARCURI. I yield back the balance of my time. Thank you.

Chairman KANJORSKI. Thank you.

We have Mr. Posey here. We will give him 2 minutes, so maybe he can crack this egg.

Mr. POSEY. Thank you, Mr. Chairman. And I will yield back a minute or two to him if I have any left.

It is just such an incredulous tale, I think, for everybody up here to understand. Maybe you all don't have that kind of a problem grasping with it, but it is just incredibly unbelievable to the people in this committee to hear these stories.

Besides Mr. Markopolos, we have the Barron's article, we had what is called the Ocrant article. We had Merrill Lynch, Goldman Sachs telling their investors, don't touch this. This is impossible. This has got to be a scam. We have hedge fund managers, money managers with the absolute minimal amount of due diligence, you know, telling their clients by the thousands, this is a joke. This cannot possibly be working. Stay away from this thing. And yet, you know, our enforcement agency is blind to the whole—I mean, it is literally hard for everybody to believe. And, you know, the question I have is, did anyone else report to you like Mr. Markopolos did and ask you to look at this? You know, report the bank robbery going on a block over?

Ms. THOMSEN. While I can't answer it specifically as to this, I can verify one of the things Mr. Markopolos talked about, which is a reluctance on the part of people in the industry to bring information to us about their peers or others in the industry. It is a frustration to us that people who—legitimate actors in the securities business who ought to be protecting the legitimacy of their business sometimes do not come to us sort of with leads about potential problems.

So, that I can say. I can't talk specifically about this particular situation. And if I could turn to—I think we all understand your frustration. And if we knew going into something that it actually was a fraud, we wouldn't investigate. We would bring that action. If we had the evidence to bring it, we would bring it. There is nothing—I mean, in a perverse way—there is nothing that makes us happier than bringing those kinds of cases.

Mr. POSEY. I think a lot of frustration was probably because we can't believe when they reported the bank robbery in process, nobody bothered to look, number one. And since you brought it up, all these insiders who kept their mouths shut who apparently knew something was going on, is there anything in the statutes that would make them culpable in this crime? I mean, if I see somebody being mugged, and I am able to do something about it, and I don't, I think I share some guilt with the crime.

Ms. THOMSEN. I think, sir, you may at a sort of moral or ethical level. I think legally the issues become whether you participated enough to be responsible as either a cause or an aider or an abettor. And we will, in all investigations, look—cast our net wide and deep to bring—

Mr. POSEY. Okay. Let us say it wasn't illegal. When you license people, don't they have to have a relatively clean background, be free of what they call moral turpitude? And wouldn't that blemish the license of every licensed person if they knew something—maybe it is not illegal, but it is a breach of morality at least held by most people in this country that would be a view. And I would think anyone that you suspect that knew this was going on and didn't report it—although obviously it would have been unacknowledged even if they had—but had they not reported it, I think their licenses should be in jeopardy, just on the grounds of the moral-turpitude-free background that you expect them to be when they get licensed.

Ms. THOMSEN. Let me defer that issue to those who know the licensing issues. I don't necessarily disagree.

Chairman KANJORSKI. Mr. Donnelly, you are recognized for 5 minutes.

Mr. DONNELLY. Thank you, Mr. Chairman.

I asked the Inspector General when he came how many red flags are enough red flags that you stop what is going on? And one of the flags was a $50 billion fund with a one-person accounting firm. Why was that one flag not enough for you to shut this down earlier?

Ms. THOMSEN. Without regard to the specifics of this particular case—

Mr. DONNELLY. Let us have a theoretical $50 billion fund with a theoretical one-man accounting firm.

Ms. THOMSEN. That is where I was headed. We need evidence, and that is what we pursue, and if we have enough evidence of fraud, we bring those cases.

Mr. DONNELLY. How early on did you know that there was a one-man accounting firm involved?

Ms. THOMSEN. I can't answer that question.

Mr. DONNELLY. You were told that in 2001, if I am not mistaken.

Ms. THOMSEN. Sir, I simply can't discuss the specifics of this one.

Mr. DONNELLY. Then let me ask you the next question, which is, is there a form for examination when your examiners go in, things that if you see these, you say, this is a red flag, something has to be done?

Ms. THOMSEN. Let me defer to Ms. Richards, who is the expert on examinations.

Mr. DONNELLY. Let me ask Ms. Richards.

Ms. RICHARDS. In the examination context, sir, given the number of registered investment advisors—and I am assuming your question goes to investment advisors and the breadth of activity—we have to take a risk-based approach to deciding both which firms to examine and which issues—

Mr. DONNELLY. Let me ask you this: When you go in and your examiners go in, and they see a $50 billion firm and one accountant, does that tip them off that there may be a situation here?

Ms. RICHARDS. Investment advisors are not required to have an audit, so the fact that it was a small auditor or a no-name auditor may or may not present a risk. We would look at other things, however, like how are the assets custodied, what are the performance claims the advisor is making.

Mr. DONNELLY. How about you combine the accounting with the fact that they go into cash at the end of every quarter? Does that then start to smell a little differently?

Ms. RICHARDS. If examiners had selected that firm for examination and had gone in, they would definitely look at the trading in client accounts and look at whether it is consistent with—

Mr. DONNELLY. So in and of itself, those are not red flags to you?

Ms. RICHARDS. It could be. It certainly could be depending on what representations the advisor made to the customer.

Mr. DONNELLY. Do you have a form of examination that here are some absolutely critical things that we will never pass on when we do an exam? One, two, three, four, five; these are things when we go in we look for? These are things when we look at each company, the basics we want to see?

Ms. RICHARDS. Yes. When we conduct a routine examination of an investment advisor, we are looking at such things as do they have—what are the representations they make to clients? Are they living by those disclosures? What are the expenses that they are deducting from client accounts? Are they in some way—

Mr. DONNELLY. I am going to give my last minute to Mr. Arcuri after this question, but it is this: Back home in Indiana, there is a fellow running a tool and die shop who is looking to put a few bucks back into his mutual fund to try to save for his retirement. Why should he have any confidence that the organizations out there have been thoroughly vetted by you?

Ms. RICHARDS. Well, with respect to mutual funds, which is your question—

Mr. DONNELLY. Or hedge funds. Or like any of these security funds. The organizations that you have jurisdiction over.

Ms. RICHARDS. We have examination responsibility over firms that are registered with the SEC, so that may not include hedge funds. It does include mutual funds. There is a robust regulatory structure around mutual funds. They are also subject to examination by the SEC, though given our resources, we don't examine every mutual fund firm on a regular basis.

Mr. DONNELLY. Let me say one last thing, and then I will turn it over to Mr. Arcuri. We had a 78-year-old man, I believe he was a friend of Mr. Ackerman's, who came before us. And in 2001, you were contacted by Mr. Markopolos. He continued to put money in, this gentleman did, into the Madoff funds because he had confidence in the system, in the SEC. He believed in you guys as a gold standard. He has zero now, and they are going to foreclose on his house.

Mr. Arcuri.

Mr. ARCURI. Thank you, Mr. Donnelly.

Ms. Richards, if you were to see an investor continually over, let us say, a 10-year period consistently make a 10 or 12 percent return for his investors, would you consider that a red flag?

Ms. RICHARDS. Yes, sir, I absolutely would. The SEC does not—

Mr. ARCURI. If you were to receive that, you would consider that possibly a red flag?

Ms. RICHARDS. Yes, sir.

Mr. ARCURI. My next question is, how about if you saw an investor who was giving 4 percent of the profit he would normally re-

ceive to the feeder companies; would you think that might be a red flag?

Ms. RICHARDS. It would be an unusual situation.

Mr. ARCURI. Okay. How about if you saw a company that continually at the end of each period turned their cash into government securities; would you consider that perhaps a red flag?

Ms. RICHARDS. We would want to understand why.

Mr. ARCURI. Okay. Now, if you had those sort of situations, and then you had someone come in who maybe you considered to be a credible lead, give you information, what would then prevent you from investigating that? Why would you not investigate that situation?

Ms. RICHARDS. My office has authority to conduct examinations, routine and cause, of registered investment advisors. So the first threshold is, is it a firm that is registered—

Mr. ARCURI. But if you were see those situations, wouldn't it be something—and you were to receive what would be a credible lead, wouldn't that be the kind of thing that you would want to look into?

Ms. RICHARDS. In situations where we receive credible leads, the first step is, is it a registered advisor? If it is, we send examiners out immediately. They show their badges without notice.

Mr. ARCURI. The bottom line is, you didn't do it. You had all of these situations in a particular case, and nothing was done by the SEC, correct? That is a yes or a no. Nothing was done.

Ms. RICHARDS. This firm registered with the SEC in 2006. Following that, there was no SEC exam of—

Mr. ARCURI. So you had the scenarios that I just described; you had a credible lead, and yet nothing was done by the SEC, correct? There was nothing done by the SEC, was there?

Ms. RICHARDS. I think that is not correct. I have testified about the extent of the regulatory examinations of the firm. And Ms. Thomsen talked about—

Mr. ARCURI. Well, you just indicated these things would be possible red flags. Ms. Thomsen said that maybe it was a credible lead. You had all these situations, either somebody wasn't talking to someone, or there was no investigation done.

I have nothing further. I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Arcuri.

The ranking member of the full committee, Mr. Bachus.

Mr. BACHUS. Thank you.

Ms. Thomsen, in your testimony you say you can't pursue every tip. And are you characterizing Mr. Markopolos's dialogue as a tip?

Ms. THOMSEN. I do characterize it as a lead or a tip, just like others.

Mr. BACHUS. Well, at some point, it became much more than a tip or a lead, right? Because Madoff was already under investigation.

Ms. THOMSEN. I can't talk about it specifically.

Mr. BACHUS. No. I am saying that in a case where someone is already under investigation, and someone gives you—in 42 different contacts—and I am talking about meetings, discussions—they gave you a case on a silver platter, he described what was going on to a T. And the auditor for Madoff was one person in a

storefront on Long Island. This begs for investigators. Would you agree that a case like that, with all that information, should have caused someone already under investigation—someone that had failed to register, that that begged for investigation?

Ms. THOMSEN. Without reference to the specifics, the more credible, the more informative a complaint is, the more we are going to investigate. And a complaint or a lead, no matter what, our job is to turn it into evidence. And that is what we love to do. When we follow things up, we are looking for evidence. We can take leads that are very unspecific.

Mr. BACHUS. I am talking about those where they—where you know, public knowledge, what is published in the newspaper. What you knew from his operation, because you had investigated it, you knew that he had failed to comply for years with the law. Was there any penalty for that? Was he sanctioned, or was he penalized for that? Was there a heightened—when someone has violated the law for years in billions of dollars in transactions, is there any punishment or heightened investigation, particularly when someone comes to you, a credible source, and gives you documented evidence?

Ms. THOMSEN. Without reference to the specifics, there are penalties that may be applied to failing to register for—

Mr. BACHUS. But they were not applied to him?

Ms. THOMSEN. There is no enforcement action. There is no public enforcement action prior to the action that we brought in December as to Mr.—

Mr. BACHUS. Well, that is after it all blew up.

Ms. THOMSEN. Yes, sir. And as I have indicated, unfortunately—and this is one of the great sort of limits of law enforcement. It is always after the fact when we come in. We don't want it to be—we want it to be as close in time to the illegality as possible.

Mr. BACHUS. I will characterize this. He gave you a case on a silver platter, someone you had been investigating for years, someone who had failed to comply with your own rules, and he wasn't even penalized.

Let me take another pay for play. In 1997, my now chief of financial services helped compose a letter with 42 pages of documentation on what was happening. What we didn't know—we had no idea what was alleged to have happened in Jefferson County. Mr. Markopolos said it was happening all over the country. Municipalities are out billions of dollars from this pay-for-play scheme. We sent that information to the SEC, chapter and verse. I have now determined that there was apparently no follow-up. Is a county commissioner with documented evidence and a Congressman writing, is that not credible information?

Over 2 years ago I wrote again pointing out that now some of these people have been disclosures and cases in Birmingham that substantiated all this, and I asked for an investigation. Now, I think at a certain point after meeting with the Commissioner himself, actually calling and asking him to come to my office, finally there was some initiation. But, you know, it was all in the paper by the time that y'all—

Ms. THOMSEN. Well, more generally about municipal securities issues, municipal securities issues are a priority for us. We have

a working group focused on it. We have brought several cases over the last years. And it is one of those areas where, unlike some broker dealers, etc., there are fewer regulatory speed bumps along the way, so that our tools are predominantly enforcement, and our ability to discover the issues is limited as a consequence. But I agree it is an important area to pursue.

Mr. BACHUS. Let me just—and I will close with this. I have requested that you consider disgorgement for these folks or for the feeder groups in the Madoff scheme, that they disgorge their profit; that these wrongdoers in the pay-for-play scheme, that they disgorge to the ratepayers and the taxpayers all over America their ill-gotten gains. And I have heard nothing. I have had no response to multiple requests that you all consider that. I would ask you to pursue that.

Ms. THOMSEN. I would be happy to get back to you on that.

Mr. BACHUS. Thank you.

Chairman KANJORSKI. Thank you very much, Mr. Bachus.

We are ready to close because we have another markup that has to proceed immediately. We have 2 minutes for Ms. Speier. But I will hold you to 2 minutes.

Ms. SPEIER. All right. I want you to each grade the SEC on how they handled the Madoff case, very quickly.

Ms. THOMSEN. Can't do it.

Ms. SPEIER. Why can't do you it?

Ms. THOMSEN. Because it would inevitably—

Ms. SPEIER. You are giving an opinion. Did the SEC do a good job? A, B, C, D, or F?

Ms. THOMSEN. I wish we had found it earlier.

Ms. SPEIER. Would you give the SEC an F?

Ms. THOMSEN. I would not. I would not grade it.

Ms. SPEIER. What is the employee salary in the Compliance and Enforcement Section on average? What are they making?

Ms. THOMSEN. You know, I don't know. It is in the hundreds of something.

Ms. SPEIER. So they are making $100,000, $150,000.

Ms. RICHARDS. I can give you more specific information. This is the range of salaries for an examiner in our New York office. So a typical examiner could range from $47,000 a year to as high as $177,000.

Ms. SPEIER. All right, $40,000 to $170,000. How many of your employees—what percentage of your employees in those two branches, Enforcement and Compliance, leave the SEC and go to work for an SEC-regulated entity?

Ms. THOMSEN. In enforcement, it is very few. Most, if they leave, go to private practice of law.

Ms. SPEIER. Ms. Richards.

Ms. RICHARDS. I think fewer people leave the SEC than they used to, but when they do go, they often go to a regulated entity in the compliance area.

Ms. SPEIER. Mr. Swanson was the lead attorney on this case. He leaves the SEC, marries Mr. Madoff's niece. Did you for 1 minute think that maybe you should go back and look at how he handled that case?

Ms. RICHARDS. Yes. And that is exactly what the Inspector General is investigating, the role of current and former SEC employees and their interactions with the Madoff firm, and whether those interactions in any way, in any way, impacted the conduct of the regulatory oversight of the firm. That is exactly what the Inspector General is looking at.

Ms. SPEIER. Mr. Einhorn complained about Allied. He came to the SEC. The attorney who handled that case, Mr. Braswell, criticized him instead of Allied. Mr. Braswell left the SEC and then went to become a lobbyist for Allied. Do you see any kind of pattern here?

Ms. THOMSEN. I don't know enough to know whether there was a pattern.

Chairman KANJORSKI. Okay. We will have to close it there. I am sorry, Ms. Speier.

Mr. Maffei, we are going to give you 2 minutes, but I ask you to take 1 minute.

Mr. MAFFEI. Yes, I will, Mr. Chairman. Thank you very much.

I just have one question. We heard a lot about the general policy for enforcement at the SEC. Ms. Richards talked about the "pull no punches" attitude. And indeed, I have talked to folks who are very, you know—in the financial services industry who are very afraid of an SEC investigation. But what I want to know, given the apparent mess of the Madoff scheme, is can you give us any data—and I really would like to know. If you can't do it now, can you provide any data on the size of the companies on which the investigatory or enforcement actions have been taken so that we will be assured that you are not just picking on the little guys and throwing the big fish back?

Ms. THOMSEN. I think we can get you that. But among other things, I would point to the auction rate securities cases, which we talked about before this committee not very long ago. I think it was in August. And some of the aiding and abetting cases we brought against the biggest financial institutions in this country for aiding and abetting Enron's fraud—Citi, Merrill, JPMorgan Chase.

Mr. MAFFEI. I would appreciate the specific data.

Ms. RICHARDS. Can I just add that we inspect firms, small firms and large firms, in much the same way with the same pull no punches attitude, and those include firms with billions and billions and billions of dollars in management. So all types of firms are subject to inspection.

Mr. MAFFEI. I would, of course, hope that there is the same standard. And then obviously the question continues, why did we miss Madoff? But I know that is a specific case, so I am not asking that question.

Thank you very much, Mr. Chairman.

Chairman KANJORSKI. Mr. Posey, 12 words.

Mr. POSEY. Thank you, Mr. Chairman. I haven't seen this much bobbing and weaving since Muhammad Ali's rope-a-dope.

Mr. BACHUS. Mr. Chairman, I would like to acknowledge Ms. Thomsen and Ms. Richards and Mr. Donohue, that there has been some very good investigative actions by the SEC, and you have some top-flight professionals over there. And we don't mean—at

least I don't mean to convey that there hasn't been some very good work by the SEC.

Ms. THOMSEN. Thank you very much.

Chairman KANJORSKI. Thank you very much.

The Chair notes that some members may have additional questions for today's witnesses, which they may wish to submit in writing. Without objection, the record will remain open for 30 days for members to submit written questions to today's participants and to place their responses in the record.

Before we adjourn, the following documents and/or written statements will be made part of the record of this hearing: Mr. Markopolos's communications with the Securities and Exchange Commission. Without objection, it is so ordered.

The complete set of documents referred to above can be accessed at the following link:

http://www.mccarter.com/new/
homenew.aspx?searchlink=showarticlenew&Show=3229

Before we adjourn the panel, I just wish to say we are going to inquire into a process or procedure to see whether the limitations placed upon this panel's testimony comport with the law, and whether or not we are able to take such action as to overcome those objections. We will be proceeding with that in the immediate future.

The panel is dismissed, and this hearing is adjourned.

[Whereupon, at 2:46 p.m., the hearing was adjourned.]

A P P E N D I X

February 4, 2009

Congressman Joe Baca
Hearing On Madoff Scandal
February 3, 2009

Mr. Chairman thank you for holding this important hearing.

This is the second in a series of hearings on the $50 billion Ponzi scheme by Bernard Madoff that has sent shock waves across the nation's financial system.

The last subcommittee hearing largely shed light on how Madoff managed to evade detection for so long.

We also learned about gaps in regulation that allowed him to carry out this investment scam.

SEC and other regulators investigated Madoff's firm at least 8 times over the past 16 years but never found clues.

We're talking about people's nest eggs, investors in public pension plans, university endowments and foundations in addition to high net worth individuals have lost $50 billion!

We need safeguards to protect all investors!

And conflicts of interest between SEC officials, its staff and members of Madoff's family need to be investigated.

More importantly, I think we need to identify where there is a need for new regulation. And if regulation is there, then we need make sure it is being effectively enforced.

I thank the Chairman for holding this important hearing and yield back the balance of my time.

Statement by Rep. Michele Bachmann
House Financial Services Subcommittee on Capital Markets,
Insurance and Government Sponsored Enterprises
Hearing entitled "Assessing the Madoff Ponzi Scheme and Regulatory Failures"

February 4, 2009

Thank you, Mr. Chairman.

When Bernard Madoff recently admitted to defrauding his customers and stealing upwards of $50 billion by executing the largest "Ponzi" scheme in U.S. history, every member of this Committee was stunned. How could this happen? How could such a broad scheme go unnoticed for years and years?

And when we learned of the investigations conducted by Mr. Markopolos over the past 9 years, we were even more disturbed and concerned about how this could have possibly slipped through the cracks.

In Mr. Markopolos' written testimony, he has submitted 115 documents dating back to May 2000 which detail his contact with the SEC attempting to present evidence that an investigation of Mr. Madoff's firm was necessary This includes everything from email and phone conversations with SEC examiners to in-depth analyses of flaws in Mr. Madoff's profit structure. As we all know, nothing was substantially investigated and Mr. Madoff was able to continue his scheme freely for nearly a decade.

So often policymakers find themselves wishing we knew now what we didn't know then and we can all agree that hindsight is 20/20. Unfortunately, the SEC actually had this information at its fingertips and did not act.They had the benefit of hindsight when it could really be useful.

As a result of the Madoff case, thousands of companies and individuals have lost tremendous amounts of money. The Securities Investment Protection Corporation (SIPC) recently distributed over 8,000 claims forms to Mr. Madoff's customers who may be eligible for relief.

But that's only the tip of the iceberg. One issue that must not get lost as we work to understand what happened and move forward to both promote relief and justice and ensure nothing like this happens again in the future is that of the many *individuals* who were invested in company pension and profit sharing plans. Through their employers, they trusted Mr. Madoff's firm to responsibly manage their investments. It remains unclear whether individual participants invested in such plans will be afforded the protections established by the Securities Investor Protection Act.

Mr. Stephen Harbeck, President of the SIPC, recently testified before our Committee that the SIPC trust fund only has $1.6 billion in funds available, with additional access to several billion more. But in the interest of fairness it is important that SIPC consider the

circumstances of individual claims. These are hardworking citizens whose pension or employee profit sharing benefits may now be lost due to Mr. Madoff. They have been just as victimized by this fraud as their companies.

I've heard devastating stories from Minnesotans in such circumstances, such as one employee who receives a $40,000 annual salary and could lose $40,000 in profit sharing benefits through this fraud. Retirees and near-retirees are clearly in the worst possible situation. As this Committee continues to examine the events surrounding and the consequences of the Madoff case, I urge my colleagues and the SIPC to make these people a priority.

Thank you, Mr. Chairman, and I look forward to hearing from today's witnesses.

Garrett Opening Statement for Madoff Hearing

(Washington, DC)– **Rep. Scott Garrett (R-NJ), Ranking Member of the Subcommittee on Capital Markets, released the following excerpts from his opening statement on today's Financial Services Subcommittee hearing on the Madoff Ponzi scheme:**

"Thank you, Chairman Kanjorski, for holding this important hearing today. I am excited about the opportunity to work more closely with you to ensure the long-term viability of our capital markets. I also want to thank all of the witnesses for their testimony.

"There is discussion of "gaps" in our current regulatory scheme that need to be filled to prevent cases like this from happening in the future. I don't believe that is the case. Each and every one of Mr. Madoff's relevant businesses fell under the jurisdiction of one or more financial regulators. Given what we currently know about this situation, I do not believe there was a regulatory gap that needs filled with more, often excessive regulation. Rather we should be focused on ensuring that current regulations are being met and that proper oversight is occurring.

"It appears the failure came from a lack of coordination or basic information sharing between agencies, specifically the different divisions within the SEC as well as FINRA.

"The failures at the SEC that allowed Madoff to continue to operate his Ponzi scheme for many years did not come from a lack of agency funding or authority, but in performing and executing the responsibilities under the powers it had.

"We cannot end all fraud nor guarantee these changes would have prevented it. However, under appropriate due diligence, at least in this case, it appears that the improprieties would have been discovered earlier. But for the fact that Mr. Madoff came out and confessed, this scam would still be going on as far as we know."

Testimony by

Stephen I. Luparello
Interim CEO
Financial Industry Regulatory Authority

Before the
Subcommittee on Capital Markets, Insurance,
and Government Sponsored Enterprises

Committee on Financial Services

U.S. House of Representatives

February 4, 2009

Chairman Kanjorski, Ranking Member Garrett and Members of the Subcommittee:

I am Steve Luparello and I currently serve as Interim CEO of the Financial Industry Regulatory Authority, or FINRA. On behalf of FINRA, I would like to thank you for the opportunity to testify today.

Unfortunately, we are all here today because the fraud that Bernard Madoff orchestrated has had tragic results for investors large and small who entrusted their money to him. Investors are disillusioned and angry, and are rightfully asking what happened to the system that was meant to protect them. It certainly appears that Madoff knew well the seams in that system that separated functional lines of regulation, and perhaps that knowledge assisted him in avoiding detection and defrauding so many unsuspecting individuals and institutions. By all accounts, it appears that Mr. Madoff engaged in deceptive and manipulative conduct for an extended period of time during which he defrauded the customers who invested with him and misled those who had the responsibility to regulate him.

Even so, Mr. Madoff's alleged fraud highlights how our current fragmented regulatory system can allow bad actors to engage in misconduct outside the view and reach of some regulators. It is undeniable that, in this instance, the system failed to protect investors. Investor protection is the core of FINRA's mission, and we share your commitment to identifying the regulatory gaps and weaknesses that allowed this fraud to go undetected, as well as potential changes to the regulatory framework that could prevent it from happening in the future.

FINRA

FINRA is the largest non-governmental regulator for securities brokerage firms doing business in the United States. Congress mandated the creation of FINRA's predecessor, NASD, in 1938. Congress limited our authority to the enforcement of the Securities Exchange Act of 1934, the rules of the Municipal Securities Rulemaking Board and FINRA rules. Under our fragmented system, broker-dealers are regulated under the Securities Exchange Act and investment advisers are regulated under the Investment Advisers Act of 1940. FINRA is not authorized to enforce compliance with the Investment Advisers Act. Authority to enforce that Act is granted solely to the SEC and to the states.

FINRA registers and educates industry participants, examines broker-dealers and writes rules that those broker-dealers must follow; enforces those rules and the federal securities laws; and informs and educates the investing public. All told, FINRA oversees approximately 5,000 brokerage firms, about 172,000 branch offices and almost 665,000 registered securities representatives.

FINRA has a robust examination program with dedicated resources, including more than 1,000 employees. In administering our exam program, FINRA conducts both routine and cause examinations. Routine examinations are conducted on a regular schedule that is established based on a risk-profile model. This risk-profile model is very important: It permits us to focus our resources on the sources of most likely harm to average investors, and allows us to conduct our examinations more efficiently. We apply our risk-profile model according to the risks presented by each firm, and it is tailored according to the business that a particular firm conducts. Cause examinations are based on information that we receive, including investor complaints, referrals generated by our market surveillance systems, terminations of brokerage employees for cause, arbitrations and referrals from other regulators. FINRA consults with the SEC and state regulators about examination priorities and frequently conducts special "sweep" examinations with respect to issues of particular concern. In 2008, FINRA conducted over 2,500 routine examinations and nearly 7,000 cause examinations.

FINRA brings disciplinary actions against broker-dealers and their employees that may result in sanctions, including fines, suspensions from the business and, in egregious cases, expulsion from the industry. FINRA frequently requires broker-dealers to provide restitution to harmed investors and often imposes other conditions on a firm's business to prevent repeated wrongdoing. In 2008, FINRA instituted disciplinary action in 1,060 cases. FINRA collected over $28 million in fines, either ordered or secured agreements in principle for restitution in excess of $1.8 billion, expelled or suspended 20 firms, barred 363 individuals from the industry and suspended 325 others.

FINRA Oversight of Bernard L. Madoff Investment Securities' Broker-Dealer Operations

Bernard Madoff's broker-dealer was registered with FINRA, and its predecessor organization, NASD, since 1960.

In its regulatory filings and FINRA examinations, the Madoff broker-dealer has consistently held itself out as a wholesale market-making firm; that means it was a firm that was in the business of executing, as a market maker, order flow that other broker-dealers directed to it for execution and otherwise trading securities for the risk of its own proprietary accounts. These relationships with other broker-dealers are treated under regulatory rules as counter-party rather than customer relationships. The Madoff broker-dealer consistently reported that 90 percent of its revenue was generated by market making and 10 percent by proprietary trading. The broker-dealer consistently represented to FINRA that it had no retail or institutional customer accounts, a position that would be consistent with the business model of a wholesale market-maker.

Examinations

During the last 20 years, FINRA (or its predecessor, NASD) conducted regular exams of Madoff's broker-dealer operations at least every other year. Madoff's broker-dealer was on a two-year examination cycle because it engaged in market making and was self-clearing. Based on this business model, our examinations tended to focus on areas such as the firm's financial and operational condition, supervisory system, supervisory and internal controls, AML compliance, internal communications and business continuity plans. In addition, in 1996 we began a separate market regulation exam program for broker-dealers, and we have conducted that exam of the Madoff broker-dealer on an annual basis since 1997. The Trading and Market Making Examination Program (TMMS) focuses on trading-related issues and is designed to complement FINRA's automated surveillance programs, as well as FINRA's examination programs for sales practice and financial and operational rules. TMMS exams focus on trade reporting, order handling and supervision.

FINRA rules require any broker-dealer, including wholesale market makers such as Madoff, to comply with best execution and order-protection requirements for customer orders routed there by other broker-dealers, even though the executing broker-dealer does not have the direct customer relationship. The firm was also required to comply with recordkeeping and trade reporting requirements. The anti-fraud provisions of the federal securities laws and FINRA rules applied to the Madoff broker-dealer's trading with other broker-dealer counterparties.

In the course of FINRA's broker-dealer exams, we found no evidence of the fraud that Bernard Madoff carried out through its investment advisory business. While there have been some reports that victims of the fraud received statements from the Madoff broker-dealer, our examinations did not reveal the existence of customer relationships that the broker-dealer would have had in

providing execution or custody of advisory assets, and they did not reveal that the Madoff broker-dealer in fact held client assets other than in a small number of inactive employee accounts. Also, FINRA did not receive customer complaints that might have alerted us to the existence of the alleged accounts.

It is worth noting that in 2006, when the SEC examined Madoff's advisory business, the only violation that it apparently found was the firm's failure to register. Our subsequent examination of the firm in 2007 was tailored to its wholesale market making operations, which resided in the broker-dealer.

Disciplinary Actions Related to Madoff

As discussed previously, the Madoff broker-dealer was subject to oversight by FINRA through, among other things, routine and cause examinations as well as more trading-focused exams. In addition, their trading was subject to oversight by our Market Regulation department. As a result, over the past ten years, the Madoff broker-dealer was subject to both formal and informal (non-public) discipline, including:

- censure and a $7,000 fine in July 2005 for limit-order display violations;
- censure and an $8,500 fine in February 2007 for limit-order display and Manning violations;
- censure and a $25,000 fine in August 2008 for violations relating to blue sheets; and
- 14 Cautionary Letters for technical trading and/or reporting violations.

Complaints Related to Madoff

FINRA has received and investigated 19 complaints against the Madoff broker-dealer since 1999. The complaints generally related to trade execution quality issues; none related to the investment advisory issues involved in the allegations against Bernard Madoff.

FINRA did not receive any whistleblower complaints alleging either frontrunning or Ponzi schemes at the Madoff money management business, nor did the SEC share the tip it received or alert FINRA to any concern that it may have had with the firm.

Issues Raised by the Madoff Fraud

Custody and Feeder Funds

FINRA's role as a regulator requires us to be mindful of changes in the markets, market structure and new products in designing our examinations and the focus of our regulatory programs. We also adapt our programs to information that we learn through implementing those programs, conversations with other market regulators or from the experiences of other regulators when there is a significant breakdown in the regulatory scheme as is the case in the Madoff situation.

Since learning of Mr. Madoff's arrest, FINRA has launched two broad reviews—one involving custody issues in joint broker-dealer/investment advisers and the other involving the role of broker-dealers as feeders or finders to money managers such as Madoff.

On the latter issue, FINRA launched an investigation to review the type of activity evident in the Madoff incident, in which finders or feeder funds referred business to a money manager or investment adviser. We are reviewing broker-dealers whose registered representatives may have referred clients to Madoff's advisory business. However, many of these finders and feeders are registered as investment advisers, not as broker-dealers, again compromising FINRA's reach in this important area.

Need for Greater Information Sharing and Oversight of Dual Registrants
Since the SEC has broad jurisdiction to examine both the broker-dealer and investment adviser lines of business, we would propose a more formalized information sharing process between the SEC and FINRA to identify potential problems with dually registered firms. This could include notifications of when the Commission requires an existing broker-dealer to register as an investment adviser, as well as sharing statements or representations made to the SEC by an investment adviser that may be pertinent to an exam of the broker-dealer.

Disparate Regulatory Oversight of Broker-Dealers and Investment Advisers
The Madoff affair illustrates how our fractured regulatory system can fail to protect investors. FINRA regulates broker-dealers, but not investment advisers, even though they provide services that are virtually indistinguishable to the average consumer. FINRA's authority, as noted above, does not extend to writing rules for, examining for or enforcing compliance with the Investment Advisers Act of 1940. That authority was granted to the SEC and the states. The limits of FINRA's jurisdiction have been recognized by the SEC, the Treasury Department in last year's Blueprint for Financial Markets, and by the investment adviser industry, which has always opposed the idea of FINRA or a FINRA-like organization to examine and enforce rules for registered advisers.

For years, FINRA has argued for regulatory reform, so that consumers can be protected no matter what type of financial professional they hire. NASD issued public statements as far back as the late 1980s on this subject. We've submitted public comments to the SEC and Treasury on this disparity. In 2008, FINRA's former CEO, Mary Schapiro, personally raised these issues with then-SEC Chairman Cox.

The absence of FINRA-type oversight of the investment adviser industry leaves their customers without an important layer of protection inherent in a vigorous examination and enforcement program and the imposition of specific rules and requirements. It simply makes no sense to deprive investment adviser customers of the same level of oversight that broker-dealer customers receive.

Broker-dealer regulation is subject to a very detailed set of rules established and enforced by FINRA that pertain to the conduct of advertising, customer account conduct and selling practices, limitations on compensation, financial responsibility, trading practices and reporting to FINRA of various statistical information used in the examination and enforcement practice. The investment advisory business is not subject to this level of regulation—even though many advisory services are virtually indistinguishable from the services of a broker-dealer.

According to the SEC, the population of registered investment advisers has increased by more than 40 percent in recent years. (In 2001, there were 7,400 advisers; there were almost 11,000 as of March 2008.) As the SEC's Director of the Office of Compliance Inspections and Examinations stated last year, during this increase in the adviser population, "our examiner staffing levels have not increased. Given this fact, we came to the conclusion that our limited resources would best be used in examining those firms and issues that have the greatest potential to pose harm to investors."[1] While the SEC has attempted to use risk assessment to focus its resources on the areas of greatest risk, the fact remains that the number and frequency of exams relative to the population of investment advisers has dwindled.

Need for Consistent Investor Protection Across Financial Services Channels

The type of investor protection gap inherent in the disparate treatment of broker-dealers and investment advisers is not isolated to that area. Unfortunately, our current fragmented system of financial regulation—where no single regulator has the full picture—leads to an environment where systemic and other risks may be left unchecked or go unnoticed, and investors are left without consistent and effective protections when dealing with financial professionals. Further, some products and services are completely outside the U.S. regulatory system.

FINRA believes that it should be simpler for investors to know exactly what product they're buying, the legal protections they are entitled to and the qualifications of the person selling it. We believe that the solution to this problem is through greater regulatory harmonization—creating a regulatory system that gives retail investors the same protections and rights no matter what product they buy. At the very least, investors should be able to enter into any transaction knowing that:

- every person selling a financial product is tested, qualified and licensed;
- the product's advertising is not misleading;
- every product sold is appropriate for them; and

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[1] "Focus Areas in SEC Examinations of Investment Advisers: The Top 10," Lori A. Richards, Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, to the IA Compliance Best Practices Summit 2008, IA Week and the Investment Adviser Association (March 20, 2008).

- there is full, comprehensive disclosure for all products being sold.

Unfortunately, not all financial products come with these simple guarantees or protections.

Establishing consistency among these four areas of investor protection would be a key first step in harmonizing the financial regulatory system. And equally as important in order to be effective, strong oversight and enforcement programs must accompany these investor protection obligations.

Conclusion

As I stated at the outset, what has happened to Madoff's investors is tragic. Investigations are ongoing and more information, no doubt, will emerge to assist all of us in analyzing exactly how this alleged fraud was executed. But some facts are already clear: the structure of our current regulatory structure keeps some activities out of the sight of some regulators, and those gaps and inconsistencies leave investors without the protections they believe they are receiving.

When Americans are being asked to take on more of the responsibility to manage their own retirement funds and to save and invest for college tuition and mortgage down payments, they need a forward-thinking regulatory system to help them meet this growing responsibility. The individual investor is the most important player in the financial markets. Unfortunately, our system has not always sufficiently protected these individuals.

A point made earlier, but one which bears repeating, is that investors deserve a consistent level of protection no matter which financial professionals or products they choose. Creating a system of consistent standards and vigorous oversight of financial professionals—no matter which license they hold—would enhance investor protection and help restore trust in our markets.

FINRA is committed to working with other regulators and this Subcommittee as you consider how best to restructure the U.S. financial regulatory system.

TESTIMONY OF HARRY MARKOPOLOS, CFA, CFE

CHARTERED FINANCIAL ANALYST

CERTIFIED FRAUD EXAMINER

BEFORE THE U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCIAL SERVICES

WEDNESDAY, FEBRUARY 4, 2009

9:30 AM

INTRODUCTION

Good Morning. Thank you for the opportunity to testify today before this Committee on the subject of the "Madoff Ponzi Scheme." I will refer to Mr. Bernard Madoff, whose alleged fraud casts a stark light over the failures of the regulatory structures, procedures and institutions in place to prevent such crimes and is the subject of this hearing, as Madoff, BM, and Mr. Madoff interchangeably within my testimony.

You will hear me talk a great deal about over-lawyering at the SEC very soon. Let me say I have nothing against lawyers. In fact, I have brought two of my own here with me today. On my right, I have Ms. Gaytri Kachroo, a brilliant transactional attorney and my long time general counsel for all personal and business matters. She is a partner at McCarter & English LLP (Boston), heading their international corporate practice and also represents investors and funds. On my left, counsel Phil Michael, of Troutman Sanders LLP, (NY) is a former deputy police commissioner and budget director for New York City, and now represents whistleblowers in fraud cases involving harm caused to government, and is a great strategist in such cases.

As early as May 2000, I provided evidence to the SEC's Boston Regional Office that should have caused an investigation of Madoff. I re-submitted this evidence with additional support several times between 2000 – 2008, a period of nine years. Yet nothing was done. Because nothing was done, I became fearful for the safety of my family until the SEC finally acknowledged, after Madoff had been arrested, that it had received credible evidence of Madoff's Ponzi Scheme several years earlier. There was an abject failure by the regulatory agencies we entrust as our watchdog. I hope that my testimony will provide you with further insights as to how the process failed and enable you to enact appropriate legislation that will

prevent this from happening in the future. As a result of my experiences, I also have some suggestions that I would like to share with the Committee for it to consider as it develops its Congressional recommendations..

I have broken my testimony into two parts:

1) Part I will provide an overview of my contacts with the SEC between 2000 – 2008 relating solely to the Madoff case with a time line of key events during the investigation.[Timeline Color Chart].

2) Part II consists of my recommendations on fixing the SEC so that it can become an effective securities regulator for the 21st century.[Charts of SEC and NASD/FINRA from 2000-2008].

I find it difficult to compress my testimony because there were so many victims, the damages have been vast, and the scandal has ruined or harmed so many of our citizens. I feel that by writing this testimony in narrative form, the public will better understand what steps my team and I took, the order in which we took them, along with how and why we took them. The details will also afford the Committee the information necessary to ask the right questions and hopefully aid the Committee in ferreting out the truth and in restructuring the SEC which currently is non-functional and, as witnessed by the Madoff scandal, is harmful to our capital markets and harmful to our nation's reputation as a financial leader around the globe. In my testimony, wherever possible I have strived to present the mathematical concepts simply and to use word explanations instead of formulas.

Part I – My Contacts with the SEC from 2000 – 2008

Just as there is no "I" in "TEAM," I had a brave, highly trained team that greatly assisted me throughout the 9 year Madoff investigation. Let me introduce the key team members to you. Neil Chelo, Chartered Financial Analyst (CFA), Financial Risk Manager (FRM) checked every

formula, math calculation, modeling technique presented to the SEC from 2000 to the present. From late 2003 to the present, as Director of Research for Benchmark Plus, a Tacoma, WA based $1 billion plus fund of funds, Mr. Chelo went out of his way to interview key marketing and high level risk managers at several Madoff feeder funds. He also obtained Greenwich Sentry audited financial statements for the year's ending 2004, 2005, and 2006. Frank Casey, a former US Army airborne ranger infantry officer with intelligence gathering experience, is the North American President for UK based Fortune Asset Management, a $5 billion hedge fund advisory firm. Mr. Casey closely tracked the Madoff's feeder funds and collected their marketing documents, figured out Madoff's cash situation. He determined that Madoff's Ponzi was unraveling in June 2005 and May 2007 and in need of additional funds to keep the scheme going, and tabulated Madoff's likely assets under management. Institutional Investor's Michael Ocrant, a brilliant investigative journalist also made key contributions to our efforts to stop Madoff. Mr. Ocrant was the only team member to actually meet Mr. Madoff in person and to step inside Mr. Madoff's operation at great personal and professional risk to himself.

These three gentlemen were my eyes and ears out in the hedge fund world, closely tracking who Madoff was dealing with, acquiring Madoff marketing literature and investigating directly with the staff of feeder funds into Mr. Madoff's fund to collect additional pieces of the puzzle. My army special operations background trained me to build intelligence networks, collect reports from field operatives, devise lists of additional questions to fill in the blanks, analyze the data, and send draft reports for review and error correction before submission to the SEC.

In order to minimize the risk of discovery of our activities and the potential threat of harm to me and to my team, I submitted reports to the SEC without signing them. My team and I surmised that if Mr. Madoff gained knowledge of our activities, he may feel threatened enough to seek to stifle us. If Mr. Madoff was already facing life in prison, there was little to no downside for him to remove any such threat. At various points throughout these nine years each of us feared for our lives. Our analysis lead us to conclude that Mr. Madoff's fund and the secret walls around it posed great danger to those questioning and investigating them. We also concluded both the fund and the secrets that assisted its growth and development were of unimaginable size and complexity. Neither my team nor I had any personal knowledge of Mr. Madoff or his psychological make up. As such we had only the conclusions of our investigation into his fund to surmise of what he may have been capable. We did know, however, that he was one of the most powerful men on Wall Street and in a position to easily end our careers or worse.

My first submission to the SEC was coordinated through Ed Manion, CFA, a member of the Boston Regional Office with 25 years of industry experience. Mr. Manion was a former trader at the Boston Company and a portfolio manager at Fidelity serving alongside Peter Lynch. He has been with the SEC for 15 years and, in my opinion, was the only person in the Boston Regional Office with the proper industry background to comprehend fully the size, scope and danger of the Madoff Ponzi scheme. Mr. Manion is a Chartered Financial Analyst (CFA) and is highly respected in Boston's financial district and is considered the go-to person for securities fraud cases in Boston. We would call Ed "the SEC's hit-man," because when the SEC brought Ed in, people often ended up in jail via SEC criminal referrals to the DOJ. Throughout the past 9 years, Ed Manion was the only SEC staff member who ever truly understood the Madoff scheme

and the threat it posed to the public. Unfortunately, as I will soon relate, my experiences with other SEC officials proved to be a systemic disappointment, and led me to conclude that the SEC securities' lawyers if only through their investigative ineptitude and financial illiteracy colluded to maintain large frauds such as the one to which Madoff later confessed. In brief, SEC securities lawyers did not want to hear from a non-lawyer SEC staffer like Mr. Manion with 25 years of trading and portfolio management experience. As much as Boston's financial community looks up to and respects Ed Manion, that's how much the SEC looked down upon and ignored Mr. Manion's repeated requests for SEC enforcement action against Mr. Madoff.

Without Mr. Manion's continued encouragement, I would have stopped the Madoff investigation after my October 2001 SEC Submission. Every time I threatened to quit the investigation, Mr. Manion would tell me I had a duty to the public to keep going no matter how badly the odds were stacked against us. I believe that the SEC would fire him if he were to testify before Congress about his role and that of the SEC during the past 9 years; but if the proper protections could be worked out in advance to safeguard his career and guarantee him another 3 years until his government retirement, I recommend that the Committee speak with him. I owe him much thanks for his dedication to the effort of sharing Mr. Madoff's alleged fraud to the appropriate authorities within the SEC.

Late 1999 – 2000

I started the Madoff investigation in late 1999 and early 2000 as a result of Frank Casey, Senior Vice-President of Marketing for Rampart Investment Management Company, Inc., telling me about the fantastic returns of one Bernard Madoff (hereafter referred to as BM). Mr. Casey told me that investors he met with in New York considered BM to be the premier hedge fund

manager because of his steady return streams with unusually low volatility. This unusually low volatility was attributed to BM having very few negative months, with the largest price decline in one month a reported minus 0.55%, or barely more than half a percent. Mr. Casey and one of my employer's partners, Mr. David Fraley, asked me to replicate BM's split-strike conversion strategy so that Rampart Investment Management Company, Inc. could offer this product and compete with BM for clients.

A split-strike conversion strategy consists of 3 main parts. Part I is a basket or grouping of stocks that you purchase. Many managers will choose to purchase their stocks in index form such that the stock basket is a 100% match to the index options they plan on using as part of the strategy. Part II consists of the call options that you are selling to generate income. Part III consists of the put options that you will be buying to protect your stock portfolio from market price declines (these cost you money just like auto insurance does). Let's simplify even further, there are 3 sources of income from this strategy, stock price appreciation (i.e. the stocks go up in price), stock dividends which you receive every quarter as the stocks in your stock basket pay their quarterly dividends, and the income you receive from selling out-of-the-money call options. However, there are also 3 sources of loss with this strategy. You lose when the stocks in your stock basket decline in price and you also lose money when you purchase put options to protect your stock basket from market price declines. The third source of loss is when the OEX index rises above the strike price of your short OEX index calls.

As you can tell from reading the above, there are lots of moving parts in this strategy and it is best left to the experts. I would be happy to diagram this strategy out on a white board

during testimony in an easier to understand form if you'd like. Since BM never actually used this strategy it may be a moot point.

Suffice it to say that the strategy is complex enough, with enough moving parts, that even market professionals without derivatives experience would have trouble keeping track of all the moving parts and understanding them fully. This is probably why BM settled on marketing this split-strike strategy to his victims. He knew most wouldn't understand it and would be embarrassed to admit their ignorance so he would have less questions to answer. And, with Ponzi schemes, you never ever want the victims to understand how the sausage is made, nor do you want them asking too many questions.

Mr. Casey obtained a one-page marketing document from the Broyhill All-Weather Fund, L.P. (May 2000 SEC Submission) which described the strategy, listed its monthly returns from 1993 through March 2000, and provided the background of the fund and its manager. I was told that "Manager B" was BM. The strategy and performance numbers foot with other information we collected in later years that all pointed to BM. I studied the Broyhill document and within 5 minutes suspected it was a fraud since the strategy as described was not capable of beating the typical percent return on US Treasury Bills less fees and expenses. Once fees and expenses were included, the Split-Strike Conversion Strategy as depicted in the marketing document would have had trouble beating a 0% return.

The reason I was immediately suspicious was that I had run a slightly similar, but actually functional, product that my firm called our Protected Equity Program (PEP). PEP delivered approximately 2/3rds of the market's return with only 1/3rd of the risk. To earn those types of returns we had to make a lot more good trading decisions than bad ones and sometimes

our returns would greatly lag the market but then catch up later. The important point to remember is that even as good as this product was, it often lagged the market whereas BM's was always doing well under all market conditions which is, of course, impossible. However, our PEP strategy was vastly superior to BM's in that we owned the actual stock in index form with perfect replication and did not have the single stock risk included in BM's strategy. Here my expertise with the product helped me to quickly determine BM couldn't have been using a split-strike strategy as he described to earn the kind of always positive return stream that he claimed.

Let me explain this critical difference, BM said that he purchased a basket of 30 – 35 stocks that closely replicated the OEX Standard & Poor's 100 stock index. But, of course, if you are using only 30 – 35 stocks to replicate a 100 stock index you have to assume a much higher degree of risk, by taking larger position weights than are in the underlying 100 stock index. You don't get compensated with extra returns by taking this additional risk, and you should experience a performance penalty when your 30 – 35 stock basket under-performs the 100 stock index. Let's assume that BM owned 33 stocks and each stock was 3.03% of his portfolio totaling 100% of his stock portfolio (33 stocks x 3.03% invested in each stock = 100% of his stock portfolio). Now let's say that one of those stocks during the 7¼ year time period from 1993 to March 2000 put in an Enron, WorldCom or Global Crossing type of performance and went to zero. BM would be down 3.03% for that month [1/33rd= 3.03%]. The odds of a 30 - 35 stock portfolio not experiencing heavy single stock losses over a 7 ¼ time period ranged between slim and none.

Furthermore, BM's strategy required all or substantially all of the stocks in his portfolio to rise during the month, something which wasn't sustainable for 7¼ years straight without

interruption. If BM had said he owned the OEX Standard & Poor's 100 stock index in its entirety, he would have passed my initial 5 minute sniff test but, fortunately for us, he was not a sophisticated enough fraudster to get his portfolio construction math correct and I suspected fraud immediately.

I then spent a couple of hours inputting BM's monthly returns into an excel spreadsheet and modeling against the S&P 500 Stock Index's monthly returns. BM made a key error in how he presented his performance because he kept comparing himself to the S&P 500 stock index when his strategy purported to replicate the S&P 100 stock index. That signaled a startling lack of sophistication on his part since there was a noticeably large difference in price returns between the two indices. This lack of sophistication on BM's part was a recurring theme during the 9 year investigation. BM's math never made sense, his performance charts were clearly deceiving, and his return stream never resembled any known financial instrument or strategy. As will be made clear in the rest of this story, to believe in BM was to believe in the impossible.

BM said he was earning 82% of the S&P 500's return with less than 22% of the risk. More alarmingly, his returns only had a 6% correlation to the S&P 500 Stock Index when I would have expected to see something like a 50% correlation and wouldn't have questioned any correlation figures between 30% - 60%. A 6% correlation was so low as to signal "FRAUD" in flashing red letters. The easiest explanation for why a 6% correlation is so low as to be wholly unbelievable is that if your returns are coming from the S&P 100 stock index, you had better at least partially resemble that stock index's performance. Having only a 6% resemblance in a situation where, due to the price limiting performance of the put and call options, one would expect a 30 – 60% correlation, was outside the bounds of rationality. The biggest, most glaring

tip-off that this had to be a fraud was that BM only reported 3 down months out of 87 months whereas the S&P 500 was down 28 months during that time period. No money manager is only down 3.4% of the time. That would be equivalent to a major league baseball player batting .966 and no one suspecting that this player was cheating, and therefore fictional.

A quick glance at Exhibit 1 of my May 2000 SEC Submission next to the letter "C" shows the "Cumulative Performance of Manager B" where Manager B is BM. Note how the line goes up at nearly a perfectly rising 45 degree angle with no noticeable downturns whatsoever from 1993 thru March 2000. Now ask yourself, how can any manager's performance be that perfectly smooth and in only the up direction when markets go down as well as up? Then ask yourself what the managers of these feeder funds were thinking as they performed due diligence or even if they were thinking while they performed due diligence. Yes, BM was a "no-brainer" investment but only in the sense that you had to have no brains whatsoever to invest into such an unbelievable performance record that bears no resemblance to any other investment managers' track record throughout recorded human history.

I then assembled OEX Standard & Poor's 100 Index Option open interest and volume statistics from the Chicago Board Options Exchange (CBOE) as reported in the Wall Street Journal's Money & Investing Section. There were not enough OEX index options in existence for BM to be managing the Split-Strike Conversion Strategy he purported to be running. This test took me less than 30 minutes to complete. At this point, I was incredulous as to how any fund would willingly invest in such an obvious fraud.

In less than four hours I knew I had proved mathematically that BM was a fraud and so I then furthered my analysis and developed two alternate fraud hypotheses to explain what might

be happening. *Fraud hypothesis 1* was that BM was simply a Ponzi scheme and the returns were fictional. *Fraud hypothesis 2* was that the returns were real but they were being illegally generated by front-running Madoff Securities broker/dealer order flow and the split-strike conversion strategy was a mere "front" or "cover." Either way, BM was committing a fraud and should go to prison.

I ran some option pricing model calculations to determine how much money BM could earn by illegally front-running his stock order flow through Madoff Securities (page 4, 2000 SEC Submission) and determined that he could earn 3 – 12 cents per share for time periods of 1 – 15 minutes if he was front-running order flow. That meant returns of 30% - 60%, given the size of the assets under management we believed he had; front-running seemed like a likely possibility in 2000 and 2001. To double check my modeling techniques and calculations, I had my assistant, derivatives portfolio manager Neil Chelo, CFA and Daniel DiBartolomeo, one of the world's most accomplished financial mathematicians, review my work. Both gentlemen concluded that either Hypothesis I or II was, in fact, correct and that BM was a fraudster. However, in 2000 and 2001 we did not have enough information on hand to determine which of the two fraud hypotheses was correct. During later time periods as Mr. Casey, Mr. Chelo, and Mr. Ocrant kept tabulating higher and higher assets under management totals, the front-running fraud hypothesis became unworkable because BM's illegal trading activity could not have gone undetected by his firm's brokerage customers.

I spent hours writing my eight-page 2000 SEC Submission and arranged with the Boston SEC's Ed Manion to meet with the Boston Regional Director of Enforcement (DOE), Attorney Grant Ward in May 2000. Given Mr. Ward's position and my understanding of his mandate, I

was shocked by his financial illiteracy and inability to understand any of the concepts presented in that submission. Mr. Manion and I compared notes after the meeting and neither of us believed that the Boston Region's DOE had understood any of the information presented. Little did I know that over the next several years I would come to understand that financial illiteracy among the SEC's securities lawyers was pretty much universal with few exceptions.

2001

In 2001, the Boston SEC's Ed Manion and I spoke often of the lack of follow up to my May 2000 SEC Submission. Immediately after 9-11, Mr. Manion called me, convinced that my work had somehow fallen through the cracks and never made it to the responsible parties in the New York Regional Office. In October 2001 or thereabouts, I resubmitted my original 8-page report, wrote an additional 3 pages and included 2 pages entitled "Madoff Investment Process Explained." The New York Regional Office never contacted me after either my May 2000 or October 2001 SEC Submissions. To my mind, the mathematical analysis provided compelling proof that an investigation was required. Yet, none was conducted to my knowledge.

2002

In 2002, I continued my research into BM. I took a key trip to Europe with Access International Advisors Limited to market a Statistical Options Arbitrage Strategy that I had developed. During that trip I met with 14 French and Swiss private client banks and hedge fund of funds (FOF's). All bragged about how BM had closed his hedge fund to new investors but "*they had special access to Madoff and he'd accept new money from them.*" It was during this trip that I knew that BM was most likely a Ponzi Scheme and that he was not front-running. If

BM was really front-running he would not want new money because additional money to invest would bring down his returns and also raise the odds of getting caught. My European trip allowed me to lower the odds that the front-running fraud hypothesis was true and focus more effort on my Ponzi scheme fraud hypothesis, which simplified the investigation. BM's masterful use of a "hook" by playing hard to get and his false lure of exclusivity were symptomatic of a Ponzi scheme. The dead give-away was BM's need for new money, another trait of Ponzi schemes, because Ponzi managers always need ever increasing amounts of new money flowing in the door to pay off old investors. I also came to realize that several European royal families were invested with BM. I met several counts and princes during my trip and it seemed they all were invested with BM or were marketing BM's strategies to noble families throughout Europe. BM had a marketing strategy that appeared to be based on false trust, not analysis.

2003 -2004

My records for 2003 & 2004 are non-existent due to my leaving my former employer at the end of August 2004 and not taking a copy of my e-mail archives with me. I am sure I worked on the case, but I don't have any supporting documentation at this time. I have a non-functioning hard drive from my old home PC which I am sending out to see if any 1999- 2004 home e-mails can be recovered that relate to this case. Unfortunately, my former employer was always on the leading edge of technology, rapidly acquiring and putting the newest, high-speed servers into service. The firm was a derivatives' management company, requiring machines that could run millions of calculations quickly. Therefore it is unlikely old e-mail records have been maintained before the mandatory 7-year e-mail retention period was enacted into law, but it can be asked for these records.

2005

In June 2005 (see page 11 of my November 7, 2005 SEC Submission) Frank Casey sent me an e-mail where I substituted "ABCDEFGH" for the name of the individual, showing that BM was attempting to borrow funds from a major European bank. This was our first inkling that BM was struggling to keep his Ponzi scheme afloat.

Fortunately, I have plenty of e-mails from the last quarter of 2005 and it was a very busy quarter for the Madoff investigation. In late October, most likely on October 25, 2005, I met with Mike Garrity, Branch Chief, of the SEC's Boston Regional Office. Mr. Ed Manion, CFA felt that Mr. Garrity was a conscientious, hard-working Branch Chief who would give me a fair and impartial hearing that might be what was needed to get this case re-submitted to the SEC's New York Office. Ed Manion scheduled an appointment for me with Mr. Garrity and I thought that perhaps the third time submitting this case would turn out to be the charm.

I met with Mr. Garrity for several hours and found him to be very patient and eager to master the details of the case. Unlike my disastrous May 2000 meeting with that office's Director of Enforcement, Attorney Grant Ward, I found Mr. Garrity to be interested and fully engaged in my telling of the scheme. Some of the derivatives math was difficult for him to understand, so I went to the white board and diagrammed out Madoff's purported strategy and its obvious failings until he understood it. A few of the more difficult concepts required repeated trips up to the white board but at the end of our meeting, it was clear that Mr. Garrity understood the scheme, it's size, and it's threat to the capital markets.

Mr. Garrity promised to follow up and he was true to his word. About a week or so later, Mike Garrity called me back telling me that he did some investigating and found some

irregularities but that he couldn't tell me what they were, only that he was in contact with the New York Regional Office and wanted to put me in touch with a Branch Chief there for follow on investigation. He also said that I would have to identify myself as "the Boston Whistleblower" when I called because he wanted to protect my identity to the extent possible.

Perhaps the most impressive thing about Mr. Garrity was his willingness to think outside of the box. He was able to imagine the impossibility of Madoff's returns and understand that BM's returns were too good to be true and this obviously concerned him. He told me that if BM were located within the New England region, he would have had an inspection team inside BM's operation the very next day.

On Friday, November 4, 2005, Mr. Garrity sent me the names and contact information for Doria Bachenheimer and Meaghan Cheung. (Branch Chief). I called the latter and revealed my identity, and e-mailed her a revised 21-page report. I then e-mailed my thanks to Mike Garrity and informed him that I would be working the case with New York. On Monday, November 7, 2007, I sent Ms. Cheung the report which the Wall Street Journal has now posted on-line less everything past Attachment 1. This report further detailed BM's fraud.

My experience with New York Branch Chief Meaghan Cheung was akin to my previous discussions with Attorney Grant Ward, and demonstrated to me an SEC failure in providing appropriate personnel to understand the case I was submitting. Ms. Cheung also never grasped any of the concepts in my report, nor was she ambitious enough or courteous enough to ask questions of me. Her arrogance was highly unprofessional given my understanding of her responsibility and mandate. When I questioned whether she understood the proofs, she dismissed me by telling me that she handled the multi-billion dollar Adelphia case. I then

replied that Adelphia was merely a few billion dollar accounting fraud and that Madoff was a much more complex derivatives fraud that was easily several times the size of the Adelphia fraud. Ms. Cheung never expressed even the slightest interest in asking me questions; she told me that she had my report and that if they needed more information they would call me. She never initiated a call to me. I did follow-up. I was the one always calling her . She was unresponsive and mostly uncommunicative when I did call, demonstrating a lack of interest and acumen for this area of investigation.

In December 2005, I decided that the third time was not a charm and that the SEC was, once again, not going to pursue the Madoff case. I also decided that if I was going to continue my investigation and attempt to involve the authorities, I should ensure my personal safety in case of possible efforts to silence me and end my investigation. I decided that I should go to the press. I went to Pat Burns, communications director at Taxpayers Against Fraud, an educational group that supports the False Claims Act, for advice and assistance on how to have my Madoff case materials investigated by the press. Mr. Burns put me in contact with John Wilke, senior investigative reporter for the Wall Street Journal's Washington Bureau. Mr. Wilke and I would become friends over the course of the next three years. Unfortunately, as eager as Mr. Wilke was to investigate the Madoff story, it appeared that the Wall Street Journal's editors never gave their approval for him to start investigating. As you will see from my extensive e-mail correspondence with him over the next several months, there were several points in time when he was getting ready to book air travel to start the story and then would get called off at the last minute. I never determined if the senior editors at the Wall Street Journal failed to authorize this investigation.

2006

On March 3, 2006, I had a 5-minute call with NY Branch Chief Cheung (Conversation memo e-mail to Frank Casey and Neil Chelo, Friday, March 3, 2006, 3:23 pm). When I mentioned that my derivatives expertise would be needed to break the case open, she dismissed me by saying that the SEC's Washington Headquarters had Ph.D.'s in an economics analysis unit with derivatives expertise. When I pointed out that the SEC likely didn't have any Ph.D.'s on staff with derivatives trading experience who truly understood how these financial instruments worked because a true derivatives expert couldn't afford to work for SEC pay, she ignored me. She was in "listen only mode." A trained investigator would have kept me on the phone for as long as possible, asking me as many open-ended questions as possible in order to advance their investigation. But as is typical for the SEC, too many of the staff lawyers lack any financial industry experience or training in how to conduct investigations. In my experience, once a case is turned into the SEC, the SEC claims ownership of it and will no longer involve the investigator. The SEC never called me. I had to call the SEC repeatedly in order to try to move the case forward and with little to no response. This may go a long way in explaining the SEC's long and consistent history of regulatory failures.

In the 2006 case materials you will see long strings of e-mails between myself, Neil Chelo and Frank Casey as we pushed the investigation forward because we felt that the SEC was not doing any work to advance the case. At the time, the SEC's reputation was slipping in the press, due to reports of its failure to investigate the Pequot insider-trading investigation. Additionally, the Integral Partners derivatives' Ponzi scheme from five years earlier was just beginning to go to trial. If the SEC could not successfully investigate and bring to justice a $50

million derivatives' Ponzi scheme, how would it handle a $30 billion derivatives Ponzi scheme? My team and I were on our own. We continued to vigorously pursue the investigation.

Perhaps the biggest breakthrough during the year was my September 29, 2006 telephone call to Matt Moran, Esq., Vice President of Marketing, for the Chicago Board Options Exchange Mr. Moran confirmed to me that several OEX Standard & Poor's 100 index options traders were upset and believed that BM was a fraudster. Mr. Moran said he couldn't talk to either the Wall Street Journal. or the SEC without permission but that if these organizations went through prope channels and got permission from Lynn Howard, the CBOE's Public Relations Head, then the CBOE staff and traders would be able to cooperate with an investigation and answer questions. This was exciting news! Unfortunately, neither the Wall Street Journal. nor the SEC were inclined to even pick up a phone and dial any of the leads I had provided to them. It is a sickening thought but if the SEC had bothered to pick up the phone and spend even one hour contacting the leads, then BM could have been stopped in early 2006. One hour of phone calls was the difference between almost 3 more years of fraud and untold billions of additional investor losses. That's how close we were and how far we were from busting this case wide open in 2006.

2007

2007 was apparently a tough year for BM. Frank Casey got a hold of key May 2007 offering documents from Prospect Capital, a San Francisco based firm that was marketing the "Wickford Fund LP," which promised to deliver a swap that paid out between 3 to 3 ¼ times whatever BM's returns were less borrowing costs and management fees. Here I am using BM

fund and Fairfield Sentry, a Greenwich, CT feeder fund interchangeably. This was a clear signal that BM was running low on new funds to keep his Ponzi scheme afloat.

In order to keep paying out funds to existing investors, a Ponzi operator must ensure that new funds are continually coming in the door to offset the outflow of payments to old investors. Creating a leveraged swap product was a sign that the inflow of new dollars was insufficient to keep the scheme going and that BM needed to create additional incentives sufficient to attract new money.

In a June 29, 2007 e-mail document submission to New York SEC Branch Chief, Meaghan Cheung I forwarded these offering documents to her office and copied Ed Manion of the Boston SEC Office. I also included updated April 2007 performance data from Fairfield Greenwich Group. The interesting thing about the performance data was that BM was noticeably stepping down his stated returns. If you look closely at the data, you will see that he went from double-digit returns from 1991 – 2000, but that all subsequent years returns were in single digits, a clear sign that he needed to cut back on the payouts to old investors in order to conserve cash and keep the scheme going. How the SEC could look at the same data we did and not arrive at the same conclusions that we did is hard to fathom. One would have to seriously question their industry experience and investigative expertise to have missed the red flags contained in the June 29, 2007 SEC Submission.

The Prospect Capital "Wickford Fund LP" performance chart just jumps out of the page at any experienced investment professional. Notice how the unlevered Sentry Fund performance is a steadily rising line. Well, that type of rising line without any downward interruption does not exist in the capital markets for any asset class over any meaningfully long period of time.

Above that steadily rising line is an exponentially rising line that depicts what the "Wickford Fund LP's" returns, using 3.1 to 1 leverage, would have been like if the fund had existed back in time. Let me explain 3 to 1 leverage. If a Madoff investor wanted to invest $1 million with BM he could do that on an unlevered basis without borrowing any money. Now Wickford Fund was allowing this same investor to invest her $1 million and borrow an additional $2 million so that she could now invest a full $3 million with BM. Nothing is free in finance and you can be sure there is a bank lending this investor the $2 million dollars she is borrowing and charging a profitable interest rate for providing this service. Wickford Fund LP is even happier to do this because they now get to charge 3 times as much in management fees because the investment amount is now $3 million and not $1 million. BM is also happier because instead of receiving $1 million, he's taking in $3 million and cheating not only the investor but the bank that is lending the investor the additional $2 million. This leveraged performance return line as provided on the graph not only does not exist for any asset class but any student of biology will recognize it as denoting a growth curve for natural organisms such as for population. How can any capital market return over any length of time only go up and never down? How did so-called due diligence "professionals" at the Madoff feeder funds miss this? How did the SEC's staff miss this? If a picture says a thousand words, then this picture said "FRAUD" a thousand times over.

In retrospect, perhaps I should have explained every single page to the SEC's New York Office. But, I was dismissed and ignored making any further attempts to explain on my part impossible. I do not know whether the cause was political interference or incompetence but the result was a refusal to look and an unwillingness to grasp even the simplest explanations for the

red flags present in the "Wickford Fund LP" offering documents. Every phone call to Meaghan Cheung made me feel diminished as a person, so I consciously chose to e-mail her so that I didn't have to undergo unpleasant and unsatisfying telephone calls.

On July 10, 2007 Neil Chelo collected a key set of financial statements for 2004, 2005, and 2006 for BM's largest feeder fund – Greenwich Sentry, L.P.. Here I am using Greenwich Sentry and Fairfield Sentry interchangeably believing them to have the same ownership. Again, red flags popped up everywhere. Greenwich Sentry used three different auditors over that three year period which is a major red flag. Berkow, Schecter & Company LLP out of Stamford, CT was the auditor in 2004, Price Waterhouse Coopers (Rotterdam, The Netherlands) was the auditor for 2005, and Price Waterhouse Coopers (Toronto, Canada) was the auditor for 2006. This raised suspicions in my mind that Greenwich Sentry L.P. might be "auditor shopping."

The financial statements themselves were nothing but a giant red flag to any investment professional looking at them because BM was in US Treasury bills at year-end and there were no investment positions to mark to market. How convenient for a fraudster not to have any trading positions for an auditor to inspect. Since US Treasury Bills exist in book-entry form only, how convenient not to have any physical securities on hand to inspect either.

In late July, I also analyzed a BM portfolio that Neil Chelo obtained, dated February 28, 2007 which contained a 51 stock portfolio, OEX Standard & Poor's Index call options and OEX Standard & Poor's Index put options. The portfolio as constructed did not look capable of earning a positive return and I marked it as having lost .32% but Frank Casey sent me a performance number for February that showed a loss about a third of what this portfolio produced. Inconsistencies like this were so constant throughout the investigation, we had

become immune to them. We would have been surprised only if something associated with BM actually made sense.

Neil Chelo lined up Amit Zjayvergiya, Fairfield Sentry's Head of Risk Management, for a 45-minute phone interview. Mr. Zjayvergiya's answers to Mr. Chelo's questions are listed in a August 24, 2007 e-mail. We discovered from this interview that BM's largest feeder fund, a fund with over $7 billion invested in BM, was not asking any of questions one would expect of a firm purporting to conduct due-diligence. Mr. Chelo is professionally certified as a Financial Risk Manager and asked several key risk management questions of Mr. Zjayvergiya and he did not receive satisfactory answers. I actually had hopes this interview would be longer and more intensive with full responses to the two full pages of questions I had sent to Mr. Chelo. Nevertheless our doubts were confirmed by the information we obtained.

2008

2008 was a strange year for everyone in global finance and our team was no exception. Because of market turbulence all of us were busy with other matters and let our BM investigation drop by the wayside with one exception which occurred in April. A good friend of mine, a University of Chicago Ph.D. in finance, Mr. Rudi Schadt, Oppenheimer Funds' Director of Risk Management, ran into a fellow University of Chicago Ph.D., a Mr. Jonathan Sokobin who was the SEC's new Director of Risk Assessment in Washington. Mr. Schadt, who was familiar with my work in the field of risk management, put Mr. Sokobin in touch with me in late March 2008. Mr. Sokobin asked that I call him, which I did a couple of days later. I wanted to give him a heads-up on some new emerging risks that I saw looming over the horizon. After our call, I felt

that I had established my bona fides as a risk expert and felt comfortable enough to send him my updated, 32-page, December 22, 2005 SEC Submission along with a short 4 paragraph e-mail. I tried calling back a few times but never got through and gave up. I never heard from Mr. Sokobin again. At this point I truly had given up on the BM investigation.

Why did BM suddenly turn himself in on Thursday, December 11, 2008? Clearly, it was because he could not meet cash redemption requests by the feeder funds and fund of funds. Due to the seductive steadiness of his returns and the purported liquidity of his strategy, the fund of funds, in a down market, would consider him the best in their lineup of managers and would most likely go to him first with their redemption requests. Many hedge funds invest in illiquid securities for which they might have trouble finding buyers in a down market. Therefore, rather than sell in a down market when there may be no buyers and drive prices even lower than they were already, these fund of fund managers felt that they would have less negative price impact by asking BM to redeem what they considered to be their "safe" investments. BM's strategy of investing in highly liquid, blue-chip stocks seemed tailor made for easy redemptions. Therefore the fund of funds managers went to BM first (and most reliable investment) and this is what brought about his downfall. Too many hedge fund investors were asking to redeem their money and BM ended up with too many of these redemption requests which brought the entire house of cards down around him.

CONCLUDING THOUGHTS

The e-mails, marketing materials, conversation records and SEC Submissions you have as part of my official document submission to Congress are what four unpaid volunteers

accomplished in our spare time to try and stop BM. We don't pretend to know what really happened on the mysterious 17th floor of the Lipstick Building at BM's corporate offices. Every bit of information we obtained was in the public domain. We never had any secret insider documents or smoking gun e-mails. We did what we could to stop BM from bilking the public. All of us feel very badly that we failed to achieve a positive result.

There were many things we definitely did not know. We never conceived that any high net worth professional investor would have 100% of their money invested in hedge funds. To investment professionals, a proper allocation to hedge funds would range between 0% - 25%, and certainly any such allocation would be spread among several managers, not given in its entirety to just one manager. And being from the institutional side of the business, we closely tracked the feeder funds and fund of funds that were investing in BM, but never realized that charities and individual investors were investing 100% of their money with BM. We also missed the obvious, that BM was Jewish, and as a result, he would be preying most heavily on the Jewish community because Ponzi schemes are first and foremost an affinity fraud.

We more closely tracked BM's affinity fraud through Europe which was a different community of victims from those targeted in the U.S. In Europe the affinity groups sought by the BM feeder funds were mainly European royal families, the high born old money families, and the nouveau riche. In Europe, the victims were mostly blue blood families. BM was truly masterful in using his feeder funds to draw in people close in make-up to the owners of the feeder funds. In this way he was able to expand his affinity victims to those beyond that of the Jewish community and gain entry into other affinity communities as well.

I am sure that we missed many other clues, warning signs and red flags but assure you that we did the best that we could with the information we dared collect. Every time we raised our heads to collect information, we exposed ourselves to discovery and feared the result.

By this time, law enforcement officials know a lot more than we do. The four of us will be waiting to find out what really went on behind closed doors. For those who ask why we did not go to FINRA and turn in Madoff, the answer is simple: Bernie Madoff was Chairman of their predecessor organization and his brother Peter was former Vice-Chairman. We were concerned we would have tipped off the target too directly and exposed ourselves to great harm. To those who ask why we did not turn in Madoff to the FBI, we believed the FBI would have rejected us because they would have expected the SEC to bring the case as subject matter experts on securities fraud. Given our treatment at the hands of the SEC, we doubted we would have been credible to the FBI.

And, I wish to clear the air on a very important matter about ethics, public trust, civic duty and what this all says about self-regulation in the capital markets. The four of us did our best to do our duty as private citizens and industry experts to stop what we knew to be the most complex and sinister fraud in American history. We were probably a lot more foolish than brave to keep up our pursuit in the face of such long odds. What troubles us is that hundreds of highly knowledgeable men and women also knew that BM was a fraud and walked away silently, saying nothing and doing nothing. They avoided investing time, energy and money to disclose what they also felt was certain fraud. How can we go forward without assurance that others will not shirk their civic duty? We can ask ourselves would the result have been different if those others had raised their voices and what does that say about self-regulated markets?

To the victims, words cannot express our sorrow at your loss. Let this be a lesson to us all. White collar crime is a cancer on this nation's soul and our tolerance of it speaks volumes about where we need to go as a nation if we are to survive the current economic troubles we find ourselves facing; because these troubles were of our own making and due solely to unchecked, unregulated greed. We get the government and the regulators that we deserve, so let us be sure to hold not only our government and our regulators accountable, but also ourselves for permitting these situations to occur.

Thank you and May God Bless the United States of America

TIMELINE -SEE CHART

Late	1999 Frank Casey "discovers" BM
Late 1999	Rampart tasks me to reverse engineer BM's strategy
Early 2000	4 hours of research proves mathematically that BM is a Fraudster
May 2000	8-page submission to SEC Boston Regional Office's Director of Enforcement
Jan 2001	Michael Ocrant starts researching the BM story for MAR Hedge
May 2001	Michael Ocrant publishes "Madoff Tops charts; skeptics,ask how"
Sep 2001	SEC's Ed Manion calls to ask me to re-submit the Madoff Case
Oct 2001	2nd SEC Submission consists of original 8-page May 2000 Submission+ 3 additional pages + 2 page Investment Process Explained
2002	Investigation continues: e-mail records lost

June 2002	Key Marketing trip to London, Paris, Geneva & Zurich where I discover that Europeans are likely BM's largest investors
2003	Investigation continues: e-mail records lost
2004	Investigation continues: e-mail records lost
Oct 2005	SEC's Ed Manion arranges for 3rd case submission
Oct 2005	I meet with Boston SEC Branch Chief Mike Garrity
Oct 2005	SEC's Mike Garrity investigates
June 2005	Frank Casey discovers that BM is attempting to borrow money at European Banks – the 1st indication that the scheme is running short of $
Nov 2005	SEC's Mike Garrity puts me in contact with New York SEC
Nov 2005	3rd SEC Submission to SEC's Error! Bookmark not defined. in NY
Dec 2005	I start to doubt NY SEC and contact WSJ Washington Bureau
Jan 2006	Integral Partners $40 million derivatives Ponzi scheme goes to trial, 5 years and 5 months after its discovery causing us to further doubt SEC competence
Sep 2006	Chicago Board Options Exchange Marketing VP tells me that several OEX option traders also believe that BM is a fraudster
2007	Neil Chelo obtains Feb 28, 2007 portfolio of BM trading positions, portfolio shows no ability to earn a positive return
June 2007	Frank Casey obtains Wickford Fund LP prospectus showing that BM is now so short of cash that he is offering a 3:1 leverage swap to obtain new funds
June 2007	This prospectus is e-mailed to NY SEC's Error! Bookmark not defined.
July 2007	Neil Chelo obtains Greenwich Sentry LP Financial Statements for 2004-06; Auditors are different for each of the 3 years which is very odd
Aug 2007	Neil Chelo has opportunity to interview Fairfield Sentry's head of risk management who displays a startling lack of acumen
Aug 2007	Hedge funds all have losses this month except for BM – he's amazing!

2008	Global markets dive, entire investigating team loses interest and is busy with more pressing matters
April 2008	Jonathan Sokobin, SEC's Director of Risk Assessment calls me per the recommendation of a mutual friend
April 2008	I send Mr. Sokobin my last SEC Submission and quit the investigation
Fall 2008	Stock Markets crumble, panicked investors rush to redeem
Dec 2008	Madoff "confesses" and turns himself in after running out of cash to meet investor redemptions

PART II REBUILDING THE SEC

The Current Situation is Dire but Fixable: there is no where to go but up!

Securities fraud is a scourge on the marketplace. Investors who suspect fraud or who aren't confident that a level playing field exists will properly require higher returns. To the companies trying to raise capital in the marketplace, investors' higher return requirements mean a higher, unaffordable cost of capital or worse, the total unavailability of capital at any price. Today, thanks to the lack of effective regulation and oversight, our capital markets are barely functioning. Markets need to be fair, efficient and transparent in order to work properly. They also need to be regulated in order to ensure a constant availability of credit at affordable rates.

Right now, investors are afraid and do not trust the banks, insurance companies, brokerage firms, credit ratings agencies, investment managers, hedge funds, or other financial institutions nor should they. Investors particularly do not trust our nation's financial regulators, particularly the Federal Reserve Bank (FED) and US Treasury who have both told them repeatedly that things were fine, when in fact, things were only about to get worse. The ultimate insult to investors is the FED's refusal to tell us which financial institutions are borrowing from the Discount Window and how much they are borrowing. This startling lack of transparency from regulators has led to a massive lack of investor confidence. Only by providing investors with full transparency and allowing them to make rational investment decisions, will our capital markets find the proper price levels so that buyers can find sellers and sellers can find buyers.

Investors want to know that the financial firms they are dealing with are solvent and right now they feel that our government isn't telling them the truth about the solvency of this nation's

largest financial institutions so the entire system remains paralyzed, needlessly wondering who the zombie financial institutions are. My advice is to take the pain up front and either nationalize or close the zombie financial institutions as soon as possible and put the uncertainty to rest. Trust will not be restored until full transparency is restored.

Every single one of this nation's too many financial regulators failed to earn their paychecks. This is the reason our financial system has been on the verge of collapse over these past several months. Unfortunately, as bad a regulator as the SEC currently is, and the SEC certainly is a bad regulator, it's the best of a very sorry lot. Compared to the FED which has led this nation to the abyss of national bankruptcy by it's refusal and inability to regulate the banks, the SEC actually looks halfway competent. Thanks to the ineptitude of financial regulators, Wall Street as we once knew it ceases to exist and too many of the nation's largest banks are on government life support, too weak to lend and too battered to survive as currently constituted.

Our nation has too many financial regulators. The separation and lack of connection and communication between them leaves too many gaping holes for financial predators to engage in "regulator arbitrage" and exploit these regulatory gaps where no one regulator is the monitor. In more than one financial institution, employees have two different business cards. One card has their registered investment advisor title (which falls under SEC regulation) and the other has their bank title (which falls under banking regulators). When the FED comes in to question them, they say they're under the SEC's jurisdiction and when the SEC comes in to question them, they say they're under the FED's jurisdiction. Clearly this situation has to be corrected so firms cannot play one regulator against the other or worse, choose to be regulated by the most incompetent regulator available while avoiding the most vigorous and thorough regulators.

The goal needs to be to combine regulatory functions into as few a number as possible to prevent regulatory arbitrage, centralize command and control, ensure unity of effort, eliminate expensive duplication of effort, and minimize the number of regulators to which American businesses have to answer. To this end, I recommend that one super-regulatory department be formed and that it be called the Financial Supervision Authority (FSA). Under it's command would come the SEC, the FED, a national insurance regulator and some sort of combined Treasury / DOJ law enforcement function with staffs of dedicated litigators to carry out both criminal and civil enforcement for all three. All banking regulators should be merged into the FED so that only one national banking regulator exists. The FED Chairman, Vice-Chairman, and Governors who set monetary policy can be spun out into a separate, independent operating units, but since they've shown themselves to be such incompetent regulators, this critical function would be stripped away from them. Pension regulation should be moved from the Department of Labor to the SEC. Futures and commodities regulation should be moved from the CFTC to the SEC. Cross-functional teams of regulators from the SEC, FED, national insurance regulator and Treasury/DOJ should be sent on audits together whenever possible to prevent regulatory arbitrage. I envision the inspection arms to be the SEC, FED and national insurance regulator while the Treasury / DOJ litigators house the litigation teams that take legal action against defendants. American businesses deserve to have a simpler, easier to understand set of rules to abide by and they also deserve to have competent regulation at an affordable price. Right now financial institutions pay a lot in fees for regulation but they aren't getting their money's worth. Government needs to give business regulation that provides a value-proposition, where fees paid to regulators equal value received by business.

The SEC is a Failed Regulator: But it Can't Remain One

The story I have related in Part 1 underscores the deeply flawed connections or lack thereof between financial regulators as well as the systemic failures of the SEC. These systemic failures are instantiated by my particular experiences with the SEC as explained above but also generally replete in the history of the SEC over the past few decades. Let me provide you with a representative list of only some of the agency's major failures. During the tech bubble years, the SEC ignored the Wall Street Analysts' recommendations, almost all of which were "buy recommendations" even though these same analysts privately advised a few privileged investors to sell these over-priced or worthless securities, leading up to the 2000 – 2003 bear market. In 2003, the SEC's Boston Regional Office turned away Mr. Peter Scannell, the Putnam market-timing whistleblower. Fortunately, Mr. Scannell survived a vicious beating and went to both the Massachusetts Securities Division (MSD) and the New York Attorney General (NYAG) who believed him and enforced the nation's first market-timing scandals while the SEC watched from the sidelines until embarrassed enough to finally enter the fray with enforcement actions of its own. In 2007 and 2008, the Auction Rate Securities scandal hit the headlines, and once again the SEC remained busy looking the other way, protecting predatory investment banks from defrauded investors. And, once again, the NYAG and MSD conducted effective and timely enforcement actions to ensure that defrauded investors got their money back. More recently, the SEC watched quietly but did nothing to prevent the train wreck as the nation's five largest domestic investment banks either failed like Lehman, were rescued by government forced acquisitions like Bear Stearns and Merrill Lynch, or became bank holding companies in order to

survive like Goldman Sachs and Morgan Stanley. And today, no investor knows what the bank's balance sheets look like because the SEC is refusing to enforce transparency rules.

When the industry you purported to regulate implodes and the nation's financial system is frozen, then it is safe to say that you've failed as a regulator. It is also safe to say that the SEC has lost the nation's confidence. The Executive Branch and Congress are faced with the following critical question – do we disband the SEC, merge it out of existence, or fix it?

Rebuilding the SEC:

I come before you not to bury the SEC but to assist you in helping to tear down and rebuild an SEC capable of effectively regulating capital markets in the 21st century. I promise to be blunt in my assessment of where the SEC is today and where it needs to go in the short term and long term. No punches will be pulled regardless of the SEC's embarrassment. Until the SEC admits to and embraces its failures, it will not be able to recover and rebuild. "*Denial*" is not just a river in Egypt, it's the mindset that the SEC has adopted. It has blamed everything on a lack of staff and resources while refusing to admit to its underlying problems. I know that I am tired of their lame excuses and I suspect that Congress and the American public are also tired of the SEC's shameless attempts to deflect blame. It's high time and past time for some personal responsibility on the part of the SEC's senior staff. Our nation's capital markets didn't fall so far and so fast without a lot of help from regulators who failed to regulate. At the very least the SEC's senior staff should be making profuse apologies to Mr. Madoff's victims. Instead all I've heard are SEC promises to look into what happened with my repeated SEC Submissions which told the SEC exactly where to look to find the fraud.

In my dealings with the SEC I have noted many deficiencies and will point those out in enough detail so that the new management team can fix them in the next four years. I believe the one over-arching deficiency is that the SEC is a group of 3,500 chickens tasked to chase down and catch foxes which are faster, stronger and smarter than they are. It's painfully apparent that few foxes are being caught and that Bernie Madoff, like too many other securities fraudsters, had to turn himself in because the chickens couldn't catch him even when told exactly where to look. As currently staffed, the SEC would have trouble finding first base at Fenway Park if seated in the Red Sox dugout and given an afternoon to find it. Taxpayers have not gotten their money's worth from the SEC and this agency's failures to regulate may end up costing taxpayers trillions in government bailouts.

Dramatically Upgrading SEC Employee Qualifications & Educational Budgets:

Amazingly, the SEC does not give its employees a simple entrance exam to test their knowledge of the capital markets! Therefore is it any wonder when SEC staffers don't know a put option from a call option, a convertible arbitrage strategy from a long/short strategy, the left side of the balance sheet from the right side, or an interest only security from a principle only security. By failing to hire industry savvy people, the SEC immediately sets their employees up for failure and so it should not be surprising that the SEC has become a failed regulator.

A good way for Congress to find out exactly what I mean when I say the SEC doesn't have enough staff with industry credentials is to query the SEC senior staff that come before your Committee. Ask them – "Do you have any financial industry professional certifications?" "Have you ever worked on a trading desk?" "What accounting, business or finance degrees do you hold?" "What financial instruments have you traded in a professional capacity?"

If Congress decides to keep the SEC in existence, then upgrading its staff, increasing its resources, and wholly revamping its compensation model is in order. In order to attract competent staff, a test of financial industry knowledge equivalent to the Chartered Financial Analysts Level I exam should be administered to each prospective employee to ensure that new employees have a thorough understanding of both sides of a balance sheet, an income statement, the capital markets, the instruments that are traded and the formulas incorporated within these instruments. Talented Certified Public Accountants (CPA's), Chartered Financial Analysts (CFA's), Certified Financial Planners (CFP's), Certified Fraud Examiners (CFE's), Certified Internal Auditors (CIA's), Chartered Alternative Investment Analysts (CAIA's), MBA's, finance Ph.D.'s and others with industry backgrounds need to be recruited to replace current staffers. One thing the incoming SEC Chair should do right away is order a skills inventory of the current SEC staff to measure the exact skills shortfalls with which she is now faced. My bet is that Ms. Shapiro will find that she has too many attorneys and too few professionals with any sort of relevant financial background.

I recommend that the Chair ask the SEC senior staff to provide her with a complete skills listing of the current SEC staff. Knowing how many SEC employees hold accounting, business, and finance degrees versus how many hold law degrees would be a useful first step in quantifying the mismatches between skills on hand versus skills required to properly regulate. Determining how many SEC employees have ever worked on a trading desk would be particularly illuminating for the new Chair. Ditto for how many SEC employees are CAIA's, CIA's, CPA's, CFA's, CFE's, CFP's, and FRM's. My bet is that the SEC staff is critically short of employees with credible industry experience.

I caution the SEC to avoid focusing on any one of the above professional certifications at the expense of the rest because all are relevant and necessary. The SEC also needs to avoid having too many people with educational and professional backgrounds that are too alike. Diversity will ensure that group-think is kept at bay and that the SEC embraces multiple relevant skill sets. Right now the SEC is over-lawyered. Hopefully it can transition away from this toxic mix as quickly as possible.

I would like to see the SEC expand its tuition reimbursement program to pay 100% of relevant post-graduate education courses with one year of additional government service for each year of graduate education. Currently, the SEC does not allow its staff time out of the office to attend industry luncheons, dinners, cocktail parties etc. nor does it pay for their attendance at these low cost learning events. SEC staffers need to be encouraged to attend industry conferences, particularly those venues where brand new securities are being featured, so that they are not caught flat-footed and behind the curve when these securities enter the marketplace. Because people tend to say and do things when they are traveling that they would never do at home, conferences are the ideal venue for the SEC to find out what's happening in the industry and, more importantly, what's about to happen. Sending SEC staff to conferences with a written information collection plan, under the supervision of a senior person, with the goal of obtaining information and marketing literature about new products and querying attendees about frauds within the industry is a cost-effective solution to keeping the SEC on level ground with the industry it regulates.

Large cities with robust financial centers have financial analyst societies and economic clubs which hold educational meetings of just the sort the SEC staff needs. For example, in my

hometown, the Boston Security Analysts Society has 5,000 members and holds educational lunches at least twice weekly, but the SEC won't reimburse its staff to attend these luncheons even though firms within the industry do. New York and Washington also have sizeable analysts societies but rarely does anyone see SEC staff attending these educational events and we all know it isn't because the SEC has no need for greater industry knowledge. Either the SEC is anti-intellectual and intentionally maintaining staff uneducated about the capital markets or it is merely being ignorant. In either case, not to budget for it's staff's education is indefensible in the 21st century. SEC employees are knowledge workers, not unthinking, replaceable cogs and deserve to have the required educational resources available to them to do their jobs.

To further illustrate the anti-intellectual bias of the SEC, consider what the SEC staff has printed on their business cards. If you're expecting to see Certified Public Accountant, Certified Financial Planner, Certified Fraud Examiner, Certified Internal Auditor, Financial Risk Manager, Chartered Financial Analyst, Chartered Alternative Investment Analyst, or some other sort of highly sought after professional designation, you will be sorely disappointed. For some unfathomable reason, most of the very few credentialed SEC staffers do not have their professional designations printed on their business cards. Why not? One would almost think that the SEC's top leadership was going out of its way to drive good people out of the SEC and destroy the morale of those who stay. The all too few SEC staffers I know with industry credentials have all told me they are not allowed to have these designations printed on their business cards. The only reason for this that makes sense is that if the SEC allowed its few credentialed staff to put these credentials on their business cards it would expose the overall lack of talent within the SEC. Therefore, one thing I would immediately recommend is that relevant

industry credentials be printed on the Staff's business cards ASAP. Not only is this good for morale, but it also tells you which staff are worth keeping and which ones need to be told to find new jobs because their skills aren't relevant and don't meet either the SEC's or the investing public's needs.

Another shocking revelation is that MAR Hedge published an expose on BM on May 1, 2001 while Barron's published their copycat BM expose on May 7, 2001 but the SEC doesn't pay for subscriptions to industry publications for its staff so their staff likely never read these damning articles which each contained numerous red flags. That's right, if the SEC staff want to read industry publications they have to pay for them on their own because the SEC won't pay for them. I remember that after reading both of these Madoff expose articles, Neil Chelo, Frank Casey and I felt 100% certain that the SEC would be shutting down BM within days. What we didn't know at the time was that the SEC doesn't read industry publications. We were shocked.

If you walk into any sizeable investment industry firm, it will have a library of professional publications for the staff to use as a resource. Typical journals on hand would be the Journal of Accounting, Journal of Portfolio Management, Financial Analysts Journal, Journal of Investing, Journal of Indexing, Journal of Financial Economics, and the list goes on and on. But, if you walk into an SEC Regional Office, you won't see any of these journals nor will you see an investment library worthy of the name. If an SEC Regional Office does have an investment library, it is usually the effort of one lone, highly motivated, employee who stocks a bookshelf on his/her own time, paying for the publications him or herself. This begs the question, where do SEC staffers actually go to research an investment strategy, find out which formulas to use to determine investment performance, or figure out what a CDO squared is?

Apparently all the SEC staff uses is Google and Wikipedia because both are free. Lots of luck figuring out today's complex financial instruments using free web resources. No wonder industry predators run circles around the SEC's staff. It's easy to fool people from an ignorant regulator that goes out of its way to ensure that its staff remains uneducated and under-resourced.

The SEC has exactly the wrong staff for the 21st century and a staff that's incapable of comprehending the financial instruments it is charged with regulating. Even if the SEC did provide a sensible publications budget for its staff so that staff could subscribe to the Wall Street Journal, Barron's, Business Week, and formed research libraries containing all the important financial journals, its staff would still need to understand what instruments are being regulated and which formulas are being used. The faulty recruitment of unnecessary and inefficient and incompetent human resources would remain.

To properly regulate the finance industry, the SEC needs to hire people who know how to take apart complex financial instruments and put them back together again. If an SEC staffer doesn't know derivatives math, portfolio construction math, arbitrage pricing theory, the Capital Asset Pricing Model, both normal and non-normal statistics, financial statement analysis, balance sheet metrics, or performance presentation formulas then they shouldn't be hired other than to fill administrative or clerical positions.

For instance, a person I know rather well in the Boston office, with over 10 years of industry experience, a double major under-graduate degree in economics and math from an Ivy League school, with an MBA degree and a Chartered Financial Analysts designation wanted to leave her job as a senior analyst at a large mutual fund company in order to have another child. She wanted out of the rat race where 60 hour work weeks were both common and expected so

she applied for a job with the SEC. During her interview she was told that she was 1) overqualified with too much industry experience, 2) over educated and 3) that she wouldn't be happy inspecting paperwork and would likely quit in frustration so the SEC didn't plan on offering her the job. This is deeply problematic as it underscores the lack of a proper recruitment policy to equip the SEC with appropriate personnel for the work with which it is mandated and the expertise expected in order to appropriately monitor our financial institutions and their numerous transactions. The SEC apparently is only interested in administrative verification, to ensure compliance with existing (outdated) securities laws. Is it any wonder, given the current SEC staff, that major financial felonies go unpunished while minor paperwork transgressions are flagged for attention?

Besides upgrading its staff at the junior and mid-levels, the SEC needs to recruit foxes to join the SEC staff in senior, very high paying positions that offer lucrative incentive pay for catching foxes and bringing them to justice. The revolving door between industry and regulators can be precluded if the SEC recruits highly successful industry practitioners who have succeeded financially during their long careers and now want to serve the American Public by fighting securities abuses. The ideal candidates would all have gray hair (or no hair at all) and the SEC would be the capstone on their already illustrious careers. The main hiring criteria would be that each candidate would have to submit a written list of securities frauds that he/she would attack and list the estimated dollar recoveries for each of these frauds. These "foxes" would then be brought on board specifically to lead mission-oriented task forces dedicated to closing down these previously undiscovered frauds, restoring trust in the marketplace, thereby lowering the cost of capital and minimizing the regulatory burdens for honest American businesses. My

theory is that it's better to target your enforcement efforts at known fraudsters while leaving honest American businesses alone other than for occasional but thorough spot inspection visits. The fraudsters would be terrified but most businesses would be relieved if the SEC adopted the proposed regulatory scheme.

In summary, the SEC needs to stop hiring more of the same people it's already been hiring. What the SEC needs to do is test its staff, identify who to retain, get rid of those who either don't have the proper skills sets for their specific mandates at a 21st century level or don't want to obtain those skills, hire foxes from industry to lead the enforcement and examination teams, increase the pay levels, and expand its educational budgets to ensure that the SEC becomes a forward leaning, learning organization that is more than a match for the industry it regulates.

The SEC needs to adopt Industry Compensation Guidelines in order to compete:

Compensation at the SEC needs to be both increased and expanded to include incentive compensation tied to how much in enforcement revenues each office collects. Industry pays a base salary plus a year-end bonus that is tied directly to revenues brought into the firm. The SEC needs to adopt the industry's compensation guidelines in order to compete for talent. Of course, the SEC Commissioners would continue to approve the levels of the fines for enforcement actions because it would be a clear conflict of interest to have the enforcement and examinations staff set the fines that lead to their own compensation. Each SEC Regional Office should get back some pre-set percentage of the fines it brings in, and I recommend a 5% level initially, toward that office's bonus pool. Regional enforcement teams that do great work and bring in a $100 million case settlement deserve to be compensated for their excellence. And, to prevent

taxpayers from having to pony up these multi-million dollar bonus pools, I recommend that fines be triple the amount of actual damages, that the guilty transgressors pay the actual costs of the government's investigation, and that SEC staff bonuses also be paid for by the guilty transgressors.

In expensive financial centers' like New York, Boston, Chicago, Los Angeles, and San Francisco, cost of living adjustments bringing base compensation to the $200,000 level make sense plus the award of annual year-end bonuses but only when merited. In the lower cost regions, a $100,000 - $150,000 base compensation would be fair, adjusted to local prevailing wage and cost data. This would be enough to attract the nation's best, brightest and most experienced industry practitioners. All compensation over and above the base compensation amount would come from each regional office's bonus pool and be tied directly to the fines (revenues) that each office generates. People who do not perform and bring in good quality cases that result in settlement awards to the government will get asked to leave and make room for people who can come in and produce solid cases.

To be effective, the SEC cannot afford to be less talented and educated than the industry, and I would argue it can't even strive to be as good as the industry, it needs to be better! If the incoming Chair sets her sights too low, that's an admission of defeat and our capital markets can't afford to have this agency continue to fail. If our regulators continue to fail, then our capital markets won't recover because investors won't return until they are assured of a fair deal with full disclosure.

I would also institute quantifiable metrics to measure the new, 21st Century regulatory effectiveness. Obvious metrics are revenue from fines, dollar damages to investors recovered,

dollar damages to investors prevented, fine revenues per employee per regional office, and the number of complaints from Congress to the regulators complaining about the severity of the fines or the thoroughness of the government's investigations. Let me tell you a story about a very competent and talented SEC attorney in the Boston Regional Office who says that every time he receives a phone call from Washington SEC Headquarters calling him off an investigation, it's for one reason and one reason only – because that is the only way the predator financial institution he is currently investigating can escape justice and escape making restitution to the victims. If the number of Congressional complaints ever went down year after year it could only have one of three meanings: 1) better members of Congress, 2) the SEC is doing such a magnificent job of fraud detection that white collar crime actually drops or 3) a worse job by the SEC that year.

Raise the Enforcement Bar to Incorporate Good Ethics into the SEC's Mission focus:

Just because it is not illegal doesn't mean the SEC should ignore unethical behavior in the marketplace, which it has been doing for several decades now by trusting the industry to self-regulate its way to good behavior. The SEC must change its mission toward ensuring full transparency, fair play, and zero tolerance for unethical financial dealings. Note that I didn't say the SEC's mission should tend away from "enforcing the nation's securities laws." Given that there is no way to keep a set of securities laws on the books that is up to date and fully accounts for all of the bad behavior that financial predators can and will engage in, the SEC needs to recognize that securities laws are not the be all and end all of regulation, they are merely the absolute bare minimum standards which market participants must follow. Securities laws will never be fully up to date or always relevant. The current crisis will see that new, more relevant

laws are enacted, but after these crises pass, securities laws will once again quickly become obsolete until the next crises appears. We need to end this cycle of overdependence on a series of rapidly outdated securities laws as our basis for enforcement and err on the side of protecting our investors.

The SEC's main focus is to mindlessly check to see if registered firms paperwork is in order and complies with the law as written. If a firm happens to be a financial predator and is engaged in market-timing or selling auction rate securities, the SEC's lawyers will not be concerned because market-timing and auction rate securities aren't illegal, merely unethical. If that firm's paperwork meets legal requirements, the SEC will give these financial predators a free pass just like it has always done. You will note that the SEC has said that the market-timing of mutual funds was not illegal, which may explain why the SEC turned away the Putnam whistleblower, Peter Scannell in 2003. The long-term, buy and hold mutual fund investors who lost that billions in returns to market-timers as a result of these actions and omissions, certainly would agree that this activity was unethical and they deserved to have this money returned to their retirement accounts. Auction rate securities issuers and investors ended up similarly disappointed thanks to the SEC's willingness to foster an "anything goes" climate on Wall Street. Enough of the securities' lawyers robotic simple compliance audits, let's shift the 21st century's capital markets to a higher plane, and start to insist on ethical capital markets that give all investors a fair deal with full transparency.

The bare minimum requirement of compliance with securities' law does not serve the higher standards and needs of today's financial markets and the pace of modern market practices. Policy standards and requirements including, good ethics, fair dealings, full transparency, and

full disclosure need to be adopted and enforced. The SEC needs to shift its focus away from the lowest common denominator, mere securities law enforcement, and upgrade it to change we can believe in by ensuring full transparency, fair play and zero tolerance for unethical financial dealings.

Revamping the Examination Process:

I am not sure how many of you have ever undergone an SEC inspection visit. I was a portfolio manager, then chief investment officer, at a multi-billion dollar equity derivatives asset management firm, and equity derivatives was considered a "high risk " area by the SEC. My firm received SEC inspection visits every three years like clockwork. I've been through these examinations and will tell you about their many obvious flaws. First, the SEC never once was able to send in an examiner with any derivatives knowledge. It was a good thing my firm was honest because if we weren't, we could have pulled a Madoff on them and they would have been none the wiser. Second, the Sec audit teams are very young and they rarely have any industry experience. Third, the teams come in with a typed up list of documents and records they wish to examine. They hand this list to the inspected firm's compliance officer (CO). The CO then takes them to a conference room and the firm provides the pile of documents and records which the SEC team inspects diligently. So, if a firm were so inclined, it could keep a second set of falsified but pristine records yet commit the equivalent of mass financial murder and get away with it, just as long as the firm had at least one set of (falsified) books and records that were in compliance.

Now let's examine what is wrong with the examination process described above. First, the team only interacts with the inspected firm's compliance team, not the traders, not the portfolio managers, not the client service officers, not the marketing staff, not the information technology department and not management. The problem with this process is that the SEC examiners only examine paperwork but neglect the tremendous human intelligence gathering opportunities that are sitting right outside the conference room. What these SEC examiners need to be doing is sending one or two people out on the trading floors and into the portfolio manager's offices to ask leading, probing questions. During every single such unscripted interview, the SEC examiner should ask, "*Is there anything going on here that is suspicious, unethical or even illegal that I should know about? Are you aware of any suspicious, unethical or even illegal activity at any competing firms that we should be aware of?* And, during that interview, the SEC examiner should be handing out his/her business card, asking that person to call them personally if they ever run across anything the SEC should be looking into either at their firm or any other firm. Unless everybody at a particular firm is dishonest, if fraud is present, at least these standard internal auditing techniques will result in a materially significant number of new enforcement cases. These are internal auditing techniques that well trained accountants, internal auditors, and fraud examiners use when conducting audits or investigations. But at present, the SEC staff is so untrained, it's almost as if this concept of talking to a firm's employees is advanced rocket science. It is my belief that SEC examiners are so inexperienced and unfamiliar with financial concepts that they are literally afraid to interact with real finance industry professionals and choose to remain isolated in conference rooms inspecting pieces of paper.

From her first day in office, the incoming SEC Chair needs to get these examiners to focus on interacting with industry professionals and querying them on what's going on in their firms and their competitors' firms. Sitting like ducks in the inspected firm's conference room and getting fed controlled bits of paper by the firm's compliance staff isn't getting the job done. As currently constituted, the current examination process is an insult to common sense, a waste of taxpayers' money, and it can't be good for SEC employees' morale either. This also reinforces the need to increase the pay scale and add incentive compensation such that more qualified people apply for and take SEC jobs. Unless and until the SEC puts real finance professionals on those examination teams, their odds of finding the next Bernie Madoff range from slim to none.

When a financial analyst is about to visit a company to determine whether or not to invest in that company's stock, the first thing he/she does is go to a Bloomberg and analyze the firm's capital structure, it's financial statements, financial statement ratios, look up the firm's weighted cost of capital, and start running horizontal and vertical analyses of the financial statements looking for trends and outliers. The trained analyst will also use his/her Bloomberg to read all the news stories on the company, look at the firm's SEC filings, and use all of the information above to build a set of questions he/she needs to answer in order to arrive at an intelligent investment decision. The analyst will also obtain Wall Street analyst research reports and read them all to see what information other analysts' research on this company's main strengths and weaknesses.

Unfortunately, the SEC staff examiner doesn't do this. The main reason is lack of training on use of a Bloomberg machine. In the rare event the staff has know how, most SEC

Regional Offices are lucky to have even one Bloomberg machine for the entire region's use. Whereas your typical investment firm would have one Bloomberg per analyst, trader and portfolio manager, the SEC unwisely only funds one per office! For SEC compliance and examinations' the use and need for Bloomberg machines are an inherent industry requirement. The work in brief cannot be done without it. Those Bloomberg machines are the lifeblood of the industry, they contain much of the data an SEC staffer would need for any fraud analysis of a company.

Here is a quick example so that you understand how vitally important a Bloomberg machine is to securities enforcement. If you type in a company's stock ticker symbol, say ABC then hit "WACC" equity go, ABC Company's weighted cost of capital would pop up on your screen. Let's say ABC Company a weighted average cost of capital of 10% between its outstanding debt which pays an average of 6% interest and its equity which has a 14% cost associated with it and the mix between debt and equity is 50/50 [(.5 x 6%) + (.5 x 14%) = 10% cost of capital]. Assume that ABC Company is a Defense Contractor and bids "cost plus 3%" on an Iraqi War contract yet the company's cost of capital is 10%. This is a clear sign that ABC Company is likely cheating the Defense Department on that contract since no company would willingly accept any contracts which fall under its cost of capital. Working for 3% when a firm's cost of capital is 10% would quickly lead the firm into bankruptcy since that contract would be costing the firm a minus 7% return if the costs being passed onto the government were accurate. A good SEC examiner would immediately suspect ABC Company was padding the costs in its Iraqi War contract and alert the DOD's Defense Criminal Investigation Service to conduct a fraud audit. If everyone in industry is using Bloombergs except for the SEC, it is little wonder

the SEC can't find fraud. The staff does not have the tools and training necessary to do their jobs.

In case you are still not convinced, take the following challenge. Name one major securities fraud case that the SEC busted wide open on its own without the felon first turning himself in? Give up? The last major pre-emptive SEC strike was Ivan Boesky, for insider trading violations over two decades ago. Today's SEC staff are more like financial crime scene investigators, coming in after the fraud scheme has already collapsed, toe-tagging the victims, trying to figure out who the bad guys were and how the fraud scheme occurred. To date the SEC's inability or unwillingness to regulate and more importantly to implement regulation with adequate tools and training have potentially cost us trillions in the recent financial crisis.

An Alternative Course of Action: Disbanding the SEC

Fortunately, the US already has two very competent securities' regulators who do a truly fantastic job and at an unbelievably low cost. Unfortunately, they are the New York Attorney General's office (NYAG) and the Massachusetts Securities Division (MSD). The NYAG and MSD have busted open the Wall Street analysts' bogus stock recommendations scandal, the mutual fund market-timing scandals, the auction rate securities scandals and a whole host of other industry violations. Where has the SEC been beforehand while all of these frauds were being committed? Sitting safely on the sidelines watching the fraud go by, daring not to get involved for fear of upsetting their masters on Wall Street. And this is the nicer, kinder explanation. Many investors may claim the SEC has been intentionally missing in action so as to aid and abet financial industry fraud to ensure that predatory financial institutions remain safe from investors. From an investors' perspective, the only two regulators that have stood up and

made investors whole are the NYAG and MSD. These two regulators need to be publicly commended for the great job they are doing on behalf of investors everywhere.

Therefore, one alternative solution for Congress to consider is to disband the SEC and give its budget to the NYAG and MSD to hire staff and keep doing what they've been doing which is a darn good job of protecting investors. One reason these two states have competent regulators is that New York City is the world's largest financial center while Boston is the world's fourth largest financial center. London is No. 2 while Tokyo is No. 3. Somehow, I doubt that the NYAG and MSD would be hiring many people from the SEC, choosing instead to find competent employees with industry experience locally to do the job more efficiently. From an efficiency standpoint, the NYAG and MSG employ far fewer people at much lower cost and do a much better job of securities regulation than the SEC. If the state regulators are providing more regulatory bang for the buck, an option would be to fund them and zero out the SEC's budget. After all, we let poorly performing private companies fail, why not let poorly performing government agencies fail too?

Congress should always keep its options open regarding further funding of the SEC. If this agency continues to fail to regulate, holding the threat of disbandment over their heads by giving its budget to state securities regulators is the ideal high card for the Congress to keep in its pocket to ensure that the SEC understands it can either improve or disappear. The SEC's most committed staffers will not allow their agency to fail, nor will they allow anyone more senior to them within the agency to lead it down the wrong path. Plus, the threat of extinction does have a certain way of focusing attention and accomplishing goals more quickly than would otherwise be

the case. Hopefully this alternative path will impose Congress's will over the SEC such that the agency meets all Congressional deadlines and mandates.

An Alternative Course of Action: Assigning the NYAG & MSD to enforce large, industry-wide cases and let the SEC conduct the routine, paperwork inspections.

This is similar to the enforcement reality already in effect where the NYAG and MSD discover the truly big industry-wide frauds and conduct nationwide enforcement actions to recover investor assets. The SEC seems to be a captive agency that purposely ignores the large frauds, focusing only on the minor transgressions it can find during the normal, routine examination process. This alternative course of action formalizes the reality on the ground today.

Congress could fund the NYAG and MSG so that it could do more of the large securities fraud enforcement cases at which it has developed great expertise. The SEC could keep its current budget and continue to police up the misdemeanors it seems to do passably well.

This alternative has the advantage of playing to each regulator's strengths. The NYAG and MSD don't have the SEC's thousands of employees with which to conduct nationwide inspections of regulated firms. However, the NYAG and MSD do have a deep bench of experienced litigators and investigators with pit bull tenacity. As they say, it's not the size of the dog in the fight, it's the size of the fight in the dog that matters. The SEC has 3,500 employees and can continue to muddle along, handling the low-level securities violations it has a known appetite for while avoiding the large fraud cases which it doesn't seem to have either the heart nor the skill to attack.

Recommendations for the New SEC Chair:

Given the SEC's current crisis situation it cannot be managed toward greatness, it needs to be led there. No amount of management can save the SEC. You manage budgets and resources but you have to lead people, and the best place to lead from is the front, setting the example for everyone behind you to follow. It will take a first-rate job of leadership, hard work and a bigger budget to turn around this agency but I know it can be done. Ms. Shapiro has been given every good leader's dream, to take command of an organization that has nowhere to go but up.

If, by year-end 2009 there is not a dramatically measurable improvement in the number of cases brought and SEC staff morale has not improved, then a replacement Chair needs to be hired. President Obama needs to go through regulatory agency heads like Lincoln went through generals in order to give the American people the government we deserve and the government we've been paying for all along. Our President needs to keep hiring and firing until he, like Lincoln, has found leaders who can create winning organizations. We can't afford any more 9-11's, Hurricane Katrina's or any other massive governmental failures like the near collapse of our nation's financial system.

At this point the SEC desperately needs new leadership at the very top. I feel very sorry for the staff in the eleven (11) Regional Offices for not receiving the proper training, resources, and support from their headquarters over a period of decades. What the SEC headquarters no longer needs is a building full of career bureaucrats shuffling paper. The new SEC Chair needs to come in and clean house with a wide broom, sweeping out the top ranks and bringing in a new, results oriented senior leadership team to replace the one that has failed us so miserably.

My recommendation to the incoming SEC Chairman is to spend one week each month at each of the eleven (11) different Regional Offices during the first year, spending each day that week with a different examination team looking at how they do their jobs. After each day's work has ended, I would take that team out to dinner for a full de-briefing, asking them what tools, training and resources they need to do their jobs better. Once I got back to Washington, I'd crack the whip and make sure my senior staff pushed those tools and resources down to my examination teams on an expedited basis. Senior staff that can't deliver resources to the Regional Offices quickly enough need to be identified and terminated. Examination teams are the tip of the spear and the SEC can only be as good as those teams in the field are, so they must take absolute top priority.

The new SEC Commissioner should consider moving the SEC out of Washington because Washington is a political center not a financial center, so you won't find the most qualified finance people there for the job at hand. Since New York is the world's largest financial center and Boston is the world's fourth largest financial center, moving the SEC to either West Chester County, NY or Connecticut, in between those two major financial centers makes a lot of sense. If the SEC wants to attract the top talent, relocating its headquarters to somewhere between Rye, NY and New Haven, CT is where this agency will best attract the foxes with industry experience it so desperately needs.

If the SEC's senior staff is as bad as it appears to be, then recognize that quickly and move to replace these people expeditiously. Far better to clean house at the top in order to show the new leadership team is serious about bailing out this sinking ship and getting it turned around in the opposite direction. Plus, I would rather have empty desks in Washington versus keeping

the dead wood on board; because allowing dead wood to linger sends the wrong message to the Regional Offices. While senior staff positions remain unfilled, promote lower ranking employees into senior roles on an acting basis to discover the up and coming future leaders of this agency. You will identify good talent using this method.

Reinvigorating and reforming the Office of Risk Assessment is another task on the new SEC Commissioner's plate because the SEC needs to put its best, most experienced finance professionals there. New inspection checklists have to be devised for every new financial product, structured product, derivative security, hybrid security, corporate entity – and all before these products are sold into the marketplace! Being even one day late to regulate is simply unacceptable. Examination audit checklists also need to be totally rebuilt so that obvious frauds such as the Madoff Ponzi scheme are never missed again. Base audit checklists for each type of firm that's out there need to be developed. Then, specific additional audit checklists that test for new and different, even never before seen frauds, have to be developed and tested in the field. The Office of Risk Assessment needs to be continually thinking of how to create fraudulent products, how to cook the books more creatively, how to launder money more effectively, and then design effective counter-measures for the examination teams to use.

I also recommend that the SEC Chair require that the examination teams add at least one or more audit steps on top of whatever checklists they've been given using their own imagination and creativity. Those examination team-created audit steps that uncover fraud can then be adopted system-wide. This agency needs every employee making contributions in order to achieve greatness. I would expect the new Chair to demand contributions from all levels of the agency and to listen to all ideas from staff, no matter what their rank or pay grade.

To further increase the SEC's auditing effectiveness, I would organize a "Center for All Lessons Learned (CALL)" similar to what the US Army has been using with great effectiveness for decades. CALL will collect and sort through every fraud that the SEC finds. These frauds would be diagnosed for both common and unique elements so that the odds of future frauds going unchecked are further reduced. I recommend that the SEC adopt the Association of Certified Fraud Examiner's Fraud Tree contained in Volume I of the Certified Fraud Examiner's Manual for use because it lists hundreds of different financial frauds and categorizes them into easy to understand categories and sub-categories. In other words, the SEC needs to shed its "*keystone cops modus operandi*" and quickly turn itself into a "*learning, winning organization*" that instills confidence in all SEC employees, regulated firms and the investing public. CALL would be a password protected, on-line web based resource for all SEC employees to use and, more importantly, to contribute to themselves. The SEC needs to be able to learn at a faster pace than the bad guys they are fighting, and the only way to increase the SEC's decision-making quickly is to demand that all levels of the organization pitch in and contribute their lessons learned. The old top down, command from above approach doesn't work in the modern era and must be abandoned if the SEC is to achieve greatness. The SEC currently has a staff of 3,500 and every single one of those thirty-five hundred brains needs to be turned on and contributing.

Another Office needs to be formed within the SEC similar to the National Transportation Safety Board's accident investigation teams. I would call this the Office the "National Financial Safety Board." MIT Professor Andrew Lo has been advocating this low cost approach to sending in inspection teams after each financial institution blow up to diagnose exactly what went wrong and in what sequence that led these institutions to fail. Whenever a public company,

broker/dealer, hedge fund, or registered investment advisor blows up, lets send in an SEC investigation team to collect the valuable lessons learned and add them to the SEC's knowledge base. I recommend that this office's knowledge base be made publicly available on the SEC's website for companies, accountants, and investors to use in preventing whatever blowups can be prevented by avoiding the mistakes of companies that have failed. From the Madoff case alone we have plenty of useful lessons for the public – for example – never allocate more than 20% to any one investment manager, never put 100% of your eggs in one basket, make sure the investment manager uses an independent third party custodian, the proper allocation to hedge funds ranges from 0% - 25% of total assets, etc.

Currently the size and frequency of the blowups is increasing at an alarming rate and the SEC needs to act quickly to turn those numbers in the opposite direction because we can't continue in the direction we've been going for much longer. This National Financial Safety Board would not prevent all future blowups from happening, but if it made our nation's financial system safer and the blow-ups less frequent and of smaller size, then we will all benefit. It is clear that we can't afford 2009 to be worse than 2008 because we barely survived 2008's financial disasters. The time to act on this is now.

Finally, I would add one more Directorate, the Office of the Whistleblower, to centralize the handling and investigation of whistleblower tips. Currently, the SEC's eleven (11) Regional Offices handle whistleblower complaints on an individualized, ad hoc basis. Every whistleblower who comes in with a tip is handled differently and no one tracks the whistleblower with the particular complaint she has brought with the object of the complaint, a particular company or individual. One would think that if ABC Company has received five complaints this

year and its nearest competitors received no complaints this year, that this would be meaningful information and merit close scrutiny. Complaints from within industry or by investors have got to be the cheapest, most effective way to identify fraudsters, yet this valuable resource is currently ignored by the SEC. There can be no good reason for dismissing this valuable tool.

If my experience is any guide, the treatment accorded whistleblowers ranges from dismissive to outright unwelcome yet whistleblowers are the best, and cheapest source of great and not so great cases. The great cases cannot be culled from among the many cases submitted if SEC staff does not answer the phone or read its mail. Whistleblowers are the single largest source for fraud detection according to the Association of Certified Fraud Examiner's (ACFE) 2008 Report to the Nation (Chapter 3, page 22, www.acfe.com). According to the ACFE, whistleblower tips were responsible for detecting 54.1% of fraud schemes at public companies whereas external audits account for a meager 4.1% of fraud cases detected (note: the SEC would be considered an external auditor). Therefore whistleblowers are a full thirteen (13) times more effective than the SEC's external audits yet there is no Office of the Whistleblower. Who wouldn't want the SEC to become thirteen (13) times more effective?

The Internal Revenue Service (IRS) started its Office of the Whistleblower in December 2006 and in two short years has grown this office to a staff of 17. The IRS now receives the largest cases with the absolute best quality of evidence in its history. Consider the cost of 17 IRS employees versus the billions in additional tax revenues they'll be responsible for bringing into the US Treasury.

The IRS offers bounty payments to whistleblowers of 15% - 30% for cases that lead to successful recoveries to the US Treasury. These bounty payments do not come out of the IRS's

budget nor do the taxpayers pay these bounties. All bounty payments are made by the guilty defendants. Therefore this is a no cost program that funds itself and allows the IRS Staff to cherry pick from the cases that literally walk in the door, selecting the credible cases for immediate investigation.

I recommend that the SEC expand and reinvigorate its almost never used whistleblower bounty program. Section 21A(e) of the 1934 Act allows the SEC to pay a bounty of up to 30% to whistleblowers but only for insider-trading theory cases. The way this works is, the SEC can fine the guilty defendant triple the amount of its ill-gotten gains or losses avoided for insider trading and can award up to ten percent (10%) of the penalty amount to the whistleblower (triple damages x 10% maximum bounty award = 30% potential maximum reward).

Unfortunately, unlike the IRS's Whistleblower Program and the False Claims Act, the SEC's reward payments are not mandatory and the SEC can refuse to pay these rewards without explanation. If Congress would expand this program to include all forms of securities' violations and make the reward payments mandatory, hundreds of cases would likely walk in the door each year, and many of these would be high quality cases that would lead to billions in investor recoveries similar to the billions that the False Claims Act (31 USC Sections 3729-3733) already provides each year.

We have two major government agencies, the Department of Justice and the Internal Revenue Service, that use whistleblower programs to identify cases that they would otherwise know nothing about. Todate false claims act recoveries total over $22 Billion since 1986. For every $1 spent in enforcement, the False Claims Act returns $15 in recoveries from fraudsters. This proves that such a program works and is not a speculative enterprise on the part of the

government. . We need the SEC to become as effective as the Department of Justice and the Internal Revenue Service at fraud enforcement.

I recommend that each tip, upon receipt, be logged in, given a case number, and for credible tips with real evidence behind them, the whistleblower and whistleblower's counsel be put in contact with the relevant SEC operating unit that is best able to investigate the complaint. Hopefully this will prevent a repeat of my experiences during the Madoff Case, where over the years I kept submitting better and more detailed case filings but ran into trouble because Boston's SEC Regional Office believed me but New York's SEC Regional Office apparently did not. Standardizing the treatment of whistleblowers to ensure that they are not ignored or mistreated should be a priority for the SEC. An annual reporting to Congress of whistleblower complaints and the SEC's follow-up actions should be mandatory.

Let me add one more important point concerning the issue of self-regulation and whistleblowing: consider that perhaps hundreds of finance professionals around the globe knew that Madoff was a fraudster or at least suspected that he was. How many of these people contacted the SEC with their suspicions? Unfortunately, I may have been the only one. If a whistleblower wanted to, how would they know who to contact at the SEC since there is no "Office of the Whistleblower?" I believe that by adding such an office, we would see honest firms sending in evidence against their crooked competitors. Getting rid of the shysters is in everyone's best interest and restoring trust in the US capital markets is imperative if we are to restore our nation's economy to health. If I'm the CEO of an honest firm and I hire new employees who worked across the street at a competitor and then find out from these new

employees that my competitor is dishonest, it would be in my economic self-interest and in the interest of good public policy to turn them into the SEC.

If self-regulation is ever going to work, we need to find ways to advertise it, reward it, and measure it. Currently, the SEC is doing none of the above. Every tool, every resource, and every person has to be brought to bear in the fight against white-collar crime. Government has coddled, accepted, and ignored white-collar crime for too long. It is time the nation woke up and recognized that it's not the armed robbers or drug dealers who cause us the most economic harm, it's the white-collar criminals living in the most expensive homes and who have the most impressive resumes who harm us the most. They steal our pensions, bankrupt our companies, and destroy thousands of jobs, ruining countless lives. No agency is better situated than the SEC to attack high-level white-collar crime. Therefore, the SEC is too important to allow too continue to fail.

Thank you for the opportunity to present my recommendations on how to rebuild the SEC into the world's best securities regulator, it has been a singular honor for me to appear before you today.

	NASD	NYSE
2001	Mary L. Schapiro President	Richard Grasso
2002	Mary L. Schapiro President	Richard Grasso
2003	Mary L. Schapiro President	Richard Grasso / John Reed
2004	Mary L. Schapiro President	John A. Thain
2005	Mary L. Schapiro President	John A. Thain
2006	Mary L. Schapiro CEO James S. Shorris EVP Head of Enforcement	John A. Thain
2007*	Mary L. Schapiro CEO Susan L. Merrill, EVP Chief of Enforcement	John A. Thain Duncan L. Niederauer, CEO
2008	Mary L. Schapiro CEO of FINRA	

* NASD and NYSE regulators merge to create FINRA

2000	2001	2002	2003	2004	2005	2006	2007	2008
SEC Chairman	SEC Chairman	SEC Chairman	SEC Chairman	SEC Chairman	SEC Chairman	SEC Chairman	SEC Chairman	SEC Chairman
Arthur Levitt	**Harvey Pitt**	**Harvey Pitt**	**William H. Donaldson**	**William H. Donaldson**	**Christopher Cox**	**Christopher Cox**	**Christopher Cox**	**Christopher Cox**
New York Office	New York Office	New York Office	New York Office	New York Office	New York Office	New York Office	New York Office	New York Office
Wayne M. Carlin Regional Director	**Wayne M. Carlin** Regional Director	**Wayne M. Carlin** Regional Director	**Mark Schonfeld** Regional Director	**Mark Schonfeld** Regional Director	**Mark Schonfeld** Regional Director	**Mark Schonfeld** Regional Director	**Mark Schonfeld** Regional Director	**James A. Clarkson** Acting Regional Director
Boston Office	Boston Office	Boston Office	Boston Office	Boston Office	Boston Office	Boston Office	Boston Office	Boston Office
Juan M. Marcelino District Administrator	**Juan M. Marcelino** District Administrator	**Juan M. Marcelino** District Administrator	**Peter Bresnan** Acting District Administrator	**Walter G. Ricciardi** District Administrator	**Walter G. Ricciardi** District Administrator	**David P. Bergers** District Administrator	**David P. Bergers** District Administrator	**David P. Bergers** District Administrator

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ATTORNEYS AT LAW

Timeline of Harry Markopolos' Investigation of Madoff Investment Scheme

Nov 1999
Frank Casey, colleague at Rampart Inv. Mgmt., "discovers" BM*

Nov 1999
Rampart directs me to reverse engineer BM's strategy*

Feb 2000
My four (4) hours of research proves mathematically that BM is fraudulent*

May 2000
I submit 8-page document to SEC Boston Regional Office's Director of Enforcement

Apr 2001
Michael Ocrant starts researching the BM story for MARHedge magazine*

May 2001
Michael Ocrant publishes "Madoff Tops charts; skeptics ask how"

May 2001
Michael Ocrant publishes, Barron's publishes "Don't Ask, Don't Tell: Bernie Madoff is so secretive, he even asks investors to keep mum"

May 2001
Barron's publishes - "Harry, Neil and Frank are amazed that BM survives both the MAR Hedge and Barron's articles"

Sep 2001
SEC Boston office's Ed Manion calls to ask me to re-submit the Madoff Case

Oct 2001
I make second SEC submission consisting of original 8-page May 2000 submission plus 3 additional pages and 2 page Investment Process explained

Jun 2002
Key marketing trip to London, Paris, Geneva & Zurich where I discover that Europeans are likely BM's largest investors

Jun 2005
Casey discovers that BM is attempting to borrow money at European Banks. This is the first indication that the scheme is running short of funds.

Jan 2006
Integral Partners, $40 million derivatives Ponzi scheme, goes to trial, 5 years and 5 months after its discovery causing us to further doubt SEC effectiveness

Oct 2005
I meet with Boston SEC Branch Chief Mike Garrity

Oct 2005
SEC's Ed Manion arranges for 3rd case submission

Oct 2005
SEC's Mike Garrity investigates

Nov 2005
I make third SEC Submission to SEC New York office's Meaghan Cheung

Nov 2005
SEC Boston office's Mike Garrity puts me in connect with SEC New York office

Dec 2005
I start to doubt NY SEC and contact WSJ Washington Bureau

May 2007
Neil Chelo of Rampart obtains February 28, 2007 portfolio of BM trading positions; portfolio shows no ability to earn a positive return*

Jun 2007
This prospectus is e-mailed to SEC New York office's Meaghan Cheung

Jun 2007
Casey obtains Wickford Fund LP prospectus showing that BM is now so short of cash that he is offering a 3:1 leverage swap to obtain new funds

Jul 2007
Chelo obtains Greenwich Sentry LP Financial Statements for 2004-06; Auditors are different for each of the 3 years which is very odd

Sep 2006
Chicago Board Options Exchange Marketing VP tells me that several OEX option traders also believe that BM is a fraudster

Aug 2007
Chelo has opportunity to interview Fairfield Sentry's head of risk management who displays a startling lack of acumen

Aug 2007
Hedge funds all have losses this month except for BM

2008
Global markets dive, entire investigating team loses interest and is busy with more pressing matters

Apr 2008
Jonathan Sokobin, SEC's Director of Risk Assessment, calls me per the recommendation of a mutual friend

Apr 2008
I send Mr. Sokobin my last SEC Submission and quit the investigation

Sep 2008
Stock Markets crumble and panicked investors rush to redeem*

Dec 2008
BM "confesses" and turns himself in after running out of cash to meet investor redemptions

Sep 1999 | Jan 2000 | Jan 2001 | May 2001 | Jan 2002 | Jan 2003 | Jan 2004 | May 2005 | Sep 2005 | Jan 2006 | May 2006 | May 2007 | Jan 2008 | May 2008 | Sep 2008

2002 Investigation continues: e-mail records lost

2003 Investigation continues: e-mail records lost

2004 Investigation continues: e-mail records lost

SEC Involvement

Warning signs

Other

Permitted for public use

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ACFE
Association of Certified Fraud Examiners

About the ACFE

The ACFE is the world's premier provider of anti-fraud training and education. Together with more than 45,000 members in more than 125 countries, the ACFE is reducing business fraud worldwide and providing the training and resources to fight fraud more effectively. Founded in 1988 by Joseph T. Wells, CFE, CPA, the ACFE proudly celebrates its 20th anniversary as the leader in the global fight against fraud.

The ACFE provides educational tools and practical solutions for anti-fraud professionals through initiatives including:

- Global conferences and seminars led by anti-fraud experts
- Instructor-led, interactive professional training
- Comprehensive resources for fighting fraud, including books, self-study courses and articles
- Leading anti-fraud periodicals including *Fraud Magazine*®, *The Fraud Examiner*, and *FraudInfo*
- Local networking and support through ACFE chapters worldwide
- Anti-fraud curriculum and educational tools for colleges and universities

Certified Fraud Examiners

CFEs are anti-fraud experts who have demonstrated knowledge in four critical areas: Fraudulent financial transactions, fraud investigation, legal elements of fraud, and criminology and ethics. In support of CFEs and the CFE credential, the ACFE:

- Provides bona fide qualifications for CFEs through administration of the CFE Examination
- Requires CFEs to adhere to a strict code of professional conduct and ethics
- Serves as the global representative for CFEs to business, government, and academic institutions
- Provides leadership to inspire public confidence in the integrity, objectivity, and professionalism of CFEs

For more information about the ACFE, visit **www.ACFE.com**

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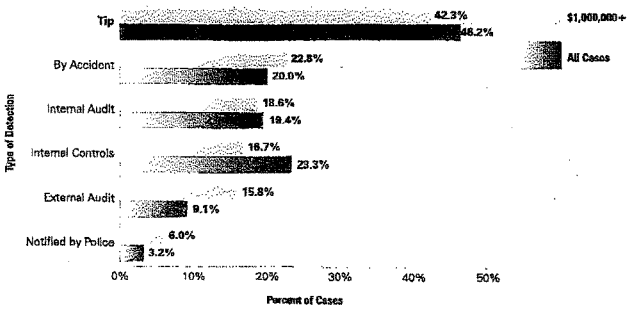
3 Detection of Fraud Schemes

Detecting the Largest Frauds

The value of effective independent audits is illustrated by their role in detecting large frauds. Among the 237 cases involving a loss of $1 million or more, external audits were cited as the detection method 16% of the time, as compared to 9% of all cases. Tips were the most common detection method for these cases with 42% of million-dollar frauds being uncovered through a tip or complaint.

Initial Detection Method for Million Dollar Schemes[6]



[6]The sum of percentages in this chart exceeds 100 percent because in some cases respondents identified more than one detection method.

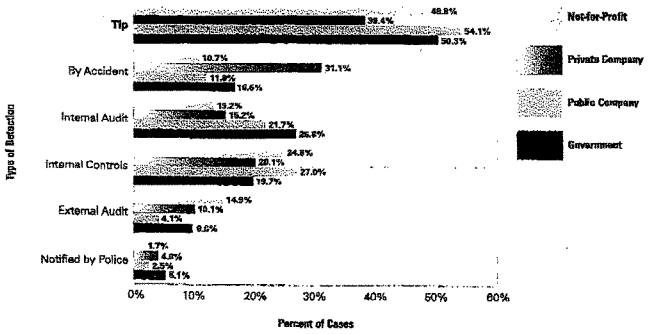
3 Detection of Fraud Schemes

Detection Methods by Organization Type

In comparing detection methods based on the victim's organization type, we see that, with a few exceptions, the relative frequency of initial detection methods is generally consistent across the four categories of organizations. In each category, tips were the most common detection method, generally followed by internal controls and internal audits. The biggest deviation we found was in frauds at privately held companies. In these cases, frauds were initially detected by accident nearly a third of the time, which is a substantially higher rate than in any other organization type. It is not clear exactly why so many frauds at privately held companies were detected by accident as opposed to other methods, but we note that this result is similar to our 2006 Report, in which 35% of frauds in private companies were detected by accident. Private companies also experienced a smaller proportion of cases being reported through a tip or complaint.

Internal audits were the source of detection in over a quarter of the government fraud cases, which exceeded the rate for any other type of organization. Surprisingly, publicly traded companies cited the smallest percentage of fraud detected by external audits even though they are the only organizations among the four categories that are generally required to undergo an independent audit. However, public companies also had the largest percentage of frauds detected through both tips and internal controls; this may reflect the continued impact of the Sarbanes-Oxley Act of 2002, which mandates the establishment of anonymous reporting mechanisms and increases the emphasis on strong internal control systems for publicly traded organizations.

Initial Detection Method by Organization Type*



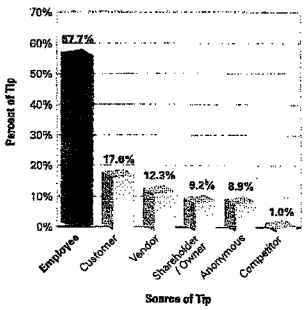
*The sum of percentages for each organization type in this chart exceeds 100 percent because in some cases respondents identified more than one detection method.

Tips

Of the 417 cases in our study in which a tip or complaint was instrumental in the detection of the fraud, 31% were received via a hotline or other formal reporting mechanism. This is a relatively high number considering that less than half of the victim organizations in our survey had a formal reporting mechanism. The fact that tips continue to be the most effective means of detecting fraud suggests that organizations could improve their detection efforts by establishing formal structures to receive reports about possible fraudulent conduct.

By far, the greatest percentage of tips came from employees of the victim organization, which is consistent with our findings in 2006. The fact that over half of all fraud detection tips came from employees suggests that organizations should focus on employee education as a key component of their fraud detection strategies. Employees should be trained to understand what constitutes fraud and how it harms the organization. They should be encouraged to report illegal or suspicious behavior, and they should be reassured that reports may be made confidentially and that the organization prohibits retaliation against whistleblowers. It is also worth noting that over 30% of tips came from external sources. While training and educating employees about reporting fraud is clearly an important step, organizations should also involve these third parties in their fraud detection programs by making them aware of the organization's reporting mechanism and encouraging them to report improper conduct.

Percent of Tips by Source*



*The sum of percentages in this chart exceeds 100 percent because in some cases respondents identified more than one source of the initial tip.

Insider Trading: Information on Bounties

Section 21A(e) of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. 78u-1(e)] authorizes the Securities and Exchange Commission ("Commission") to award a bounty to a person who provides information leading to the recovery of a civil penalty from an insider trader, from a person who "tipped" information to an insider trader, or from a person who directly or indirectly controlled an insider trader. This pamphlet is designed to provide interested persons with information on bounties and the Commission's rules for making a bounty application. Section 21A(e) of the Exchange Act and the Commission's bounty rules are set out at the end of this pamphlet.

What is "Insider Trading?"

"Insider trading" refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security. Insider trading violations may also include "tipping" such information, securities trading by the person "tipped" and securities trading by those who misappropriate such information. Examples of insider trading cases that have been brought by the Commission are cases against: corporate officers, directors, and employees who traded the corporation's securities after learning of significant, confidential corporate developments; friends, business associates, family members, and other "tippees" of such officers, directors, and employees, who traded the securities after receiving such information; employees of law, banking, brokerage and printing firms who were given such information in order to provide services to the corporation whose securities they traded; government employees who learned of such information because of their employment by the government; and other persons who misappropriated, and took advantage of, confidential information from their employers.

Because insider trading undermines investor confidence in the fairness and integrity of the securities markets, the Commission has treated the detection and prosecution of insider trading violations as one of its enforcement priorities.

How Much May be Paid as a Bounty?

Insider trading may result in enforcement action by the Commission or in criminal prosecution by the Department of Justice. The Exchange Act permits the Commission to bring suit against insider traders to seek injunctions, which are court orders that prohibit violations of the law under threat of fines and imprisonment. The Commission may also seek other relief against insider traders, including recovery of any illegal gains (or losses avoided) and payment of a civil penalty. The amount of a civil penalty can be up to three times the profit gained (or loss avoided) as a result of insider trading.

The Commission is permitted to make bounty awards from the civil penalties that are actually recovered from violators. With minor exceptions, any person who provides information leading to the imposition of a civil penalty may be paid a bounty. However the total amount of bounties that may be paid from a civil penalty may not exceed ten percent of that penalty.

How Will the Commission Make Bounty Determinations?

All Commission determinations regarding bounties including whether to make a payment, to whom a payment shall be made, and the amount of a payment (if any), are in the sole discretion of the Commission. Any such determination is final and not subject to judicial review. Nothing in the Commission's rules or in this pamphlet is intended to limit the Commission's discretion with respect to bounties.
In making determinations regarding bounty applications the Commission will be guided by the purposes of the bounty provisions. These purposes include the intent of the United States Congress to encourage persons with information about possible insider trading to come forward. The Commission will also consider other factors that it deems relevant. Examples of other factors that may be relevant are: the importance of the information provided by an applicant; whether the information was provided voluntarily; the existence of other applications in the matter; and the amount of the penalty from which bounties may be paid.

Normally, the Commission will not make any determination on a bounty application until a payment of a penalty is both ordered by a court and recovered. A person who files an application meeting the requirements of the Commission's rules will be notified of the Commission's determination on the application.

How and When Do You Apply for a Bounty?

An application must be clearly marked as an "Application for Award of a Bounty," and must contain the information required by the Commission's rules. The application must give a detailed statement of the information that the applicant has about the suspected insider trading.
Any person who desires to provide information to the Commission that may result in the payment of a bounty may do so by any means desired. The Commission encourages persons having information regarding insider trading to provide that information in writing, either at the time they initially provide the information to the Commission or as soon as possible afterwards. Providing information in writing reduces the possibility of error, helps assure that appropriate action will be taken, and minimizes subsequent burdens and the possibility of factual disputes. In any event, a written application for a bounty must be filed within 180 days after the day on which the court orders payment of the civil penalty.

Can You Apply for a Bounty Anonymously?

The Commission recognizes that there may be instances when a bounty applicant wishes to remain temporarily anonymous. The bounty rules take these instances into account. While the Commission will only award bounties to applicants who provide their identity and mailing address, that information may be added by a later amendment to the application. The amendment must be filed within 180 days after the entry of the court order requiring the payment of the penalty upon which the bounty is based. An anonymous applicant who fails to file such an amendment (and anyone who fails to make a written application) runs the risk of losing eligibility for a bounty through lapse of time and ignorance of the fact that a penalty has been recovered.

Absent compelling cause, the Commission ordinarily does not disclose the identity of a confidential source. In some instances however disclosure of that identity will be legally required, or will be essential for the protection of the public interest. For example, a court may order disclosure during litigation, or the Commission may need to present the testimony of a bounty claimant to ensure the success of an enforcement action. Consequently while the Commission and its staff will give serious consideration to requests to maintain the confidentiality of a source's identity, no guarantees of confidentiality are possible.

Statutory and Regulatory Provisions

Section 21A(e) of the Exchange Act

[T]here shall be paid from amounts imposed as a penalty under this section and recovered by the Commission or the Attorney General, such sums, not to exceed 10 percent of such amounts, as the Commission deems appropriate to the person or persons who provide information leading to the imposition of such penalty. Any determinations under this subsection, including whether, to whom, or in what amount to make payment, shall be in the sole discretion of the Commission, except that no such payment shall be made to any member, officer, or employee of any appropriate regulatory agency, the Department of Justice, or a self-regulatory organization. Any such determination shall be final and not subject to judicial review.
Subpart C of Part 201 of Title 17 of the Code of Federal Regulations
Procedures Pertaining to the Payment of Bounties Pursuant to Subsection 21A(e) of the Securities Exchange Act of 1934

Rule 61 Scope of subpart

Section 21A of the Securities Exchange Act of 1934 authorizes the courts to impose civil penalties for certain violations of that Act. Subsection 21A(e) permits the Commission to award bounties to persons who provide information that leads to the imposition of such penalties. Any such determination, including whether, to whom, or in what amount to make payments, is in the sole discretion of the Commission. This subpart sets forth procedures regarding applications for the award of bounties pursuant to subsection 21A(e). Nothing in this subpart shall be deemed to limit the discretion of the Commission with respect to determinations under subsection 21A(e) or to subject any such determination to judicial review.

Rule 62 Application required

No person shall be eligible for the payment of a bounty under subsection 21A(e) of the Securities Exchange Act of 1934 unless such person has filed a written application that meets the requirements of this subpart and, upon request, provides such other information as the Commission or its staff deems relevant to the application.

Rule 63 Time and place of filing.

Each application pursuant to this subpart and each amendment thereto must be filed within one hundred eighty days after the entry of the court order requiring the payment of the penalty that is subject to the application. Such applications and amendments shall be addressed to: Office of the Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303.

Rule 64 Form of application and information required.

Each application pursuant to this subpart shall be identified as an Application for Award of a Bounty and shall contain a detailed statement of the information provided by the applicant that the applicant believes led or may lead to the imposition of a penalty. Except as provided by Rule 65 of this subpart, each application shall state the identity and mailing address of, and be signed by, the applicant. When the application is not the means by which the applicant initially provides such information, each application shall contain: the dates and times upon which, and the means by which, the information was provided; the identity of the Commission staff members to whom the information was provided; and, if the information was provided anonymously, sufficient further information to confirm that the person filing the application is the same person who provided the information to the Commission.

Rule 65 Identity and signature.

Applications pursuant to this subpart may omit the identity, mailing address, and signature of the applicant; provided that such identity, mailing address and signature are submitted by an amendment to the application. Any such amendment must be filed within one hundred eighty days after the entry of the court order requiring the payment of the penalty that is subject to the application.

Rule 66 Notice to applicants.

The Commission will notify each person who files an application that meets the requirements of this subpart, at the address specified in such application, of the Commission's determination with respect to such person's application. Nothing in this subpart shall be deemed to entitle any person to any other notice from the Commission or its staff.

Rule 67 Applications by legal guardians.

An application pursuant to this subpart may be filed by an executor, administrator, or other legal representative of a person who provides information that may be subject to a bounty payment or by the parent or guardian of such a person if that person is a minor. Certified copies of the letters testamentary, letters of administration, or other similar evidence showing the authority of the legal representative to file the application must be annexed to the application.

Rule 68 No promises of payment.

No person is authorized under this subpart to make any offer or promise, or otherwise to bind the Commission with respect to the payment of any bounty or the amount thereof.

Source: SEC Form 2222 (6-89)

http://www.sec.gov/divisions/enforce/insider.htm

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TESTIMONY OF

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Before the

United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises
Concerning Investor Protection and Securities Fraud

Wednesday, February 4, 2009

Chairman Kanjorski, Ranking Member Garrett, and members of the Subcommittee:

We appreciate the opportunity to appear today on behalf of the Securities and Exchange Commission ("SEC") to discuss the mission and mandate of the SEC, our critical work to protect investors, the work of our respective divisions and offices, and certain general information with respect to the alleged fraud perpetrated by Bernard L. Madoff and Bernard L. Madoff Investment Securities LLC. We are submitting this written testimony jointly on behalf of the Securities and Exchange Commission.

We assure the Subcommittee that the Commission and its staff take the alleged Madoff fraud very seriously. The losses incurred by investors as the result of Mr. Madoff's alleged fraud are tragic, and we appreciate the impact of those losses on the lives of investors.

Collectively, together with Chairman Schapiro and the Commissioners, we are committed to reducing opportunities for fraud, and to detecting it quickly, to best protect investors from those who would seek to prey on them.

The activities and conduct of Mr. Madoff and others are under active and ongoing investigation by criminal authorities, by the SEC's Enforcement Division and, with respect to past regulatory activities, by the SEC's Office of Inspector General. We are not authorized to provide specific information about matters under active investigation or past regulatory activities in this matter. We cannot jeopardize the process of holding the perpetrators accountable.

This testimony describes the mission, role, creation and operation of the SEC, including the functions of each of our divisions and offices, certain industry demographics, certain legal obligations of investment advisers and broker-dealers, information concerning tips and complaints provided to the SEC staff, and coordination among functional offices and divisions. This testimony also provides general information concerning the Madoff matter. Finally, this testimony describes generally some steps that the SEC is considering in light of the Madoff matter in order to make fraud less likely to occur in the future, to speed its detection and to provide American investors protection from fraud.

The Mission of the SEC

The mission of the SEC is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.[1] The agency's staff is dedicated, hardworking, and committed to the mission of the SEC.

Our investor protection mission is more compelling than ever. As investors turn to the markets to help secure their futures, pay for homes, and send children to college, they must have confidence that their interests are being protected. Moreover, all Americans share a common interest in protecting their investments from fraud.

The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to basic facts about an investment prior to buying or selling it. To achieve this, the SEC requires public companies to disclose meaningful financial and other information to the public. This provides a common pool of knowledge for all investors to use to judge for themselves whether to buy, sell, or hold a particular security, and to allow people to make informed investment decisions.

The SEC also oversees the key participants in the securities world, including securities exchanges, securities brokers and dealers, investment advisers, and mutual funds. The SEC is concerned primarily with promoting the disclosure of important market-related information, maintaining fair dealing, and protecting against fraud.

Crucial to the SEC's effectiveness in each of these areas is its enforcement authority. Each year the SEC brings hundreds of civil enforcement actions against individuals and companies for violations of the securities laws. Typical infractions include insider

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[1] "*The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*," available at www.sec.gov/about/whatwedo.shtml.

trading, accounting fraud, ponzi schemes, and providing false or misleading information about securities and the companies that issue them.

Creation of the SEC

The SEC was created in 1934, following the stock market crash in October 1929. Public confidence in the markets plummeted, and large and small investors lost great sums of money in the ensuing Great Depression. There was a consensus that for the economy to recover, the public's faith in the capital markets needed to be restored. Congress held hearings to identify the problems and search for solutions.

Based on findings in those hearings, Congress passed the Securities Act of 1933. This law, together with the Securities Exchange Act of 1934, which created the SEC, was designed to restore investor confidence in our capital markets by providing investors and the markets with more reliable information and clear rules of honest dealing. The main purposes of these laws can be reduced to:

- Companies publicly offering securities for investment dollars must tell the public the truth about their businesses, the securities they are selling, and the risks involved in investing.

- People who sell and trade securities – brokers, dealers, and exchanges – must treat investors fairly and honestly, putting investors' interests first.

Organization of the SEC

The SEC consists of the Chairman of the SEC, four other Commissioners, and approximately 3,500 employees. The SEC has 19 functional divisions and offices and is located in Washington D.C., and in eleven regional offices in New York, Boston, Philadelphia, Atlanta, Miami, Chicago, Ft. Worth, Denver, Salt Lake City, Los Angeles and San Francisco.

The SEC is organized functionally to, among other things: enforce the federal securities laws; interpret federal securities laws, subject to judicial review; issue new rules and amend existing rules; inspect registered firms for compliance with the law; review disclosures by public companies; oversee accounting and auditing rules; coordinate with foreign regulators; and provide a first-response to investor complaints and education for investors.

The functions of our respective divisions and offices are described below.

- **The Division of Enforcement**

The Division of Enforcement conducts investigations of possible violations of the federal securities laws. Enforcement lawyers, accountants and investigators investigate possible violations, recommend that the Commission bring civil actions in federal court or before

an administrative law judge, and prosecute these cases on behalf of the Commission. The Enforcement staff obtains information about possible violations of the securities laws from many sources, including market surveillance activities, investor tips and complaints, other Divisions and Offices of the SEC, the self-regulatory organizations ("SROs") and other securities industry sources, and media reports. As an adjunct to the SEC's civil enforcement authority, the Enforcement Division works closely with law enforcement agencies in the U.S. and around the world to bring criminal cases when appropriate.

All SEC investigations are conducted privately. Facts are developed to the fullest extent possible through informal inquiry, interviewing witnesses, examining records, reviewing trading data, and other methods. Once the Commission issues a formal order of investigation, the Enforcement Division's staff may compel witnesses by subpoena to testify and produce books, records, and other relevant documents. Following an investigation, SEC staff may present their evidence to the Commission for its review. Based on that evidence, the Commission, where appropriate, authorizes the staff to file a case in federal court or bring an administrative action. Each year, the SEC brings enforcement cases involving all types of securities fraud, e.g., financial and accounting fraud, offering fraud (including ponzi schemes), insider trading, market manipulation and other types of violations. The Division of Enforcement has approximately 1,150 employees, roughly 80 fewer than at its peak in FY 2005. Enforcement personnel are located in Washington D.C. and in New York, Boston, Philadelphia, Atlanta, Miami, Chicago, Denver, Salt Lake City, Fort Worth, San Francisco, and Los Angeles.

- **The Office of Compliance Inspections and Examinations**

The Office of Compliance Inspections and Examinations administers the SEC's nationwide examination and inspection program for registered self-regulatory organizations, broker-dealers, transfer agents, clearing agencies, investment companies, investment advisers, and rating agencies. The purpose of examinations is to detect fraud and other violations of the securities laws, foster compliance with those laws, and help ensure that the Commission is continually made aware of developments and areas of potential risk in the securities industry. The examination program plays a critical role in encouraging compliance within the securities industry, which in turn also helps to protect investors and the securities markets generally.

In examinations, examiners, accountants and lawyers review books and records and gather information that can indicate whether the firm is in compliance with the securities laws. Based on a variety of factors, examinations are focused on particular firms. Examinations are risk-focused on particular firms, and particular areas of conduct. When the Office finds deficiencies, it issues a "deficiency letter" identifying the problems that need to be rectified. Violations that appear serious are referred to the Division of Enforcement. The Office of Compliance Inspections and Examinations has 425 staff dedicated to examinations of registered investment advisers and mutual funds, and approximately 365 staff dedicated to examinations of registered broker-dealers. Notwithstanding the explosive growth in the firms it examines and inspects, the staff of the Office has 90 fewer positions than it had at its high-water mark in FY 2006.

Examiners are located in Washington, D.C. and in the Commission's eleven regional offices in New York, Boston, Philadelphia, Atlanta, Miami, Chicago, Denver, Salt Lake City, Fort Worth, San Francisco, and Los Angeles.

- **The Division of Trading and Markets**

The Division of Trading and Markets conducts regulatory activities on behalf of the Commission with respect to major securities market participants including: the securities exchanges; broker-dealers; self-regulatory organizations ("SROs") including the Financial Industry Regulatory Authority ("FINRA") and the Municipal Securities Rulemaking Board; clearing agencies that help facilitate trade settlement; transfer agents (parties that maintain records of securities owners); securities information processors; and credit rating agencies. The Division of Trading and Markets develops rulemaking recommendations concerning broker-dealers, SROs and other market participants for Commission consideration; responds to no-action requests and requests for exemptive relief; administers financial integrity rules for broker-dealers; reviews proposed changes to rules filed by the SROs; interprets laws and regulations for the public and SEC inspection and enforcement staff; and assists the Commission and its staff in enforcement matters involving broker-dealers and other market participants. The Division of Trading and Markets has approximately 170 staff, including lawyers, accountants, financial analysts, economists and technology specialists.

- **The Division of Investment Management**

The Division of Investment Management conducts regulatory activities on behalf of the Commission with respect to investment companies, including mutual funds, and investment advisers. The Division of Investment Management: reviews investment company disclosures for compliance with the federal securities laws; responds to no-action requests and requests for exemptive relief; develops rulemaking recommendations concerning investment companies and investment advisers for Commission consideration; interprets laws and regulations for the public and for SEC inspection and enforcement staff; and assists the Commission and its staff in enforcement matters involving investment advisers and investment companies. The Division of Investment Management has approximately 150 staff.

- **The Office of the General Counsel**

The General Counsel is the chief legal officer of the Commission, with overall responsibility for the establishment of agency policy on legal matters. The General Counsel's Office provides legal advice and guidance to members of the SEC's staff, and represents the SEC in civil, private, or appellate proceedings as appropriate, including appeals from the decisions of the federal district courts or the Commission in enforcement matters. Through its amicus curiae program, the General Counsel's Office files briefs in private appellate litigation involving novel or important interpretations of the securities laws, and the Office is responsible for coordinating with the Department of

Justice in the preparation of briefs in the Supreme Court on behalf of the United States involving matters in which the SEC has an interest. The General Counsel's Office also administers the SEC's ethics program through its Ethics Office, and is responsible for the review of proposed legislation. The General Counsel's Office has approximately 130 staff.

Industry Demographics

The securities markets regulated by the SEC are large and diverse. There are approximately: 12,000 public companies whose securities are registered with the SEC; 11,300 investment advisers; 950 fund complexes (representing over 4,600 registered funds); 5,500 broker-dealers (including 173,000 branch offices and 665,000 registered representatives); and 600 transfer agents. There are also: eleven exchanges; five clearing agencies; ten nationally recognized statistical rating organizations; SROs such as the Financial Industry Regulatory Authority and the Municipal Securities Rulemaking Board; and the Public Company Accounting Oversight Board. The SEC has the authority to bring enforcement proceedings against these market participants, as well as for unregistered entities and individuals who may engage in securities law violations, including insider trading, market manipulation, ponzi schemes, and other types of fraud.

Segments of the securities markets have increased dramatically in the last decade: these include the number of branch offices of registered broker-dealers (in 2001, the number of branch offices of registered broker dealers was 75,000; that number grew to 173,000 in 2008) and the number of registered advisers (in 2002, there were 7,547 advisers registered with the SEC, and there are nearly 11,300 today). A large number of the new registrants have been advisers to hedge funds. In addition, there has been significant growth in structured financial products and credit derivatives in recent years. For example, the 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 collateralized debt obligations 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.

Select Laws and Regulations Governing Broker-Dealers and Investment Advisers

- **Rules Applicable to Investment Advisers**

An investment adviser (defined as any person in the business of advising others about securities for compensation) with more than $25 million of assets under management generally must be registered with the SEC.[2] State securities authorities regulate smaller

[2] Certain persons or firms are excluded from the definition of an investment adviser, and these persons or firms need not register with the SEC (e.g., a broker-dealer whose provision of investment advisory services is "solely incidental" to its brokerage activities and who does not receive "special compensation" for its provision of investment advisory services) and persons or firms meeting the definition of investment adviser are not required to register in certain other situations (e.g., certain hedge fund managers).

advisers. There is no SRO for investment advisers, and the SEC provides primary oversight.

It is unlawful for an investment adviser to defraud clients or prospective clients. Investment advisers have a fiduciary duty to their clients to act in their best interest and to avoid conflicts of interest or to fully disclose them. The anti-fraud provisions apply to all persons and firms meeting the definition of an investment adviser, whether or not registered with the Commission.

Under the "compliance rule," all investment advisers registered with the Commission or required to be so registered must adopt and implement written policies and procedures designed to prevent violations of the law and rules. The adequacy and effectiveness of these policies and procedures must be reviewed annually. All such advisers also must designate a chief compliance officer who is responsible for administering the adviser's compliance policies and procedures.

Investment advisers must also maintain and preserve specified books and records, and make them available to Commission examiners for inspection. All records of such advisers are subject at any time, or from time to time, to such reasonable, periodic, special or other examination by representatives of the Commission as the Commission deems necessary or appropriate in the public interest or for the protection of investors.

Under the "custody rule," advisers that have custody of client securities or funds must implement a set of controls designed to protect those client assets from being lost, misused, misappropriated or subject to the advisers' financial reverses. In particular, funds and securities must be maintained by a "qualified custodian," which includes regulated banks, registered broker-dealers, registered futures commission merchants, and foreign financial institutions that meet certain conditions. Investment advisers may have self-custody (or use an affiliate as a custodian) if the adviser or affiliate is also registered as a broker-dealer, a futures commission merchant or is regulated as a bank. When an adviser has custody of client assets, periodic account statements must be sent to clients, directly from the qualified custodian, which permits clients to reconcile custodian statements with reports received from the investment advisers. In some cases custodians report only to the adviser, in which case the adviser must arrange for an independent public accountant to do a surprise verification of all funds and securities in the account at least once each year.

Advisers are also subject to a variety of requirements to provide disclosures to their clients and prospective clients. The "brochure rule" under the Advisers Act generally requires such advisers to deliver to each of its advisory clients and prospective advisory clients a written disclosure statement, or "brochure." The brochure describes the adviser's business practices and educational and business background and material information regarding its compensation. All such advisers also must disclose any legal or disciplinary events that are material to an evaluation of the adviser's integrity or ability to meet its contractual commitments to clients. All advisers that have custody or discretionary

authority over client funds or securities must also disclose any financial conditions of the adviser that are reasonably likely to impair the ability of the adviser to meet contractual commitments to clients.

- **Rules Applicable to Broker-Dealers**

Broker-dealers are subject to regulation and oversight by the SEC and by one or more SROs (including regulations for members, surveillance, routine and cause examinations and enforcement actions for violations). SROs perform routine examinations and oversight of their member firms.

Among the important regulatory requirements for broker-dealers are the financial responsibility rules imposing requirements with respect to capital, the safekeeping of customer securities and cash, making and maintaining books and records, and filing periodic financial statements and annual audit reports with the SROs and the Commission. These rules are described below.

The broker-dealer capital rule, known as the "net capital rule" is designed to ensure that a broker-dealer maintains sufficient liquid assets so that if it fails it can promptly liquidate and pay all claims of customers and other creditors without the need of a formal proceeding. The rule prescribes an absolute minimum amount of net capital a broker-dealer must have in order to be able to conduct a securities business.[3]

The "customer protection rule" is designed to safeguard customer securities and cash. The rule provides that a broker-dealer may not use customers' cash and securities for its own proprietary purposes. It requires that the broker-dealer hold fully-paid and excess margin securities in its possession and control; and it requires that the broker-dealer create a reserve fund equal to the net cash owed to customers. In combination, these requirements are designed to ensure that customers' cash and securities at a broker-dealer are kept safe and separate from the proprietary activities of the broker-dealer, and to keep these assets available for prompt return to customers in the event the broker-dealer fails.

The "books and records" rules specify minimum requirements with respect to the records that broker-dealers must make, and how long those records and other documents relating to a broker-dealer's business must be kept.

Most broker-dealers are also required to file annual audit reports with the Commission and with each SRO of which the broker-dealer is a member (broker-dealers are also required to file periodic financial reports with the SROs). These audit reports must contain statements of financial condition; income; cash flows; changes in stockholders' or partners' or sole proprietor's equity; and changes in liabilities subordinated to claims of general creditors.

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[3] The minimum amount of net capital a broker-dealer must maintain is the greater of a fixed dollar amount and an amount calculated using one of two financial ratios.

Under the law, the annual audit conducted by the audit firm must be sufficient to provide reasonable assurance that any material inadequacies would be disclosed with respect to the broker-dealer's: (a) accounting system; (b) internal accounting controls; (c) procedures for safeguarding securities; and (d) the practices and procedures used in, for example quarterly securities examinations, counts, verifications and comparisons, complying with the requirement for prompt payment for securities, and in obtaining and maintaining physical possession or control of customer securities as required. If an accountant finds any material inadequacies as part of this review, a special report must be provided to the Commission.

With respect to the registration of broker-dealer auditors with the Public Company Accounting Oversight Board ("PCAOB"), the Sarbanes-Oxley Act of 2002 ("SOX") required auditors of registered broker-dealers to be registered with the PCAOB. SOX focused the PCAOB's responsibilities specifically on the auditors of public companies. Section 205 of SOX required the auditors of non-public broker-dealers to register, and the Commission understands that the PCAOB believes the statute does not give it the necessary authority to examine the auditors of non-public broker-dealers after they have registered or to discipline them for audit failures. The Commission had provided temporary exemptions from registration, which have now expired. The potential for legislative reform of the financial services regulatory structure provides an opportunity for clarification of Congressional intent in this area. The Commission's staff stands ready to provide any assistance the Subcommittee staff may require on this and other matters.

Generally, all broker-dealers registered with the Commission must be members of the Securities Investor Protection Corporation ("SIPC"). Under the law, SIPC may pay advances to compensate customers when the amount of securities and cash recovered from a failed firm is insufficient to make customers whole. These advances are limited to $500,000 per customer, including a maximum of $100,000 for cash claims. SIPC initially pays for customer advances and the administrative costs of SIPA liquidations out of the "SIPC Fund" (which is funded through member assessments). The Commission monitors the liquidation process and how the Trustee determines and satisfies customer claims (as set forth in the Securities Investor Protection Act). The Commission's staff is closely monitoring the Madoff liquidation proceedings.

Protocols for Examinations of Investment Advisers and Broker-Dealers

During examinations, the SEC's staff will seek to determine whether a firm is: conducting its activities in accordance with the federal securities laws and rules adopted under these laws (including, where applicable, the rules of SROs subject to the SEC's oversight); adhering to the disclosures it has made to investors; and implementing supervisory systems and/or compliance policies and procedures that are reasonably designed to ensure that the firm's operations are in compliance with the law.

Examinations may be conducted on an announced or unannounced basis. When the examination is announced, the staff will send the firm a letter notifying it of the

examination and containing a request list that identifies certain information or documents that SEC examiners will review as part of the examination. In many examinations, the examiners will visit the firm to conduct examination work on-site. The scope of the examination will be tailored to the activities of the firm and its compliance risks. In formulating the findings of the examination, the examiners may consult with other staff within the SEC, including supervisory staff and staff in relevant offices and divisions, to ensure that the findings are consistent with SEC rules, regulations, and interpretations.

When an examination has been completed, the examiners will typically conduct an "exit interview" with the firm during which they will discuss the status of the examination and any issues identified during the examination. The firm will then be sent a written notification of the results of the examination, generally either: a "deficiency letter" that describes the issues identified, asks the firm to undertake corrective action and to provide the staff with a written response outlining those actions; or a letter stating that the examination has concluded without findings. If serious problems are found, the examination staff may also refer the problems to the SEC's Division of Enforcement, or to an SRO, state regulatory agency, or other regulator for possible action.

Broker-dealers are subject to primary oversight by an SRO that conducts periodic routine examinations of its broker-dealer members. The SEC conducts targeted examinations of broker-dealers to review specific risk issues, for cause, and to oversee the work performed by the SROs.

Investment advisers, mutual funds and other types of registrants are not subject to examination oversight by an SRO. For these firms, the SEC provides primary examination oversight.

Because only a small portion of registered firms can be examined each year, the process of selecting firms for examination and the area of the firm's activity for review is of crucial importance. The staff's methodology includes: 1) a risk-based methodology for selecting investment advisers for priority examination;[4] 2) a methodology for identifying higher-risk activities at registered securities firms; and 3) cause examinations to target firms where specific indications of wrongdoing have been identified, and sweep examinations that focus on examining a particular risk across firms.

Tips, Complaints and Reports

The SEC staff receives hundreds of thousands of tips each year from various sources. Some are from credible sources that provide detailed information in support of the tip, and some are newspaper clippings or printed promotional material sent with no further explanation. Tips come from industry participants, investors, competitors, and present or former employees, and others are anonymous. Complaints, tips and referrals come to the

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[4] *See* SEC, *2004-2009 Strategic Plan*, at 32. "Risk-Based Inspection Cycles: The SEC will fully implement a risk-based methodology for selecting and setting examination and inspection cycles for investment advisers and funds. Larger or higher risk entities will be examined more frequently to ensure that the agency quickly identifies problems before they affect large pools of savings."

SEC by telephone calls, handwritten letters, long reports, complaint forms from the Enforcement Division's Office of Internet Enforcement, newspaper articles with company names circled in red ink, formal referrals from other regulators, referrals from other Offices and Divisions of the SEC, notes from reformed fraudsters, and anonymous notes.

While the SEC does not have the resources to fully investigate all tips and complaints received, SEC staff use experience, skill and judgment to triage the complaints to devote attention to the most promising leads and the most serious potential violations. Each year, many enforcement actions are brought that first came to the attention of the staff through a complaint or a tip. In light of recent events, the Commission has made it a priority to improve the handling of complaints, tips and referrals to make optimal use of resources.

Coordination Among Divisions and Offices

The staff is expected to actively coordinate in performing their functional responsibilities. For example, in conducting examinations or investigations, or in initiating enforcement actions, the examination and/or enforcement staff communicates with staff in the Division of Trading and Markets, Office of Risk Assessment, Office of the General Counsel, Division of Investment Management and other relevant divisions or offices.

With respect to the conduct of examinations, the staff has various processes through which they coordinate and share information. As an initial step in this process, the examination staff consults with other Divisions and Offices to obtain input on areas for examination focus (risk issues as well as the number and types of examinations that are planned for the upcoming year). Each year, the Division of Investment Management and the Division of Trading and Markets staff work with the exam staff as it develops the focus and priorities for examinations and coordinates on issues and questions raised in the inspection and examination of investment advisers, investment companies and broker-dealers. Among other things, exam reports and deficiency letter templates are also provided to relevant divisions for consideration and comment. During examinations, examiners communicate with staff from other Divisions to resolve specific interpretive issues. Finally, training is conducted for exam staff with participation from various other division and office staff. When violations of the law are discovered in examinations, the examination staff refers them to the Division of Enforcement staff for investigation, and then often works with Enforcement staff in the subsequent investigation.

With respect to enforcement investigations, the Enforcement staff often consults with relevant staff in the Divisions of Trading and Markets, Investment Management and the Office of General Counsel (and other relevant SEC offices or divisions) for advice concerning the legal issues raised. If matters are brought to the Commission for formal enforcement investigation or enforcement action, the enforcement staff and staff in the various divisions are expected to communicate and coordinate with respect to legal interpretations and other issues.

Enforcement Actions Involving Bernard Madoff

On December 11, 2008, the SEC sued Bernard L. Madoff and his firm, Bernard Madoff Investment Securities, LLC, for securities and investment advisory fraud in connection with an alleged Ponzi scheme that allegedly resulted in substantial losses to investors in the United States and other countries. The alleged 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).

The Commission's complaint alleges that Mr. Madoff admitted to two senior employees of his firm that for many years he had been conducting the investment advisory business of his firm as a ponzi scheme -- using funds received from new investors to pay returns to previous investors -- and he estimated that the scheme has resulted in losses of approximately $50 billion. The complaint further alleges that Madoff also informed these senior employees of his firm that he had approximately $200-300 million left, which he planned to use to make payments to selected employees, family and friends before turning himself in to the authorities.[5] The SEC immediately sought, and obtained, a preliminary injunction and other emergency relief to prevent the dissipation of any remaining assets.[6]

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, in connection with Mr. Madoff's alleged ponzi scheme.

The two actions filed by the SEC and United States Attorney's Office could potentially result in billions of dollars in liability and decades of incarceration. Among the other remedies available to the SEC in civil enforcement actions are disgorgement of ill-gotten gains, permanent injunctive relief against violations of the federal securities laws, remedial undertakings, civil penalties, revocation of registration and investment adviser or industry bars. Criminal authorities have the power to seek incarceration, and other conditions on an individual's liberty, such as probation, denial of voting rights, mandatory curfew and house arrest.

The United States District Court for the Southern District of New York granted the application of SIPC for the liquidation of Bernard L. Madoff Investment Securities LLC and appointed a trustee. The SIPC trustee will marshall the assets and process the claims of customers and creditors of Madoff's firm in an equitable manner.[7]

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5 SEC v. Bernard L. Madoff et al., 08 Civ. 10791 (S.D.N.Y. Dec. 11, 2008), Complaint at 2, 4-6.

6 SEC v. Bernard L. Madoff et al., 08 Civ. 10791, Order on Consent Imposing Preliminary Injunction, Freezing Assets and Granting Other Relief Against Defendants (Dec. 18, 2008).

7 Id.; see also "*Information for Madoff Customers*," available at http://www.sec.gov/divisions/enforce/claims/madoffsipc.htm.

Past Enforcement Investigations and Examinations Relating to the Madoff Firm

For the reasons described above, in order to avoid compromising with ongoing criminal and civil investigations and in light of the ongoing inquiry by the SEC's Inspector General, we can provide only very limited information with respect to the SEC's past regulatory contacts with Madoff.

- **Examinations**

The Madoff firm became registered as an investment adviser in September 2006. SEC staff did not examine the investment advisory operations of the firm.[8]

The Madoff broker-dealer operation was subject to routine examination oversight by the Financial Industry Regulatory Authority ("FINRA") and also to several limited-scope examinations by the SEC staff for compliance with, among other things, trading rules that require the best execution of customer orders, display of limit orders, and possible front-running, most recently in 2004 and 2005. These examinations were focused on the firm's broker-dealer activities.

- **Enforcement Investigations**

The SEC's New York Regional Office commenced an investigation of Mr. Madoff and his firm in early 2006. Two years later, in January 2008, that investigation was closed without any recommendation of enforcement action.

With respect to earlier SEC enforcement investigations related to Mr. Madoff or his firm, the SEC filed two enforcement actions in 1992 alleging violations of the securities registration provisions in connection with offerings in which investors' funds were invested in discretionary brokerage accounts with an unidentified broker-dealer, who in turn invested the money in the securities market. The unidentified broker-dealer in these cases was Bernard L. Madoff Investment Securities. These cases are described below:

- SEC v. Avellino & Bienes et al. In that case, two individuals, Frank Avellino and Michael Bienes, raised $441 million from 3200 investors through unregistered securities offerings. They formed an entity, Avellino & Bienes ("A&B"), which offered investors notes paying interest rates of between 13.5% and 20%. A&B collected the investors' monies in a pool or fund that was invested in discretionary brokerage accounts with Mr. Madoff's broker-dealer firm, and the Madoff firm in turn invested the monies in the market. A&B received returns on the invested

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[8] Approximately 10% of registered investment advisers are examined every three years. Other registered investment advisers are not subject to routine examinations on a cycle and may be examined in cause, sweep or random examinations.

funds from the Madoff firm, but kept the difference between the returns received from Madoff's firm and the lesser amounts of interest paid on the A&B notes.[9]

- SEC v. Telfran Associates Ltd., et al., was a spinoff from A&B and involved the creation of a feeder fund to A&B. In Telfran, two individuals who had invested in A&B, Steven Mendelow and Edward Glantz, formed an entity called Telfran Associates. Telfran raised approximately $88 million from 800 investors through unregistered securities offerings over a period of three years. Telfran sold investors notes paying 15% interest, which they in turn invested in notes sold by A&B that paid between 15% and 19% interest. Since investor funds collected by A&B were invested with Mr. Madoff, the Telfran investor funds were also invested with the Madoff firm, albeit indirectly.[10]

Although the SEC was initially concerned that these unregistered offerings might be part of a fraud on the investors, the trustee appointed by the court in the Avellino & Bienes case found that the investor funds were all there, and there were no apparent investor losses. In both cases, the SEC sued the entities offering the securities and their principals for violations of the securities registration provisions of the federal securities laws. The SEC also sought the appointment of a trustee to redeem all outstanding notes and the appointment of an accounting firm to audit the firms' financial statements.

Potential New Steps

Finally, this testimony describes generally some ideas that the offices and divisions of the SEC are considering recommending to the Commission to explore in light of the Madoff matter, including both changes and improvements to regulation and oversight, which might make fraud less likely to occur and improve the ability to detect it. Among the issues being considered are the examination frequencies for investment advisers, the existence of unregistered advisers and funds, the different regulatory structures surrounding brokers and advisers, the existence of unregulated products, and the need to strengthen the custody and audit requirements for regulated firms. These ideas remain in the initial stages in the divisions and the Madoff matter remains under investigation, so these ideas are subject to refinement as more analysis is conducted and more facts are learned.

We are also looking at ways to improve the assessment of risk — and at the adequacy of information required to be filed by registered firms and used to assess risks and whether the risk assessment process would be improved with routine access to additional information. We are targeting firms for examinations of their custody of assets, and expanding our efforts to examine advisers and brokers in a coordinated approach to

[9] [9]SEC v. Avellino & Bienes et al., Lit. Rel. No. 13443 (Nov. 27, 1992); Lit. Rel. No. 13880 (Nov. 22, 1993).
[10] SEC v. Telfran Associates Ltd., et al., Lit. Rel. No. 13463 (Dec. 9, 1992); Lit. Rel. No. 13881 (Nov. 22, 1993).

reduce the opportunities for firms to shift activities to areas where they are not subject to regulatory oversight.

In a range of ways, we are thinking expansively and creatively about changes that could reduce opportunities for fraud, as American investors deserve the best possible protection from ponzi schemes and other frauds.

In conclusion, we reiterate our commitment, on behalf of the SEC and its staff, to the vigorous protection of American investors.

SPENCER BACHUS
6TH DISTRICT, ALABAMA

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RANKING REPUBLICAN MEMBER

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January 23, 2007

The Honorable Christopher Cox
Chairman
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-2000

Dear Chairman Cox,

It was a pleasure to speak with you and your staff in my office on January 5. As we discussed during that meeting, I am forwarding you materials about municipal bonded indebtedness in Jefferson County, Alabama. This matter has been of interest to me for a number of years during which I have gathered this file of information about swaps in general and Jefferson County in particular.

Included in these materials is a 1997 letter sent by a local commissioner to then-SEC Chairman Arthur Levitt. Since this letter is now almost ten years old and there have been two chairmen in the interim, I wanted to bring it specifically to your attention.

The SEC has initiated a swaps investigation into transactions that occurred in Jefferson County in the 1990's. Although it is not certain that false representations were made in those transactions, my view is that the cost of water and sewer services in the county has risen as a result of these swaps.

Therefore, this is an issue of significant concern to my constituents and to me. While a primary mandate of the SEC is to protect investors and the integrity of capital markets, I hope damages to the taxpayers and utility rate payers will also be considered as this case moves forward. Penalties are certainly appropriate to send a message to the industry, but disgorgement is also suitable in a case where the damages may not have been to investors, but to taxpayers.

Thank you for your consideration. I look forward to your response and to working with you throughout the 110th Congress. Please have your staff contact Kevin Edgar or Michael Borden if they have any questions.

Sincerely,

Spencer Bachus

Spencer Bachus
Member of Congress

PRINTED ON RECYCLED PAPER

JEFFERSON COUNTY COMMISSION

BETTYE FINE COLLINS
COMMISSIONER OF COMMUNITY & ECONOMIC DEVELOPMENT
203-A Courthouse
Birmingham, Alabama 35263-0072

November 17, 1997

Mr. Arthur Levitt
Chairman
Securities and Exchange Commission
450 Fifth Street, NW
Suite 610
Washington, DC 20549

Jefferson County, Alabama Municipal Bond Transactions

Dear Mr. Levitt:

I was struck by the application to Jefferson County, Alabama of the following quotation from the dust jacket of *F.I.A.S.C.O.*, the expose on practices in the derivatives business by Frank Partnoy:

> Funny business, you know? Lure people into that calm and then just totally [abuse] 'em.
>
> – UNNAMED DERIVATIVES SALESMAN IN A TAPED CONVERSATION, AS EXCERPTED FROM FEDERAL COURT PROCEEDINGS

The statement well describes what some public finance professionals did to Jefferson County last spring and are continuing to do. I ask that you direct an investigation of a complex derivatives transaction in which Jefferson County was "abused."

While I have been unable to ascertain all of the facts, I believe that the incident involves "pay to play," selection of financing team members (including professional political fund raisers and former elected and appointed public officials) wholly on the basis of political connections, a paid consultant for the underwriters whose role is undisclosed, the fraudulent misrepresentation of the benefits of a complex derivatives transaction, the mispricing of that transaction, the fraudulent failure to disclose

compensation, excess compensation, and a broker dealer acting as underwriter and financial adviser in the same transaction.

I am one of five members of the Commission of Jefferson County, Alabama which has responsibility for the legislative and administrative affairs of the largest county in the State of Alabama. I have endeavored without success to learn the full facts concerning Jefferson County's recent sewer financings and an associated interest rate swap, to have the full Jefferson County Commission instigate an investigation with competent legal and financial advisory assistance, and to have the County Attorney launch such an investigation. Since I have been unable to get Jefferson County to look into the situation and remedy any problems or otherwise obtain complete facts, I now turn to you in the belief that your statutory authority and responsibility encompass the circumstances described in this letter. I believe the circumstances to be much more abusive than those dealt with recently by the S.E.C. in the case of Smith Barney Inc. and Dade County, Florida.

The essential facts of the situation (but without some of the damning details) are stated in an article from the August 8, 1997 issue of *Grant's Muntcipal Bond Observer,* attached as Exhibit 1.

Faced with a federal court order mandating substantial improvements to Jefferson County's sewer system, the county initiated the first of several financings in early 1997. I had proposed a competitive sale but was outvoted by my colleagues who wanted to dispense the political patronage incidental to picking members of the financing team. I was invited to pick my favorites but declined to do so. An article in The Birmingham News attached as Tab 2 accurately describes what went on.

On February 12, 1997, the Jefferson County Commission approved $311,940,000 principal amount of fixed rate sewer revenue refunding warrants, Series A through C (as I understand that warrants are essentially the same as bonds, I will use the term "bond" or "bonds" hereafter). The Series A bond issue refunded, among other issues, $130 million principal amount of Series 1995A bonds that bore interest at a variable rate approximating the Public Securities Association (PSA) index plus 31.2 basis points. On March 5, 1997, the Jefferson County Commission approved $296,395,000 principal amount of fixed rate bonds, Series D. On the same day the Commission authorized an interest rate swap from fixed to floating with Morgan Guaranty Trust Company of New York, represented by J. P. Morgan Securities Incorporated and Raymond James & Associates, Inc. in a notional principal amount of $175 million. A ten year swap was

confirmed late on March 5 at the effective rate of PSA index plus 98.5 basis points with a 7% cap, with the cap being good for two years (I am informed that since PSA has very seldom been over 7% the cap is almost worthless).

I have a number of concerns about the way these transactions were handled. First, on March 5, I asked the individual representing Raymond James and J. P. Morgan whether a variable rate bond issue, such as the Series 1995A issue that had been re-funded, would be less costly to Jefferson County than a fixed rate issue combined with a swap back to floating. I was informed that a fixed rate issue combined with a swap was less costly:

> Collins: "Is this going to cost the county more ... annually than our normal situation with these floating bonds, will there be additional expense to the county?"
>
> Prince (of Raymond James): "There will be less expense to the county." [See transcript of March 5, 1997 proceedings at Tab 3.]

I now find that the variable interest rate resulting from the swap transaction is effectively PSA plus 98.5 basis points, instead of the historical cost of the Series 1995A variable rate issue of PSA plus 31.2 basis points (I am informed that a new variable rate issue might have been put in place for less than 31.2 basis points over PSA and without the expenses of refunding the Series 1995A issue, issuing the Series 1997D bonds, and then swapping a portion of the Series 1997D bonds back to a floating rate from fixed). The difference between 31.2 basis points over PSA and 98.5 basis points over PSA amounts to $3,227 per day, $1,177,750 per year and $11,777,500 for the ten year term of the swap.

The swap confirmation provided for Morgan Guaranty to pay Jefferson County 4.814% every six months, and for Jefferson County to pay Morgan Guaranty PSA every three months. I find swap pricing very confusing; so far as I know, after persistent inquiry, Jefferson County did not obtain any analysis or justification of the pricing of the Morgan Guaranty swap. An after the fact justification is attached at Tab 4. I have seen newsletters from another major swap dealer, indicating that a few days before and a few days after the March 5 pricing of the Jefferson County swap, the appropriate pricing would have been for Jefferson County to receive 5.03% (rather than 4.814%) and pay the PSA index. This difference amounts to $1,036 per day, $378,000 per year, and $3,780,000 for the ten year term of the swap. I am told that three "off the record" quotes from major swap dealers indicate that the swap was mispriced. I presume that the S.E.C. has the power to get "on the record" quotes.

I was also concerned about fees:

Collins: "Does your company stand to make higher fees because of this particular arrangement than you would on a normal bond deal?"

Prince: "Let's see -- higher interest rate than a normal bond deal -- well, it uh, no it would be less. ..."

In fact, Raymond James earned fees on the Series 1997A bonds, on the Series 1997D bonds and on the interest rate swap. The actual combined fees are a multiple of the fees that would have been earned if the Series 1995A floating rate bonds had remained outstanding and the principal amount increased. The county was actually not informed of the total amount of Raymond James' fees until several months later after I started asking questions (see Tab 5). I am told that public finance is not as profitable as it used to be and that firms like J. P. Morgan are seeking derivatives transactions because they have high margins. It seems to me that this transaction was arranged as a derivatives transaction so that the parties could earn large fees without disclosing them. Jefferson County is a victim of a form of churning combined with excessive fees.

The role of Raymond James in the swap transaction is curious. Raymond James purported to represent J. P. Morgan in the swap transaction, but it gave advice to the county. The spread that J .P. Morgan earned was later justified by the fee it had to pay Raymond James. Since J. P. Morgan passed on the Raymond James fee to the county, should the county have approved it in advance? Was Raymond James acting as financial adviser to the county at the same time it was acting as underwriter in a negotiated underwriting?

According to published reports, Raymond James has retained a number of consultants to assist it in obtaining business. One of these consultants is James C. White, former Finance Director of the State of Alabama in the administration of former Governor James E. Folsom, now a Raymond James public finance banker. James C. White is reported to have been influential with at least one commissioner in obtaining the Jefferson County business for Raymond James, but after persistent inquiry I can find no record of disclosure of his role in the Jefferson County transaction being disclosed as required by applicable rules.

On March 5, 1997, the day that the Series 1997D bond issue and the associated interest rate swap were presented to the Jefferson County Commission for approval, I raised a number of questions. Until March 5, no one had attempted to explain in writing or orally to me or, to my knowledge, any other commissioner the structure of the financing. No financial models, no information on interest rates or swap rate comparables, no schedule of fees and expenses of the financing, no justification or rationale in writing or orally was made available to us. Mr. Steve Sayler, county Finance Director, was not present for the March 5 meeting; at my insistence, the meeting was recessed until he could attend. In person, he offered only vague assurances. Consequently, I abstained from voting. Essentially, the Commission wrote Steve Sayler, Raymond James and J. P. Morgan a blank check, which they cashed and (in the case of Raymond James and J. P. Morgan at least) deposited in their pockets to the extent of a substantial portion ($630,000 in the case of Raymond James). Raymond James also received over $300,000 as a fee for investing bond proceeds. The amount of this fee was not approved by the Commission. All of this is in addition to underwriting fees which were not in any way demonstrated to be competitive. The only "market" information on issuance expenses received by the Commission in advance is referred to in Exhibit 17 below.

Following the closing of the Series 1997D bond issue, I sent Steve Sayler a request for information. He was very slow to respond, and has yet to respond completely. Because of my insistence that there was something wrong with the transaction approved March 5, the Jefferson County Commission held a "hearing" in September to discuss the transaction. Raymond James presented, for the first time, months after the transaction closed, their theory of why an interest rate swap was advantageous to Jefferson County. A copy of the written portion of their presentation is presented at Tab 12. Raymond James then told the Commission that one of the advantages of an interest rate swap was that the county could actually trade in and out of the swap to take advantage of market changes. The county finance director illustrated this concept with the drawing reproduced as Tab 13. The idea presented was that interest rates move up and down and that the county could benefit by putting on a fixed to floating swap when interest rates are high and unwind it when interest rates are low. Of course, Raymond James and J. P. Morgan would be happy to tell the county when interest rates are high and when they are low! Some of my friends refer to this drawing as a piece of "public finance pornography" worthy of Orange County. In any event, my advisors were given only a brief opportunity to speak at the "hearing" and were harassed as they did so. The hearing was interrupted by a bomb threat and has never reconvened, perhaps because Raymond James has figured out even from the brief presentation by my advisors that they have a problem.

The following documents, some of which are referred to above are pertinent to this letter. The numbers refer to the tabs at which the documents are found.

(1) August 8, 1997 article from *Grant's Municipal Bond Observer.*

(2) Article from *The Birmingham News* on selection of the financing team.

(3) Transcript of Jefferson County Commission proceedings of March 5, 1997.

(4) Raymond James letter justifying swap pricing.

(5) Raymond James letters disclosing fees after the fact.

(6) Collins request for information on transaction.

(7) Follow up memorandum on information request.

(8) Second follow up memorandum.

(9) Memorandum responding to information request (accompanying two boxed of documents).

(10) Communication relating to reversal of interest rate swap.

(11) Raymond James presentation dated September, 1996 on the benefits of a fixed to floating swap. The presentation discusses a 30 year swap, rather than the ten year swap actually negotiated. The

presentation claims that Jefferson County would be better off with a swap than with floating rate debt.

(12) Presentation of September, 1997, after the transaction, presenting a different justification.

(13) Illustration of when to execute and unwind a swap, or how to speculate on interest rates.

(14) Letter from Compass Bank raising questions regarding the proposed swap. This letter was apparently ignored.

(15) Copy of swap confirmation.

(16) Newsletters from Chase setting forth indicative swap rates as of the dates indicated.

(17) A schedule of issuance expenses that was distributed to Commissioners in the fall of 1996. It will be noted that the range of estimated expenses is extraordinarily broad, does not refer to any specific comparables or independent analysis which would indicate that the schedule is relevant to Jefferson County, and does not include any fees with regard to a swap or investment of bond proceeds.

I have had a hard time fighting fraud and "pay to play" by myself. I need your help. I will be happy to respond to any questions that you have.

Very truly yours,

Kathye Finn Collins