S. HRG. 111–38

THE MADOFF INVESTMENT SECURITIES FRAUD: REGULATORY AND OVERSIGHT CONCERNS AND THE NEED FOR REFORM

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

HOW THE SECURITIES REGULATORY SYSTEM FAILED TO DETECT THE MADOFF INVESTMENT SECURITIES FRAUD, THE EXTENT TO WHICH SECURITIES INSURANCE WILL ASSIST DEFRAUDED VICTIMS, AND THE NEED FOR REFORM

JANUARY 27, 2009

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C O N T E N T S

TUESDAY, JANUARY 27, 2009

WITNESSES

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

MADOFF INVESTMENT SECURITIES FRAUD: REGULATORY AND OVERSIGHT CONCERNS AND THE NEED FOR REFORM

TUESDAY, JANUARY 27, 2009

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:04 a.m., in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. Good morning. The Committee will come to order. We meet today and the subject matter is the "Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform."

First, let me welcome Members of our Committee. Let me begin by welcoming Michael Bennet, a new member of the U.S. Senate from Colorado. We are delighted to have you with us, Senator, and are looking forward to your service on this Committee.

Senator BENNET. Good morning.

Chairman DODD. We also have a new Member, Mike Johanns from Idaho here as well. Thank you——

Senator JOHANNS. Nebraska.

Chairman DODD. Excuse me. Nebraska. I apologize. Thank you for joining us.

We have Senator Vitter, Senator DeMint as well, and Kay Bailey Hutchison is joining us, I believe. So new Members, we are getting larger and larger here. We are going to have to enlarge this circle somehow and wrap around the room. But I thank all of you for joining the Committee, and I am looking forward to your service on the Committee as well. I hope you will find it worthwhile. We have got a lot of work to do on this Committee. We will be making some announcements shortly about our agenda coming up as we see it over the next couple of months, and we look forward to your participation as well with us all. So thank you for joining the Committee. Thank you, Senator Bennet, as well.

I will make a brief opening statement. I will turn to Senator Shelby for any opening comments he may have. And then, as is the custom, I will ask more of my colleagues if they would like to make some opening comments as well on the subject matter. Then we will hear from our witnesses and try and move along with a good, engaging question period as well.

A year ago, the CEO of a very trusted and respected securities firm and a former Chairman of NASDAQ said the following, and I quote him: "In today's regulatory environment, it is virtually impossible to violate rules. This is something that the public really doesn't understand. It's impossible for a violation to go undetected, certainly not for a considerable period of time."

The speaker was none other than Bernard Madoff, and that cunning statement, he knew then and we know now, was breathtaking in its deception. In stark contrast to Mr. Madoff's statement, his fraud is noteworthy for its duration—it may well have lasted for decades—and the amount of money investors lost, which was nearly $50 billion. But for all of this deception, Mr. Madoff was right about one thing: The public really didn't understand. Nor, it appears, did the regulators.

Today, we are going to discuss how the securities regulatory system failed to detect a fraud of this magnitude, the extent to which securities insurance will assist defrauded victims, and what can be done to prevent this sort of thing from happening again.

This much we do know: Since Bernard L. Madoff's Investment Securities LLC started in 1960, the firm has been subject to examination and oversight by the Securities and Exchange Commission and by the securities industry self-regulatory organization, the Financial Industry Regulatory Authority—or FINRA—and its predecessor, NASD.

The firm's clients have limited insurance to the Securities Investor Protection Corporation—SIPC, as it is known. Mr. Madoff pioneered electronic trading systems and was the Chairman of the NASDAQ stock market. Members of his family held leadership positions in NASD.

At some point decades ago, Mr. Madoff began accepting money to invest from individuals, charities, pension funds, institutions, and hedge funds. He sent these clients account statements on his firm's stationery. He charged only sales commissions. Reportedly, he told clients that the value of their accounts went up around 10 percent every year.

His reputation grew quickly. Some investors begged to be introduced to Mr. Madoff and for him to invest their funds. Others were not so sure. In 2001, *Barron's* reported some experts doubted his methodology and were troubled by his secrecy in an article entitled "Don't Ask, Don't Tell."

In 2005, derivatives expert Harry Markopolos gave the SEC staff a detailed paper entitled—and this is it—"The World's Largest Hedge Fund Is a Fraud." Now, that was sent out in 2005, in which he stated that the Madoff Securities is "the world's largest Ponzi scheme." He identified numerous red flags: returns that were too good to be true, consistent gains over 10 percent every year, in bull and bear markets alike; investment strategies that could not produce stated returns. There was Madoff's practice of charging only commissions rather than the much larger percentage of assets and profits typically charged by advisers, curiously leaving hundreds of millions of dollars on the table.

It has been reported that the Madoff firm's auditor, Friehling & Horowitz, had only three employees, including a 78-year-old Florida retiree and a secretary. The one actual accountant at the firm certifies to AICPA, the organization, that he did not even perform audits. All of these red flags were ignored.

In 2006, following the SEC examination, the Madoff brokerage firm also registered as an investment banker—an investment adviser, excuse me. Yet somehow regulators missed a massive fraud.

Then on December 11, 2008, Mr. Madoff was arrested for securities fraud after he reportedly told his sons he had perpetrated a giant Ponzi scheme, that is, paying returns to certain investors out of the investments received from other investors. His assets and the firms have been frozen. As investigations are ongoing, let me say that we will respect these investigations and not ask the Members who are here today, the witnesses, for facts which cannot be disclosed publicly at this time. However, I will ask that you be thorough and hold responsible the people who facilitated this securities fraud.

The media has reported breathlessly about certain celebrities who invested with Mr. Madoff, but most of those who lost their money because of massive fraud were not celebrities or Hollywood stars. Quite the contrary, they are municipalities, pension funds, charities, and individuals, one of whom is here today with us from my home State of Connecticut. Along with funds of funds, hedge funds, and foreign banks, these individuals have collectively lost billions of dollars. Some charities have shut down entirely because of this action. The town of Fairfield, Connecticut, has lost alone some $42 billion.

Today, we will hear from a Connecticut physician, Dr. Henry Backe, who will testify to the pension losses experienced by his colleagues and the nurses and other medical staff who support them. How could regulators have missed so many warning signs? Did the examination staffs lack adequate expertise or numbers? Were they intimidated by Mr. Madoff's influence in the securities industry? Did they lack legal authority or, as I suspect, are there deeper problems?

Former Chairman Chris Cox has suggested as much. On December 16, he announced that credible and specific allegations going back to at least 1999 were, and I quote him, "repeatedly brought to the attention of the SEC staff but were never recommended to the Commission for action." Indeed, in a decade's worth of inquiries into Mr. Madoff's firm, the SEC had not so much as issued a single subpoena.

For some investors, the breathtaking losses will be mitigated in part by SIPC's insurance fund. Today, we want to hear what types of investors would be covered by SIPC and to encourage SIPC to gather Madoff assets and provide payouts to eligible shareholders quickly.

The Madoff fraud was a regulatory failure of historic proportions, but what is most disturbing about it is that it went undetected until the perpetrator himself confessed. How many other Madoff schemes are there out there? And do we have any idea? And what steps are we taking to see to it that we apprehend these people earlier?

And so today we will also consider how to prevent crimes like these ongoing from going forward, whether we require more resources, additional rulemaking, or legislation. I will ask the SEC and FINRA to update this Committee every 3 months on the steps you are taking to prevent similar Madoff schemes in the future.

Even if this is an extraordinary and out-of-the-ordinary case, the Madoff fraud makes crystal clear how critical transparency and accountability are to our markets' continued success. It makes clear how inseparable proper oversight cops on the beat are to a dynamic, competitive financial system.

Our markets are only as strong as those who regulate them and the laws and values which market participants observe. Going forward, the American people need to know that this Committee is committed to strengthening regulation, rebuilding confidence, and, above all, sending a clear message to investors across the world that the era of "don't ask, don't tell" on Wall Street is over.

And with that, let me turn to my colleague from Alabama, the former Chairman of the Committee, Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Chairman Dodd.

The Madoff fraud is disturbing, as Senator Dodd said, on several different levels. Most significantly, many Madoff investors have seen their money disappear virtually overnight. They are now scrambling to provide basic necessities, shelving plans of retirement or attempting to re-enter the workforce at a time when jobs are hard to come by. We learn daily of charities that are curtailing their activities because of their Madoff-related losses. These losses are particularly unfortunate because they appear to have been, at least to some extent, avoidable.

Notwithstanding the numerous red flags waved under their noses, the SEC and the Financial Industry Regulatory Authority, or FINRA, missed crucial opportunities to detect the fraud when it was much smaller in scope. The fact that the regulators were put on notice through direct tips, press articles, and industry chatter raises serious questions about the state of our regulatory system.

For example, in November of 2005, the SEC received a lengthy submission from a credible source repeating and elaborating upon allegations made in 1999 that outlined a detailed set of red flags that made the tipper very suspicious that Bernie Madoff's returns are not real, and raising the possibility that Madoff Securities is the world's largest Ponzi scheme.

In the almost 20 pages that follow, the tipper, a derivatives expert, made a compelling case that something was amiss at Madoff Securities. He cited, among other things, Madoff's unusual compensation arrangement, the inability of the options market to sustain Madoff's strategy with the level of assets he had under management, the failure of firms using similar strategies to achieve comparable returns, and the mathematical impossibility of Madoff's returns. The tipster pointed to press articles and industry colleagues that shared similar suspicions about Madoff.

While it would be impossible for the SEC to open a formal investigation in response to every tip that comes in, a reliable method of triage is necessary. Certain complaints can be dismissed for the lack of credibility. The tip that the SEC received in the Madoff case came from a tipper who had a track record of credibility with the SEC.

During the course of investigating the tip, the staff discovered that Mr. Madoff lied to the SEC about both the number of customer accounts at his firm and the nature of trading in those accounts. Although the SEC staff forced Mr. Madoff to comply with the law by registering as an investment adviser, they refrained from digging deeper.

I understand that FINRA did not receive a copy of the complaint at issue, but Madoff's firm was a member of FINRA for years. Public news articles also suggested a possible connection between potentially fraudulent activities at Madoff's and Madoff's brokerage activities. While FINRA does not have direct regulatory oversight over investment advisers, its investigators routinely ask questions about outside activities when they relate to the broker-dealer under their jurisdiction. Yet there is no indication that FINRA made any inquiries about these reports. I believe questions about the allegations as related to the brokerage business would not have been outside FINRA's purview and should have been asked.

I want to be clear, Mr. Chairman. I am not suggesting that individuals within our regulatory structure are responsible for the Madoff scandal. Blame here is easily assigned. Madoff and anyone who assisted him in carrying out the fraud are responsible. Rather, today I am suggesting that our regulators' experience with the Madoff firm over the years did present opportunities to intervene, but they did not.

Therefore, I see this hearing as an opportunity to identify the structural or internal impediments at the SEC and FINRA that allowed the Madoff fraud to thrive for so many years without being detected. The natural reaction of a regulatory agency confronting a failure of this magnitude is to cry lack of resources and lack of access, but I hope that we will hear more thoughtful analysis this morning than that.

Regulators were at the Madoff firm on multiple occasions over the years, and at times they were armed with credible information suggesting that something was wrong. Were the concerns dismissed only after careful, objective, and thorough inquiry? Or were they swept under the rug due to carelessness or deference to who was at that time a respected founding member of the modern securities industry?

All of here today would like the answers to those questions. If mistakes were made, let us get them out in the open and learn from them. If the structure failed, let us determine how it failed and fix it. If individuals failed, let us identify them and hold them accountable. Only then can we re-establish confidence in our regulators and begin to repair the damage done by Madoff and his accomplices.

Thank you, Mr. Chairman.

Chairman DODD. Well, thank you very much, Senator.

I mentioned Mr. Markopolos, who was planning to be with us today but got ill with the flu and could not come down. But I am going to ask consent that this, "The World's Largest Hedge Fund Is a Fraud," and the subtitle here, "Potential fallout of Bernie Madoff turns out to be a Ponzi scheme," this article written 4 years ago, and a statement of his be included in the record this morning as well, so we will take care of that. Without objection.

With that, let me turn to Senator Menendez.

STATEMENT OF SENATOR ROBERT MENENDEZ

Senator MENENDEZ. Thank you, Mr. Chairman, for holding what I think is an incredibly important hearing to examine how our Federal regulators failed to uncover the largest Ponzi scheme in history and what we can do to prevent something like this from ever happening again.

I have no doubt that 2008 will go down in history as one of the darkest years for our system of Federal financial regulation. The failure of regulators to check the irresponsibility on Wall Street allowed financial titans to grow so large and powerful that their collapse was a systemic disaster for our economy. Not only were regulators unable to rein in the reckless practices that ultimately led to these firms' downfall, we now know they were not even able to protect outright fraud and theft.

Bernard Madoff is the most visible and incredible example of this calamitous failure, taking advantage of the lack of regulatory due diligence to steal billions of dollars over the course of decades. And just like the subprime mortgage meltdown, there were countless red flags—you mentioned a very detailed list of them, Mr. Chairman—that should have caught the attention of our regulators, but, unfortunately in this case the SEC seemed to be colorblind. This was not a small-time scam that only involved a few investors. It was an elaborate scheme that cost thousands of people an estimated $50 billion. And it is almost inconceivable to me how a single individual was able to steal $50 billion over the course of several decades without the SEC being able to detect any of it whatsoever.

The shock caused by this modern-day heist has reverberated throughout Wall Street, further crippling investors' already weakened confidence that securities investing can be reasonably secure. And in addition to the scandal's effect on investor confidence, there are personal, tangible repercussions as many retirees who saved their entire life found out their nest eggs were just empty shells.

Charities that fund projects for education and health care will have to dramatically cut back on the assistance they provided at a time in which their help is even more desperately needed. So an underprivileged child who has no investments and nothing to do with Wall Street might now be denied a scholarship to college because the charity can no longer afford it. Or a single mother without health care who relies on free clinics for treatment for her children might no longer have this option.

It soon becomes clear that Mr. Madoff's scheme and the regulatory failures that followed it have more than just financiers as its victims. If we have learned anything from 2008, we have learned that our regulatory system is broken down and it is in need of comprehensive reform. We simply cannot put a new paint job and pretend everything is OK. In my mind, we need a complete overhaul in order to fundamentally change the way business is conducted on Wall Street.

But before we can prescribe a cure for the problems on Wall Street, we must first diagnose the illness. We have to examine how this scheme was perpetrated right under the notes of the Securities and Exchange Commission. Was it a lack of authority, a lack of resources, a lack of transparency? Or, much worse, was the root cause something much deeper, something indicative of a larger, more systemic problem facing the Securities and Exchange Commission?

One thing is clear: The failure of our regulators has severely undermined the American people's confidence in the integrity of our capital markets. This lack of confidence threatens to keep credit frozen and prolong the recession unless we act responsibly and quickly. And I hope today, Mr. Chairman, we can get a better sense of what that might be and be able to move on it expeditiously.

Chairman DODD. Thank you, Senator, very much.

Senator Corker.

Senator CORKER. Mr. Chairman, out of respect for the witnesses and all of you, I am going to wait and listen to them.

Thank you.

Chairman DODD. Thank you very much.

Senator Bennet, we do the early bird rule here, I tell the new Senators, and so if you get here early, you get to go first.

STATEMENT OF SENATOR MICHAEL F. BENNET

Senator BENNET. Thank you, Mr. Chairman. I would like to first offer my gratitude to you and Ranking Member Shelby for your leadership of the Committee and for the hospitality and kindness that you and your staffs have shown me as the newest Member of this panel.

As I take my seat on this Committee, I am aware that this is a crucial time in our history. Millions of Americans are out of work, struggling to keep a roof over the heads, and worried about how they are going to make ends meet. Today, I join you on behalf of the many Coloradans affected by the Bernie Madoff investment scandal, including the Nurse-Family Partnership, a Denver-based nonprofit organization that helps low-income families with children meet their health care needs. That organization lost a million-dollar contribution from a foundation that went under because of Madoff losses.

I look forward to serving on this Committee, Mr. Chairman, and I ask that my full statement be entered into the record.

Chairman DODD. Absolutely. And welcome again.

Senator BENNET. Thank you.

Chairman DODD. Senator Johanns.

STATEMENT OF SENATOR MIKE JOHANNS

Senator JOHANNS. Since this is my first hearing, let me offer just a couple of thoughts in appreciation to our Chairman and our Ranking Member for pulling this hearing together. This is a very, very important issue.

Turning to the present matter, we examine today how Bernie Madoff was able to pull off what really is regarded as the largest Ponzi scheme in history, effectively swindling thousands of investors out of billions of dollars, but even more significantly, how he did that over a period of decades, apparently without detection.

If there was ever a time in our Nation's history where the public needs to rely on the regulators to know that their investments are safe and secure and that the regulators are doing their job, it is now. And yet I fear that we are sending absolutely the opposite message to people. The public needs that confidence.

It is especially troubling to me to discover that the SEC ignored or failed to effectively follow up on a series of tips that warned of the wrongdoing, tips going back as far as 1999, if not further. I simply do not understand that. I do not understand it as a former mayor, as a former Governor, and as a former member of the United States Cabinet. I do not know how you could miss that. I do not understand how they could miss a memo that literally pointed out that this was a Ponzi scheme.

I hope the witnesses today will provide needed information not only to the Members of this Committee but to the members of the public. I hope that the witnesses today will assure us that the regulatory plan in place is sufficient; or in the alternative, if it is not, point out to us where you think the problems existed and why this went so long without any action being taken.

We will never be able to prevent or legislate against completely dishonest people. We recognize that. But when we are made aware of that dishonesty, it baffles me that action was not taken to bring the hammer down.

With that, let me just again say, Mr. Chairman, Mr. Ranking Member, I appreciate the opportunity to be a Member of this very important Committee.

Chairman DODD. Well, we welcome you, Senator. Thank you very much, and you bring a wealth of experience to this Committee. We look forward to your deep involvement with us on these questions. So thank you very, very much.

Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman. I want to thank you for holding this hearing, and Ranking Member Shelby as well.

The Bernie Madoff fraud was a punch to the gut of our financial system which was already reeling from too many haymakers. While I remain confident that at the end of the day our financial markets will emerge upright and stronger than ever, this can only happen if everyone learns from the mistakes that were made.

Madoff's fraud was so immense and obvious and took place over such a long period of time, it is simply inexplicable how the SEC missed it. It is as if there were a giant elephant standing next to the SEC in a rather small room for 25 years, and the SEC never noticed the elephant or even smelled the peanuts on his breath. And it is not as if the SEC was not looking around the room. Since 1982, the SEC and FINRA conducted eight examinations of Bernie Madoff's firm, and, of course, following up on the detailed tips provided by Harry Markopolos, whom the Chairman has wisely pursued in bringing here and getting his statements into the record, the SEC's Enforcement Division conducted a full investigation of Madoff's firm in 2006, and yet the SEC did not even come close to unraveling this fraud.

All they had to do was peel away one layer of the onion skin, and it would have been apparent how broad and deep this fraud was. There are people who have told the story of asking Madoff about his investments, and when his explanation did not hold, they said, "We are not investing." If they could figure this out, why couldn't the SEC?

In short, Mr. Chairman, I think we are a far cry from the SEC that was established by Joseph Kennedy and Franklin Roosevelt in the 1930s. That SEC was one which aggressively sought out fraud and adopted its methods to best achieve its goals. Today's SEC appears stagnant and behind the times, almost always closing the barn door too late and slowly but surely failing in its principal message of maintaining investor confidence in the integrity of our capital markets.

Our witnesses today are experts on the securities regulation, and I will defer to them on particulars. I am very interested in Professor Coffee's suggestions of a conservator of a type. But I think it is clear that major changes are necessary in how we regulate securities.

One such change has already occurred: the rejection of the laissez-faire principle that we can have totally unregulated markets that function well. This flawed theory concocted by ivory tower academics and debunked countless times is particularly pragmatic when it is wielded by people who are in charge of actual regulation. As was too often the case in the last administration, one member of the SEC basically said that he did not even believe in the New Deal regulations that were put forward.

So I am confident that the changing of the guard, particularly the appointment of Mary Schapiro as the new SEC Chairman, will be a good start toward reforming the SEC. But that is not enough. We must also take all due steps to improve the tools with which the SEC does its job.

First and foremost, the SEC must have more resources. The enforcement and examination staff have actually shrunk in recent years, even as the number of investment advisers, such as Madoff's firms, that they must oversee has soared. The fact that the SEC was stretched too thin to conduct an examination of Madoff's investor advisory operations is inconceivable and something that we must address immediately.

That is why Senator Shelby and I, among others, are introducing the Safe Markets Act today, which, among other things, would authorize the hiring of 100 new SEC enforcement staff as well as FBI agents and prosecutors to go after criminal fraud.

But having sufficient resources is only half the equation. We also must ensure those resources are being well allocated. The SEC must have professionals in place who understand how markets work and who are able to detect complex financial frauds. Expanding the Office of Risk Assessment proposed by Chairman Donaldson would be a great first step toward this end, and I am wondering what the panelists think of that.

There is no doubt that the SEC has some of the best lawyers in the country, but they also have to hire more of the top financial experts as well.

Finally, as I suggested earlier this month in a little bit more of a parochial vein, the SEC's Office of Compliance Inspections and Examinations, as well as its Office of Risk Assessment, would be best served by moving their functions to Wall Street. It makes no sense to have the cops who are patrolling their beat hundreds of miles away. At the same timing, moving these functions to New York will improve the SEC's ability to hire top professionals with the skills and experience to detect complex financial frauds.

I want to thank the witnesses and thank the Chairman. I look forward to the testimony. Unfortunately, I care about this but I will be in and out because we have a Finance Committee markup on the stimulus. So I want to apologize in advance to the witnesses, but I have read their testimony.

Chairman DODD. Thank you, Senator, very much. And I would point out that Connecticut is close to New York as well. It might be a venue——

Senator SCHUMER. Right on the border would be fine with me, Mr. Chairman.

[Laughter.]

Chairman DODD. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. I appreciate your holding this hearing. I would think that actually the Enforcement Division's location in the greater Washington area is still a pretty good place for it to be located.

But we have got a lot of witnesses. I am anxious to hear their testimony, and I hope we have lots of time for questions, because I have got lots of questions.

Thank you.

Chairman DODD. Thank you very much.

Senator Merkley.

STATEMENT OF SENATOR JEFF MERKLEY

Senator MERKLEY. Thank you very much, Mr. Chair, and I am delighted to join this Committee. I look forward to working with you and with our Ranking Member Senator Shelby.

Certainly this is an extraordinary first hearing to participate in. As the leader of various nonprofits in the past, it is incomprehensible to me how even the most basic auditing efforts could not have revealed such massive fraud, and knowing that the type of oversight that is essential when there are massive assets at stake is certainly many steps up from that of a basic nonprofit.

I look forward with great interest to understanding how we got where we are and how we are going to restore integrity in our financial markets and our investments.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator, very much, and we are delighted that you have joined the Committee as well. Thank you for your willingness to serve with us.

We will begin with Dr. Coffee as our first witness. We thank Professor Coffee for being here. He has been before this Committee on numerous occasions over the years.

For those who are not aware of Professor Coffee's background, he is the Adolf A. Berle Professor of Law at Columbia Law School and renowned securities law expert who has helped this Committee on numerous occasions when I have been a Member of this Committee, and we thank you for being with us today.

STATEMENT OF JOHN C. COFFEE, JR., ADOLF A. BERLE PROFESSOR OF LAW, COLUMBIA UNIVERSITY LAW SCHOOL

Mr. COFFEE. Thank you. Chairman Dodd, Ranking Member Shelby, fellow Senators, I am happy to be here, and to begin let me paraphrase Warren Buffett: The tide has gone out on Wall Street, and we are now increasingly finding “who has been swimming naked,” because they show up when the tide goes out.

Sadly, it has long been this way. In my written comments, I review a dozen different recent Ponzi schemes. I will not take your time to go through them today, but the generalization I would initially offer is that these spectacular frauds are usually discovered by investors on their collapse, sometimes by postal inspectors when there have been widespread mailings by people having no connection with the securities industry, and only occasionally by securities regulators. Thus, the point that I want to stress the most is that there are cost-effective, adequate remedies that can be implemented that have proven effectiveness, that have worked for years to prevent Ponzi schemes, but are not now applicable to most investment advisers or to most hedge funds. And I think these techniques should be adopted because we are probably going to be more successful at deterring and preventing Ponzi schemes than detecting ones once the fraud has begun.

Let me begin also by emphasizing that Mr. Madoff is not really unique. Spectacular crook that he was, he is unique only in the absolute magnitude of this fraud, which is an order of magnitude greater, and the lengthy duration of his fraud, which does raise the questions you are all realizing, all focusing on, about the quality of regulatory supervision.

But apart from that, Ponzi schemes are not rare. They are increasing and they are fairly recurrent. Professor Tamar Frankel has conducted an analysis of the losses suffered by investors based simply upon judicial decisions. She finds that in 2002, U.S. citizens lost $9.6 billion from Ponzi schemes, and there were four other years out of the last dozen years in which the losses suffered by U.S. citizens exceeded $1 billion. This is not a one-shot problem. This is something that happens regularly.

Now, reviewing other Ponzi schemes, I find that there is increasing frequency and increasing scale, partly because we have seen a few bad apples in the hedge fund market. The Bayou Fund is probably the leading example. But the real cost of this fraud falls ultimately not just on individual investors, but it falls on investor confidence, and it is going to have a chilling shadow that is going to deter many hedge funds from being able to start or continue. So the costs here are more than just individual investors. It is a whole system of finance that is under a growing shadow. It is not going to be able to start again until we fix the system.

Now, what would work to fix the system? Here I want to get to the basic reforms. I note in my testimony a striking contrast. In the 69 years that we have had the Investment Company Act of 1940, there has not been a single mutual fund, to my knowledge, that has failed because of a Ponzi scheme. There have been some frauds—relatively few—but not a real Ponzi scheme. The Ponzi schemes tend to occur either in unregulated hedge funds or, even more typically, in alternative investments put together by investment advisers, registered and unregistered.

What explains the superior track record of mutual funds? Very simply, the leading characteristics, the leading distinction between a mutual fund and a hedge fund is the existence of an independent custodian, who is a trustee, who holds the investors' funds in a separate bank or broker-dealer account and does not let the money manager, the investment adviser, either have access to that fund or to misappropriate those funds. Rather, the custodian buys or sells securities at the instruction of the investment adviser, but it does not remit the funds to the care of the investment adviser. It simply gives the money back and forth to the investors.

Now, when we have seen spectacular failures in the hedge fund industry, it has usually been those hedge funds—and they are the minority—that do not on their own decide to use an independent external custodian. Thus, here is where Mr. Madoff is particularly relevant. Mr. Madoff was, until 2006, a broker-dealer who gave investment advice. After 2006, he was a registered investment adviser, and he was required to use, by law, under the Investment Advisers Act, a "qualified custodian." Who did he use as his qualified custodian? Pursuant to SEC rules, he used himself.

Now, when you self-clear or when you are your own custodian, I think you are violating the first rule of common sense: You cannot be your own watchdog. This happened because the SEC, I am afraid, gave us an illusory rule. It was amended once in 2003, but not adequately. It still allows the investment adviser, where it has a broker-dealer affiliate, to use its own broker-dealer to be its own custodian. And I think that permits incest. The small, closely held broker-dealer firm wants to keep everything in-house and, thus, there is no accountability, no watchdog.

There was a second significant SEC failure that I want to point to. Following Sarbanes-Oxley, broker-dealers were supposed to use accountants who are registered with the PCAOB, the Public Company Accounting Oversight Board. But on three occasions, the SEC adopted and extended an exemptive rule that said privately held broker-dealers that did not have public shareholders owning the broker-dealer firm did not have to use such a PCAOB-registered accountant. And that is why Mr. Madoff was able to use the fly-by-night accountant who has previously been described.

Now, this kind of exemptive rule is, in my view, deregulation carried to excess—indeed, deregulation gone wild—because, again, you need to protect not simply shareholders but also customers. The premise of this exemptive rule, which was adopted and extended on three different occasions between 2003 and 2008, was that, well, because private broker-dealers do not have public customers, they do not need audited financial statements. That ignored that there was someone else called "customers," and there were thousands of customers out there. And had you had to use a registered accounting firm, it would not have been possible to do what Mr. Madoff did or, even more evident, what the Bayou Fund did. The Bayou Fund was even more direct. They invented a bogus accounting firm that had no existence. They printed up fake stationery, and they wrote their own audit reports. That is two occasions in the last 2 or 3 years that this has happened, and I think it shows that we need to have a real auditor that has some accountability and is subject to the oversight of the PCAOB.

Now, for the future, that problem is solved because this year, after Mr. Madoff, the SEC did not again extend this exemptive rule for privately held broker-dealers. But we still have the problem that you can self-clear, that you can be your own custodian, and I think that is a serious problem.

I would note that the industry is coming to agree with me. The Investment Adviser Association, a leading trade group, has now endorsed the idea that there should be an external custodian for investment advisers, and I think that makes eminent sense. When you see the trade associations adopting reforms, I think it means its time is probably already overdue, we should move to that relatively quickly.

OK. Now, there is one other topic that I think the Committee wants me to touch on briefly, and I do not want to speak too long. This Committee wants to focus on the quality of the regulatory supervision. I am not here to point fingers. The SEC's Inspector General is much better positioned than I to conduct a long investigation as to what happened within the SEC. But I do want to touch upon two purely legal conclusions. These relate to the need for examinations and to the jurisdiction of FINRA.

Cost-constrained as the Office of Compliance Inspections and Examinations is—and it is very cost-constrained—and necessary as it is that under these circumstances they use risk-adjusted criteria, I do not believe they used proper risk-adjusted criteria in deciding not to examine Madoff securities in 2006. In 2006, the SEC knew that Mr. Madoff had investment advisory clients, and they compelled him to register as an investment adviser. Once you do that, the first question immediately is: Who is your custodian? What is the quality of the care and protection for those accounts? I think given the size of the investments at some $17 billion was already as of 2006 under his investment and management, there was a need for an immediate examination of his records and the quality of the custodial care. And that was triggered by additional red flags that the Committee has also noticed, including the use of an unregistered accountant and the fact that there have been press reports not in secret little back rooms but in Barron's, questioning what was going on at Madoff Securities. That calls for an immediate need, even on the most constrained circumstances, for an immediate examination.

Last conclusion, FINRA, and I am not talking about the personalities. I am saying simply that FINRA did have jurisdiction over Madoff Securities that extended to all of its activities. Prior to 2006, Madoff Securities was conducting its investment advice as part of its brokerage operations. There is an exemption in the Investment Advisers Act for a brokerage firm that permits it to give investment advice so long as that activity is solely incidental to its brokerage business. Therefore, whether or not they were properly using that exemption, they were claiming that exemption and saying in our brokerage business we are giving investment advice. That puts it fully within the scope of FINRA's jurisdiction.

After 2006, now the only way Madoff conducted an investment advisory business was by using his own brokerage firm as the custodian. Therefore, the question that is squarely within FINRA's jurisdiction is: What kind of custodial services are you providing for this investment adviser—who is not legally separate, who is only one floor away? And I think, therefore, you had to ask: What is going on with respect to the custodial services you are providing to one of the largest investment advisers in America?

All right. I do not want to go into further details about the quality of the supervision, but my point is that we do not have FINRA having no jurisdiction. They have broad jurisdiction. I once served on an NASD broker-dealer disciplinary committee, and I found that if a broker-dealer refused to answer any request by the NASD for books or records, they were subject to discipline, and they could be thrown out of the industry, and during my tenure on the NASD's own broker-dealer discipline Committee, we did throw people out of the industry because they refused to provide books and records in response to an NASD or FINRA request.

So I think there was more that could have been done. The enforcement powers were there.

Thank you.

Chairman DODD. Well, thank you very much, Professor Coffee. Very, very helpful, and obviously we will give the SEC and FINRA and some people a chance to respond to that, but I have sort of drawn the same conclusion you did.

I wanted to thank Senator Shelby and other Members here. Ms. Schapiro has now been confirmed by the Senate. There was a glitch in the paperwork, and it required her being voted on again a second time. So she has been confirmed twice to be the Chairman of the SEC in the last few days. So I thank our colleagues for allowing that to go forward so she can be on the job. We thank you for that.

Dr. Backe, we thank you for being here.

STATEMENT OF HENRY A. BACKE, JR., M.D., ORTHOPEDIC SURGEON, FAIRFIELD, CONNECTICUT

Mr. BACKE. Good morning, Senator Dodd and other Senators. Thank you for allowing me to speak on behalf of 140 United States taxpaying citizens from the State of Connecticut. I am an orthopedic surgeon and a partner of Orthopaedic Specialty Group, a medical practice located in Fairfield, Connecticut. We care for the medical needs of the insured and uninsured people of the greater Bridgeport, Connecticut, region of New England. OSG, incorporated in 1971, has been in existence for over 75 years. We employ 130 people with annual incomes ranging from $28,000 to $130,000. We have some employees who have worked with us for over 30 years. OSG has had a retirement plan for its employees since the 1970s. We currently have 140 participants.

We have followed all the ERISA rules and regulations governing pension plans and have been diligent in our fiduciary responsibilities. We have hired pension administrators for recordkeeping; our pension documents have been kept current with appropriate amendments by our attorneys, and our accountants have completed every required filing since the plan's inception.

Sixteen years ago, in 1992, we engaged Bernard Madoff Investment Securities Company to be our investment adviser and have invested all the plan's assets with Madoff. Participants in the plan include 15 doctors and 125 staff members such as nurses, x-ray technicians, medical assistants, and administrative personnel. The plan was funded by employee contributions, individual rollovers, and employer contributions. As of November 30, 2008, the plan had a net capital investment in the plan, of $11,581,000 and a statement balance of approximately $33 million.

The partners of OSG have made routine visits to Madoff's offices in New York City since 1993. The OSG Plan took comfort in the fact that its assets were invested with a well-known, highly respected investment adviser and broker-dealer that was registered with the SEC and subject to routine examination and oversight by the SEC and FINRA. For over 15 years, the OSG Plan received confirmations from Madoff for thousands of securities transactions, mostly in blue-chip stocks of major U.S. corporations and U.S. Treasury securities. We also received from Madoff monthly statements of our account activity, as well as quarterly and annual portfolio management reports.

The OSG Plan was audited by the U.S. Department of Labor in 2005 and no concerns were raised. We also had an independent audit conducted in 2008, of 2007 and 2006, by a reputable accounting firm in Connecticut and, again, no concerns were raised.

As recent as October 2008, we sent three of our partners to Madoff's office to discuss the volatile markets and check our investments. One partner, now 70 years of age, had over 30 years' worth of retirement contributions and was interested in self-managing his account since he was preparing to retire. We were assured by Madoff's firm that his money was accessible and he could move it to a different type of account that he could manage at any time.

The news in early December 2008 that all of the investment activity in Madoff was a sham and that Madoff was, in fact, the world's largest Ponzi scheme, was devastating to us. We have three senior employees close to retirement who now do not know when or whether they can stop working. This affects OSG's recruitment plan to hire new physicians. We gave two new physicians employment offers that we now are unsure we can honor because senior doctors with plans to retire soon have now decided they need to keep working full-time for many more years.

Our employees are scared, worried, and angry. They express loss of confidence in the Federal Government and its agencies. Some have declined to have payroll deductions made for their plan contributions going forward. Some have expressed concerns that they will have to sell their homes when they retire since all their savings have been stolen.

We have seen disagreements and friction among our employees over this matter. We fear we may have a very uncomfortable and very unhealthy work environment if this takes years to sort out. This is the last thing a medical practice needs when treating patients. Our physicians are some of the most well trained and highly respected orthopedists in the area, but our community's perception of OSG has changed. Partners have told me people have asked if we are closing down.

We have had to hire multiple attorneys for OSG, our plan, and our employees. This month alone we have already incurred legal bills in excess of $70,000. I personally spend at least 2 hours of my day dealing with this tragedy rather than taking care of patients.

Then, to add further insult to injury, we learned that the SEC had information linking Madoff to the Ponzi scheme as far back as 1992, and that starting in 1999 a gentleman named Harry Markopolos regularly advised the SEC that Madoff was a giant Ponzi scheme—in fact, provided a road map to the SEC as to how to unmask Madoff as a fraud. But the agency allowed Madoff not only to continue in operation, but to continue to take in billions of additional dollars of victims' funds, including the funds of the OSG Plan.

We learned next that it was highly likely that the Securities Investor Protection Corporation, which took over Madoff, may take the position that the OSG Plan participants were not individual customers of Madoff and each not entitled to SIPC coverage. Instead, it was likely that SIPC was going to treat the plan itself as the only customer of Madoff. In other words, the 140 participants in the plan, who lost a total of $11,581,000 capital investment, would have to share in a maximum recovery of $500,000. This is not right and it is not just.

Our pension plan functioned as an individual retirement savings plan. Each participant received individual statements; each was able to roll over moneys from outside accounts to their own account within the pension plan. Each participant was allowed to, and some did, take out loans against their account. The intent was individual accounts, and the plan operated in that way. Madoff traded on behalf of the plan as one account. One of my partners spoke with an attorney from SIPC last month who advised him that the initial intent of SIPC was to cover the individual investor.

Senators, the 140 participants in the OSG Plan are not wealthy hedge fund investors, nor are they beneficiaries of multimillion-dollar offshore trusts. They are regular working-class Americans, most of modest means who annually put aside a substantial percentage of their wages to try to ensure that they could enjoy a dignified retirement in the near or distant future. They were let down by Madoff, the regulators, the SEC, and FINRA. We hope and request that SIPC, which was created to protect small investors from harm, will help us as individuals.

We respectfully request that our legislators ensure that participants in pension plans, be it ours or any other who invested through Madoff, will be covered by SIPC insurance individually, or that they are recompensed in some other manner by the Federal Government in light of the SEC's repeated failure to stop Madoff from stealing money. We would like to see the Government provide quality oversight through its agencies so that pension plans do not suffer this theft loss in the future. This would help restore the confidence and trust of Americans saving for retirement.

We would like the IRS to clarify or expand what can be considered a theft loss in this situation and/or waive the maximum contribution restrictions for individuals or employers affected by Madoff so they can rebuild their pension plans on an accelerated schedule.

On behalf of OSG, we, as citizens of the United States of America, appreciate your time and work on our behalf. What we need now more than anything is quick resolution to this issue so we can get back to our own professions and jobs taking care of the health of our fellow Americans.

Thank you very much for your time.

Chairman DODD. Doctor, thank you very much for being here and for your testimony. We appreciate it very, very much and appreciate the passion that you bring to this in talking about the people you work with every day. So we thank you for that.

Now I want to introduce Ms. Lori Richards. She is the Director of Compliance Inspections and Examinations at the U.S. Securities and Exchange Commission. She has served on the SEC staff for over 20 years, and we thank you for being here this morning.

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

Ms. RICHARDS. Thank you, Chairman Dodd, Ranking Member Shelby, and Members of the Committee. I am Lori Richards, Director of the SEC's Office of Compliance Inspections and Examinations, and I appreciate the opportunity to appear before this Committee today to discuss the examination program and the functions of the SEC.

In this regard, my views are my own, and they do not necessarily reflect the views of the Commission or any other member of the Commission staff.

I want to assure the Committee at the outset that the SEC takes the alleged fraud by Mr. Madoff extremely seriously, and 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 future and more likely to be detected.

With the Commission's direction and under the new SEC Chairman, we expect that we will identify changes and improvements to both regulation and to oversight. I will share some of these ideas with you this morning. I also want to say I very much appreciate the testimony and hearing the testimony of Professor Coffee and also Dr. Backe.

I begin by noting that I have served as a member of the Commission staff for more than 20 years, and that the agency's staff are dedicated, hard working, and keenly committed to the agency's mission to protect investors. Speaking as an examiner, we are focused hard on fraud, and we are committed to finding fraud.

We examine firms that are registered with the SEC, and they vary in size and in type. They include many that are run honestly and in compliance with the law, and they also include firms that are engaged in deception, in dishonesty, in falsification of records, and fraud of various kinds.

Examinations have identified many different types of frauds, including Ponzi schemes, that have sought to have been carefully hidden. The alleged fraud in this instance remains very much an ongoing matter under investigation by criminal authorities, by the SEC's Enforcement Division, and with respect to the SEC's past regulatory activities with respect to Madoff by the SEC's 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 Madoff firm. I can provide, however, the following general information concerning examinations of the Madoff business.

Examinations of the Madoff broker-dealer firm did not find the fraud committed by Mr. Madoff. The Commission's examination staff did not examine his investment advisory operations, which first became registered with the SEC in late 2006. The SEC conducted limited-scope examinations of the Madoff broker-dealer operations for compliance with, among other things, trading rules that would require the best execution of orders, display of limit orders, and possible front-running, most recently in 2004 and 2005. The firm's investment advisory business became registered in 2006 and was not examined by the SEC. For the reasons that I noted, I must not discuss these examinations in any greater detail.

Some broader information, however: Given the number of registered investment advisers today, there are over 11,000, and the fact that this population has grown very rapidly in recent years, the SEC cannot examine every investment adviser on a routine frequency. The SEC has 425 staff dedicated to examinations of all registered investment advisers and mutual funds, and approximately 315 staff dedicated to examinations of all registered broker-dealers.

About 10 percent of registered investment advisers are examined every 3 years. These examinations are not audits. They are limited in their scope, and they are targeted to specific activities of a registered firm. Investment advisers are not subject to examination or oversight or regulation by a self-regulatory organization, and this differs from the oversight model for broker-dealers, who are subject to periodic, routine examinations by an SRO.

Finally, I want to assure this Committee that we hold the protection of investors as our sole goal, and also that we are thinking expansively and creatively about changes that could reduce the opportunities for fraud and increase the likelihood of detection of fraud in the future. We very much look forward to working in this respect in this critical effort with the Commission and with incoming Chairman Schapiro.

Among the areas that we will study are: the examination frequencies for investment advisers; the existence of unregistered funds and advisers; the different regulatory structures surrounding brokers and surrounding investment advisers; the existence of unregulated products; and strengthening the custody and audit requirements for regulated firms.

We are also very much looking forward to ways, identifying ways that we at the SEC can improve our assessment of risk and at the adequacy of information that is required to be filed by registered securities firms that is used now to assess risk.

We are looking at whether our risk assessment process would be improved with routine access to information such as, for example, the identity of an investment adviser's auditor, its custodian, its administrator, its performance returns, as well as additional information. Pulling all information together at the SEC so that SEC staff analysts can review it is a significant priority for us.

We are also targeting firms for examinations to look at their custody of assets, and we are expanding our efforts to examine advisers and brokers in a coordinated approach to reduce the opportunities for firms to shift activities to areas where they are not subject to regulatory oversight.

In these and other ways, we are committed to assuring the highest level of protection for American investors.

I would be happy to provide additional information to this Committee in response to your questions.

Chairman DODD. Thank you very much, and we will come back. I have some obvious questions we need to raise.

Ms. Linda Chatman Thomsen—is that a correct pronunciation?

Ms. THOMSEN. Yes, sir, it is.

Chairman DODD. She is the Director of the Division of Enforcement of the U.S. Securities and Exchange Commission. She has served on the SEC staff for 14 years, and we thank you for your service and thank you for being here today.

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

Ms. THOMSEN. Thank you very much. Good morning, Chairman Dodd, Ranking Member Shelby, and Members of the Committee. I appreciate the opportunity to appear here today to discuss Madoff-related matters. I am Linda Thomsen, and for nearly 14 years, it has been my very great privilege to serve on the staff of the Enforcement Division of the Securities and Exchange Commission. And as Ms. Richards mentioned, we all take these Madoff matters extremely seriously and appreciate this Committee's interest.

I want to thank the Committee at the outset for understanding that because of our collective desire to preserve the integrity of the investigative and prosecution processes, there are matters that I cannot discuss. None of us wants to do anything that would jeopardize the process of holding perpetrators accountable.

I should also note that my views, while informed by my experience as a member of the Commission staff, are my own and do not necessarily reflect the views of the Commission or any other member of the staff.

On December 11, 2008, the SEC filed a lawsuit against Bernard Madoff and his firm. The Commission's complaint alleges that Mr. Madoff had been conducting a giant Ponzi scheme for years, with estimated losses of approximately $50 billion. That same day, the United States Attorney's Office for the Southern District of New York filed a related criminal action. These actions expose Mr. Madoff to billions of dollars in liability and decades of incarceration. Our investigations are continuing, and we are coordinating our efforts.

I would like to step back and turn to the general topic of how we deal with tips and complaints and how they develop into cases.

The Enforcement Division receives hundreds of thousands of tips each year. And while we appreciate and examine every lead we receive, we simply do not have the resources to fully investigate them all.

The primary consideration in determining whether to pursue any particular tip depends on whether, based on judgment and experience, the tip provides sufficient information to suggest that it might lead to an enforcement action.

When we have a promising lead, we investigate. We follow the evidence, we pursue the culpable, and we do so without fear or favor. When we begin, we usually do not know whether or not the law has been broken and, if so, by whom. We have to investigate. And when we investigate, we are resource-constrained. Every day we are compelled to make difficult judgments about which matters to pursue, which matters to stop pursuing, and which matters to forego pursuing at all. Every investigation we pursue, or continue to pursue, entails opportunity costs. A decision to pursue one matter means that we may be unable to pursue another.

The staff of the Enforcement Division is devoted to public service and our mission of investor protection. The hard-working men and women of the staff live to bring cases, particularly big and difficult cases. The staff is bright, creative, and professionally zealous; for us, there is nothing more rewarding than pursuing, bringing, and winning a big case.

We need only look at the days surrounding the bringing of the Madoff case to see ample evidence of the staff's commitment. During the Monday-to-Monday period between December 8 and December 15, 2008—and the Madoff was brought in the middle of that period—the Commission also pursued a number of other matters, including suing an attorney for selling bogus notes; suing former Fidelity employees for taking illegal gifts and gratuities. We finalized some of the landmark auction rate securities cases, which quickly provided billions of dollars of liquidity to thousands of investors. We sued a Russian broker-dealer for operating in our markets in violation of our rules. We settled a complex reinsurance financial fraud matter. We brought a case involving a wide-ranging market manipulation and kickback scheme. And we filed a $350 million dollar settlement with Siemens for bribing foreign officials, the largest SEC Foreign Corrupt Practices Act settlement in the act's 30-year history.

Everyone at the SEC wishes the alleged Madoff fraud had been discovered sooner. We are committed to finding ways to make fraud less likely and to make fraud detection more likely. But we need to acknowledge a hard truth our forefathers recognized: If men were angels, we wouldn't need government. We wouldn't need laws or law enforcement either. The reality is that people do break the law and when they do so, there is harm, and it is sometimes very significant harm.

Among the steps we are taking on the enforcement front is looking for ways to identify, among all of the information we receive and develop, in addition to tips and complaints, other information, the systemic risks and emerging trends we should investigate. We are also making sure that enforcement personnel have access to market, trading, accounting, economic, and analytical expertise when they need it and that they have the training to know when they should call upon that expertise.

We could also use more resources. We always do our utmost to do more with less. With more resources, we could do more. More resources would allow us to spend more time identifying risks and to pursue more investigations and to pursue them more deeply. We could invest more in technology that we would use to help maximize our effectiveness and efficiency.

Finally, all of us need to do everything we can to encourage a culture, especially among those who make their livings from other people's investments, that embraces the idea that mere compliance with the law, narrowly viewed, is not the highest goal to which we aspire, but the base from which we start. We should all continue to work toward ensuring a system where those who work in it are responsible stewards of the treasures entrusted to them.

Thank you very much, and I would be happy to answer questions.

Chairman DODD. Thank you very much.

We have been joined by our colleague from Rhode Island, Senator Reed. Senator Reed, thank you for joining us. Do you want to make any quick comment at all?

Senator REED. No. Thank you, Mr. Chairman.

Chairman DODD. Let me turn next, if I can, to Stephen Luparello. Did I pronounce that correctly?

Mr. LUPARELLO. You did, Senator.

Chairman DODD. Mr. Luparello is the Interim Chief Executive Officer of FINRA. Mr. Luparello began at FINRA—its predecessor, the NASD—in 1996 and has since been the head of the Market Regulation Department and Senior Executive Vice President of Regulatory Operations.

We thank you for being with us.

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

Mr. LUPARELLO. Chairman Dodd, Ranking Member Shelby, and Members of the Committee, 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 rightfully asking what happened to the system that was meant to protect them. There is 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 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.

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 allow this fraud to go undetected, as well as potential changes to the regulatory framework that could prevent it from happening in the future.

Bernard 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.

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 every year since. The Madoff broker-dealer consistently reported to FINRA that 90 percent of its revenues were generated by market making and 10 percent by proprietary trading.

When examining the Madoff broker-dealer operation, 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 Bernard Madoff allegedly carried out through his advisory business.

While we did receive a small number of customer complaints through 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.

FINRA also did not receive any whistleblower complaints alleging either front-running or Ponzi schemes at the Madoff money management business, nor did the SEC share the tip it received or alert FINRA to any concern it may have had about 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 1980s, NASD officials issued public statements urging reform. As recently as this past August, FINRA's former CEO, Mary Schapiro, personally raised those issues with the SEC Chairman.

Unfortunately, the statutory limits of FINRA's jurisdiction did not allow us to be an extra set of eyes looking at the totality of the Madoff business. Any number of misrepresentations that can facilitate a fraud like this, whether the firm had customers or it did not, whether the trades ran through the broker-dealer or they did not, whether the firm custodied the assets or they did not, likely would 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 at 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 that 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 such fraud.

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.

Thank you, and I would be happy to answer questions.

Chairman DODD. Thank you very much as well.

Mr. Stephen Harbeck is the President and CEO of SIPC, the Securities Investor Protection Corporation and has been with SIPC since 1975. We thank you.

STATEMENT OF STEPHEN P. HARBECK, PRESIDENT AND CEO, SECURITIES INVESTOR PROTECTION CORPORATION

Mr. HARBECK. Thank you, Mr. Chairman.

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, I appreciate the opportunity to appear before you today and discuss the work of SIPC, the Securities Investor Protection Corporation. I have been the President and CEO of SIPC for the past 6 years. I have worked at SIPC for 33 years and was general counsel prior to my appointment as President and CEO.

SIPC was created in 1970 by a Federal statute, but that Federal statute specifically states that SIPC is not a government entity. It is a membership corporation of essentially all brokerage firms registered with the SEC. Membership is not voluntary. It is required by that law. Our resources include $1.7 billion worth of liquid assets in treasury bills that have been raised by assessments on our members. We also have a line of credit with an international consortium of banks and a $1 billion line of credit created by statute with the United States Treasury. SIPC has never used Government funds.

SIPC has no regulatory role. It has no function in examinations, investigations, or discipline. SIPC relies on the SEC and FINRA to inform SIPC when brokerage firms' customers are in need of protection. Once that protection is deemed to be necessary, SIPC initiates a very specialized form of bankruptcy. Within that bankruptcy, SIPC can advance up to $500,000 worth of protection, of which a maximum of $100,000 is based on a claim for cash, and SIPC may also advance money for the administrative expenses of these bankruptcies. It is very important to note that customer assets are never used to pay administrative expenses such as legal fees or trustees' fees or rent.

The year 2008, specifically the last calendar quarter of 2008, was unlike any period in SIPC's prior 39-year history. The collapse of Lehman Brothers and subsequently the collapse of the Bernard Madoff Investment Securities firm present enormous challenges, but these cases present very, very different fact patterns.

In the Lehman Brothers case, SIPC initiated a liquidation proceeding on September 19, a Friday, to assist and facilitate the sale of that firm's assets to Barclay's Bank. After a marathon hearing extending well past midnight, the United States Bankruptcy Court for the Southern District of New York approved that sale, and over the weekend, $142 billion of customer assets were transferred to either Barclay's Bank, the brokerage firm arm of Barclay's, or another firm. We are very pleased with that result. There are many other problems in the enormous nature of the Lehman Brothers case, but the initial stages have gone very well.

The Madoff Investment Securities case is an entirely different matter. This was theft, pure and simple. The state of the records was such that—well, to go back to when we started the case, we initiated a liquidation proceeding on December 15, after Mr. Madoff confessed to having stolen property over decades.

Unlike the Lehman Brothers case, where customer records were accurate, it became very apparent very early that the records that Mr. Madoff had been sending to investors bore little or no relation to reality. The records made it impossible for us to transfer all or any part of a customer's account to another solvent brokerage firm, as was done in Lehman Brothers. The claim forms, however, were sent by the trustee for the liquidation on an expedited basis. The claim forms were mailed to customers on January 2, and mailed to more than 8,000 people—in other words, to anyone on the books and records who may have ever done business with Madoff, if we could find an address for them. To date, over 900 claims have, in fact, been filed.

The trustee in Madoff has requested information from all such customers as to how much money they have put in and how much money they have put out in this fraudulent scheme. In some situations, particularly where investors have not made withdrawals, it will be relatively easy to determine exactly how much a claimant has put into the scheme, and we hope that, using all available resources, we will be able to track and make determinations on all customer claims.

In terms of the $50 billion figure that has been frequently cited, that is Mr. Madoff's figure, and it appears that this sum includes the phony annual profits that he reported as well as the contributions made by investors. As several people have said, this defalcation is on a completely different order of magnitude than any previous SIPA liquidation.

Until customer claims are received and processed and further accounting work is accomplished, we will not know the extent of the draw on SIPC's resources. But with the maximum amount that SIPC can advance any one claimant being $500,000, even if the valid amount of the claim is much higher, that is the maximum amount that we can advance to any one customer.

The trustee has taken possession of approximately $100 million worth of assets. He has identified a total of approximately $830 million worth of liquid assets which he may be entitled to in relatively short order.

In terms of legislative issues, certainly the sufficiency of SIPC's $1 billion line of credit, which was enacted in the original statute in 1970, may bear adjustment. There has been no adjustment since

1970, and using the Consumer Price Index, a $4.3 billion fund would seem—or line of credit would seem more appropriate. Further, the expansion of the securities markets themselves since 1970 might indicate that is an appropriate topic to discuss.

As the Madoff case continues, we will figure exactly what other factors of our statute may call for adjustment or adjustment within our bylaws and, with that, I would be pleased to answer any of the Committee's questions.

Chairman DODD. Well, thank you very much. Let me thank all of you this morning for your testimony. It has been very, very helpful to hear some of the comments. Obviously, there are a lot of questions that I am sure my colleagues have.

I am going to put the clock on here to about 8 minutes per Member. That is a little better than these short periods of time since we do not have an overwhelming number of us here, and we will move along if we can.

Let me, first of all, I mentioned in my opening statement that I would like the SEC and FINRA to report every 3 months to this Committee on actions that you are taking to improve the effectiveness of examinations and the handling of credible tips in order to reduce the amount of investor fraud. Will you agree to that?

Mr. LUPARELLO. Absolutely, Senator.

Ms. RICHARDS. Yes, Senator.

Chairman DODD. All right. Thank you.

Let me, if I can, first of all, in the case of Ms. Richards, I was struck when Professor Coffee was talking about the fact that this is not new, that Ponzi schemes have been around for a long time. Obviously, the fact that they are called "Ponzi schemes" indicate how long they have been around. But they are not new at all in the securities area. In fact, I think you cited one, some $4 billion, I think, at one period of time, and then a billion a year or something.

Mr. COFFEE. It was $9.6 billion in 2002 alone. That was the record year before 2008.

Chairman DODD. Yes. Well, I was impressed, Ms. Richards, when you cited some of the things that ought to be done now in response to Madoff. Why haven't they be done earlier? If, in fact, you have $9 billion worth of these schemes going on, why is it taking just the Madoff case for the SEC to respond in a way you did this morning by suggesting a number of steps should be taken? Why wasn't that done 10 years ago, or longer, if, in fact, this problem has been with us for as long as it has been?

Ms. RICHARDS. Yes, Senator, thank you for the question. I can commit to you that at the SEC we have been looking at ways to prevent fraud forever. For example, when we conduct examinations of a registered investment adviser, we are very intently focused on confirming the existence of those assets with a custodian—that is a routine aspect of our examinations—and as well looking at the account statements that are sent to customers and then matching them up with those custodian account statements.

Chairman DODD. What about some of the suggestions that were made by Professor Coffee in dealing with the custodial obligations of these financial advisers? Again, this is not new. This is the game. This is how it gets played. Was there some debate? You have been there for 20 years. You have been there for 14 years, Ms. Thomsen. Was there any debate or discussion at the SEC about these matters? Were they rejected as ideas? What has happened here?

Ms. RICHARDS. There has been debate about these ideas, in particular, the idea with respect to having an independent custodian of records. Now, any examiner would tell you that that is a strong internal control and that that is the most desirable situation, to have an independent entity in charge of customer assets.

At the current time, by our estimates, as many as a thousand investment advisers have custody with an affiliated custodian, either a bank or a brokerage firm or a commissions merchant. That combination can give rise to—unless the entity is truly independent, it gives rise to the possibility for fraud. And so that is one of the changes that I hope that the Commission will strongly consider in the days ahead.

Chairman DODD. Is there some downside to this that I should know about as well?

Ms. RICHARDS. Well, there are costs. There would be additional costs for requiring an investment adviser to have a third-party custodian. That would change existing custodial relationships.

Chairman DODD. That is a cost to them.

Ms. RICHARDS. A cost to them.

Chairman DODD. That is not a great argument. Give me another one, if you have got one here.

[Laughter.]

Ms. RICHARDS. I am not in the best position to argue the other side of this issue. As an examiner, having independence of accountants, of custodians, and of administrators I think is a strong internal control, and it is one that I believe the Commission will study very quickly in the coming days and weeks.

Chairman DODD. Well, I hope it goes beyond studying. I will speak for myself as the Chairman of this Committee. We want more than studies in these matters. If we are having this continuing problem with these cases, this one obviously becoming as celebrated as it is given the volume and the length of it over time. I have spoken to Ms. Schapiro about this. We raised the issue during her confirmation hearing. But, clearly—and I suspect I am speaking for all of us on this Committee—we want some action very quickly in this area. So I will be very interested in hearing some response about this particular point.

Let me, if I can, because I am struck with the FINRA debate, if I may raise it, Mr. Luparello. This is deeply troubling, listening to Professor Coffee, and others have talked about this in the past. Was there any indication at FINRA that you did not want to deal with this matter? Here Mr. Madoff is a member of NASD, President of NASDAQ himself, his family deeply involved. Is there any evidence at all of some resistance on the part of FINRA to deal with this matter because of his involvement with NASD and with NASDAQ?

Mr. LUPARELLO. Absolutely not, Mr. Chairman. Professor Coffee may actually vest in us a little bit more jurisdiction than we have been able to exercise over the years. The Madoff firm, the Madoff firm represented year in and year out, in our examinations, in their Form BDs, and all publicly available information, that they were a wholesale market maker, one without customers. So the existence of the money management business, while perhaps known to some examiners, not to others, was seen as outside of our jurisdiction.

Chairman DODD. But it was not separated until after 2006. Up until that time, it is one entity. It is even one entity after that, for that—it is one floor away.

Mr. LUPARELLO. No, it is—that is correct, and it was—it was clearly an integrated entity from that standpoint. But from——

Chairman DODD. So merely someone saying to you, creating this fiction, in a sense, that FINRA all of a sudden has to stop everything, you cannot—do you believe the—I have read the statutory language, and it seems to me quite clear that the ability to reach and to get documents and evidence where there is suspicion of fraud does not have a bright line to it.

Mr. LUPARELLO. That is absolutely correct. The ability to compel documents from entities that are registered with us is very broad. Our ability to continue to investigate when it is conduct that is not brokerage conduct is somewhat more circumspect.

Chairman DODD. So if you just create this advisory operation here, you can avoid then FINRA really having any jurisdiction. Is that your argument?

Mr. LUPARELLO. That is the argument that has been made against us over the years.

Chairman DODD. In effect, then, you become worthless, in a sense. What is the purpose at this point? Creating that kind of a fiction merely then avoids any kind of real supervision.

Mr. LUPARELLO. Well, as we have testified, and as we have made statements over the years, the ability to basically take a small step and refer to your business as advisory business and, therefore, not be required to bring it into the broker-dealer has been a source of frustration for us over the years.

Chairman DODD. Let me come back to the SEC, if I may. I am still frustrated a bit by all of this. We have all talked about the Markopolos memos and evidence, the 19- , 20-page document that he sent to the SEC in 2005. But he states in there—and I do not know if I have it in front of me. I had it here. Did I give it to someone?

There is a statement he makes in the opening page of that document—here it is; I can put it here—that I was struck by. He says, "I have also spoken to the heads of various Wall Street equity derivative trading desks, and every single one of the seniors managers I spoke with told me that Bernie Madoff was a fraud."

So this was not just one individual. How did the SEC not pick up this? I understand—and, by the way, let me preface my remarks. I have great respect for the people who work with you and work in your operations. I think all of us do here. They work very, very hard, and I suspect the limitation of resources and other things are not inconsequential in this discussion. So I want it to be clear, at least from the Chairman's standpoint here, that I am not indicting a division at all. I have great respect for the people who work very, very hard every day.

But you understand how mystifying it is that for literally decades, with warnings, I am told, by Wall Street firms that would have nothing to do with Madoff, the word was out on this guy. How does the SEC avoid not reacting to this?

Ms. THOMSEN. Mr. Chairman, I understand your frustration, and I think some of us share it. I have to say at the outset that the specifics of how we dealt with Mr. Markopolos' complaint and the investigation which we began and then closed are things we simply cannot discuss for many reasons, but most important in my mind is there is a criminal investigation. The allegations against Mr. Madoff right now are allegations, and they are extraordinarily serious allegations, and none of us want to get in the way of bringing a fraud to justice. But with that by way of background, let me step back and try to do it more broadly.

As I say, we get thousands, hundreds of thousands of tips and leads every year, and many of them are written in language which is very similar to the language of Mr. Markopolos. And so we have to—they are not evidence in and of themselves, and what we have to do is try to establish that evidence. Sometimes people write us with information that is simply wrong. Sometimes it is misinterpreted, *et cetera.* So we have to take those leads or tips and from them try to develop—investigate and develop evidence.

And then what we have to do—and this is the hardest thing that we have to do—as we develop the evidence, we go down roads and sometimes we find no evidence of fraud. And then we have to decide: Do we take another step? And we continue to do that until such time as we conclude that we have found a fraud or we have to stop. And deciding to stop is where you have to make the judgment call: Do I deploy resources somewhere else?

You can never be 100 percent sure that there is not a problem. When you find a problem, you know there is a problem. When you are not finding a problem, you do not know whether that is because there is not a problem or because you have not found it yet. And that is done in the context where we have things to look at, not only do we have Mr. Madoff's firm, but thousands of other firms, thousands of other advisers, public companies.

So it is really those kind of judgment calls that we have to make along the way, and I have to tell you that at a certain level, I think not finding something that is there is every law enforcer's, every cop's, every investigator's worse nightmare.

Chairman DODD. I understand that.

Ms. THOMSEN. We want to find them all.

Chairman DODD. But the SEC had done examinations. Isn't one of the simpler questions you might ask "Who is your auditor? Who does your auditing?" Would that be sort of a preliminary question?

Ms. THOMSEN. It is often a question.

Chairman DODD. And if you discovered it was three people in a room in New Jersey, one of which is a secretary, the other one does not do audits, I mean, would that jump out at you?

Ms. THOMSEN. In an investigation as opposed to an examination, we would certainly eventually look at, in most investigations, the role of the auditor. It depends on the investigative path you take whether or not that in and of itself is compelling. I do not know and I cannot talk about what was known about the particular circumstances here. But certainly red flags—we see red flags and we pursue red flags. Red flags do not necessarily mean that there is a fraud, and that is what we need to establish.

Chairman DODD. Well, we certainly know that the accounting firm was not registered with the PCAOB, and that is for sure. I wonder if you might—just a question quickly. Do you support not exempting nonpublic broker-dealers such as Madoff from being audited by an accounting firm that is not registered with the PCAOB?

Ms. THOMSEN. As an enforcement type, I support all efforts to put road blocks in the way, and speed bumps. One of the things I think is worth mentioning here is as we talk about Ponzi schemes, many Ponzi schemes are perpetrated by individuals and firms that have no registration whatsoever, so there is no examination speed bump along the way. In the last 2 years, we have brought 70 actions involving Ponzi schemes, 70-ish, and a little less than half of them have involved emergency actions where we have tried to stop something that is ongoing and to freeze assets to get back to people.

They are terrible schemes, and they harm investors, and when investors lose their life savings, whether it is $10,000 or $10 million, it is always a tragedy.

Chairman DODD. So may I interpret from that that you would support extending Sarbanes-Oxley accounting requirements to these kinds of firms?

Ms. THOMSEN. I personally would.

Chairman DODD. Thank you very much.

Senator Johanns, and let me say, Senator Shelby—the Appropriations Committee, the full Committee, is meeting to mark up the stimulus package, and he is a senior Member of that Committee and, therefore, could not stay, but he has asked me to submit a series of written questions he has for the panel, and I would ask you to respond to them at your earliest convenience, if you could.

Ms. THOMSEN. Of course.

Chairman DODD. Senator Johanns.

Senator JOHANNS. Mr. Chairman, thank you.

I must admit I sit here in amazement at what you are saying. Again, having been a Cabinet member, if somebody dropped a report on my desk or in my inbox this thorough, this complete, asking for an investigation, and it was titled "The World's Largest Meat Packer Is a Fraud," holy smokes. I mean, I would have the Inspector General in my office. I would have my General Counsel in the office. These allegations are huge, and I suspect they were treated that way.

Now, I do not want to interfere with an investigation. I have been around investigations enough to know you do not do that. You let the legal people do their thing. But I would like to know who saw this report and what action they took in response to seeing it.

You know, did the top person say to the Inspector General, "Holy smokes, this looks very, very serious. I want a no-hold-barred investigation"? And did the Inspector General engage? I want to know did the General Counsel engage. And I think I can know those things as a Member of this Committee without interfering in an investigation. I am not asking for anything. Is it possible for you to literally trace for us who touched this, who looked at it, what direction they gave in response to this document?

Ms. THOMSEN. That is precisely what the SEC's Inspector General is doing. That is another ongoing investigation, and that, as I understand it, is his mandate and what he is undertaking as to what—and, otherwise, I really cannot speak about it because of the issues with the criminal investigation, and others.

And let me just say in that regard, without saying much more, among other things, just to demonstrate how very seriously we take it, some of the conduct in the prior investigation may itself have amounted to crimes, such as 1001 violations or perjury, and we want to be sure to preserve the integrity of any criminal investigation.

So I do understand the Inspector General is looking into precisely the questions you are asking, Senator, and will be delving into all of those details.

Senator JOHANNS. That is good. It is good they have engaged now. That is positive. In a whole host of negative things, that is a positive thing. But I guess what I am interested in is did they engage way back. This was first reported to the Boston office in May 1999. This was reduced to writing and dated November 7, 2005. This gentlemen is a persistent guy. I mean, it is like he is knocking on the door of the regulatory people and, you know, it perplexes me that if it was reported to Boston, this kind of serious allegation, in May 1999 and he feels the need to follow up nearly 5, 6 years later, what happened in the interim?

Ms. THOMSEN. And, again, that is precisely—those are the topics that the SEC's Inspector General is pursuing.

Senator JOHANNS. Let me ask you this, just for the reassurance of all of the investors out there, like the nurse in the doctor's office and the doctors, *et cetera.* If this is the course of conduct over a period of time with the SEC and whoever else is involved in this, how can you ensure to me and to investors out there that the light bulb is finally on and you are paying attention, that they are being protected today by your works?

Ms. THOMSEN. Sir, we are passionate about our work. We do it—people come to the SEC to do nothing other than enforce the law. As I said, those of us in the Enforcement Division want to bring cases. We want to stop fraudsters. We want to get every Ponzi schemer, every market manipulator, every insider trader. To us, they are nothing more than thieves and crooks and cheats and that is our mission. That is our passion.

It is a sad truth that sometimes they get away with things for some period of time. I hate that. We all hate it and we are working as we have outlined to constantly improve our processes so that we can find more frauds and find them sooner.

Senator JOHANNS. This gentleman, on page 15, he has a section here in his request for an investigation that says, "Potential fallout if Bernie Madoff turns out to be a Ponzi scheme." It seems kind of prophetic figuring that this was written a few years ahead of when it was all figured out. But he lists these ten things that he thinks will happen if, in fact, this is a Ponzi scheme. How much of that has come true?

Ms. THOMSEN. Again, because of the ongoing investigation, I cannot respond specifically to anything that is part of the past investigation. I can say, as we all have, that any time any fraud goes on, market confidence is affected. If it is a little fraud, it may only be as to the one or two investors who are affected. But I think every fraud affects not only the confidence, for example, of the individuals involved, but the confidence across the board. I think fraud does terrible things to the market and market confidence.

Senator JOHANNS. Here is what I would offer, and I see my time is running out and I don't want to extend beyond the time, but I understand the investigations. But here is what I would tell you. As a very, very junior Member of this Committee, I am going to pay very close attention to this investigation and there will be a day where the investigation is done where I will ask these questions again. Who knew? When did they know it? What action did they take? What was the result of that action? And who should be accountable to that?

Again, having been in one of these positions where I sat where you did on some very uncomfortable days, if you made a mistake, you have to step up or we don't know how to fix it. We don't know what the right solution is. We don't know if it is a human problem, where somebody just dropped the ball, or we need to regulate more, because ultimately, the cost of this does go back to the people who make the investment. We want to make sure we do that right.

So I guess what I would say to you, just to alert you, is I will accept your answer today that you don't want to interfere with investigations. I don't, either. But I don't intend to forget about this, either, because there will be a day where the investigation is over and I will need to know what happened.

Ms. THOMSEN. We welcome that inquiry and we don't intend to forget about it, either. Thank you, Senator.

Senator JOHANNS. Thank you, Mr. Chairman.

Chairman DODD. Very good, Senator. Thank you very, very much.

Senator Bennet.

Senator BENNET. Thank you, Mr. Chairman.

I just have one question, and I don't know if it is Ms. Thomsen or Ms. Richards who is the right person to answer it, but the resource constraints that you mentioned in your testimony, I am sure are very real, and I am sure also will persist for a very long time no matter what we do, just based on the volume of complaints that you get. I wondered as a general matter how you prioritize the complaints that come in. What kinds of things do you look at, characteristics of the firms?

The Chairman mentioned the three people in New Jersey doing the auditing. I mean, is there a list of things and characteristics that you look at to decide what rises to the top of the pile and what can wait until later, and has this case in any way changed the way you are thinking about approaching the complaints that are coming in right now, because none of us, and I am sure you know that we can't wait to respond to this particular case.

You mentioned, for example, the fact that, I think, there were 1,000 registered investment advisors that don't have an independent custodian. Is that a characteristic that you look at when a complaint comes in? So how do you set these priorities?

Ms. THOMSEN. Why don't I start a little on complaints and then perhaps Ms. Richards could talk a little bit about examinations, because there are risk factors that present themselves other than through the complaint process.

But in the complaint process, and I have outlined this in a little more detail than I spoke earlier in my written testimony, which I forgot to ask be submitted for the record, but I hope it will be, we have a variety of complaints, as I say, hundreds of thousands every year. So obviously we have to try to find the ones that are the most fruitful to pursue. We look at things like the gravity of the allegations. The more serious the conduct that is alleged, the more likely it is to get more scrutiny. The more specific the information that is provided in a complaint, the more likely it is to be pursued.

We look for things like whether or not it is in our jurisdiction, for example. The fact that we—take people who complain to us don't necessarily understand what we have jurisdiction over, so we have to sort out things where we might not have jurisdiction.

We look for the source of the complaint. Is it, for example, someone who is having an argument with an ex-spouse, a frequent source, by the way, of tips about insider trading and some of them actually turn out to be quite fruitful. So we look for bias on the part of the complainant. So all of those factors get taken into account.

If a tip or a complaint is about in a specific arena, so it is an accounting kind of complaint, for example, we try to get our Chief Accountant's Office looking at it to see whether there is—we bring expertise, if you will, to the complaint.

We have also tried in some ways to reach out for leads. Despite the fact that we get hundreds of thousands of complaints unsolicited, we have developed systems to review suspicious activity reports, for example, because we think they oftentimes can contain relatively fruitful information that we should be pursuing.

So it is all those factors. It is judgment, you know, informed by experience, and we try to—and we also actually, excuse me, we try to see whether we are getting multiple complaints about the same issue or entity, which is another way to suggest that this complaint has a little more credibility than another.

And then I think it is fair to say that when we are deciding whether to do further investigation beyond the face of any complaint, we err on the side of doing more, but that is not an on/off switch. It is a decision you make every day. So you may, for example, in an insider trading case where you get a complaint, you might go and look at trading records or activities on the days in question and then you decide whether you go further than that. So those are decisions you make all along the way that tip—or a lead is just that, a lead, a beginning.

Senator BENNET. If I could just ask—thank you for the answer. I am more concerned with whether or not there is a set of priorities that relate to the characteristics of the firm itself. I mean, obviously, you think about credibility of witnesses, you think about personal relationships, but Professor Coffee talked about some things that would be considered best practices even though they are not called for by the current regulatory apparatus or by statute.

So do the people that are your investigators have a rubric of some kind that says, here are characteristics of firms that we think probably are operating well and fairly on behalf of their investors? Here are some characteristics where we worry more that there may be something going on.

Ms. THOMSEN. Absolutely, and on that, I am going to defer to my colleague, Lori Richards, who runs the examination program.

Ms. RICHARDS. We have exactly that kind of analysis and it is based—we do a couple of different kinds of analyses, but I think the one that most directly applies to your question is we do a risk assessment of every registered investment advisor, 11,300, and we do it four times a year and it is based on the information in their filings with us. So right off the bat, there is a limitation, because it is based on what they tell us.

But in that analysis of their filings, one of the factors that we look at is whether they have custody, whether they themselves have custody of customer assets. That is one of the risk factors that we look at, and as I said, I think there are toward 1,000 investment advisors that have that risk characteristic.

The other kinds of risk characteristics that we look at are how is the investment advisor paid? Is he paid based on performance fees, for example, which may give him an incentive to inflate his performance or take risks with respect to the investments on behalf of clients in order to pump up his own fees? Does he have a disciplinary history? Is he a recidivist, such that there may be more of a risk that he or she could engage in additional misconduct?

So we use all the data that is available to us in Form ADV to do that risk assessment. Now, one of the things that we believe very strongly is that we should pull in additional types of data and information and that—like intelligence agencies, if you think about it—or any organization that receives disparate types of information from multiple sources, from investors, from the media, from filings, from enforcement investigations, from examinations, a variety of types, of sources of information come into the agency.

What we really believe is necessary is that we need to be able to harness all that information so that we are not just relying on the self-reported information by an investment advisor. We would have all information at an analyst's fingertips and we could make better risk assessments. So that is absolutely on top of our list.

Then the other question about individual complaints and tips and press reports, we have a very active program of doing cause examinations. If we get a complaint or a tip or read an article in the paper that implicates possible violations of the law involving a registered firm that is in our jurisdiction, we prioritize that and send examiners in as soon as possible. Those examinations take up about 25 percent of our time.

So I hope that answers your question. We are very much thinking about the risk characteristics that existed with respect to this particular firm and more broadly looking at ways that we can harness information to do a better job of assessing risk.

Senator BENNET. Thank you. Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator.

Before I turn to Senator Warner, clearly, you need to reevaluate the risk assessment. If we missed Madoff, it seems to me we have got to go back and revisit that whole model, don't you agree?

Ms. RICHARDS. I agree that the risk assessment is critical and I believe that we can get a better quality risk assessment by getting better quality information to the SEC staff to do a better job at risk assessment, because as I said in response to the last question, if we are only relying on self-reported information from investment advisors, in some instances, it is going to be reliable, and in other instances, it is subject to fabrication and lies.

Chairman DODD. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman.

I want to continue this line because Senator Bennet raised exactly where I was headed, too. You have got protocols. You have got to have some kind of checklist you go down, and while it may not be appropriate to micro-manage down to this level, I think you hear the Committee's enormous concern and frustration with how this enormous fraud went undetected for so long.

So I would ask perhaps, Mr. Chairman, if we could get this list of their protocols and their checklists submitted to the Committee at some point so we could at least take a look at it. And clearly, as the Chairman said, and my question is going to be, do you think that risk assessment works, your current process? My sense is it clearly didn't in this case.

You made, Ms. Richards, in some of your earlier comments, you raised the question of, for example, independent custodian, looking forward to studying that, and you raised the question about whether we should have certified auditors. But in this Madoff case, wouldn't the fact that there was not an independent custodian, the fact that there wasn't a certified auditor, have on your current risk assessment process bumped this up higher so that it would have gotten a little deeper looking?

Ms. RICHARDS. That is an excellent question and we are certainly going back and looking at this particular firm and at our risk assessment methodologies. I can't talk about this particular firm. I can say, however, that the risk assessment methodology—

Senator WARNER. You can't tell us whether, if you have got two red flags of a nonindependent custodian and a noncertified accountant, in any firm's case would be enough indication that this is something we need to dig into?

Ms. RICHARDS. I would be happy to share with you the factors that we look at in Form ADV. Whether the firm uses an affiliated custodian is one of the items. The identity of the accountants is not, and so that clearly is an item that I believe and——

Senator WARNER. What about—let us go to a couple of other areas. What about the fee structure? I mean, Mr. Madoff—as an investment advisory, I have been involved in this field for some time. It is rare to see an investment advisor who isn't going to charge a management fee and take a little percentage of the ups. Mr. Madoff represented that he was simply doing this—going to gain all his fees simply on execution of the trades. Isn't that in and of itself another red flag that should have said, hey, is this guy doing this all out of the his good heartedness?

Ms. RICHARDS. I can't speak about the particular Madoff filing, that how the——

Senator WARNER. Is the fee structure one of those factors?

Ms. RICHARDS. It is a risk factor.

Senator WARNER. Is the fee structure——

Ms. RICHARDS. Yes, Senator.

Senator WARNER. ——one of those factors?

Ms. RICHARDS. Yes, Senator.

Senator WARNER. What about the question of the actual performance of the fund? I mean, one of the things that is so stunning and perhaps should have been a red flag actually to investors, as well, in terms of the buyer beware, the fact that Mr. Madoff through up and down times had such absolutely consistent returns has to be an extraordinary outlier if you do any type of review of performance. Is performance of funds one of the criteria you look at?

Ms. RICHARDS. Many academics have said that presenting consistent returns over a period of time is indicative of something, and we certainly have read that academic literature. At the current time, hedge funds and investment advisors are not required to file with the SEC their performance returns so we don't have access to that data. We have recently relied on self-reported hedge fund performance returns to a private data base. So again, that data is not verified. We have no idea whether it is accurate or not. But we have used those private data sources in order to supplement our risk assessments and identify registered hedge fund advisors for examination. But we agree that performance returns can be very useful in identifying aberrations.

Senator WARNER. So currently, the risk assessment process does look at the independent status of the custodian or not——

Ms. RICHARDS. Yes.

Senator WARNER. ——does not look at whether the auditor is registered or certified or not, is that correct?

Ms. RICHARDS. Investment advisors are not required to submit the name of their——

Senator WARNER. It does look at the fee structure——

Ms. RICHARDS. Yes.

Senator WARNER. ——but does not look at performance?

Ms. RICHARDS. Yes, that is correct.

Senator WARNER. So two out of the four. If we had perhaps had all four of those as criteria, might that have led to a more thorough analysis, not just in this firm but in other firms?

Ms. RICHARDS. I so strongly believe that the risk assessment methodology has to be improved with better access, not just to this data, but I believe there are other types of data points, too, that would help us do better risk assessment.

I do want to say, however, that we don't believe that firms not identified as high-risk for our purposes present no risk. Every investment advisor can be engaged in fraud. So risk assessment is a first start. It helps us to prioritize our examination resources. But one of the fundamental questions, I think, is whether all investment advisors should be subject to some routine level, some minimal level of examination oversight, because risk assessment—risk assessment gives you a way to prioritize risk but it doesn't tell you the situations where there is risk that you have not identified. So it can help us, but it is not the be all and end all.

Senator WARNER. One of the questions, and I know that Senator Shelby and Senator Schumer have talked about additional resources, and I saw your numbers, 425 in terms of investment advisors and I believe 300-and-some in terms of broker dealers, clearly, there may be need for additional personnel. But in addition to additional personnel, obviously, the complexity of the markets has exponentially increased over the last decade.

As you look about additional resources, I would hope that continuing education and ongoing upgrading of the skills of your workforce, and sharing the Chairman's earlier comments, I know this is a dedicated agency with folks who really want to try to get the job done, but making sure that you stay abreast of what is going on in the markets and what are these new tools that as Wall Street continues to create new tools, is that part of your request or would that be part of your current——

Ms. RICHARDS. Yes, sir. I agree completely with everything you have said. When the agency received additional funding to pay examiners and other SEC staff at pay parity levels with other regulators, it really—thank you to this Committee for that—it really allowed us to hire and retain higher-qualified people and we need to continue to do that. In the examination program in particular, I really want us to hire quants, economists, and people who can analyze complex trading strategies and really help examiners really identify emerging risks——

Senator WARNER. And then to keep them current even after they have been hired, correct?

Ms. RICHARDS. Yes, and I would like us to improve our training programs. We have, I think, very good training programs, but I believe that we can work hard to improve them, to make sure that people are maintaining education and expertise.

Senator WARNER. Thank you.

Mr. Luparello, I have got a question on FINRA. I believe you mentioned this earlier, but I just want to make sure I understand. Let us assume that we have got the FINRA folks in looking at a broker dealer. They are trying to get documents. They are trying to go forward. It is my understanding under the current situation that if the head of that broker dealer said, hold it, you can't go to those documents because those are my investment advisory documents, you immediately stop.

Mr. LUPARELLO. Well, it gets complicated in a situation like the Madoff situation when it was a single legal entity. That usually comes up more in the context where the other business lines are in separate affiliates and we clearly get stopped.

Our ability to compel documents may take us a little bit of the way, but it will never allow us to go fully and investigate the parts of that single legal entity that are not the broker dealer parts of the entity. So in the advisory context, it gets complex because of the convergence between advisory business and brokerage business, which starts to look more and more——

Senator WARNER. But are you saying—because I hope you are not saying that if you have somebody in looking at a broker dealer and they thought they were onto something and they thought something smelled bad, and all of a sudden the CEO of the firm said, hold it, you can't go there because that is in our investment advisory part of our business, that even if you were legally precluded from going on, that you wouldn't come back and either relay that information to the SEC or someone. Tell me that is not the case.

Mr. LUPARELLO. You are absolutely correct. We will take——

Senator WARNER. So in this case, in the case of Madoff, my understanding was when he became an investment advisor, didn't he use the investment advisor reasoning as one way to preclude FINRA from looking——

Mr. LUPARELLO. Actually—I am sorry to interrupt, Senator.

Senator WARNER. No, go ahead.

Mr. LUPARELLO. He just fundamentally misrepresented the business to us. All of our examinations, including after 2006, the Form BD he filed after 2006 continued to represent no advisory business in the broker dealer, so——

Senator WARNER. And there was no—from your investigators, there was no skepticism about it? There was no red flag? They accepted that at face value?

Mr. LUPARELLO. There were no red flags presented to us and there were no indicia of any sort of customer activity in the books and records of——

Senator WARNER. But in the normal course, if there was that kind of bright line wall precluding you from investigating further because of the investment advisory component, that investigator might come back and say, hey, we need to turn this over to this SEC because this——

Mr. LUPARELLO. Absolutely. We often, in our examinations, investigations of broker dealers, take our jurisdiction as far as it can go, and then once we hit that jurisdictional dead end, refer that conduct over to the SEC. We do that hundreds of times a year in fraud cases and insider trading cases and other types of cases. Absolutely.

Senator WARNER. Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator. Very good questioning.

Senator Corker.

Senator CORKER. Chairman, thank you for having this hearing. We all have a lot of logistical things that we are dealing with. I came back to this hearing in large part just to pay respect for those of you who testified and for putting a human face on this tragedy, especially, Dr. Backe, listening to your testimony and knowing of the many issues that that has presented within your firm, and I know that has happened all across America. I am most appreciative.

I do want to follow up with Senator Warner's questioning about the actual FINRA-type examinations. I think most of us felt that for years when credit rating agencies gave credit ratings, they actually were doing something. I think we realized that they were taking the information that was given to them by others and just saying whether it was OK or not. There were actually no audits, no real accounting, and I know they were not hired to do that, but certainly a lot of faith was put into that process where really faith was not due.

In FINRA, in your examination, do you all actually ping back, and when you said that he presented numbers to you that you didn't see any discrepancies in, do you all actually check accounts, do things that would give you the opportunity, far beyond credit rating agencies, to know that there is a problem or not?

Mr. LUPARELLO. Absolutely, Senator. We don't rely simply on the information that they provide to us when we do our examinations, and that is especially true when we are doing investigations. We attempt to probe past just the books and records of the broker dealer.

Again, in the Madoff context, in our history of doing examinations, the firm always represented itself to us as a wholesale market making firm without customer accounts, and again, we were never the recipients of any sort of red flags in terms of whistleblower complaints or customer complaints that led us to have skepticism about that. Had we had skepticism about that, we would have pushed back a little farther.

Senator CORKER. You know, just for what it is worth, as a layman sitting here, that seems hard to digest, and just for what it is worth, I thought Professor Coffee's two comments that he made about the accounting firm's exemptive issue there and just all firms having custodial accounts were no-brainers. I mean, it is just almost something that you would expect would be happening.

I know that most people around our country look at the banking institutions and they are concerned about whether they have deposit insurance. I know candidly myself, a year ago, I began making sure that whatever I had was insured. And yet you look at $11 million worth of investment, rising to $33 million in value, and you realize that there are huge issues here as it relates to making sure that the right things are happening. It seems like we focus more, Mr. Chairman, sometimes on the actual financial institutions, and yet in these cases there is far more risk.

So I would just say in general, again, coming back just to say that this seems to me to be an issue that a lot of work needs to be done on, certainly at a minimum having custodial accounts so that the actual investment advisor is not touching the money. I know that I received numbers of e-mails from around the country from people assuring me that that was the case in their particular case. The SEC, I know that the two of you who have come to testify today probably are not directly involved in deciding some of the things that occurred with this particular case, but it does seem to me that huge amounts more in investment needs to take place to make sure that the public is protected.

I don't know if that has been requested. I certainly hope that the new Chair, Ms. Schapiro, who was just approved, will come forth with intelligent askings in that regard, and I just want to say to all of you, I think the comments that were made on the front end about the public, not only are people directly affected, people that I am sure you have watched their families grow up and worked with them and I am sure you feel a sense of personal responsibility for what has occurred regardless of whether that is the case. You know these people.

In addition to that, our economy, our country is built on trust in investing. I think it is incumbent upon us to do everything possible, especially during this particular time, to ensure that the public does feel that they can make investments and not put it in a mattress someplace because they feel that is the only safe place it can be.

So with that, Mr. Chairman, not wanting to be redundant with some of the other questioning that has taken place, I thank you for the hearing. I look forward to working with you and others to ensure that we do everything possible to—I know things are going to happen in the future, and we all know that, but to make sure that we have done everything possible to ensure that it doesn't.

Chairman DODD. Thank you, Senator, very, very much. I appreciate that.

Senator Merkley.

Senator MERKLEY. Hi, Ms. Richards. In your comments, if I understood them correctly, you noted that the Enforcement Division receives hundreds of thousands of tips, that many of these tips involve arguments and language not dissimilar to the information that was provided in this document, "The World's Largest Hedge Fund is a Fraud." I have read this document. I find it is an extraordinary document. I can't imagine that you receive more than a very occasional document of this magnitude. Am I correct in my impression that this type of extensive quantitative analysis, rigorous inspection of firms, is a very, very unusual type of document for you all to receive?

Ms. THOMSEN. I think I will take that because it was actually me that talked about the complaints that come to the Enforcement Division, and on a scale of—leaving aside anything in particular related to Mr. Madoff for the reasons I have previously discussed, a large—a long complaint with many exhibits and particular information is more rare than, say, an e-mail complaint. An e-mail complaint, we get hundreds, indeed some days thousands of those. So at a certain level, it is longer, more detailed.

When we get it, we—but we do get many of them, and when we get them, we don't know unless and until we examine whether they are——

Senator MERKLEY. Let me cut to the chase——

Ms. THOMSEN. Sure.

Senator MERKLEY. ——because I don't think we are quite getting there. A document like this, this type of reasoning, this type of expertise, 29 red flags listed, do you get one of these a year? Do you get 100 of these a year? Do you get 1,000 of these a year?

Ms. THOMSEN. I don't know the answer to that, but I can get back to you on that.

Senator MERKLEY. OK. This document in which this individual says that he presented this information in May 1999. He is now writing in November 2005. He says, "I have spoken to the heads of various Wall Street equity derivative trading desks and every single one of the senior managers I spoke with told me that Bernie Madoff was a fraud." He goes on to say, "I have outlined in this document a detailed set of red flags that make me very suspicious that the returns aren't real, or if they are real, that they involve front-running customer order flow." He goes on to say that, "I am very concerned about the personal safety of myself and my family as a result of this report" and asking it not to be shared with anyone. He goes on to say that he is putting this forward in a situation where he should probably just not put his head up and speak out, but because he considers this a serious issue of public interest.

He lays out 29 arguments, each one very carefully supported, involving a whole series of circumstances that could just not be the case. Now, I would expect a document like this, you would have analysts, quantitative analysts who understand the complex mathematical arguments he is making about why the returns couldn't be real, why you wouldn't organize a firm that would forego 4 percent revenues on a massive amount of investments, is there a document that you all have in which your team went through this and said, no, this is not real. This 29 arguments can be explained. Was this carefully evaluated by the SEC?

Ms. THOMSEN. Again, Senator, I know that this is frustrating to many, including myself, I cannot discuss what happened in connection to this particular complaint or the investigation.

Senator MERKLEY. Let me speak more broadly.

Ms. THOMSEN. Sure.

Senator MERKLEY. Do you have any concern that detailed complaints involving massive amounts of money are not getting the sort of rigorous examination that they need in order to make sure that our securities trading system has a high level of integrity?

Ms. THOMSEN. I have enormous concern that we have so much information that we have to find the right ways to mine it, to get to the highest priority investigations, the ones that present the greatest amount of risk, and that is what we have all been talking about. Regardless of whether we have a—we could get a long complaint that includes all kinds of information and it is all wrong. We could get a short complaint from someone who appears to be sort of not exactly coherent and it could be dead on. So finding ways to mine all the information we get and extract from it those leads that we can file with our resources is something that we are acutely focused on.

We have recently formed a working group focusing on risk, and we are worrying about how we handle complaints to extract information. It is always the case that if you pull one complaint out of 100,000, regardless of what happens—but I understand your point. We are trying extremely hard——

Senator MERKLEY. Let me move on to another area, if I could.

Ms. THOMSEN. Sure. Of course.

Senator MERKLEY. I just came from a hearing involving health care and the conversations about prevention and how much dollar-for-dollar that that is smarter than curing disease after it happens. I think much the same applies in terms of preventing fraud. Rather than incorporating whether or not people have independent audits into a risk assessment model, why not absolutely require firms that are managing money and investments to have independent audits?

Ms. THOMSEN. I think I will defer to the examination side on this one.

Ms. RICHARDS. That is an excellent idea. We would much rather be in a prevention mode than in a detection and clean-up mode after the fraud has already occurred. So I know that prevention is going to be foremost in the minds of the Commission and the new

Commission Chair when we start to evaluate whether these regulatory fixes could be implemented.

Senator MERKLEY. Is it your all's testimony here today that the SEC now adamantly supports, then, requirements for independent audits?

Ms. RICHARDS. No, sir. I am not testifying on behalf of the Commission. I am testifying on behalf of myself. But as an examiner, I know the value of independent audits.

Senator MERKLEY. Ms. Thomsen, does the SEC have a position on this?

Ms. THOMSEN. Like Ms. Richards, I am testifying for myself. I will say that as an enforcement type, the more regulatory requirements there are along the way, as you suggest, help prevent things and it makes—it is better for investors. And so to the extent—every fraud prevented is a victory in my book.

Senator MERKLEY. I am puzzled why on this you can't answer for the SEC or have someone from the SEC provide us with that information, but let me ask a similar question, then. Would it make sense in your personal perspectives, based on the experience that you all have had, that the SEC require independent custodians rather than simply incorporating whether or not independent custodians exist into a risk model?

Ms. THOMSEN. In my personal opinion, yes.

Ms. RICHARDS. Yes, I agree.

Senator MERKLEY. Mr. Chair, thank you.

Chairman DODD. Thank you, Senator, very, very much.

Senator MERKLEY. Oh, I have 12 seconds. Can I ask one more question?

Chairman DODD. Certainly. Time is up.

[Laughter.]

Chairman DODD. No, go ahead.

Senator MERKLEY. I will try to be very quick. Dr. Backe, I appreciated your testimony. You made the point that right now, the investments, the accounts of the people who work with you are being treated as a single pool and only insured once for $500,000, not insured as individual accounts. I believe this question would go to Mr. Harbeck. Can you explain, is there a possibility that the individual investors in Dr. Backe's firm can be insured as individual investors?

Mr. HARBECK. In the ordinary run of the mill situation with a pension fund, where the pension fund manages the dollars and the pension fund itself gives instructions to the brokerage firm with respect to purchases and sales and redemptions, that fund is the customer. That has been the law in the Second Circuit since the mid-1990s, the case of *SEC v. Morgan Kennedy.* It has been litigated and that precedent has never been overturned.

401(k) plans may be different. Back in 1975, when that Morgan Kennedy case was decided, I don't believe if there were 401(k) plans, they were not widely spread and widely used. The Doctor mentioned that some of his people had attempted to use self-managed plans. If the brokerage firm recognized the individual and sent individual statements to the individual, that person might well be considered a customer under a 401(k) plan. But not having seen the orthopedic group's paperwork, I can't tell you as I sit here today whether it would fit under one category or the other.

Senator MERKLEY. I thank all of you for helping enlighten us on these issues, these very important issues. Thank you, Mr. Chair.

Chairman DODD. Thank you very much, and I have some questions regarding that, as well, when I get to the next round here, but I appreciate the Senator raising that issue. It is a very important one.

Senator Jack Reed is the Chairman of our Subcommittee on the Securities Industry and I appreciate his work over the years.

Senator REED. Thank you, Mr. Chairman, and thank you, ladies and gentlemen, for your testimony.

Ms. Thomsen, there could be a perception here that all of this activity by the SEC was rather passive, that the tips came in and you evaluated the tips. But with all these rumors swirling about, as described in this memorandum, was there any independent initiative by the SEC, or was there any information from an SEC official unrelated to these tips saying we have some suspicions?

Ms. THOMSEN. Again, leaving aside the Madoff situation for obvious reasons, tips and leads are just one source of investigation and cases for us. We do and have for the last several years engaged in trying to identify cases through a risk analysis which includes thinking about where there could be a problem and pursuing it on a systematic basis.

And in my written testimony, for example, I talk about a case we just recently brought about pension accounting and pension assumptions which was a case that we developed when we realized that, after the San Diego case, that there were issues with pensions, there might well be issues with pension assumptions, and we went through a process of identifying which firms might have the greatest exposure and then triaged that until we ultimately led to a successful enforcement case. That is a process we would like to do more of because it is more affirmative.

One of the things about enforcement, of course, that goes without saying is that we can't do anything until someone breaks the law. I would be very, very happy if they never did in terms of bringing an enforcement action, but whenever anyone breaks the law, we would like to be there as soon as possible, and one of the things we want to do is think affirmatively. So, among other things, we are looking forward to increased activity in the Office of Risk Assessment, as has been alluded to, because we would partner with them to identify things like that.

We also, leaving aside the tip process, we use, as I just alluded to, our investigations as sources of problems. That is, if we see a problem in a particular firm, we think about the industry as a whole, say it is a public company and it is a certain kind of industry. We will think about that industry. We will try to look for outliers. So those are the kinds of things we are trying to do in addition to, as you would say, reacting. We do need to react, obviously, but we also need to be thinking proactively to where the problems are and trying to get there.

Senator REED. I understand that you cannot comment specifically on this particular case, but the specificity of the memorandum, the repeated sort of repetition, at what level would the decision be made to disregard or not to initiate an enforcement action?

Ms. THOMSEN. Again, I really can't talk specifically about the particulars with respect to this particular complaint. I can say that the supervisory structure and the decisionmaking process generally in enforcement is built around relatively small groups of investigators, an investigative attorney who usually comes to the SEC with some experience, a branch chief who typically has years of experience within the agency, and then an assistant director. These groups, these assistant director groups, if you will, relatively speaking, small——

Senator REED. May I just cut to the——

Ms. THOMSEN. Oh, sorry. Of course.

Senator REED. ——using Senator Merkley's comment, the chase. Would an issue of this magnitude or this repetition or this seriousness be brought to the attention of individual Commissioners or the Commission?

Ms. THOMSEN. Oh, the matters that come to the Commission from the enforcement staff fundamentally fall into two categories. One, when we initiate a formal investigation, we go to the Commission for authority to get subpoena power to initiate a formal investigation. The next time enforcement matters typically come to the Commission are when we recommend enforcement action.

Senator REED. So would a matter like this go to the Commission in any one of those capacities?

Ms. THOMSEN. A matter that is—without specificity to this particular matter, a matter that is not pursued, closed for whatever reason——

Senator REED. Let me ask it another way——

Ms. THOMSEN. ——typically does not go to the Commission.

Senator REED. If you are seeking subpoena power to investigate a matter like this, but not this matter——

Ms. THOMSEN. Yes, sir?

Senator REED. ——it would go to the Commission?

Ms. THOMSEN. If we are seeking subpoena power, we would——

Senator REED. If you are seeking to continue the investigation——

Ms. THOMSEN. We would go——

Senator REED. ——which obviously in this case you would presume you would need subpoena power, because I don't think Mr. Madoff or anyone like him would be willing to give you records, you would have to go to the Commission.

Ms. THOMSEN. If we seek subpoena power, we would go to the Commission.

Chairman DODD. Does it require their approval?

Senator REED. Pardon?

Chairman DODD. Does it require their approval?

Senator REED. Would it require their approval, then, or disapproval?

Ms. THOMSEN. For us to get subpoena power, we need the permission of the Commission, yes sir.

Senator REED. Thank you.

Ms. THOMSEN. We may also—I don't want to leave a misunderstanding.

Senator REED. Go ahead.

Ms. THOMSEN. We are able to investigate oftentimes quite far without subpoena power.

Senator REED. Professor Coffee, I am interested in the role of the feeder funds, because an impression that might be right or wrong, but that some people didn't realize they were investing with Mr. Madoff. They thought they were investing with other entities, which presumably are regulated by the SEC. So there are two issues here. One is the involvement of the SEC with these feeder funds, and second, just the fiduciary obligations of these funds to ensure that their investments are being applied.

Mr. COFFEE. That is a very legitimate concern. I think that is a very legitimate concern. A number of actions have been filed, including by distinguished universities like NYU and Yeshiva, against some of these feeder funds on the grounds that there were material misstatements and material omissions. What I would direct to this Committee's attention is there is at least one decision in the Southern District of New York that says even misstatements about whether you were diversifying or conducting diligence are never actionable under the Federal securities law. This is the *South Cherry Street LLC v. Hennessey Group* decision that is getting a lot of attention in New York because this is the subject of a great deal of pending litigation.

So there could be a point at which this Committee might want to look and make sure that the feeder funds are actually subject to the anti-fraud rules, because some of these decisions seem to suggest that statements about diversification or due diligence are not actionable as securities fraud, and I think that would be the wrong result.

But I think you are quite correct that this is the next area for these investigations to go. What did the feeder fund do? And the most alarming possibility, which no one here can comment on, is that we will find at some point that Madoff or his employees were making some kind of payments under the table to feeder funds, because that could explain why they took all of their funds and invested in him, and his whole business model as a broker dealer was based upon paying for order flow.

So there is going to be an interesting concern for investigators on whether there were ever payments made to get feeder funds to invest in his fund. In his last year or two, he had to be desperate because it was collapsing around him, and I would suspect that it would have not been beyond him to pay the feeder funds under the table, because for decades, he had paid brokers to direct order flow to him and the two are not that functionally different.

Senator REED. May I ask one follow-up question to either Ms. Richards or Ms. Thomsen, and that is do you in your information gathering, and you have described in quite detail what you look at, and again, you are getting information that is limited to self-disclosure, do you in any way treat a feeder fund different than this purported investment advisor, in the sense that one is simply collecting money and giving it to someone making decisions about investments whereas the other entity supposedly is actually making decisions about where the money goes? Is there any difference, or are they all the same, as investment advisors?

Ms. RICHARDS. If it is a registered investment advisor, it would be subject to our examinations. Again, we can only examine, routinely, 10 percent of registered advisors.

Senator REED. Yes.

Ms. RICHARDS. I don't know that all—I don't know the extent of feeder funds that are not registered with the SEC, but to the extent they are registered with the SEC, they would be subject to routine examinations of, as I say, 10 percent, as well as cause exams or sweep exams.

Senator REED. Mr. Chairman, my time has expired. Thank you very much, ladies and gentlemen.

Chairman DODD. Did someone else want to comment? Were you going to make a comment?

Senator REED. Oh, excuse me. I don't want to cutoff a comment.

Ms. THOMSEN. No, but I would say that from an enforcement perspective, feeder fund or not, we are going to look at the facts and evidence of their behavior and the laws that apply to it. So there is no distinction other than the distinction as to their conduct.

Senator REED. Thank you very much. Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator.

Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman DODD. Good job, Jack.

Senator MENENDEZ. I am especially troubled by the sheer magnitude of the warnings the SEC received in the Madoff case and either neglected to look into it or just scratched the surface and called it a day. Specific allegations were brought to the attention of the staff as early as 1999. But even after regulators conducted eight investigations over 16 years, virtually nothing was done.

And so let me ask you, when your 2005 investigation revealed that Mr. Madoff misled the SEC about the strategy he used for customer accounts, withheld information about the accounts, violated SEC rules by operating as an unregistered investment advisor, didn't you think it was appropriate to use your subpoena power to collect information rather than just rely on Mr. Madoff's voluntary responses and submissions?

Ms. THOMSEN. Senator, as I have said, I cannot talk about the particulars of this investigation——

Senator MENENDEZ. Well, that is not satisfactory, so let me just change the question for you. You have a case, any case, and that case ultimately reveals to you that an individual creates a strategy that misled you about the way in which they used their customer accounts, that they withheld information from the accounts, that they violated SEC rules by operating as an unregistered investment advisor. In such a set of circumstances, regardless of who it was, wouldn't that say to you that, in fact, you should use your subpoena power to collect information rather than just accept voluntary submissions?

Ms. THOMSEN. If I may, sir, let me talk about when we use—when we get subpoena power versus not getting subpoena power because that may—without reference to particular items. We can investigate and do often investigate without subpoena power. Indeed, we bring actions. We go to the Commission and recommend action be brought when we have never had subpoena power. Some, we collect information. We can take testimony without subpoenas. We can get information from not only the persons and entities we are focused on, but from others. That is especially true in the regulated entity arena where the businesses feel that they need to give us the records in all events so they do it without need of subpoena. When people provide information to us, they are—regardless of whether they have a subpoena, they can be subject to 1001 criminal prosecution if they provide false information.

So whether or not we seek a subpoena, it really depends on whether or not we need to have a subpoena to obtain certain kinds of records. Phone records, for example, we can never get without a subpoena. So those are decisions we make along the way.

In terms of the information that we seek and the roads we go down, we go down roads until, in the best judgment of the investigator, it doesn't make any sense to continue, and we are never stopped by the fact that we need to get a subpoena. Getting——

Senator MENENDEZ. Well, I appreciate your answer telling me all the things you could do. What I am concerned is about what you do when there are a series of circumstances presented to you, not what you could do. The reality is, why would someone hide all of this information if it isn't for the reasons of fraud? Why would that not, in fact, instigate you to go much further?

Ms. THOMSEN. Again, if we think that there is fraud going on, we will continue. And while I cannot talk about the specifics of this particular case, we don't turn a blind eye to fraud. If we see it, if we suspect it, we pursue it. We don't want fraudsters out there. It is our job to find them and——

Senator MENENDEZ. So Mr. Madoff was smarter than all of you?

Ms. THOMSEN. Again, I can't comment on what we did or why we did it.

Senator MENENDEZ. Well, I have a real problem, Mr. Chairman. I understand the specifics of the case, but if I can't get even general answers to processes, how does one pursue a process so that we understand when the Commission is using its powers effectively and when it is not using its power effectively?

I appreciate the broad statement that we don't let fraud go on, but gosh, the bottom line is you had a series of warning signs. You had an investigation. You had all the elements of why someone would, in fact, pursue it just for the purposes of fraud and that didn't generate anything. I don't get a sense that, in fact, you can give me what is your process to ensure that circumstances like this don't happen prospectively.

Ms. THOMSEN. Well, Senator, let me say this, that the Inspector General has the same concerns that you have, as we all do, to find out precisely what happened here, what steps were taken, and what decisions were made, and he is pursuing that with vigor and we are not getting in the way of that investigation.

Senator MENENDEZ. Dr. Coffee, let me ask you a question. Several of Mr. Madoff's family members worked for agencies responsible for regulating Mr. Madoff's firm. It seems to me that it might be simple human nature that people would not be as quick to investigate and punish one of their own if, in fact, they were family members versus being complete strangers. Do you think that this is an area of concern that we should be looking at?

Mr. COFFEE. I think that there are others within Madoff Securities that have to bear responsibility, and we have already heard from FINRA that they were never told about this investment advisory business. I would think the Chief Compliance Officer of Madoff Securities, who happens to be the brother of Bernie Madoff, has a lot to answer for in terms of whether he defrauded the SEC or FINRA in making false statements about the nonexistence of investment advisory clients or the failure to disclose what was the business they were actually doing. So I think there were many possible areas where there could have been false statements made to government agencies or to FINRA that are within the scope of Federal criminal law.

Senator MENENDEZ. And finally, Dr. Backe, let me ask you, you are one of the direct victims of the scheme. There are several from my home State of New Jersey that unfortunately face the same set of circumstances. While I know we don't focus on taxation issues in this Committee, it seems to me that one of the areas is that you all paid estimated taxes based on some phantom interest income, because you obviously were never really actually having your monies invested and having interest income which Mr. Madoff claimed that you did have. Have you received any guidance from the IRS or any other Federal agency about the possibility of being able to get back some of that money?

Mr. BACKE. Well, our situation is a little different because this was a pension fund, so it never was taxable income, and there lies our problem, because our experts and our consultants tell us that we are therefore not allowed to claim a theft loss. The company already took the deduction for the contribution for 2008, 2007, and 2006, so we can't make another contribution. We asked our accountants and asked them to ask other accountants if we could at least refund 2008, because basically the money never got invested. Actually, none of the money ever got invested all along.

So we are in a bind because there is a lot of controversy out there whether or not a theft loss is applicable to pension funds. We also know that Madoff's records were in disarray, and we being a 401(k), we don't know whether the rules that SIPC uses really apply to our entity and we do not know where to turn, and that is one of the reasons I am here, to see if the government can step in and SIPC can step up and tell us, give us direction, what should we do? Thank you.

Senator MENENDEZ. Mr. Chairman, I hope we can, whether working with the Finance Committee or whomever, look at this question of phantom interest. It seems to me that it might very well be worthy of the IRS having a special unit to assist those people who were victims here who were paying what they ostensibly thought were clearly taxes that they owed and obviously they didn't owe, and the question is how to give some relief to some of these individuals along the way. It would be something, I think, worthy of pursuing and I appreciate——

Chairman DODD. My colleague, why don't you draft a letter for us to sign together with you to the Finance Committee and the IRS raising those issues and questions and asking for some responses. I would be glad to cosponsor with you.

Senator MENENDEZ. I am happy to do so.

Chairman DODD. I thank you, Senator, very much for your questions and reflecting. And just repeating again from earlier, I agree. I appreciate the SEC's willingness, and FINRA, to report to this Committee every 3 months on the recommendations you are going to be making regarding not just this fact situation, we intend obviously at the completion of the investigation to be fully informed as to how that was conducted and what the results were, and I appreciate the fact that even at this juncture, the SEC is sharing with the Committee some of the documentation so we have an ongoing appreciation of what is occurring, but also the recommendations as to how we avoid these kinds of schemes, which have been going on, as Professor Coffee points out, for a long, long time. I think his initial comments here were revealing in many ways, that the magnitude of this and the length of this may be unique, but the problem itself is an ongoing one and so we need to address that issue.

I want to address the SIPC benefits issue that was raised by Senator Merkley but is important. I went back and looked, Mr. Harbeck. SIPC Chairman Armando Bucelo, at his confirmation hearing in May of 2006, testified, and I will quote him, he said, "Our board is committed to maintaining adequate resources to fulfill SIPC's statutory mission. SIPC's fund now stands at well over $1.3 billion, a historic high. As Chairman, I have initiated a broad level investment committee to make sure SIPC continues to be prudent in management of the fund, that no taxpayer funds—I repeat, no taxpayer funds—have ever been used in the SIPC program and the board continually monitors the adequacy of SIPC funding."

So over the years, we have had confirmation hearings here. The question has been raised about whether or not additional funds were necessary. You indicated this morning in your testimony that you felt more funds were going to be necessary.

Mr. HARBECK. Senator, we have done risk management analysis by outside consultants, and they informed us that the prospect of an event such as either Lehman Brothers or the Madoff failure would happen once in every 5,000 years. Two of them happened in the last calendar quarter of last year.

This is such an outlier in terms of the potential exposure to SIPC that when one looks at the fact that the regulators in the ordinary course of their business will find a fraud at the $1 million level—it is very difficult to steal a million dollars from a brokerage firm. The prospect of stealing $10 million from a brokerage firm has only happened 10 times in 39 years. The regulators do a good job, generally speaking, of finding these kinds of actions.

SIPC has initiated 322 cases over 39 years. In 230 of those cases, the net cost to SIPC of paying customers, paying administrative expenses, and closing the case was under $1 million.

So I cannot explain this event in the ordinary parlance of what happens historically. We will, if necessary, use our commercial lines of credit, and again, if necessary—and it is by no means certain that it will be—we will seek to use our Treasury line of credit.

Chairman DODD. You have had a $150 fee, an annual fee, for a long time.

Mr. HARBECK. That is correct.

Chairman DODD. The 1970s, I think you said.

Mr. HARBECK. No. Since 1995 was the last time we were on assessments based on net operating revenue.

Chairman DODD. I do not know if you are going to have a comment for today, but I would like to hear back from you, if you are going to be requesting an increase in that fee.

Mr. HARBECK. The board is aware of the situation, and I am certain the board—at every board meeting we ever had, the issue of whether we have sufficient resources is always an issue. The last board meeting we did have was prior to the Madoff case. I am certain the board in 3 days' time will be dealing with this issue.

Chairman DODD. I would be very interested in hearing in the Committee the results of that. Let me ask you this. I am going to go back to Senator Merkley's question. I have the exact same question here, the question, obviously, that Dr. Backe is raising, and others will, I presume, as well.

You made the distinction based on the—was it the Hennessey case?

Mr. HARBECK. No. It is *SEC v. Morgan*——

Chairman DODD. I am sorry. That was another case.

Mr. HARBECK. Yes, *SEC v. Morgan Kennedy.*

Chairman DODD. That was one, but it was prior to 401(k)s.

Mr. HARBECK. Yes, sir.

Chairman DODD. This is a 401(k), as I understand it, Dr. Backe.

Mr. BACKE. Yes, that is correct.

Chairman DODD. I wonder, Professor Coffee, are you knowledgeable in this area?

Mr. COFFEE. I do not know as much as the other end of the table, but I am aware of it is Rule 100 under SIPC that deals with the nature of the custody. I think what—the SIPC rules or the tax rules?

Chairman DODD. The SIPC rules.

Mr. COFFEE. I think they were correctly explained earlier in his testimony that SIPC does look to whether the plaintiff can establish that there was indeed a customer account recognized by the brokerage firm. This could be through correspondence. It does not have to be a formal account.

Chairman DODD. And so the distinction being a pension fund or a 401(k) is the deciding factor?

Mr. COFFEE. I would say the distinction is whether or not the brokerage firm sent you account statements in your name. That would be the strongest evidence that they were recognizing you as a customer.

You may want to correct me on that.

Mr. HARBECK. No. I believe that is accurate. But, Senator, the one thing neither the independent trustee nor SIPC wants to do is discourage individuals from filing claims based on the documentation in their hands. We have urged anyone who believes they have been wronged in this matter to file a claim with the trustee, and the reason for that is there are very few things in law that are black and white. But one of the things that is black and white is that someone who does not submit a claim will not be paid.

Chairman DODD. Yes.

Mr. HARBECK. So anybody who believes they are victimized here should submit a claim to the trustee.

Chairman DODD. I think the doctor is writing a claim right now. [Laughter.]

Mr. BACKE. I have already gotten 140 claim forms.

Mr. HARBECK. They should be sent not to SIPC, but to the trustee, Irving Picard.

Chairman DODD. Now, there has been no decision reached on this matter yet.

Mr. HARBECK. Absolutely not. Not without looking at the documents.

Chairman DODD. All right. I appreciate that.

Let me, if I can, I wanted to mention, by the way, that Barbara Roper of the Consumer Federation of America has written to us, and I will ask consent that her correspondence with us regarding this matter be included in the record as well.

Chairman DODD. But I would like to—she raises the issue that has been raised already, but I would like to raise it again, if I could. She says, "Do the regulators know why they did not recognize the Madoff scheme for years?" Again, I know you do not want to comment on the specifics of this, but just as a broad matter, given again there is a history of this kind of behavior, granted on a smaller scale and maybe for less time, but from a 30,000-foot perspective rather than an individual case perspective, what is the answer to that question?

Ms. THOMSEN. Well, let me start and others can jump in. It is a collusive fraud or a very well orchestrated fraud with a few people. It is designed to be hidden. And let me talk specifically about Ponzi schemes because they in some ways are among the thorniest frauds that we encounter.

A Ponzi scheme works as long as there is more money coming in than going out, and most Ponzi schemes are done in an unregulated environment. No one is in inspecting the firm. No one is reviewing their books and records. It is an entity that operates outside of a regulatory regime.

It typically uses and exploits relationships, affinities, sometimes friends and what-not, and people come into an organization or into the investment with a high degree of trust. They also tend to use both a sense of exclusivity—that is, we are letting you invest with us, we do not let everybody in here—and a certain mistrust of outsiders looking in. So they encourage—or, rather, discourage discussing what is going on with the particular investment with anyone other than members of the organization.

When, as happens in Ponzi schemes, those who invest get their money when they ask for it, they are not on notice that anything is going on, and in some instances, in some of the most elaborate Ponzi schemes where the returns are quite high, they are quite happy because they are getting good returns on their money—until it stops flowing in, and then the whole thing collapses very, very quickly. And they are very difficult to discover ahead of time unless you can find solicitations, and they are oftentimes not done in writing, but occasionally you find them, or if you find an investor who, for whatever reason, is suspicious of those returns and comes to someone so that you can go in early and explore.

We have had success in Ponzi schemes where we have gotten money back to people, significant amounts, 60, 70 cents on the dollar, which is a very high percentage in this kind of scheme. But we also have to confront the psychology around Ponzi schemes, which is very, very difficult.

Years ago, we prosecuted one—it was one where we did find a flyer, we did get in early, we were able to shut it down, freeze the assets, and get investments back to the investors, somewhere in the neighborhood of 60 cents on the dollar. And then the promoter who had been enjoined by our action started a new scheme, and the investors who had now only gotten 60 cents on their dollar back reinvested with that promoter. Indeed, I was in court with one of those investors. She was testifying about what had happened. And during the lunch break, she talked to the promoter and decided that she could invest with him again. And this was a woman of some sophistication.

So that psychology is one of the things that we confront in frauds. I think until—well, if you are getting a good return from a promoter, it is difficult for people to see some of the flaws. And when you are in an unregulated environment, we do not have the regulatory speed bumps or other sources of information. That is one of the reasons. It is not terribly satisfying. We wish we could find all fraud.

Chairman DODD. I think if we had listened—I mean, I was struck, again, by Professor Coffee's comments at the outset that over the years, of the 16,000 mutual funds—I think that is roughly the number, that there has never been one. Is that what you said?

Mr. COFFEE. I am not aware of a Ponzi scheme in a public registered mutual fund.

Chairman DODD. Yes. So establishing some of the rules here would seem—again, one wonders why given the fact that over the years this is nothing new. In fact, as I said earlier, I think Mr. Ponzi dates back to the early part of the 20th century, so this is a century-old problem. And the resistance in the past to applying the same kind of regulatory structures to protect people in these matters I think have been revealing.

Professor Coffee, you have heard the testimony this morning of our witnesses from the SEC and FINRA. Are there any additional thoughts your have or recommendations you would make?

Mr. COFFEE. Well, I would just mention two. They are not really in my testimony. And I am not going to engage at all in any kind of finger pointing.

There is a matter that is being discussed, I think by many, as to whether or not the jurisdiction of FINRA should be expanded to give them jurisdiction over investment advisers. We have just heard that there is an iron wall. We may have some small disagreements about whether they get around that wall a little. But it is possible that FINRA should have jurisdiction over investment advisers or, alternatively, that investment advisers should have to have their own self-regulatory organization.

There are going to be two sides to that question, and there is going to be some opposition from investment advisers. But I think that is one of the issues that should be on the table for Congress to at least recognize.

There also is the question—and this will also spark division—as to whether SIPC, which I am not criticizing in any respect, should behave more like the FDIC and be assigned by Congress some regulatory responsibilities. That is, in the insurance business, we find that private insurers do direct their premiums to the relative risk. So the risky environmental company pays a higher premium for environmental insurance than one that complies with all best practices. Now there is a flat rate, as you just described, and that to a degree probably does subsidize the Bernard Madoffs of this world, because if the insurer was going to charge the premium based on relative risk, they would charge a higher insurance premium to those broker-dealers that did their own custodial work and did not use external custodians.

That is the area where I think we could think about using SIPC and its insurance as something more of a deterrent to risky financial entrepreneurs. Again, that will be controversial also.

Chairman DODD. Yes. Do you want to comment on that?

Mr. HARBECK. Well, the FDIC does have a built-in regulatory function as well as an insurance function. There is no comparable entities to the SEC or FINRA in—there is no self-regulatory world in the banking world.

Senator, if you were to assign SIPC the role of inspections and examinations, I would seek to hire the experts. I would seek to hire the people who are already doing this. There are four or five levels of people that you have to fool. I would have to hire some of those people away from their current positions, and I am not certain that we would get a better result.

Chairman DODD. Well, that is an interesting question and one we will debate in this Committee.

I am going to leave the record open. I wanted to ask quickly, too, because it has been raised, and that is the issue about staffing and resources. And you heard Senator Corker and others raise the issue, and certainly this is an important question, whether or not you have the adequate resources and personnel to do the jobs.

I would ask that—and we will certainly ask Chairman Schapiro, but through the witnesses who are here today to convey back to the SEC, rather than waiting for another hearing on this matter, that as Chairman of the Committee, I would like to get a report on what sort of resources and personnel needs you feel, aside from the investigation that is going on right now, but what is inadequate, what is lacking here in order for you to do these jobs. And I read your testimony last evening, and you cite in some detail the personnel, just the absence of personnel and the number of cases you have to follow. And I respect that. I am not suggesting that that is not a problem at all. So I would like to get some indication as to what would be needed in this area. I am not going to suggest you are going to get what you are asking for, but I would like to know what you think you need.

Ms. THOMSEN. Of course. I would be happy to do that.

Chairman DODD. And then we will leave the record open as well regarding these additional questions my colleagues may ask as well. Some could not be here this morning because of the other matters that are ongoing here with the stimulus package and other questions before the Senate.

But I thank all of you for being here, and, again, I want to say to you, to our witnesses from the SEC—and I think I express the views of all of us up here. There is a great deal of respect for the work done by people at the SEC. We are terribly disappointed in this particular case for the reasons you have heard this morning. There seems to have been a glaring missed obligation regarding this matter that went on so long with so many flags being raised, as mentioned earlier. But we should not allow that to necessarily be the view that we do not respect the work done by the many people who work at the SEC every day. I would not want the record to reflect that.

Ms. THOMSEN. Thank you.

Chairman DODD. I thank you all. The Committee will stand adjourned.

[Whereupon, at 12:58 p.m., the hearing was adjourned.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR TIM JOHNSON

Thank you, Mr. Chairman, for holding this hearing. It is unfortunate that we are here today to take a closer look at the fraud committed by Bernie Madoff—a clear example of a serious failure in our regulatory system. It could be months, or even years, before we fully understand what actually happened at Bernie L. Madoff Investment Securities L.L.C, but I am hopeful that the pending investigations will point to needed changes in the regulation, accounting, and auditing of securities firms, broker-dealers and investment advisors.

While Congress will use the next few weeks to craft a stimulus bill to try to stabilize our economy, it is this Committee that will be responsible for examining the regulatory system and working toward solutions to ensure that the crisis we are currently experiencing never happens again. I am optimistic that the new SEC Chairman, Ms. Schapiro will make appropriate reforms within her agency, and engage with Congress to make the needed legislative changes to our system of securities and investment regulation.

PREPARED STATEMENT OF SENATOR MICHAEL F. BENNET

Thank you, Mr. Chairman. I would first like to offer my sincere gratitude to both you and the Ranking Member for your leadership of this Committee, and for the hospitality and kindness that you and your staffs have shown me as the newest Member of the panel.

As I take my seat on this Committee, I am aware that I do so at a crucial time in our history. Millions of Americans are out of work, struggling to keep a roof over their heads, and worried about how they're going to make ends meet. This committee will face head-on the challenge of responding to an economy in crisis. Though I know that the job will not be easy, I accept my position on this committee with eagerness, humility, and a deep sense of responsibility to the Coloradans I represent.

Today I join you on behalf of the many Coloradans affected by the Bernie Madoff investment scandal, including the Nurse-Family Partnership, a Denver-based nonprofit organization that helps low-income families with children meet their healthcare needs. The organization lost a $1 million contribution from a foundation that went under because of Madoff losses.

I also come on behalf of the Fire and Police Pension Association of Colorado, which was protected against losses only because time was on its side. For reasons unrelated to fraud concerns, last June the pension fund withdrew $5 million from an account directly handled by Bernie Madoff. Had this transfer not taken place, the situation could have been dire for some of the men and women who serve and protect the people of Colorado.

There are certainly countless other Coloradans whose savings contribute to the unimaginable $50 billion in losses related to Bernie Madoff's investment scheme.

It is crucial that we get to the bottom of what was clearly the utter failure of our regulatory system. I am confident that the witnesses we have here today, particularly those from the Securities and Exchange Commission, can shed some light on how this failure happened. I thank them all for being here. But getting answers is only the first step.

We need to repair a seriously broken regulatory system under which investigators have consistently lacked the resources and big-picture perspective necessary to keep an eye on the financial activities of increasingly large investment entities.

We also need to make sure that regulators foster proper relationships with the investors they oversee. We need to recruit and maintain a competent regulatory workforce at the SEC—a workforce that does not allow personal or social relationships to cloud its judgment.

Finally, we must ensure that the foundations, non-profits, individuals, and retirees who have lost money as a result of this fraud have some recourse. There's been discussion of how much loss the Securities Investor Protection Corporation (SIPC) can cover, and I gather that it's not much. I am interested to see if there are other ways to provide some relief to victims who are still reeling from their losses.

This Committee will lead the charge of repairing a regulatory system that has slipped off its tracks. I am honored to be the Committee's newest Member, and I look forward to our important work in the months ahead.

Thank you.

PREPARED STATEMENT OF JOHN C. COFFEE, JR.

ADOLF A. BERLE PROFESSOR OF LAW,
COLUMBIA UNIVERSITY LAW SCHOOL

JANUARY 27, 2009

THE MADOFF INVESTMENT SECURITIES FRAUD: REGULATORY AND OVERSIGHT CONCERNS AND THE NEED FOR REFORM

"You only find out who's swimming naked when the tide goes out."

——WARREN BUFFETT
Annual Letter to Berkshire Hathaway shareholders

Chairman Dodd, Ranking Member Shelby, and Fellow Senators, I am pleased and honored to be invited to testify here today. I have been asked to address reforms that might prevent future Ponzi schemes and the jurisdiction (or lack thereof) of the SEC and FINRA over investment advisers similar to Mr. Madoff. I will get to these points quickly without further delay.

I. The Persistence of Ponzi Schemes

The tide has gone out on Wall Street, and in Warren Buffet's words, we are now finding out "who has been swimming naked." Sadly, it has been the recurrent pattern in Ponzi schemes, [1] and similar investment frauds, that they are revealed not by regulatory detection and enforcement, but by their own collapse under the pressure of investor demands for redemption when the market sours (and investors become belatedly anxious). As a result in part of the spectacular collapse of the Madoff fraud, investors are now demanding redemption at a record level, and other Ponzi schemes are coming to light. Symptomatically, many of the recent Ponzi schemes show the same basic pattern and thereby also reveal what reforms could best prevent them at relatively low cost. In truth, the only features that are truly distinctive about the Madoff fraud are its extraordinary scale (an order of magnitude higher than any other such scheme) and its multi-decade duration. Uniquely, Mr. Madoff was able (i) to transcend traditional "affinity fraud" and move to a global scale through the use of "feeder funds" (*i.e.,* hedge funds that seek to diversify through investing in other funds—or "fund of funds"), and (ii) to maintain investor confidence in his operation for several decades (which factor, of course, aggravates the problem of inadequate regulatory oversight).

Ponzi schemes occur in all societies, and there have been similar scandals in Russia, Eastern Europe (particularly in Albania where one helped cause the fall of a government), India and, very recently, the U.K. In the U.S., although Ponzi schemes are infrequent and represent only a tiny minority of alternative investments, they do produce substantial losses on a recurring basis. Other scholars have computed the losses from Ponzi schemes, as shown by litigated court cases, and concluded that the prior record year was 2002 when "over $9.6 billion" was lost. [2] But annual losses of over $1 billion are frequent, with over $1.6 billion lost in 1995 and 1997 and over $1 billion in 1996, 1990, and 1976. [3] The amount so lost varies radically from year to year largely because Ponzi schemes tend to be uncovered only in periods of market stress—"when the tide goes out on Wall Street."

Any estimate of the total losses caused by Ponzi schemes is likely to understate, because litigated cases ignore those schemes in which the collapse is so complete that there is no hope of recovery and hence no incentive for litigation. In that light, it seems more important to examine some representative case histories in order to identify common denominators. The following appear to be the leading recent cases:

1. Bernard L. Madoff Investment Securities, LLC ("Madoff Securities"). On the facts known so far, two basic failures in internal controls are evident in the Madoff case: First, Madoff cleared his own trades and did not use either an independent custodian or a clearing broker to execute and clear his trades. Second, Madoff was audited by a small auditing firm, Friehling & Horowitz, which

[1] According to Wikipedia.com, "A Ponzi scheme is a fraudulent investment corporation that pays returns to investors out of money paid by subsequent investors rather than from profits." The name comes from Charles Ponzi, who gained notoriety for such an investment scheme in Boston shortly after World War I. This definition may, however, overstate, as most Ponzi schemes do involve some real investments in assets or securities with only a portion of the new investors' investments being paid to the old investors.

[2] See Statement of Tamar Frankel, Professor of Law and Michaels Faculty Research Scholar, Boston University School of Law before the House Committee on Financial Services, January 5, 2009, at p. 2.

[3] *Id.*

only had three employees. Of these three, one was a secretary; another was Jerome Horowitz, an 80-year-old, semi-retired partner, living in Florida, and the third was David Friehling, who was not subject to even the peer review process mandated by New York State because he claimed not to conduct audits (ironically, this may have truer than regulators realized). The Friehling & Horowitz firm was not registered with the Public Company Accounting Oversight Board ("PCAOB"), because of an overbroad exemptive rule (discussed below) that the SEC repeatedly adopted in the wake of Sarbanes-Oxley to spare broker-dealers that were not publicly held from the oversight of a PCAOB-registered auditor.

2. Bayou Group LLC. Organized in 1996 and re-organized in 2003, the Bayou Fund and its various successor hedge funds were all managed by Bayou Management LLC, and the trading activities of the group were conducted through a single, captive broker-dealer called Bayou Securities LLC. [4] All these entities were owned and controlled by Sam Israel ("Israel"), the chief executive of Bayou Management. Thus, as in the case of Madoff, there was no independent custodian or clearing broker.

   Beginning in 1999 and continuing through 2005, Israel and his chief financial officer created a non-existent and entirely fictitious auditing firm, Richmond-Fairfield Associates, to generate false performance summaries and false financial statements to mislead investors. Weekly, monthly, quarterly, and annual financial reports were generated by this bogus auditing firm and distributed to investors.

   The Bayou Ponzi scheme collapsed in 2005, but it had lost money from its outset, pursuing an options trading strategy not unlike that which Bernard Madoff claimed to have been pursuing. Before its collapse, Israel caused the Bayou funds to make a bank transfer of $120 million from various accounts to a bank account at PostBank in Germany; $100 million of this amount was then transferred to a bank account controlled by Israel in the United States. This latter amount was seized by the Arizona Attorney General in May 2005 and restored to the bankrupt estate. Again, it needs to be underscored that such a $120 million transfer to a foreign bank is precisely what a reputable independent custodian would not allow. Similarly, had the auditor for the Bayou Funds been required to have been registered with the PCAOB, it would have been comparatively simple for investors to check and ascertain whether they were dealing with a legitimate auditor (instead of an entirely bogus firm). Nor would Israel have dared to invent a bogus auditor.

   As of August 31, 2005, the loss that resulted from this classic Ponzi fraud exceeded $218 million. [5]

3. Arthur Nadel and Scoop Management. Currently a fugitive from justice, Mr. Nadel ran six Florida-based hedge funds with reported assets of over $350 million. In the wake of the Madoff collapse, anxious investors sought redemptions, and Mr. Nadel disappeared. At least, a $50 million shortfall in funds has been reported. Red flags again are evident with respect to the auditing of these funds. In 2005, the Hedge Co. Net Index ousted Mr. Nadel's funds from its Web site index because of his failure to provide current audited results. [6]

4. Martin Armstrong and Princeton Economics International. This 7-year Ponzi scheme purported to trade currencies, in particular gold and silver, and raised over $3 billion. Investors who purchased his "Princeton Notes" appear to have lost over $700 million. [7] In January 2002, Republic Securities, the broker dealer that traded for Mr. Armstrong and handled his accounts, plead guilty to conspiracy and securities fraud charges and paid approximately $569 million in restitution. Although this represents the fairly unique case in which (i) there was a custodian, and (ii) it was complicit in the fraud, the $569 million in restitution obtained from it shows that an independent custodian can at least provide restitution to victims.

5. J.V. Huffman and Biltmore Financial Group. [8] This relatively small $25 million fraud was uncovered by the North Carolina Secretary of State's Securities Division, and the SEC later brought suit in November 2008. Mr. Huffman assured

[4] This summary of the facts comes from In re Bayou Group LLC, 2008 Bankr. LEXIS 3261 (Bankr. Ct. S.D.N.Y. October 16, 2008). Mr. Israel and others are now serving prison terms.

[5] *Id.* at 36.

[6] See "Fund Fugitive's 1905 Finagling," *N.Y. Post,* January 20, 2009, at p. 30.

[7] For the basic information on this case, I am relying on The Press Release issued by the U.S. Attorney's Office for the Southern District of New York on April 10, 2007 (available on LEXIS).

[8] See "SEC Charges N.C. Resident, Biltmore Financial Group for Operating Multi-Million Dollar Ponzi Scheme," States News Service, November 12, 2008 (available on LEXIS).

investors that he "operated like a mutual fund." His fraud continued for over 17 years. Like Mr. Madoff, Mr. Huffman paid a steady high return (as much as 16.54 percent in 2007, but never below 8 percent). In fact, Mr. Huffman never invested his investors' funds in securities, mortgages, or other investments, but used them to subsidize his lavish lifestyle. In short, his modus operandi was similar to that of Madoff, but on a smaller scale, and he again did not use any custodian or clearing broker.

6. Pinnacle Development Partners LLC and Gene O'Neal.[9] Before its collapse in 2006, this real estate investment fund raised more than $69 million over 15 months by promising a 25 percent return on its notes in 45 days (later extended to 60 days). Some 2,000 investors (mainly in the United States) invested. According to the indictment, Mr. O'Neal "recycled" some $25 million in invested capital from new investors to old investors. In order to foster the illusion of actual economic activity, real estate properties were transferred between Pinnacle's three partnerships with the sale price paid by one partnership being as much as 10 times the initial acquisition price paid by another partnership. Prior to the indictment, the SEC did obtain a preliminary injunction in this case.
7. Other Noteworthy Cases. In 1997, John Bennett, Jr., was sentenced to prison (and served 11 years) in connection with a $700 million Ponzi scheme that principally focused on churches, colleges, and cultural institutions.[10] Promising to return to investors double the amount of their donations to his Foundation for New Era Philanthropy, he solicited individuals and institutions with an evangelical Christian orientation (again, as with Madoff, this is an example of "affinity fraud"). In another high profile case, Martin Frankel looted around $200 million and then fled to Germany, carrying twelve passports and several million dollars worth of diamonds. J.T. Wallenbrock & Associates sold promissory notes, raising over $230 million from over 6,000 investors.[11] Reed E. Slatkin perpetrated a classic Ponzi scheme that raised over $600 million and continued for over 15 years. Using fake financial statements that referenced fake brokerage firms, he mainly solicited Hollywood entertainment figures and fellow Scientologists—again, an example of affinity fraud.[12] To the best of my knowledge, with the exception of the Martin Armstrong case, there has not been a legitimate, independent custodian involved in any of these cases.
8. Summary. Although many more cases could be cited, two observations deserve emphasis: First, both the scale and frequency of Ponzi schemes seems to be increasing. Although Madoff is in a class by himself, the increase in the size of the typical Ponzi scheme appears to be the product of the growth of the hedge fund industry and the new popularity of alternative investment schemes. The SEC has also noted this correlation.[13] Second, the increased frequency of Ponzi schemes contrasts sharply with the fact that no mutual fund registered under the Investment Company Act of 1940 has ever collapsed and been exposed as a Ponzi scheme. In fairness, the relevant contrast here is not between mutual funds and hedge funds (for example, Mr. Madoff was not running a hedge fund, but was an investment adviser). Rather, it is between mutual funds, which seem immune to Ponzi schemes, and other investment vehicles, which are less regulated and seem more vulnerable to fraud.

II. Can Ponzi Schemes Be Efficiently Prevented?

As just noted, a marked disparity exists between the seeming immunity of mutual funds and the relative vulnerability of other collective investment vehicles: mutual funds have not experienced Ponzi schemes, while hedge funds, other pooled investments (real estate investment trusts), and investment advisers have. In the past, Ponzi schemes were frauds perpetrated by solo entrepreneurs or a small, tight-knit group, working within a cohesive "affinity group" that trusted them because of their shared background. More recently, however, larger hedge funds—Bayou and Arthur

[9] See "Head of Purported Real Estate Investment Bund Indicted in $69 Million Ponzi Scheme," March 8, 2007, U.S. Fed News (available on LEXIS).

[10] See Infield, "Similarities in Madoff Case and a Local One," The Philadelphia Inquirer, December 17, 2008 at p. A-1.

[11] These cases are summarized in Jerry Markham, Mutual Fund Scandals—A Comparative Analysis of the Role of Corporate Governance in the Regulation of Collective Investments, 3 Hastings Bus. L. J. 67, 119 (2006).

[12] See "The 10 Nastiest Ponzi Schemes Ever," Business Pundit, December 15, 2008.

[13] See "Registration Under the Advisers Act of Certain Hedge Fund Advisers," 69 Fed. Reg. 72054, at 72056 (Dec. 10, 2004) (noting that 51 enforcement cases had been brought in preceding 5 years against hedge fund advisers for losses exceeding an estimated $1.1 billion).

Nadel's Scoop Management are the leading examples—have engaged in similar practices.

What distinguishes mutual funds from hedge funds and investment advisers that may explain this disparity? Two differences stand out: (1) independent custodians, and (2) PCAOB-registered auditors. A third difference is the requirement of an independent board in the case of a mutual fund, but this difference is not easily generalized and would be infeasible for most investment advisers. Desirable as independent boards may be, they are unlikely to be able to stop a determined crook. The first two reforms are thus examined below:

A. The Custodian

Section 17(f) ("Custody of Securities") of the Investment Company Act of 1940 requires a registered management company to "place and maintain its securities and similar investments in the custody of" a bank or a dealer admitted to a national securities exchange, "subject to such rules and regulations as the Commission may from time to time prescribe fro the protection of investors." [14] As amplified by SEC rules, the custodian requirement largely removes the ability of an investment adviser to pay the proceeds invested by new investors to old investors. The custodian will take the adviser's instructions to buy or sell securities, but not to remit the proceeds of sales to the adviser or to others (except in return for share redemptions by investors). At a stroke, this requirement eliminates the ability of the manager to "recycle" funds from new to old investors.

In the nearly 70 years since the passage of the Investment Company Act of 1940, frauds have occurred in connection with mutual funds, but not true Ponzi schemes. Admittedly, a truly predatory investment adviser might find ways to circumvent the custodian requirement, but most Ponzi schemes appear to develop as acts of desperation as investment managers that have incurred losses struggle to hide them and "borrow" some of the funds from new investors in order to pay the promised return to the original investors. Their desperate hope is that they can eventually recoup their losses (indeed, this appears to have been the Bayou experience). Section 17(f) eliminates both this opportunity and incentive.

In the case of hedge funds, because they are exempt from the Investment Company Act, [15] Section 17(f) is simply inapplicable to them. To be sure, many and probably most hedge funds do use an independent custodian as a matter of "best practices," but some do not (as the Bayou fund and the hedge funds run by Arthur Nadel appear to show). Thus, both the Bayou Funds and those run by Mr. Nadel were able to make large payments to their investment advisers at the point of collapse (for example, as discussed earlier, Bayou transferred $120 million to a German bank, of which $100 million was quickly returned by that bank to Mr. Israel). The vulnerability of hedge funds thus seems obvious.

In the case of investment advisers (and this is the category into which Madoff Securities falls), the SEC's rules are more complex. Under Rule 206(4)-2 ("Custody of Funds or Securities of Clients By Investment Advisers") under the Investment Advisers Act of 1940, [16] an investment adviser must maintain client funds or securities with a "qualified custodian." However, the term "qualified custodian" is defined by Rule 206(4)-2(c)(3) to include any broker-dealer registered under the Securities Exchange Act of 1934, at least to the extent that it is "holding the client assets in customer accounts." This means that an investment adviser who was not itself a registered broker-dealer would have to use a clearing or prime broker to hold its customers' securities and funds. But to the extent that Madoff was a registered broker-dealer, he was permitted to clear his own trades through his own broker-dealer firm. Worse yet, because Mr. Madoff claimed to be trading through his British subsidiary, even Madoff's New York brokerage employees were not necessarily aware of his trading activities (as his trades were allegedly done through a foreign affiliate).

Obviously, the simplest most direct reform that has the greatest chance of preventing Ponzi schemes is to require use of an independent custodian—by both investment advisers and hedge funds. [17]

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[14] See 15 U.S.C. § 80a-17(f)(1). Section 17(f) also permits the management company to maintain securities with "such company, but only in accordance with such rules and regulations or orders" as the SEC may prescribe.

[15] See Sections 3(c)(1) and (7) of the Investment Company Act (exempting funds held by "qualified purchasers" and by less than 100 owners where no public offering is made).

[16] See 17 CFR § 275.206(4)-2.

[17] This author originally made this proposal in a December 16, 2008, Op/Ed piece for CNN.com. See Coffee, "Where Was the SEC?" *www.cnn.com.* Since then, others have also endorsed this proposal, as discussed later.

B. A PCAOB-Registered Auditor

It has escaped almost no one's attention that Madoff Securities was "audited" by effectively a one-person auditing firm that was not registered with the Public Company Accounting Oversight Board ("PCAOB").

Why wasn't Friehling & Horowitz registered with PCAOB when it was auditing a broker-dealer with custody over more than $30 billion in customer accounts? Under the Sarbanes-Oxley Act, broker-dealers were required to use such a registered auditor.[18] The answer here is simple, blunt and disappointing: the SEC exempted all broker-dealers that were privately held (*i.e.,* not a publicly held "reporting" company under the Securities Exchange Act of 1934) from the requirement that they use a PCAOB registered accountant. In Securities Exchange Act Release No. 34-54920,[19] the SEC extended earlier orders issued in 2003, 2004, and 2005 that exempted privately held broker-dealers from the obligation to use a registered public accounting firm.

The rationale for this position seems both dubious and symptomatic. Although a privately held firm may have few shareholders who need properly audited financial statements, it may have many customers (and the SEC) who have an interest in knowing that appropriate auditing procedures have been followed. Because the SEC did not (in the wake of the Madoff scandal) renew this exemptive order in December, 2008, the point is now moot. For the future, privately held broker-dealers will be required to use PCAOB-registered auditors.

C. The Insurer: SIPC

The Securities Investment Protection Corporation ("SIPC") is the functional analogue to the Federal Deposit Insurance Corporation ("FDIC"); the former protects customers of insolvent broker-dealers, while the latter protects depositors of insolvent banks. But the analogy between them is inexact for many reasons. A key difference is that SIPC is a "passive safety net," which makes no significant effort to prevent failures or to price its insurance in terms of the riskiness of the individual broker-dealer firm.[20]

Normally, private insurers price their insurance in terms of the riskiness of the insured and its activities. A chemical company that was a toxic polluter would pay more for insurance covering environmental claims than an efficiently run chemical company that stayed well within both the law's requirements and industry "best practices." Such pricing forces the polluter to internalize the costs of its own misconduct and creates a disincentive.

In contrast, throughout its history, SIPC has either charged its broker-dealer members a flat fee (which has been as low as $150 in 1996 and 1997) or made an annual percentage of revenues assessment (which has been as low as 0.065 percent during the 1990s). It thus does not distinguish between its member firms, even though they represent different risk levels. SIPC also has no watchdog powers over its members; it neither proscribes unsafe or unsound practices nor conducts examinations of its members.

A private insurer would, of course, appraise the risk level of the insured's behavior. Thus, if a broker-dealer did not use an independent custodian, this failure would result in an increased premium to those of its customers who sought insurance covering the risk of insolvency and/or misappropriation of their accounts.

To the extent that SIPC today neither plays a meaningful watchdog role (as the FDIC does) nor prices its insurance on a risk-adjusted basis, it is subsidizing high risk broker-dealers. Put differently, the future Bernie Madoffs are receiving an undeserved discount on their insurance costs that increases their incentive to commit fraud. Correspondingly, to the extent that broker-dealer customers are at least partially insured, they have less reason to fear risky or fraudulent broker-dealers—and so a "moral hazard" problem arises.

These comments are not intended as criticisms of the current management of SIPC, which has no authority to play a watchdog rule today. But it does lead to three policy conclusions: (1) SIPC insurance should be risk-adjusted; (2) "cheap" SIPC insurance can be socially costly; and (3) SIPC could be given a watchdog role with respect to unsafe and unsound financial practices by broker-dealers, because they will ultimately bear the loss.

[18] See Section 205(c)(2) of the Sarbanes-Oxley Act (amending Section 17(e) of the Securities Exchange Act to require use by a broker-dealer of a "registered public accounting firm").

[19] See 2006 SEC LEXIS 2886 (December 12, 2006).

[20] This point is not original with this author. See Thomas W. Joo, Who Watches the Watchers? The Securities Investor Protection Act, Investor Confidence, and the Subsidization of Failure, 72 S. Calif. L. Rev. 1071 (1999).

D. Policy Conclusions

The most important reform is to require an external and independent custodian for all collective investment vehicles. The SEC has adequate authority to do this for registered investment advisers, but lacks authority over hedge funds. Although some industry opposition can be expected, it is noteworthy that, in the wake of Madoff, the Investment Advisers Association ("IAA") has already endorsed a requirement that all advisory assets be handled by external, independent custodians.[21] This position may be their preferred alternative to another, more controversial policy recommendation that FINRA be given jurisdiction over investment advisers (on which I take no position). Still, it does suggest that any political opposition to a custodian requirement can be overcome.

III. Regulatory Oversight

The most obvious question that arises in the wake of the Madoff scandal was why regulators failed to detect the fraud, or to even conduct a detailed examination of his investment advisory business, over a multi-decade period. This question is being currently investigated by the SEC's Inspector General, and I will not attempt to prejudge this issue, anticipate his conclusions, or pass judgment on the Enforcement Division's performance in this case; nor am I well positioned to evaluate the credibility of the warnings that the SEC received.

Still, two issues are more susceptible to a legal analysis from my perspective:

First, although Madoff Securities was only required to register as an investment adviser by the SEC in 2006, Madoff Securities was not thereafter examined by the SEC's Office of Compliance Inspections and Examinations. Even given the severe cost constraints under which the SEC labors, was this omission justifiable?

Second, given that the Financial Industry Regulatory Authority ("FINRA") (and its predecessor, the NASD) had jurisdiction over Madoff Securities for several decades, was its failure to closely inspect the firm's advisory activities justifiable based on the argument that it lacked jurisdiction over investment advisers?

In both cases, as discussed below, I believe the justifications for inattention are insufficient.

A. SEC Examination

Historically, investment advisers were examined by the SEC's Office of Compliance Inspections and Examinations in the first year after they registered with the SEC as investment advisers. Here, that would have been 2006 or 2007. Yet, because of cost constraints, no such examination was conducted, as this Office now uses risk-based criteria to determine which firms to examine.

Although hindsight has 20/20 vision which overlooks how difficult it is to discern frauds, I must conclude that if the SEC's risk-adjusted criteria did not consider Madoff Securities to be a risky case that justified an early examination, those criteria need to be revised. The critical facts were that even, as of 2006, Madoff Securities (1) had many billions of dollars in customer accounts under its management, (2) did not use an external custodian or prime broker, but cleared its own trades; (3) used an unusual options trading strategy that on closer inspection seemed incapable of implementation; and (4) used the same trading strategy for all clients, rather than provided individualized investment advice—and so arguably resembled an unregistered investment company. Opaque trading strategies have long been an identifying characteristic of Ponzi schemes. Although Madoff Securities had long paid a high return to its investors, the strange consistency in these returns over decades was puzzling, had attracted much skeptical commentary within the industry, and was arguably as much a warning signal as a re-assuring factor. Still, if one fact stands out, it was the sheer magnitude of the amount under management. This and the fact that the Madoff Securities' advisory business had not previously been vetted by the SEC called out for an early examination.

B. FINRA's Jurisdiction

Prior to 2006, Madoff Securities was only a broker-dealer and not a registered investment adviser. Thus, during this period, I see no reason that FINRA (or at that time the NASD) should have abstained from examining and monitoring the advisory side of Madoff Securities. This side was never formally separated in a different subsidiary; nor was it even geographically remote.

Section 202(a)(11) of the Investment Advisers Act defines the term "investment adviser" to mean "any person who, for compensation, engages in the business of advising others . . . ," but then excludes from this definition "(C) any broker or dealer

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[21] See Sara Hansward, "Adviser Group Urges That Investor Assets Be Held By Custodians," Investment News, January 12, 2009, at p. 2.

whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefore . . ."[22] Thus, if Madoff Securities was not registered as an investment adviser, it had to be taking the position (rightly or wrongly) that it was servicing these clients "solely incidental to the conduct of" its business as a broker-dealer. If so, that brokerage business was by definition within the NASD's and FINRA's jurisdiction. After 2006, when Madoff Securities did register as an investment adviser, it was required (as earlier discussed) by Section 206(4) of the Investment Advisers Act and Rule 206(4)-2 thereunder to use a "qualified custodian" to hold its customers' funds and securities. As earlier discussed, Madoff Securities, the investment adviser, could use (and did use) Madoff Securities, the broker dealer, as its "qualified custodian" (*i.e.,* it could "self-clear"). But this conduct in holding securities and executing trades was the conduct of a broker-dealer and was fully within the NASD's jurisdiction.

Finally, Madoff Securities had no right or privilege to resist any inspection by the NASD (or later FINRA) or to fail to provide information on the ground that its investment advisory business was exempt from NASD oversight. If it resisted on this ground, the NASD and FINRA had full power to discipline it severely. NASD Rule 8210 makes it clear beyond argument that the NASD can require a member firm to permit the NASD to inspect its books, records, and accounts and to provide other information. As the NASD further advised its members in its Notice to Members 00-18 (March 2000):

> Implicit in Rule 8210 is the idea that the NASD establishes and controls the conditions under which the information is provided and the examinations are conducted.

I have previously served on an NASD disciplinary committee and found that any associated person of a member firm who resists a NASD investigation or directs others not to testify can be barred (and was so barred, in at least one instance during my term of service) from the industry for such resistance.

Let me conclude with a simple illustration: Imagine that on an examination of a broker-dealer, the NASD found that several roulette wheels were in operation in one of its offices and gambling was occurring (legally or otherwise). In my judgment, even though such activity did not involve the conduct of a brokerage business, the NASD (and later FINRA) on such a discovery could and should seek to determine the impact of these activities on the broker-dealer's financial condition and its books and records. Similarly, on learning that Madoff Securities held billions of dollars of customer funds and securities for which it was the "qualified custodian," it was incumbent on the NASD to examine the adequacy of the internal controls relating to the management, custody, and security of those accounts. Similarly, at this point, the NASD might have examined the audited financial statements of Madoff Securities and properly asked who the firm's unknown accountant was.

I express no view on whether the NASD or FINRA necessarily should have uncovered the Madoff fraud, but I reject as overbroad the claim that they had no jurisdiction or reason to inquire.

Thank you for your time and attention, and I would be happy to attempt to answer any questions that you may have.

PREPARED STATEMENT OF HENRY A. BACKE, JR., M.D.

ORTHOPEDIC SURGEON, FAIRFIELD, CONNECTICUT

JANUARY 27, 2009

Good morning Senators. Thank you for allowing me to speak on behalf of 140 United States taxpaying citizens from the State of Connecticut. I am an Orthopaedic Surgeon, and a Partner of Orthopaedic Specialty Group ("OSG"), a medical practice located in Fairfield, Connecticut. We care for the medical needs of the insured and uninsured people of the greater Bridgeport, Connecticut, region in New England. OSG, incorporated in 1971, has been in existence for over 75 years. We employ 130 people with annual incomes ranging from $28,000 to $130,000. We have some employees who have worked with us for over 30 years. OSG has had a retirement plan (the "Plan") for its employees since the 1970s. We currently have 140 participants of which 34 are now employed elsewhere or retired. We have followed all the ERISA rules and regulations governing pension plans and have been diligent in our fiduciary responsibilities. We have hired pension administrators for recordkeeping; our pension documents have been kept current with appropriate amendments by attor-

[22] See 15 U.S.C. § 80b-2(a)(11).

neys, and our accountants have completed every required filing since the Plan's inception.

Sixteen years ago, in 1992, we engaged Bernard Madoff Investment Securities Co. ("Madoff") to be our investment advisor and have invested all the Plan's assets with Madoff. Participants in the Plan include 15 doctors and 125 staff members such as nurses, x-ray technicians, medical assistants and administrative personnel. The Plan was funded by employee contributions, individual rollovers, and employer contributions. As of November 30, 2008, the plan had a net capital investment with Madoff of $11,581,000 and a statement balance of approximately $33 million. The Partners of OSG have made routine visits to Madoff's offices in New York City since 1992. The OSG Plan took comfort in the fact that its assets were invested with a well known and highly respected investment adviser and broker-dealer that was registered with the SEC, and subject to routine examination and oversight by the SEC and FINRA. For over 16 years, the OSG Plan received confirmations from Madoff for thousands of securities transactions, mostly in blue chip stocks of major U.S. corporations and U.S. Treasury securities. We also received from Madoff monthly statements of our account activity, as well as quarterly and annual portfolio management reports.

The OSG Plan was audited by the U.S. Department of Labor in 2005 and no concerns were raised. We also had an independent audit conducted in 2008, by a reputable accounting firm in CT and again no concerns were raised. As recent as October 2008, we sent three of our Partners to Madoff's office to discuss the volatile markets and check on our investments. One Partner, now 70 years of age, had over 30 years worth of retirement contributions and was interested in self managing his account since he was preparing to retire. We were assured by Madoff that his money was accessible and he could move it to a different type of account that he could manage at any time.

The news in early December 2008, that all the investment activity in Madoff was a sham, and that Madoff was in fact the world's largest Ponzi scheme, was devastating to us. We have three senior employees close to retirement who now do not know when or whether they can stop working. This affected OSG's recruitment planning to hire new physicians. We had given two new physicians employment offers that we are now unsure we can honor because senior doctors with plans to retire soon have now decided they need to keep working full time for many more years. Our employees are scared, worried and angry. They express loss of confidence in the Federal Government and its agencies. Some have declined to have payroll deductions made for their Plan contributions going forward. Some have expressed concerns that they will have to sell their homes when they retire since all their savings have been stolen. We have seen disagreements and friction among our employees over this matter. We fear we may have a very uncomfortable and unhealthy work environment if this takes years to sort out. This is the last thing a medical practice needs when treating patients. Our physicians are some of the most well trained and highly respected orthopaedists in the area, but our community's perception of OSG has changed. Partners have told me people ask if we are closing down.

We have had to hire multiple attorneys for OSG, our Plan, and our employees. This month alone we have already incurred legal bills in excess of $70,000. I personally spend at least 2 hours of my day dealing with this tragedy rather than taking care of patients.

Then, to add further insult to injury, we learned that the SEC had information linking Madoff to a Ponzi scheme as far back as 1992, and that starting in 1999 a gentleman named Harry Markopolos regularly advised the SEC that Madoff was a giant Ponzi scheme, and in fact provided a roadmap to the SEC as to how to unmask Madoff as a fraud. But the agency allowed Madoff not only to continue in operation, but to continue to take in billions of additional dollars of victim's funds, including the funds of the OSG Plan.

We learned next that it was highly likely that the Securities Investor Protection Corporation ("SIPC"), which took over Madoff, may take the position that the OSG Plan participants were not individual customers of Madoff, and each not entitled to SIPC coverage. Instead, it was likely that SIPC was going to treat the plan itself as the only customer of Madoff. In other words, the 140 participants in the plan, who lost a total of $11,581,000 capital investment, would have to share in a maximum $500,000 recovery. This is not right or just. Our pension plan functioned as an individual retirement savings plan. Each participant received individual statements; each was able to rollover moneys from outside accounts to their own account within the Pension Plan. Each participant was allowed to, and some did, take out loans against their account. The intent was individual accounts and the plan operated in that way. Madoff traded on behalf of the Plan as one account. One of my

Partners spoke with an attorney from SIPC who advised him that the initial intent of SIPC was to cover the individual investor.

Senators, the 140 participants in the OSG plan are not wealthy hedge fund investors, nor are they beneficiaries of multimillion dollar offshore trusts. They are regular working class Americans, most of modest means who annually put aside a substantial percentage of their wages to try to ensure that they could enjoy a dignified retirement in the near or distant future. They were let down by Madoff, the regulators, the SEC and FINRA. We hope and request that SIPC, which was created to protect small investors from harm, will help us as individuals.

We respectfully request that our legislators ensure that participants in pension plans, be it ours or any other who invested through Madoff, will be covered by SIPC insurance individually, or that they are recompensed in some other manner by the Federal Government in light of the SEC's repeated failure to stop Madoff from stealing money. We would like to see the government provide quality oversight through its agencies so that pension plans do not suffer this type of theft loss in the future. This would help to restore the confidence and trust of Americans saving for retirement.

We would like the IRS to clarify or expand what can be considered a "theft loss" in this situation and/or waive the maximum contribution restrictions for individuals or employers affected by Madoff so they can rebuild their pension plans on an accelerated schedule.

On behalf of OSG, we, as citizens of the United States of America, appreciate your time and work on our behalf. What we need now, more than anything, is quick resolution to this issue so we can get back to our own professions and jobs taking care of the health of our fellow Americans. Thank you.

PREPARED STATEMENT OF LORI A. RICHARDS

DIRECTOR, OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS,
SECURITIES AND EXCHANGE COMMISSION

JANUARY 27, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, I appreciate the opportunity to appear before the Committee today on behalf of the Securities and Exchange Commission ("Commission" or "SEC") to discuss the examination program and functions of the Commission. As evidenced by the Commission's recent enforcement action, and by the testimony of my colleague Linda Thomsen, the director of the Commission's Enforcement Division who is here with me today, the Commission is extremely concerned about the alleged fraudulent activity by Mr. Madoff.

In my testimony today, I will discuss the Commission's examination program, including how firms and risk issues are selected for examination, and the steps taken during examinations. I will summarize very generally the examinations that were conducted of the Madoff broker-dealer operations, and the steps that we are taking to respond to the risk of this type of fraud. This is an ongoing matter, under investigation by both the SEC's Enforcement Division, 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 this firm, and I am not participating in the current investigation or examinations of the firm. My views are my own and they do not necessarily represent the views of the Commission or other members of the staff.

I begin by noting that I have served as a member of the Commission's staff for more than 20 years. The agency's staff are dedicated, hardworking, and keenly committed to the agency's mission to protect investors. Speaking as an examiner, we are focused hard on fraud, and we are committed to finding fraud. We examine many different firms—these include many that are run honestly and in compliance with the law, and they also include those that are engaged in deception, dishonesty, falsification of records and fraud of various kinds. Examinations have identified many different types of frauds, including carefully hidden Ponzi schemes. Examinations of the Madoff broker-dealer firm did not find the alleged fraud committed by Mr. Madoff, and the Commission's staff did not examine his advisory operations, which first became registered with the Commission in late 2006. I will describe the expansive steps that we are taking to identify possible improvements, both to regulation and to oversight, which might make fraud less likely to occur in the future and more likely to be detected. We are very much looking forward to working with new Chairman Schapiro and the Commission in this effort.

I. The Commission's Examination Program

The examination program of the SEC plays a valuable role in protecting investors: (See, Compliance, Office of Compliance Inspections and Examinations, *http://www.sec.gov.*)

> 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.

The Commission has 425 staff dedicated to examinations of registered investment advisers and mutual funds, and approximately 315 staff dedicated to examinations of registered broker-dealers. Examiners are located in Washington, DC, 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 Commission has large and diverse examination responsibilities. The registered population consists of approximately: 11,300 investment advisers—a population that has grown rapidly in recent years, as further described in this testimony; 950 fund complexes (representing over 4,600 registered funds); 5,500 broker-dealers (including 174,000 branch offices and 676,000 registered representatives); and 600 transfer agents. [1] Institutions subject to examination include enterprises with multiple business units, tens of thousands of employees, registered and unregistered lines of business, and complex strategies and operational systems, as well as small one-person firms operating locally.

Broker-dealers are subject to primary oversight by a self-regulatory organization ("SRO") that conducts periodic routine examinations of its broker-dealer members. Investment advisers, mutual funds and other types of registrants are not subject to examination oversight by an SRO.

The number of registered advisers has increased dramatically in recent years. From 1998 through 2002, the SEC staff examined every registered adviser using a periodic exam frequency of once every 5 years at the most, and sought to examine newly registered advisers early in their operations. The staff was able to do this because the population of registered advisers was much smaller than it is today. Then, after 2002, the number of registered advisers increased by 50 percent (in 2002, there were 7,547 advisers, and there are nearly 11,300 today). A large number of the new registrants have been advisers to hedge funds. The growth in adviser registrants outstripped the staff's ability to examine every firm on a regular basis. As noted above, 425 staff people conduct examination oversight of investment advisers and mutual funds. [2]

Given the number of firms registered with the SEC, the Commission examines only a small portion of the securities business each year. Last year, for example, the Commission's staff conducted: 1,521 investment adviser examinations (approximately 14 percent of the registered community); 219 fund complex examinations (approximately 23 percent); and 135 transfer agent examinations (approximately 22 percent). [3] These examinations included: routine examinations of certain investment advisers, examinations "for cause" based on an indication of a compliance problem, and "sweep" examinations focused on a particular risk area. [4] The staff also conducted 720 cause, oversight and sweep examinations of broker dealer firms. (Together with the routine and other examinations conducted by FINRA, approximately 57 percent of broker-dealers were examined.)

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 re-

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[1] There are also eleven exchanges, five clearing agencies, ten nationally recognized statistical rating organizations, SROs such as the Financial Industry Regulatory Authority ("FINRA") and the Municipal Securities Rulemaking Board, and the Public Company Accounting Oversight Board ("PCAOB"), which are examined by Commission staff.

[2] The number of staff available to conduct adviser and fund examinations has varied over the years. The staff numbers listed below include examiners, accountants, supervisors and support staff, as well as staff dedicated to the adviser filing program. 1997—318; 1998—320; 1999—353; 2000—362; 2001—365; 2002—379; 2003—399; 2004—477; 2005—489; 2006—475; 2007—425; 2008—425; 2009—425.

[3] The staff also conducted inspections of selected exchanges, clearing agencies, nationally recognized statistical rating organizations, self-regulatory organizations, and the PCAOB.

[4] The Commission's examination program is conducting a small pilot program of deploying monitoring teams to remain in regular contact with a small number of the largest adviser complexes. This pilot is loosely modeled on the Federal Reserve's program of regular oversight for Large Complex Banking Organizations.

view is of crucial importance. Given the number of firms subject to examination oversight and the breadth of their operations, examinations are not audits and are not comprehensive in scope.

Under the Commission's direction and guidance, OCIE has developed a risk-based program for selecting firms and activities for examination. This methodology has three components: 1) a risk-based methodology for selecting investment advisers for priority examination; 2) a methodology for identifying higher risk activities at registered securities firms; 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. The details of these methodologies are for internal use, though we have described them generally publicly, and they are summarized below.

A. The Risk-Based Methodology for Selecting Investment Advisers for Priority Examination

Given the growth in the number of registered firms, and the need for the Commission to use its resources most effectively, in 2003 the examination program transitioned to a risk-based approach. The risk-based approach is intended to prioritize registrants for examination, and to assign examination staff to those advisers and funds that appear to present the greatest potential for having an adverse impact on investors. This process does not suggest that registrants given lower priority do not present risk. Rather, it is a form of triage, to help match available staff resources to the most pressing risks. It seeks to identify advisers who should be given first priority in the allocation of staff resources. Higher risk advisers are those that should be allocated priority in terms of staff resources, and medium and lower risk advisers are given lower priority in the allocation of staff resources. The Commission's Strategic Plan summarizes the risk-based approach to examinations. The plan states:

> 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. [5]

To assess relative risks and thereby prioritize advisory firms for examination, all investment advisers' filings with the Commission (on Form ADV), as well as results of any past examinations, are analyzed each year by surveillance staff in OCIE. [6] Characteristics that may indicate heightened risk include: an adviser receiving performance-based fees; an adviser selling products or services other than investment advice to its advisory clients; an adviser engaging in principal transactions or cross transactions; an adviser compensating any person for client referrals; an adviser with custody of advisory clients cash and/or securities; and an adviser with a disciplinary history. [7]

Based on this risk scoring process, advisers with risk scores in the top 10 percent are designated "higher risk" and placed on a 3-year examination cycle. That is, they will be scheduled for examination at least once in the following 3-year period.

B. Identifying Risk Issues for Examination

As noted, examiners also identify particular issues for focus during examinations. A key new tool that examiners use to identify such risks with respect to advisers, funds, broker-dealers and other types of firms, is a program known as the "Risk Assessment Data base for Analysis and Reporting" (or "RADAR"). RADAR is a software tool that allows examiners to identify the risks they have observed in examinations, assess the risk's probability of occurrence and potential impact, and recommend possible responsive actions. RADAR allows the staff to see and to prioritize compliance risks for examination attention, investor education efforts, or other regulatory attention. Every examiner participates in the RADAR process.

The use of RADAR has helped identify a large number of risks. Risk personnel in OCIE, working with the SEC's Office of Risk Assessment, then sort and analyze these risks to prioritize them. This process does not suggest that activities given lower priority do not present risk. Rather, again, it is a form of triage, to help match available staff resources to the most pressing risks.

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[5] See SEC, 2004–2009 Strategic Plan, at 32.

[6] Many of an adviser's more detailed disclosures about the nature of its business and its conflicts of interest are set out in Form ADV Part 2. Currently, Part 2 is not filed with the SEC.

[7] An outside firm evaluated this risk assessment methodology in 2008 and concluded that it appeared to have demonstrable value in identifying higher risk advisers.

At the conclusion of the RADAR process, focus areas are identified internally to the Commission and other Commission staff as part of the examination program's annual goals. These and other focus areas are examined in special "sweep" examinations of a number of firms at once, or in routine examinations. The risk of theft and misappropriation of investor money and falsification of performance results is, of course, a focus area during examinations. In addition, among recent focus areas, were, for example:

- Valuation of illiquid or difficult to price securities;
- Manipulative rumors;
- Sales of securities to seniors;
- Controls over non-public information and to prevent insider trading;
- Adequacy of advisers and funds' compliance programs, supervision and governance;
- Undisclosed payments for business;
- Supervision and compliance over branch offices;
- Suitability of sales of complex structured products to retail investors;
- Advisers' performance claims;
- Sales practices in sales of variable annuity products and variable life insurance;
- Pricing, mark-ups, disclosure, suitability, and underwriting of fixed-income securities;
- Auction rate securities;
- Compliance with the net capital rule;
- Best execution, and execution quality of algorithmic and automated trading systems;
- Compliance with short sale rules;
- Broker-dealers' sales of microcap securities;
- Controls for information security and the prevention of identity theft;
- Anti-money laundering programs; and
- Business continuity planning.

C. Cause and Sweep Examinations

A cause examination is conducted when the staff receives specific indications of possible wrongdoing. The information can be obtained from any source, *e.g.*: a tip; another examination; an investor complaint; another office in the SEC; another regulator; or the press. Cause examinations play an important role—for advisers, funds, and broker-dealers, they generally take up between 20 percent and 25 percent of staff resources in any given year. They give the staff the ability to respond very quickly to fast-breaking problems, once an indication of the possible problem becomes known.

Sweep examinations are conducted to focus on a particular risk issue across a number of firms at once. They allow the staff to single out and analyze the severity of a risk and to identify compliance controls that are effective and ineffective, across a number of firms. General findings from sweep examinations and other types of examinations are used to assess emerging compliance risks, and are often made public in the staff's ComplianceAlerts, in order assist firms in preventative compliance efforts.

II. The Madoff Investment Adviser Was Not Examined

The SEC staff did not examine the Madoff investment adviser. The firm registered as an investment adviser in September 2006. As noted above, about 10 percent of registered investment advisers are examined routinely, every 3 years. [8]

III. Examinations of the Madoff Broker-Dealer

The Madoff broker-dealer operation was subject to routine examination oversight by the firm's SRO, and was also subject 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. (As noted above, the firm's advisory business became

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[8] Advisers are required to update Form ADV information annually and as material information becomes inaccurate. A limitation on the risk assessment process is that it is based in part on information self-reported from Form ADV.

registered in 2006 and was not examined.) For the reasons I noted, I must not discuss these examinations in any greater detail.

IV. New Steps

The Commission's staff is working hard to identify new steps, including both changes and improvements to regulation and oversight, which might make fraud less likely to occur. Among the issues that we're studying and I expect that we will study under the new Chair of the Commission, 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 strengthening the custody and audit requirements for regulated firms.

We're 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 information such as, for example, the identity of an adviser's auditor, its custodian and administrator, performance returns, as well as other information. We're targeting firms for examinations of their custody of assets, and expanding our efforts to examine advisers and brokers in a coordinated approach to reduce the opportunities for firms to shift activities to areas where they are not subject to regulatory oversight.

In a range of ways, we're thinking expansively and creatively about changes that could reduce opportunities for fraud, and we very much look forward to working with the Commission and Chairman Schapiro in this critical effort.

PREPARED STATEMENT OF LINDA C. THOMSEN

DIRECTOR, DIVISION OF ENFORCEMENT,
SECURITIES AND EXCHANGE COMMISSION

JANUARY 27, 2009

Good morning Chairman Dodd, Ranking Member Shelby, and Members of the Committee. I appreciate the opportunity to appear here today to discuss matters relating to the Ponzi scheme allegedly perpetrated by Bernard L. Madoff and related enforcement concerns. I am Linda Thomsen and for nearly 14 years it has been my privilege to serve on the staff of the Securities and Exchange Commission.

Before I go any further I want to thank the Committee for understanding that because of our collective desire to preserve the integrity of the investigative and prosecution processes there are matters that I cannot discuss today.[1] None of us wants to do anything that would jeopardize the process of holding the perpetrators accountable. That being said, I will try to address some of the overarching issues related to the Madoff situation. In that regard, my views are my own, and while they are informed by my years on the staff of the Commission, they do not necessarily reflect the views of the Commission or any other member of the staff.

Publicly Disclosed Investigations of Bernard L. Madoff, Bernard L. Madoff Investment Securities, LLC, and Associated Persons

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*

[1] As set forth below in this testimony, the SEC filed a civil enforcement action alleging securities fraud against Bernard L. Madoff and Bernard L. Madoff Investment Securities LLC on December 11, 2008, and the United States Attorney's Office filed a parallel criminal action the same day. These actions are presently being litigated before the United States District Court for the Southern District of New York. Aside from the allegations of the publicly filed complaints, I cannot comment on the pending civil and criminal litigation or the underlying investigations in order to avoid jeopardizing the ongoing legal and investigative processes. In addition, I cannot comment on any historical SEC enforcement investigations of Mr. Madoff, his firm or associated persons because the information is non-public and the SEC's Office of the Inspector General is actively investigating any such prior matters. The SEC's Inspector General recently testified before the House of Representatives Financial Services Committee regarding the scope of his investigation. See H. David Kotz, Inspector General, U.S. Securities and Exchange Commission, Testimony Before the U.S. House of Representatives Committee on Financial Services, January 5, 2009, available at *http://www.sec.gov/news/testimony/2009/ts010509hdk.htm*

LLC, 08 Civ. 10791 (LLS) (S.D.N.Y. Dec. 11, 2008). 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 of Mr. Madoff's alleged Ponzi scheme.

With respect to past SEC enforcement investigations related to Mr. Madoff or his firm, two enforcement actions were filed by the SEC's New York Regional Office in 1992 alleging violations of the securities registration provisions in connection with offerings in which the 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. The first matter was entitled *SEC v. Avellino & Bienes, et al.* [2] 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 percent. 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 Mr. Madoff in turn invested the monies in the market. A&B received returns on the invested funds from Mr. Madoff, but kept the difference between the returns received from Mr. Madoff and the lesser amounts of interest paid on the A&B notes.

The second matter, *SEC v. Telfran Associates Ltd., et al.,* was a spinoff from A&B and involved the creation of a feeder fund to A&B. [3] 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 3 years. Telfran sold investors notes paying 15 percent interest, which they in turn invested in notes sold by A&B that paid between 15 and 19 percent interest. Since investor funds collected by A&B were invested with Mr. Madoff, the Telfran investor funds were also invested with Mr. Madoff, albeit indirectly.

Although the SEC was initially concerned that these unregistered offerings might be part of a huge fraud on the investors, the trustee appointed by the court in Avellino & Bienes found that the investor funds were all there. The returns on funds invested with Mr. Madoff appeared to be exceeding the returns the promoters had promised to pay their investors, so there were no apparent investor losses. [4] 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.

Both cases were settled by the promoters' consent to reimburse each investor the full amount of their investment and to submit to an audit by an accounting firm, and their further consent to be permanently enjoined from further unregistered offerings in violation of the Federal securities laws. In addition, each of the companies making the unregistered offerings agreed to pay a penalty of $250,000, and each of the principals in those companies agreed to pay a civil penalty of $50,000. [5] By executing the SEC's consent orders, Avellino & Bienes, Telfran and their respective principals agreed to cease offering unregistered investment opportunities to the public. Because the court-appointed trustees in Avellino & Bienes concluded the investor funds were all there and all investor funds in both cases were ultimately reimbursed to the investors, the SEC did not pursue fraud charges in those cases. Neither Mr. Madoff nor his firm was named as a defendant in either case.

As widely reported in the press, the SEC's New York Regional Office commenced another investigation of Mr. Madoff in early 2006. Two years later, in January 2008, that investigation was closed without any recommendation of enforcement action.

Securities Regulators, Criminal Authorities, and Other Parties Who May Investigate the Alleged Ponzi Scheme and Related Matters

Many securities regulators, criminal authorities, and private parties have the authority to investigate, or conduct civil discovery from, Mr. Madoff, his firm, and others who might potentially be held civilly or criminally liable in connection with the alleged Ponzi scheme. Together, these regulators, criminal authorities and other parties have an extremely broad range of possible remedies and sanctions.

[2] *SEC v. Avellino & Bienes, et al.,* Lit. Rel. No. 13443 (Nov. 27, 1992).

[3] *SEC v. Telfran Associates Ltd., et al.,* Lit. Rel. No. 13463 (Dec. 9, 1992).

[4] Randall Smith, Wall Street Mystery Features A Big Board Rival, *Wall St. J,* Dec. 16, 1992, at C1.

[5] *SEC v. Avellino & Bienes, et al.,* Lit. Rel. No. 13880 (Nov. 22, 1993); *SEC v. Telfran Associates Ltd., et al.,* Lit. Rel. No. 13881 (Nov. 22, 1993).

On December 11, 2008, the SEC filed a civil action alleging securities fraud against Mr. Madoff and his firm Bernard L. Madoff Investment Securities LLC in the United States District Court for the Southern District of New York. 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 giant Ponzi scheme—using funds received from new investors to pay returns to previous investors—and 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.[6] The SEC immediately sought, and obtained, a preliminary injunction and other emergency relief to prevent the dissipation of any remaining assets.[7] 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 advisor or industry bars, which may be either time-limited or permanent.

Also on December 11, 2008, the United States Attorney's Office for the Southern District of New York filed a criminal action against Mr. Madoff in connection with the alleged Ponzi scheme. Criminal authorities generally have authority to seek incarceration of criminal defendants, as well as to obtain criminal restitution and fines. Criminal authorities may also have the power to seek the imposition of conditions on an individual's liberty, such as probation, denial of voting rights, mandatory curfew and house arrest.

All told, the two actions filed by the SEC and United States Attorney's Office alone (depending, of course, on findings of liability and guilt), expose Mr. Madoff to billions of dollars in liability and decades of incarceration. Both the SEC and the United States Attorney's Office are continuing our investigations and fact-finding. As is our practice, we and the Federal criminal prosecutors are coordinating our efforts as allowed by law.

There are numerous other parties and entities that may be able to pursue Mr. Madoff, his firm and related entities or individuals. For example, the Financial Industry Regulatory Authority, or FINRA, may pursue disciplinary action against Mr. Madoff's in connection with any activities undertaken in its capacity as a registered broker-dealer. Like the SEC, FINRA can order disgorgement, impose civil fines and bar or impose conditions on the employment of an individual by any broker-dealer firm, again either permanently or for a specified time.

The 50 States, as well as their respective securities regulators and criminal authorities, may also investigate and bring civil or criminal actions against Mr. Madoff, his firm and related entities or individuals under applicable state laws. Several states have reportedly commenced such investigations against Mr. Madoff or Madoff-related entities. State attorneys general, securities regulators and criminal authorities are authorized to seek many of the same sanctions as their Federal counterparts, though the available remedies and sanctions may vary to some extent under differing state laws. Further, any period of incarceration would be served in a state, rather than Federal, prison or other detention facility.

The investors who reportedly incurred losses as a result of Mr. Madoff's alleged Ponzi scheme include a large number of foreign nationals, banks and corporations. To the extent foreign citizens, corporations and instrumentalities have suffered losses as a result of Mr. Madoff's alleged misconduct, foreign governments, their respective securities regulators and criminal authorities may also have power to investigate and bring actions under foreign law. For example, the United Kingdom's Serious Fraud Officehas reportedly commenced an investigation of Mr. Madoff, particularly the activities conducted through his London office.

Private citizens and corporate entities may have standing to pursue civil actions against Madoff and associated entities or persons, either in the United States or in their home countries. Private civil actions are primarily brought to seek compensatory and possibly punitive damages. While many private actions have already been filed against Mr. Madoff and various others, the efficacy of these actions will depend in part on the existence and the amount of assets from which a judgment might be satisfied.

Finally, in the SEC's action against Madoff, the United States District Court for the Southern District of New York granted the application of the Securities Investor

[6] *SEC v. Bernard L. Madoff, et al.,* 08 Civ. 10791 (S.D.N.Y. Dec. 11, 2008), Complaint at 2, 4–6.

[7] *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).

Protection Corporation (SIPC) for the liquidation of Bernard L. Madoff Investment Securities LLC and appointed a trustee. The SIPC trustee will marshal the assets and process the claims of customers and creditors of Madoff's firm in an equitable manner.[8]

Enforcement Division Complaints, Tips, and Referrals

The Enforcement Division receives hundreds of thousands of tips each year from various sources. Some are from credible sources who provide detailed information in support of the tip, and some consist of nothing more than newspaper clippings or printed promotional material sent with no further explanation. Some come from industry competitors, some from disgruntled present or former employees, some from present or former investors, and others are totally anonymous. On the one hand, complaints, tips, and referrals from the public often provide valuable information about potential securities violations; on the other hand, sources at times may be attempting to enlist the SEC's authority and resources in efforts to advance their own private interests, which may or may not be consistent with our enforcement mission.

Complaints, tips, and referrals come to the Enforcement Division in every imaginable form. We get telephone calls, handwritten letters, thick bound dossiers with numbered exhibits and extensive accounting analyses, 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, informal referrals from other Offices and Divisions of the SEC, notes from reformed fraudsters, anonymous scribbling, seemingly random pieces of a company's financial statements, and occasional lengthy and disjointed diatribes that make no discernible securities-related claims.

While we appreciate and examine every lead we receive, we simply do not have the resources to fully investigate them all. We use our experience, skill and judgment in attempting to triage these thousands of complaints so we can devote our attention to the most promising leads and the most serious potential violations. Because the process necessarily involves incomplete information and judgment calls made in a tight timeframe, we are also continually working on ways to improve our handling of complaints, tips and referrals to make optimal use of our limited resources.

There are a number of major channels through which complaints, tips and referrals flow in to the Enforcement Division. First, there are calls and letters that are processed and screened by the Office of Investor Education as complaints, tips and referrals or "CTRs." The most promising of these are forwarded to attorney staff in the Enforcement Division. Second, on the SEC's Web site, there is an Electronic Complaint Center that allows members of the public to record complaints and tips on simple online forms. The online complaints are reviewed and triaged by the professional staff of the Enforcement Division's Internet Enforcement Group, which refers them to staff for further investigation based on subject matter or geography.

Yet another group of staff within the Division reviews and evaluates hundreds of "Suspicious Activity Reports" or "SARS" that are filed with Federal banking regulators by banks and financial institutions nationwide. SARS that potentially involve securities are forwarded to the SEC. After screening by experienced staff, promising referrals based on SARS are sent to enforcement staff throughout the country.

FINRA and stock exchanges (referred to as "Self-Regulatory Organizations" or "SROs") are another source of referrals. The SROs provide continual and cutting-edge computerized surveillance of trading activities in their respective markets. They regularly report suspicious activities and trading anomalies to the Enforcement Division's Office of Market Surveillance through a variety of periodic reports. They also provide referrals regarding particular suspicious trades that may show possible insider trading ahead of a publicly announced transaction, such as a merger or acquisition. The SEC's Office of Market Surveillance automatically opens a preliminary investigation of each such referral and then forwards it to appropriate staff, generally based on geographic location of the issuer or suspected traders. The staff then becomes responsible for further inquiries that will either lead to the opening of a full investigation or the closure of the preliminary investigation.

The Enforcement Division also receives referrals of potential securities law violations from other Offices and Divisions within the Commission. These referrals are either taken up directly by the Regional Office where the complaint was discovered or arose, or are directed to staff having appropriate expertise regarding the particular type of complaint. For example, referrals involving accounting issues are di-

[8] *Id.;* see also Information for Madoff Customers, available at *http://www.sec.gov/divisions/enforce/claims/madoffsipc.htm*

rected to the Office of the Chief Accountant in the Enforcement Division for further evaluation and referral to staff as appropriate. Similarly, referrals from throughout the Commission regarding over-the-counter stocks, potential microcap fraud and securities spam are directed to the Trading and Markets Enforcement Group, which has extensive experience in this market segment, for further evaluation and possible referral to staff.

It is important to note that many complaints, tips and referrals are made directly to staff in the Office nearest the complainant and are investigated or addressed by that office. Among the options available to staff receiving a tip or lead are further investigation of the lead, declining to pursue the lead for lack of apparent merit, transfer of a potentially viable lead to an office with a closer geographical connection to the alleged misconduct, or referral of the lead to subject matter experts for further evaluation and possible assignment to staff.

The primary consideration in determining whether to pursue any particular tip depends on whether, based on judgment and experience, the tip provides sufficient information to suggest that it might lead to an enforcement action involving a violation of the Federal securities law. This determination requires the exercise of judgment regarding, among other things: the source of the tip; the nature, accuracy and plausibility of the information provided; an assessment of how closely the information relates to a possible violation of Federal securities law; the validity and strength of the legal theory on which a potential violation would be based; the nature and type of evidence that would have to be gathered in the course of further investigation; the amount of resources the investigation might consume; and whether there are any obvious impediments that would prevent the information from leading to an enforcement action (for example, the conduct complained of is not securities-related).

When we determine that we have a promising tip, we investigate. We follow the evidence where it leads and will pursue and develop evidence regarding the liability of a full array of persons and entities—from the central players to the peripheral actors—and we do so without fear or favor. In commencing an investigation, we usually do not know whether or not the law has been broken and, if so, by whom. We have to investigate, and our investigation may or may not lead to the filing of an enforcement action. We are resource constrained. The approximately 3,500 employees of the SEC (of whom approximately 1,000 are in the Enforcement Division) are charged with regulating and policing an industry that, as described in Ms. Richards' testimony, includes over 11,300 investment advisers, 4,600 registered mutual funds, over 5,500 broker-dealers (with approximately 174,000 branch offices and 676,000 registered representatives), as well as approximately 12,000 public companies. Every day we are compelled to make difficult judgments about which matters to pursue, which matters to stop pursuing, and which matters to forego pursuing at all. Every investigation we pursue, or continue to pursue, entails opportunity costs with respect to our limited resources. A decision to pursue one matter means that we may be unable to pursue another. No single case or investigation can ever be considered in a vacuum, but rather must be viewed as one of thousands of investigations and cases we are or could be pursuing at any given time.

In pursuing our work, the staff of the Enforcement Division is devoted to public service and our mission of investor protection. In recent days there have been suggestions that the staff is not motivated to pursue the big case and somehow is inclined to look the other way. Nothing could be further from the truth. Based on my experience with the hard-working men and women in the Enforcement Division, our staff lives to bring cases, particularly big and difficult cases. The staff is bright, creative and professionally zealous; for most of us, nothing is more rewarding than pursuing a good case. Athletes may score runs or kick goals, but we bring enforcement actions. The filing of an enforcement action is one of the few solid benchmarks of success in the pursuit our mission.

One need only look at the 8 days surrounding the bringing of the Madoff case to see ample evidence of our commitment. During the Monday to Monday period between December 8 and December 15, 2008, the Commission also:

- Sued Mark Dreier, an attorney selling bogus notes;[9]
- Brought an action against Fidelity traders for taking illegal gifts and gratuities;[10]

[9] *SEC v. Marc S. Dreier,* Lit. Rel. No. 20823 (Dec. 8, 2008).
[10] Former Fidelity Employees to Pay More Than $1 Million to Settle SEC Charges for Improperly Accepting Lavish Gifts Paid For By Brokers, SEC Press Rel. No. 2008-291 (Dec. 11, 2008).

- Finalized some of the landmark auction rate securities cases, which provided billions of dollars of liquidity to thousands of investors within just months after that market froze; [11]
- Sued a Russian broker-dealer for operating in our markets in violation of our rules; [12]
- Settled a complex financial fraud matter involving reinsurance; [13]
- Filed, in coordination with criminal authorities, an action to halt a wide-ranging market manipulation scheme; [14] and
- Filed a $350 million dollar settled action against Siemens for bribery of foreign officials in violation of the Foreign Corrupt Practices Act, [15] the largest SEC settlement in the Act's 30-year history.

Everyone at the SEC wishes the alleged Madoff fraud had been discovered sooner. We are committed to finding way to make fraud less likely and fraud detection more likely. But we need to acknowledge a hard truth our forefathers recognized—if men were angels we wouldn't need government. We wouldn't need laws either. The reality is that people do break the law and when they do so, there is harm, sometimes great harm.

Looking at what we can do to deter fraud or find it sooner, the steps fall into three general categories: law enforcement; law and regulation; and resources. On the enforcement front, we are looking for ways to help identify from among the various streams of information we receive and those that our staff independently develops, the systemic risks and emerging trends we should investigate. We have pursued risk-based investigations where we identify a potential trouble spot and then develop investigative plans to test whether the problem exists at a given company and the markers for the problem that might enable us to identify it more quickly in other firms.

Just last week, we brought a case against General Motors involving pension accounting and related disclosures that was the result of that process. [16] For the last several years, the SEC has been concerned about the adequacy of the assumptions underlying public issuers' pension accounting and related reserves, as well as related disclosure issues. In an analogous context, the Enforcement Division had already confronted substantial disclosure problems related to pension obligations in our enforcement action against the city of San Diego. In that case, the SEC brought an enforcement action against the city of San Diego for issuing bonds without adequately disclosing the city's overwhelming future pension obligations to city employees. [17] We were concerned that the kind of pension-related disclosure and accounting issues we encountered in the San Diego case might be an even bigger problem in the context of corporations that are public issuers—which may have many more employees and much more complex pension obligations. Accordingly, the Enforcement Division decided to review pension accounting assumptions and related disclosures at a number of large public issuers, and the GM case announced last week was the result of that review. Our risk-based initiatives are resource-intensive and time-consuming, but they have produced results—both in terms of filed enforcement actions and the related deterrent effects in the market.

On the law and regulation front, as has been widely acknowledged, our current system includes many products and businesses that are largely unregulated (hedge funds, for example); products and businesses that are regulated only on the state level (many insurance products, for example); and balkanized regulation on the Federal level (the different regulatory schemes that apply to broker-dealers and investment advisors, for example).

For example, there are products that appear to be comparable from an investor's perspective that are in fact subject to widely varying degrees of oversight and regulatory risk (and indeed, these varying products are oftentimes sold to an investor by the same person). By the same token, in the course of a single conversation with a customer, an investment professional may be acting in his capacity as a broker-dealer or in his capacity as an investment adviser, with differing disclosure and legal obligations at any given moment, but the customer is usually unaware of any

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[11] *SEC v. Citigroup Global Markets, Inc., et al.,* Lit. Rel. No. 20824 (Dec. 11, 2008).
[12] In the Matter of CentreInvest, Inc., OOO CentreInvest Securities, Vladimir Chekholko, William Herlyn, Dan Rapoport, and Svyatoslav Yenin, Exch. Act. Rel. No. 59067 (Dec. 8, 2008).
[13] *SEC v. Zurich Financial Services,* Lit. Rel. No. 20825 (Dec. 11, 2008).
[14] *SEC v. National Lampoon et al.,* Lit. Rel. No. 20828 (Dec. 15, 2008).
[15] *SEC v. Siemens Aktiengesellschaft,* Lit. Rel. No. 20829 (Dec. 15, 2008).
[16] *SEC v. General Motors Corporation,* Lit. Rel. No. 20861 (Jan. 22, 2009).
[17] In the Matter of city of San Diego, California, Exch. Act Rel. No. 54745 (Nov. 14, 2006).

difference between these roles, and would find the distinctions bewildering in any event.

Consideration should be given to harmonizing the regulatory regimes that apply to these similar products and businesses. Such harmonization could benefit not only the individual investor but also the market as a whole by contributing to restored market confidence.

On a more micro level, consideration should be given to quite specific steps that might contribute to slowing down or detecting fraud within an investment advisory business. For example, consideration could be given to requiring third party custody of customer assets, imposing requirements regarding qualifications, size and resources of accounting firms eligible to audit such businesses, or requiring additional disclosure.

As to resources, over the past few years our job has grown substantially. Just one example is noted in Lori Richards' testimony. In 2002, there were 7,547 registered investment advisers; today, there are 11,300—an increase of 50 percent. The amount of resources available to the SEC has not kept pace with the rapid expansion in the securities market over the past few years—either in terms of the number of firms or the explosion in the types of new and increasingly complex products, including securities, hedge funds and related trading strategies, collateralized debt obligations, credit default swaps and financial derivative products, some of which were expressly designed to avoid SEC regulation and oversight. Nor have our resources expanded to address the ongoing globalization of the international financial markets.

While we always do our utmost to do more with less, if we had more resources, we could clearly do more. We could do more investigations, file more enforcement actions and achieve more deterrence. More resources would also allow us to spend more time to determine whether a particular problem may be widespread in certain market segments—those risk based investigations I described earlier. Resources could also allow us to use more technology in our work. Technology can be quite useful in maximizing our effectiveness, but technology is often expensive, requires consistent maintenance, and must be periodically updated. We also need to be sure that enforcement personnel have access to market, trading, analytical, accounting and economic expertise when they need it and that they have the training to know when they should call upon that expertise. The agency's renewed focus on risk assessment will help to address these concerns.

Finally, we need to focus on investor education and the creation of a strong compliance tone and culture in the securities industry. All of us need to encourage investors to be their own best advocates and to practice basic safe investing principles, such as skepticism and diversification. And all of us need to do everything we can to encourage a tone and culture, especially among those who make their livings from other people's investments, that mere compliance with the law, narrowly viewed, is not the highest goal to which we aspire, but the base from which we start. We should all work toward a system where those who work in it are responsible stewards of the treasures entrusted to them.

PREPARED STATEMENT OF STEPHEN I. LUPARELLO

INTERIM CHIEF EXECUTIVE OFFICER,

FINANCIAL INDUSTRY REGULATORY AUTHORITY

JANUARY 27, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, 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. Per the Committee's request, a complete list of the positions once held by Bernard Madoff with NASD or its affiliates is attached to this testimony as an addendum.

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 2-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 10 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
- Fourteen 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

[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).

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
- 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 Committee as you consider how best to restructure the U.S. financial regulatory system.

Positions Once Held by Bernard Madoff With NASD or Its Affiliates:

- NASD Board: 1984, 1985, 1986, 1987
- SOES Users Committee: 1985, 1986, 1989 (Chair)
- Trading Committee: 1984, 1985 (Chair), 1986, 1987
- Board Surveillance Committee: 1990, 1989
- Limit Order Taskforce: 1989
- International Committee: 1985, 1986, 1989, 1992, 1993
- Strategic Planning Committee: 1990, 1991, 1992, 1993
- Advisory Council: 1983
- Long Range Planning Committee: 1989
- NASDAQ Board: 1989, 1990–1991 (Chairman)
- NASDAQ National Nominating Committee: 2001

PREPARED STATEMENT OF STEPHEN P. HARBECK

PRESIDENT AND CHIEF EXECUTIVE OFFICER,
SECURITIES INVESTOR PROTECTION CORPORATION

JANUARY 27, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to appear before you today to discuss the work of the Securities Investor Protection Corporation, known as SIPC. My name is Stephen Harbeck and I have been the President and Chief Executive Officer of SIPC for the past 6 years. I have worked at SIPC for 33 years and was General Counsel prior to my appointment as President and CEO.

SIPC was created under the Securities Investor Protection Act of 1970 ("SIPA") to provide specific financial protection to customers of failed securities broker-dealers. Although created under a Federal statute, SIPC is not a government entity. It is a membership corporation, the members of which are, with very limited exceptions, all entities registered with the Securities and Exchange Commission ("SEC") as securities broker-dealers. Membership is not voluntary; it is required by law.

As a fundamental part of its statutory mandate, SIPC administers the SIPC Fund from which advances are made to satisfy claims of customers. The Fund is supported by assessments on SIPC member firms and its assets currently total $1.7 billion. In addition, SIPC maintains a commercial line of credit with an international consortium of banks, and, by statute, has a $1 billion line of credit with the United States Treasury. SIPC has no authority to examine or investigate member firms. Those are the functions of the SEC and the Financial Industry Regulatory Authority which is a self-regulatory organization ("SRO) of the securities industry. When either of those entities or any other SRO informs SIPC that the customers of a brokerage firm are in need of the protections of SIPA, SIPC may initiate a customer protection proceeding to return to customers the contents of their securities accounts within specified limits. The proceedings are a specialized form of bankruptcy. A trustee and counsel are designated by SIPC, and appointed by the United States District Court, subject to a hearing on disinterestedness. The case is then referred to the appropriate Bankmptcy Court for all purposes.

To the extent securities or cash is missing from customer accounts, SIPC may use its funds, within limits, to restore customer accounts to the appropriate account balances. SIPC may advance up to $500,000 per customer on account of missing securities, of which up to $100,000 may be based upon a claim for cash. SIPC does not protect customers against market loss in an account. It is also important to note that customer property is never used to pay any of the administration expenses, such as fees of accountants, lawyers or even the trustee in a SIPA proceeding.

Through 2007, SIPC liquidated 317 brokerage firms, and returned over $15.7 billion in cash or securities to customers. Of that sum, SIPC used $322 million from the SIPC Fund to restore missing cash or securities. To date, SIPC has never used any government funds or borrowed under its commercial line of credit.

2008 was very different from anything in our past history. In addition to three smaller cases, SIPC has faced in recent months two unprecedented events: the initiation of liquidation proceedings for Lehrnan Brothers Inc. in September 2008, and the liquidation of Bernard L. Madoff Investment Securities LLC, in December 2008. Both of those cases present significant challenges, but the two cases are very different.

Lehman Brothers Inc.

The Lehman Brothers Inc. ("LBI") liquidation was preceded by the Chapter 11 filing of Lehman Brothers Holdings Inc. on September 15, 2008. The Holding Company owned the SIPC member brokerage firm, LBI, which in turn held securities customer accounts. In order to facilitate the sale of brokerage assets, SIPC initiated a customer protection proceeding on Friday, September 19, 2008. On application by SIPC to the United States District Court for the Southern District of New York, LBI was placed in SIPA liquidation, James W. Giddens was appointed as trustee, and the law firm of Hughes Hubbard & Reed LLP was appointed as his counsel. That day, upon removal of the proceeding by the District Court, the United States Bankruptcy Court for the Southern District of New York held an extended hearing and approved the sale of assets of LBI to Barclays Bank.

Over the following weekend, the trustee for LBI transferred customer account positions, which contained $142 billion in customer assets, to two broker-dealers, one of which was the brokerage arm of Barclays. As a result, many of the customers of the defunct firm were able to exercise control over their respective portfolios in a seamless way. While much remains to be done in every aspect of the LBI matter, the initial stages have proceeded very well.

Bernard L. Madoff Investment Securities LLC

The failure of Lehman Brothers Inc. was linked to the complex, systemic failure of the subprime mortgage situation. The failure of Bernard L. Madoff Investment Securities LLC, a registered securities broker-dealer and SIPC member, involved a very different problem: the theft of customer assets on an unprecedented scale. The firm was placed in a SIPA liquidation proceeding on December 15, 2008, after the principal of the firm, Bernard Madoff, confessed to having stolen customer property over a period of many years. Irving H. Picard was appointed as trustee, and the law firm of Baker & Hostetler LLP was appointed as his counsel.

Unlike the LBI case, where customer records were accurate, it became apparent very early in the Madoff case that the customer statements Mr. Madoff had been sending to investors bore little or no relation to reality. The records sent to customers were inaccurate when compared to the inventory of securities actually held by the brokerage firm. For that reason, it was not possible to transfer all or part of any customer's account to another, solvent brokerage firm. Instead, pursuant to SIPA, Mr. Picard sought and received authority from the Bankruptcy Court for the Southern District of New York to publish a notice to customers and creditors, and to mail claim forms to them, as required by law, no later than January 9, 2009. The notice of the initiation of the case was published on January 2, 2009, and claim forms mailed to more than 8,000 investors at their addresses as they appeared on the Madoff firm's records within the last twelve months.

The trustee has requested information from each customer as to the sums given to the Madoff brokerage firm, and sums withdrawn from the firm, to assist in the analysis of what each customer is owed. There are some situations, particularly where the investors have not made withdrawals, where it will be relatively easy to determine exactly how much a claimant put into the scheme. In other situations, the extended time period of the deception, coupled with numerous deposits with or withdrawals of assets from the brokerage over time, may make that reconstruction very difficult. SIPC and the trustee are committed to using all available resources to resolve these issues quickly.

Mr. Madoff apparently has stated that he stole $50 billion. Even though this sum may include the annual "profits" he reported to investors in his fraudulent scheme, this defalcation is on a different order of magnitude than seen in any SIPA liquidation that has preceded it. Until customer claims are received and processed and further accounting and related work accomplished, SIPC will not know the extent of the demand on its resources. We can predict that the demand will be in excess of any previous case. Of course, the maximum amount under SIPA that SIPC can advance to any one claimant is $500,000 (including the $100,000 cash limit), even if the valid amount of the claim is much higher. The extent of recovery by customers beyond the amounts advanced by SIPC will depend upon the amount of customer property that the trustee is able to recover. To date, the trustee has identified over $830 million in liquid assets of the defunct brokerage firm that may be subject to recovery. Of these amounts, the trustee already has collected $91.8 million. Finally, the trustee has in place a team of highly trained attorneys, forensic accountants, and computer specialists, to assist him in locating and recovering assets. The trustee and SIPC will be aggressive in their pursuit of such recoveries.

The Committee has expressed interest in a number of specific points concerning the Madoff case. In order to give the Committee a better understanding of those specifics, I would note the following:

SIPC's Jurisdiction Over the Madoff Firm

SIPC's jurisdiction is limited to brokerage firms registered as such with the SEC. Although there have been name changes over time, the Madoff firm has been a member of SIPC since SIPC's inception in 1970. The SIPA statute contemplates, and the Supreme Court agrees, that SIPC intervention is a last resort. When a brokerage firm is financially incapable of returning securities and cash in customer accounts, then and only then is SIPC involved. In the Madoff case, FINRA and the SEC presented SIPC with evidence that, at the very least, he Madoff brokerage firm owed customers $600,000,000 worth of stock that it did not have on hand. That was the factual predicate for the exercise of SIPC's jurisdiction.

At the time of its failure, the Madoff firm was registered as both a brokerage firm and as an investment advisor, but there was only one corporate entity. SIPC does not have jurisdiction over any entity that is registered as an investment advisor.

SIPC's Process and Timetable in the Madoff Case

As mentioned above, SIPC filed its application for a decree declaring the customers of the Madoff firm to be in need of the protections available under SIPA on December 15, 2008. A trustee was appointed that day. On January 2, 2009, the trustee mailed a notice of the initiation of the SIPA proceeding and a claim form to the last known address of all customers, and to any other possible claimants then known to the trustee. Several hundred claims have been received by the trustee.

The extended nature and scope of the theft over several decades makes this an unprecedented case. The SEC and SIPC have conferred at the staff level about the appropriate treatment of claims under these circumstances. SIPC's Board will review this issue on January 30. I expect a similarly rapid review of the issue by the SEC. The legal issues are as complex as they are unprecedented. In any event, I would hope that the trustee could begin satisfying simple, straightforward claims as early as February.

The Sufficiency of the SIPC Fund

Until all claims are filed and evaluated, it is not possible to determine exactly how much SIPC may be called upon to advance to the customers of the Madoff firm.

Because SIPA limits the maximum advance SIPC may make with respect to any one customer claim, the call upon SIPC's resources is limited. By way of example, a perfectly valid claim for $100,000,000 would be eligible only for a maximum of $500,000 from SIPC. (Customers will also share, *pro rata,* in the corpus of "customer property" the trustee collects.) Until all claims are filed, and forensic accounting completed, it cannot be determined if SIPC's resources will be adequate.

The Prospect of Statutory Amendment

The failures of Lehmnan Brothers and Madoff call into question the sufficiency of SIPC's statutory line of credit with the United States Treasury. This credit line of $1 billion has not changed since 1970. Other refinements to the statute may also be considered. As this case moves forward and we have a clearer picture of the facts and their implications, SIPC will maintain a dialog with Congress about any issues that may give rise to the need for changes to SIPA.

I would be pleased to answer any questions from the Committee.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM JOHN C. COFFEE

Q.1. The SEC's examiners were looking at the Madoff firm in 2006 and were aware that he had misled them. Does it concern you that the enforcement staff did not try to get subpoena authority to look into the matter?

A.1. To obtain subpoena authority, the SEC's enforcement staff must commence a "formal" investigation (as opposed to an "informal" once), and this requires a Commission vote. During this period, the SEC's enforcement staff in my judgment feared that their request might be rejected, might have resulted in other limitations being placed on their investigation, or simply might become contentious at the Commission level, thereby weakening their leverage in litigation. Thus, the staff may have sought in a number of cases to resolve cases at the "informal" stage. Obviously, this is unfortunate. By constraining the Enforcement Division, the Commission made it easier for some frauds to go undetected as a result of premature settlements.

Q.2. In your estimation, is the fact that the SEC did not catch this fraud an indication of systemic problems in the Division of Enforcement and Office of Compliance Inspections and Examinations. If so, what are those problems?

A.2. Although one failure does not alone demonstrate a systemic problem, I believe that the Office of Compliance, Inspections, and Examinations is systematically using poor criteria to determine in which instances to conduct an expedited examination. There also appears to be poor communication between the two offices, as the Division of Enforcement should have communicated the fact to the Office of Compliance, Inspections and Examinations that Madoff had mislead them (we simply do not know if this happened). Beyond this, the facts that (i) Madoff Securities served as a "self-custodian" for Madoff's investment advisory operations and (ii) Madoff used an unknown (and tiny) accounting firm that was not registered with the PCAOB should have been factors that lead to an immediate examination (as should the fact that Madoff had long resisted registration as an investment advisor). Admittedly, the Office of Compliance, Inspections, and Examinations cannot examine all brokers or investment advisers in all years, but these factors should have put Madoff at the top of the list (as should the immense amount of assets known to be under his investment management).

That they did not shows that the Office is using very poor criteria for judging relative risk.

Q.3. In your testimony, you noted that there appears to be a growing phenomenon of Ponzi schemes. You also discussed problems at unregulated entities. The Madoff fraud, however, seems to be another example of a growing trend of fraud at regulated entities. For example, we saw widespread market timing abuses perpetrated by registered investment advisors, mutual funds, and registered broker-dealers. We saw the collapse of the Consolidated Supervised Entity program. Often, rumors of problems at registered entities are swirling for years before the SEC reacts.

Has the SEC been as effective as it should be at monitoring what is going on in the industries it regulates?

A.3. Not at all! In part, it has been underfunding, and in part the Staff's recurrent passivity has been a consequence of a deregulatory bias that assumes that internal controls at firms are adequate to deter fraud. Finally, the "market timing" and option "backdating" scandals have shown that there are times when SEC officials have known of abuse but decided to tolerate it. To say the least, that is alarming.

Q.4. Mr. Madoff was highly regarded by both the SEC and FINRA. He and his relatives served in advisory capacities to the two organizations.

Do you believe that Mr. Madoff's status contributed to the fact that his fraud was not discovered by the SEC and FINRA?

A.4. This is a matter of inference, rather than objective evidence, but I strongly suspect that Mr. Madoff's well-known industry status contributed to the "light touch" review that he received. The SEC's Inspector General reached a similar conclusion in his report on the Morgan Stanley investigation.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR JOHNSON FROM JOHN C. COFFEE

Q.1. The Madoff Ponzi scheme is one of the largest financial frauds in U.S. history. From point of view, how did the Madoff Ponzi Scheme fall through the cracks of the U.S. regulatory system?

It is obvious to me that there are aspects of our regulatory system that do not work. Unfortunately, it took an economic crisis of the current magnitude for us to realize that changes are needed in the financial services' regulatory structure. What do you believe is the starting point for modernizing the regulation of securities entities, investments, broker-dealers, and investment advisors?

A.1. Put very simply, hedge funds need to be subjected to SEC registration and SEC oversight for safety and soundness. Although the same close regulation as applies to mutual funds may not be necessary, the SEC should be able to review trading practices, including the over-the-counter swaps market, for excessive risk-taking. Finally, independent, unaffiliated custodians should be mandated for all investment advisers.

Q.2. In hindsight, would you propose any changes to the relationships between the SEC and FASB and the SEC and the PCAOB?

A.2. I do not believe that FASB or the PCAOB have any relationship to the Madoff scandal. From time to time, the FASB has been pressured to relax their accounting standards (this goes back to the "expensing" of stock options issue in the 1990s), and it appears to be happening again with respect to "mark to market" accounting. But there is no easy cure.

Q.3. The Madoff Ponzi scheme went undetected for possibly decades. Do you believe there are other fraudulent schemes in the United States that have gone undetected and could substantially harm families, retirees, communities, philanthropic organizations, and other investors as this one did?

A.3. Almost certainly yes. And, subsequent to this hearing, the Allen Stanford Ponzi scheme was exposed, demonstrating this.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR JOHANNS FROM JOHN C. COFFEE

Q.1. What options from the Treasury's Blueprint for Regulatory Reform would you implement?

A.1. The United States needs a "systemic risk regulator" capable of monitoring capital adequacy, safety and soundness, and risk management practices at all financial institutions that are either "too big" or "to entangled" to fail. My specific reactions to the "Blueprint" proposal of The Treasury Department in April 2008 are set forth in detail in a long article entitled, "Redesigning the SEC: Does the Treasury Have a Better Idea?", which is forthcoming in the Virginia Law Review and is currently available on the SSRN Web site. I would be happy to e-mail or send it on request, but do not wish to impose it on you. Basically, I support the "twin peaks" model discussed in the Blueprint, under which a "consumer protection agency" (*i.e.,* the SEC) would remain independent from the "systemic risk regulation" agency.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR JOHNSON FROM HENRY A. BACKE, JR.

Q.1. The Madoff Ponzi scheme is one of the largest financial frauds in U.S. history. From your point of view, how did the Madoff Ponzi scheme fall through the cracks of the U.S. regulatory system? Was there ever anything irregular in your dealings with Madoff's firm?

A.1. The Madoff Ponzi Scheme fell through the cracks of the U.S. regulatory system numerous times because the Securities Exchange commission (SEC) did not investigate thoroughly Harry Markopolos' advice and warnings. Bernard Madoff was also allowed to be an investment advisor without being registered for many years. It seems apparent that no one should be able to be an investment advisor or Broker dealer without being registered in the United States.

The SEC did a cursory investigation and never subpoenaed records or documents; they never investigated Bernard Madoff's investment advisory business where the fraud took place. If they had done so and checked that the securities he purported to own for his clients were in his companies name, they would have uncovered the fraud or potentially prevented the continuation of the Ponzi scheme.

Either the investigators were incompetent or did not do a thorough investigation for some unknown reason to date.

Bernard Madoff had significant influence as a SEC advisory panel member; he had conflicts of interest with the investigation and was allowed leniency in the investigations.

To my knowledge there was never anything irregular about my Defined Contribution Pension plan's dealings with Madoff's firm.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR JOHANNS FROM HENRY A. BACKE, JR.

Q.1. What options from the Treasury's Blueprint for Regulatory Reform would you implement?

A.1. Investment Advisors should not be able to use their own broker dealer to execute trades. Investment Advisors must be obligated to use an independent custodian. Broker dealers must use certified, registered accountants for audits and the audits should include confirming the securities exist in the appropriate name.

The Securities Exchange Commission (SEC) and Finance Industry Regulatory Authority (FINRA) must have more jurisdiction to investigate broker dealers and any associated advisory business.

There should be more transparency and public access to information regarding broker dealers and investment advisory businesses.

SEC and FINRA should share information about firms they are investigating.

SIPC limits should be adjusted to current value of the dollar to account for inflation. Broker dealers should pay higher premiums to ensure adequate funds to protect each individual investor.

The SEC should examine more than 10 percent of Investment Advisor businesses each year. Every firm should be evaluated on a 5- to 10-year cycle.

SIPC coverage is meaningless unless the definition of "customer" is extended to the individual investor. As of now, the broker dealers are using SIPC to their advantage.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM LORI A. RICHARDS

Q.1. Independent Custodian: At the hearing, Columbia Law School Professor John C. Coffee recommended "the most important reform is to require an external and independent custodian for all collective investment vehicles." If the law required this, what impact might this have had in the Madoff situation or in other situations? Do you plan to study this recommendation to determine whether some type of custodial requirement would be appropriate to recommend to the Commission?

A.1. Speaking as an examiner, separation of functions is an important control mechanism. We are working to identify measures that might make fraud less likely, which may include changes to the SEC's rules with respect to the custody of assets. As Chairman Schapiro testified on March 26, 2009, before the United States Senate Committee on Banking, Housing and Urban Affairs, she has asked the Commission's staff to work on a series of reforms to better protect investors when they place their money with a broker-dealer or an investment adviser. As noted, the Commission has already proposed rule amendments to require investment advisers with custody of client assets to undergo an annual "surprise exam" by an independent public accountant to confirm the safekeeping of those assets.

Q.2. Oversight of FINRA Examinations: Please describe the scope of the Commission's authority over the examinations conducted by FINRA of broker-dealers and the extent and frequency of the Commission's supervision of FINRA's examinations. Include in this discussion examinations conducted pursuant to Section 13(c) of the Securities Investor Protection Act, which provides that, subject to limited exceptions, the SRO of which a member of SIPC is a member shall inspect or examine such member for compliance with all applicable financial responsibility rules.

A.2. Section 17(a) and (b) of the Securities Exchange Act of 1934 ("Exchange Act") provide Commission staff with the authority to conduct examinations of SROs. Section 19(g)(1) of the Exchange Act requires SROs to comply with the provisions of the Federal securities laws and the SRO's own rules and to enforce compliance by its members with these provisions.

As part of its oversight of SROs, the Commission's examiners conduct comprehensive inspections of the SROs' regulatory programs. These inspections include FINRA District Offices, which are conducted on a 3-year cycle, and FINRA's Risk Oversight & Operational Regulation Group. During these inspections, the SEC staff inspectors review FINRA's examination and surveillance programs for member financial responsibility and operational compliance.

In addition, the SEC examiners conduct "oversight" examinations of broker-dealers to evaluate an SRO's examination work. The SEC conducts over 700 broker-dealer examinations each year. Generally between 150 and 200 of these are oversight examinations. Oversight examinations of broker-dealers serve the dual purposes of evaluating the quality and effectiveness of an SRO's examinations of its member firms, as well as detecting violations or compliance risks at broker-dealers. During an oversight examination, examiners analyze and sample a broker-dealer's records from the same time period and focus areas that the SRO reviewed during its examination. Particular emphasis is placed on certain identified risk areas that may include financial and net capital, sales practice and supervision, books and records, customer complaints, arbitrations, litigation, and anti-money laundering. These examinations may also include a review of whether the firm implemented any corrective measures recommended by the SRO.

If these examinations and inspections identify deficiencies the SEC staff provides oversight comments to the SRO outlining the issue and requesting remedial action or other improvements.

Q.3. Review of Auditor: Ms. Richards, you testified that you are looking at "whether the risk assessment process would be improved with routine access to information such as, for example, the identity of an adviser's auditor." Please describe the types of information you are considering and whether the Commission has adequate legal authority to access such information.

A.3. Given the number of registered firms, it is essential that we work to improve our risk-based oversight of broker-dealers and investment advisers. We believe that the risk assessment process utilized for examinations can be greatly enhanced by timely access to reliable information and data. The staff in the Office of Compliance Inspections and Examinations (OCIE), together with other agency staff, is presently working on an initiative to identify the key data points that would facilitate a risk-based oversight methodology and better allow the staff to identify and focus on those firms presenting the most risk. Once we have identified data points, we will explore how best to obtain the information and the agency's authority to do so.

Q.4. SIPC: Mr. Harbeck in his testimony said that "FINRA and the SEC presented SIPC with evidence that, at the very least, the Madoff brokerage firm owed customers $600,000,000 worth of stock that it did not have on hand. That was the factual predicate for the exercise of SIPC's jurisdiction."

Which Office, Division or other unit of the Commission presented SIPC with such evidence? Please provide the text of the Commission's communication to SIPC as well as the analysis that formed the basis of the conclusion underlying the communication.

A.4. The Commission's Division of Trading and Markets is the agency's liaison with SIPC.

Q.5. Resources and Examinations: The testimony states "the Commission's staff did not examine his advisory operations, which first became registered with the Commission in late 2006." Why did OCIE not conduct an examination of Bernard L. Madoff Investment Securities LLC when the broker-dealer registered as an investment adviser? Did OCIE lack sufficient resources to conduct examinations of newly registered investment advisers?

A.5. Given the number of registrants, the SEC is not able to conduct routine periodic examinations of all newly registered investment advisers. Currently, there are more than 11,000 investment advisers registered with the Commission, an increase of over 40 percent since 2001. The Commission has approximately 425 staff dedicated to examining investment advisers (including advisers to hedge funds) and mutual funds. Due to the large investment adviser population and limited Commission resources, the SEC has implemented a risk-based approach to prioritize registrants for examination and to allocate examination resources to the most pressing risks. Based upon a risk-scoring process that includes information from a firm's Form ADV filing and its most recent examination (if any), advisers with risk scores in the top 10 percent are designated as "higher risk" and are prioritized for examination, on a 3-year examination cycle. This does not mean that firms that score outside of that top 10 percent pose no risk; rather, the approach represents a form of triage for issues and registered entities that appear to pose the highest risk. Other firms may be examined for cause, randomly or as part of a sweep. Additional resources would allow the SEC to conduct more examinations, including of newly registered investment advisers, and to place all registered advisers and mutual funds on a periodic exam cycle.

Q.6. Please describe the typical experience levels of staff who conduct exams of an investment advisor and of a broker-dealer. On average, how many new examiners are hired by your Office each year and what is their typical experience level?

A.6. The SEC's examination staff is comprised of lawyers, accountants and examiners, many with CFAs and CPAs. Approximately 60 percent of current examination staff had private sector experience prior to joining the Commission. While the number of new examiners hired each year rises and falls due to various factors, we have seen a positive long term trend in the experience levels of new hires. Congress' pay parity legislation, implemented in 2002, provided the Commission with the authority to pay its staff higher salaries commensurate with other Federal financial regulators. This, in turn, allowed the Commission's examination program to bring in greater numbers of staff with experience in the securities industry, in auditing, and in compliance. Over 73 percent of the examination staff hired in the last 5 years had such experience prior to joining the Commission's staff.

Q.7. Please explain the circumstances under which the Commission staff and FINRA (and its predecessor) staff conducted examinations of the broker-dealer Bernard L. Madoff Investment Securities LLC and their frequency. Do protocols for such exams include procedures that are designed to detect a Ponzi scheme?

A.7. The Madoff broker-dealer operation was subject to routine examination oversight by FINRA. The broker-dealer was also subject to limited-scope examinations by SEC examination 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. The SEC examinations were generally focused on the firm's compliance with applicable trading rules.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM LORI A. RICHARDS

Q.1. It is my understanding that the Madoff firm met all three risk factors that you outlined in a speech last year. With $17 billion under management, the firm was large. There were questions about compliance and supervisory controls, and Bernie Madoff's brother was chief compliance officer for the firm. The secretive nature of the advisory business and the fact that it was solely funded through brokerage commissions presented increased compliance risk.

Did your staff conduct an examination of the Madoff firm in its first year as an investment advisor? If not, why not?

A.1. The Madoff broker-dealer operation was subject to routine examination oversight by FINRA. The broker-dealer was also subject to limited-scope examinations by SEC examination 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. The SEC examinations were generally focused on the firm's compliance with applicable trading rules.

The Commission's staff did not examine the Madoff firm's advisory operations, which first became registered with the Commission in late 2006 and thus subject to the SEC's examination authority at that time. Given the number of registrants, the SEC is not able to conduct routine periodic examinations of all newly registered investment advisers. Currently, there are more than 11,000 investment advisers registered with the Commission, an increase of over 40 percent since 2001. The Commission has approximately 425 staff dedicated to examining investment advisers (including advisers to hedge funds) and mutual funds. Due to the large investment adviser population and limited Commission resources, the SEC has implemented a risk-based approach to prioritize registrants for examination and to allocate examination resources to the most pressing risks. Based upon a risk-scoring process that includes information from a firm's Form ADV filing and its most recent examination (if any), advisers with risk scores in the top 10 percent are designated as "higher risk" and are prioritized for examination, on a 3-year examination cycle. This does not mean that firms that score outside of that top 10 percent pose no risk; rather, the approach represents a form of triage for issues and registered entities that appear to pose the highest risk. Other firms may be examined for cause, randomly or as part of a sweep. Additional resources would allow the SEC to conduct more examinations, including of newly registered investment advisers, and to place all registered advisers and mutual funds on a periodic exam cycle.

Q.2. In 2001, two journalists published articles that reported skepticism by former Madoff investors and experts about Mr. Madoff's ability to generate the types of returns he was producing through the investment strategy he was purporting to use and raised the specter of possible illegal conduct.

Did your staff review these articles and, if so, what steps did your staff take to assess the validity of these claims?

A.2. The Commission's Inspector General is conducting an investigation into the Commission's investigation and examinations of the Madoff firm and has requested the staff not to conduct any internal inquiries or reviews during the pendency of his investigation. As a result, until that review is completed, we are not in a position to answer this question. Generally, when preparing to conduct an examination of a registered firm, examiners typically review relevant news articles, as well as any prior examination reports, documents provided by the firm, and other research. During examinations of investment advisers and broker-dealers, the staff will seek to determine whether a firm is: conducting its activities in accordance with Federal securities laws and rules adopted under these laws (including, where applicable, the rules of SROs subject to the Commission'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.

Q.3. FINRA contends that it had no responsibility to ask questions about Mr. Madoff's activities, even when he himself considered those activities to be part of his brokerage business and the defrauded customers were receiving brokerage statements. Part of your office's responsibility is overseeing SROs in their oversight of member firms.

Do you concur with FINRA's position that Mr. Madoff's fraudulent activities were completely outside of FINRA's jurisdictional purview?

A.3. In light of the ongoing Inspector General investigation into the Commission's investigations and examinations of the Madoff firm, since his request that the staff not conduct any inquiries or reviews during the pendency of his investigation, we have not conducted any inquiries or reviews of FINRA's examinations of the Madoff brokerage business, and are not in a position to comment on FINRA's response.

Q.4. Please describe any tips that your office received about the Madoff firm and any actions your office took in response to those tips.

A.4. On January 22, 2009, the Commission produced to the U.S. Senate Committee on Banking, Housing, and Urban Affairs copies of complaints received by the Commission regarding Madoff.

In light of the fact that the Commission's Inspector General is conducting an investigation into the Commission's investigations and examinations of the Madoff firm and his request that the staff not conduct any internal inquiries or reviews during the pendency of his investigation, we are not in a position to provide further information as to actions taken in response to these complaints.

Immediately upon her arrival at the Commission earlier this year, Chairman Schapiro asked her staff to conduct a comprehensive review of internal procedures used to evaluate the more than 700,000 tips, complaints, and referrals the SEC receives each year. In early March, the SEC announced that it enlisted the services of the Center for Enterprise Modernization, a federally funded research and development center operated by The MITRE Corporation, to help the SEC establish a centralized process that will more effectively identify valuable leads for potential enforcement action as well as areas of high risk for compliance examinations. The MITRE Corporation helped the SEC to scrutinize the agency's processes for receiving, tracking, analyzing, and acting upon the tips, complaints, and referrals from outside sources. Having recently completed this review, the MITRE Corporation is now in the process of helping the SEC identify ways it can begin immediately to improve the quality and efficiency of the agency's current procedures, and to help the agency acquire and implement technology solutions to assist the SEC staff in more effectively managing, analyzing and utilizing tips, complaints, and referrals.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR JOHNSON FROM LORI A. RICHARDS

Q.1. The Madoff Ponzi scheme is one of the largest financial frauds in U.S. history. From each of your points of view, how did the Madoff Ponzi Scheme fall through the cracks of the U.S. regulatory system?

A.1. The examination program appreciates and shares the widespread concern about the agency's failure to detect the fraud perpetrated by Bernard Madoff. As previously noted, the Commission's Inspector General is conducting an investigation of these matters and has asked the staff not to conduct any independent inquiries or reviews. However, as noted during our testimony, the Commission did not conduct an examination of the Madoff firm's investment advisory business. Due to the large number of investment advisers, the SEC cannot examine all registered investment advisers on a routine basis. Currently, there are more than 11,000 investment advisers registered with the Commission, an increase of over

40 percent since 2001. The Commission has approximately 425 staff dedicated to examining investment advisers (including advisers to hedge funds) and mutual funds. Additional resources would allow the SEC to conduct more examinations, including of newly registered investment advisers, and to place all registered advisers and mutual funds on a periodic exam cycle.

Q.2. There were numerous instances in which individuals and the press raised serious questions about the integrity of the Madoff business prior to December 11, 2008. How does the SEC determine which complaints are worthy of investigation?

How does the SEC intend to restore confidence to the investors it is designed to protect after its failure to detect the Madoff scheme?

A.2. As previously noted, Chairman Schapiro has taken immediate steps to improve the agency's ability to process and pursue appropriately the more than 700,000 tips and referrals it receives annually. The SEC has retained the Center for Enterprise Modernization a federally funded research and development center operated by The MITRE Corporation to help the SEC scrutinize the agency's processes for receiving, tracking, analyzing, and acting upon the tips, complaints, and referrals from outside sources. Having recently completed this review, the MITRE Corporation is now in the process of helping the SEC identify ways it can begin immediately to improve the quality and efficiency of the agency's current procedures, and to help the agency acquire and implement technology solutions to assist the SEC staff in more effectively managing, analyzing and utilizing tips, complaints, and referrals.

In addition, as Chairman Schapiro testified on March 26, 2009, before the United States Senate Committee on Banking, Housing and Urban Affairs, she has asked the Commission's staff to work on a series of reforms to better protect investors when they place their money with a broker-dealer or an investment adviser. On May 14, 2009, the Commission issued a proposal for rule amendments that would require registered investment advisers with custody of client assets to undergo an annual "surprise exam" by an independent public accountant to verify that those assets exist.

Q.3. Would either of you suggest changes in the SEC's relationship with either the PCAOB or FASB to facilitate better transparency and accountability?

A.3. I defer to the views of the Commission and the Office of the Chief Accountant with regard to these issues.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR JOHANNS FROM LORI A. RICHARDS

Q.1. What options from the Treasury's Blueprint for Regulatory Reform would you implement?

A.1. I defer to the Chairman of the SEC and the Commission with regard to this issue. I look forward to working with the Chairman and Commissioners to consider these and other important reform measures.

GENERAL RESPONSE TO QUESTIONS FROM THE SENATE BANKING COMMITTEE

SEC Enforcement Division's Statement of Limitations Applicable to Responses to Questions From All Senators

In March 2009, former Enforcement Director Linda Chatman Thomsen left the SEC to return to the private sector. SEC Chairman Mary Schapiro appointed Robert Khuzami, a former Federal prosecutor, as Director of Enforcement, a post he assumed on March 31, 2009. Accordingly, although Ms. Thomsen originally testified before this Committee, these responses are not made on behalf of Ms. Thomsen, but instead are made generally on behalf of the Division of Enforcement under its new Director Robert Khuzami. Mr. Khuzami makes these responses based on his conversations with the staff and not based on his own personal knowledge.

The SEC filed a civil enforcement action alleging securities fraud against Bernard L. Madoff and Bernard L. Madoff Investment Securities LLC on December 11, 2008, and the United States Attorney's Office filed a parallel criminal action the same day. These actions are presently being litigated before the United States District Court for the Southern District of New York. Mr. Madoff subsequently admitted liability for securities fraud, accepted a permanent bar from the securities industry, forfeited virtually all of his assets in the criminal action and was recently sentenced to 150 years in prison. Mr. Madoff's attorney reportedly stated that Mr. Madoff has not yet decided whether to appeal his criminal sentence, and the amount of disgorgement and penalties to be ordered in the SEC's civil action has yet to be determined.

Aside from these developments with respect to Mr. Madoff personally, the overall Madoff Ponzi scheme continues to be aggressively investigated by the SEC, the United States Attorneys' Office and the trustee addressing investor claims on behalf of the Securities Investors' Protection Corporation (SIPC). The SEC has not commented on, or made public any of the details regarding, any of its investigations or examinations involving Mr. Madoff or his firm to avoid jeopardizing the ongoing litigation and the continuing investigations of other individuals and entities who may have been involved in the fraud. These ongoing investigations are bearing fruit.

On June 22, 2009, the SEC filed an action against Mr. Madoff's marketing solicitors—Cohmad Securities Corporation, its principals Maurice J. Cohn and Marcia B. Cohn, and registered representative Robert M. Jaffe-charging them with marketing investments with Madoff when they knew, or recklessly disregarded, facts indicating that Madoff was operating a fraud. On the same day, the SEC filed an action against Stanley Chais, a California-based adviser who oversaw three feeder funds that invested all of their assets with Madoff, resulting in $1 billion in investor losses when the Ponzi scheme collapsed. The SEC alleges that Chais misrepresented his role in managing the funds' assets and distributed account statements to investors that he should have known were false. Chais allegedly told Madoff that Chais did not want any losses in the feeder funds' trades, and so for nearly a decade, Madoff reported thousands of transactions on behalf of the feeder funds without a single loss on any equities trade. Previously, on March 18, 2009, the SEC charged the auditors of Mr. Madoff's broker-dealer firm, Friehling and Horowitz, CPAs, P.C. and individual CPA David G. Friehling, with securities fraud for representing they had conducted legitimate audits, when in fact they had not. The United States Attorney's Office also filed a parallel criminal action against the auditors.

In each of these cases, Mr. Madoff's relationship with the defendants dates back at least a decade, if not considerably longer, and well before the SEC's investigation of Mr. Madoff's advisory business in 2006. The same is true of Mr. Madoff's relationships with the principals of other feeder funds, as well as other firms and individuals involved in his investment advisory business. Because these firms and individuals were already involved with Mr. Madoff before the SEC's prior investigation commenced in 2006, it is possible that representations made or facts discovered in the prior investigation may have some bearing on the pending litigation and continuing investigations. In addition to the defendants in these filed matters, the SEC is continuing to investigate other individuals and entities involved with Mr. Madoff or his firm, many of whom also may have played some role in the SEC's prior investigation. The SEC continues to investigate other firms and individuals who may have been involved with Mr. Madoff or his firm at other times as well.

To preserve the integrity of the investigative and prosecution processes, there are questions specifically relating to Mr. Madoff that the Enforcement Division presently cannot answer. Aside from the allegations of the publicly filed complaints, the Enforcement Division cannot comment on the pending civil and criminal litigation or the underlying investigations to avoid jeopardizing those processes.

The Enforcement Division is limited in its ability to provide further information on prior SEC enforcement investigations of Mr. Madoff, his firm or associated persons because the SEC's Office of the Inspector General is actively investigating all such prior matters and the Inspector General specifically requested that the Enforcement Division not conduct its own inquiry while his investigation was ongoing. The Inspector General testified before the House of Representatives Financial Services Committee regarding the scope of his investigation. See H. David Kotz, Inspector General, U.S. Securities and Exchange Commission, Testimony before the U.S. House of Representatives Committee on Financial Services, January 5, 2009, available at *http://www.sec.gov/news/testimony/2009/ts010509hdk.htm.* The Enforcement Division is informed that the Inspector General anticipates he will complete his investigation and provide a report to Congress in approximately August 2009.

The SEC's Enforcement Division is mindful that this panel—and the public—is deeply concerned about the Division's failure to detect the fraud perpetrated by Mr. Madoff. In recognition of that, as the newly appointed Director of the Division of Enforcement, I testified before this Committee's Securities, Insurance and Investment Subcommittee on May 7, 2009, that:

> Many have questioned our effectiveness in light of the revelations surrounding Bernard Madoff and his egregious conduct. Let me be clear—we failed in this instance in our mission to protect investors. Whatever explanations eventually surface, be they human failures, organizational shortcomings or deficiencies in process, or all three, there is no excuse, and not a day goes by that we in the Enforcement Division don't regret the consequences. But faced with this, we have done what any responsible public agency must do—we have used the episode as a wake-up call to undertake a rigorous self-assessment of how we do our job.

The Enforcement Division assures this panel that we will work toward preventing such a failure in detection from happening again. We also ask that you consider this failure in the context of the Division's history of successful enforcement and vigorous efforts to protect investors, and the many talented and committed members of the enforcement staff who work very hard every day on behalf of investors.

As Chairman Schapiro has previously testified, I can assure the Committee that as soon as we receive the Inspector General's report, the agency will promptly take all appropriate actions and address any remaining shortcomings. However, we want to make clear that we have not been waiting for the Inspector General's report to begin making potential improvements to our processes, whether or not they are directly related to the agency's handling of the Madoff investigation. We have begun to make substantial changes and have undertaken numerous initiatives aimed, in part, at addressing potential issues related to the Madoff matter.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FOR LINDA C. THOMSEN BY ROBERT KHUZAMI

Q.1. Enforcement Budget: Ms. Thomsen testified that "The amount of resources available to the SEC has not kept pace with the rapid expansion in the securities market over the past few years—either in terms of the number of firms or the explosion in the types of new and increasingly complex products."

Are more resources needed by the Division of Enforcement to effectively perform its mission? Does the Commission plan to allocate more resources to Enforcement in the future, and if needed, ask for a larger annual budget?

A.1. The Division of Enforcement needs more resources to more effectively perform its mission. The approximately 3,500 employees of the SEC (of whom approximately 1000 are in the Enforcement Division) are charged with regulating and policing an industry that includes over 11,300 investment advisers, 4,600 registered mutual funds, over 5,500 broker-dealers (with approximately 174,000 branch offices and 676,000 registered representatives), as well as approximately 12,000 public companies. The SEC receives up to approximately 750,000 investor complaints annually. Every day Enforcement staff is compelled to make difficult judgments about which matters to pursue, which matters to stop pursuing, and which matters to forego pursuing at all.

Chairman Schapiro has already requested additional resources for Enforcement through her appropriations testimony for 2010 and 2011. For 2010, the Chairman requested funds for approximately 50 new staff slots. For 2011, as the SEC will presumably assume an even broader regulatory role in the financial markets, the Chairman has requested funds for approximately 1000 additional staff. The staff increases requested by Chairman Schapiro provide a rough measure of the extent to which the SEC, and particularly the Division of Enforcement, are presently understaffed. While the Chairman's appropriations testimony does not distinguish between staff for the Enforcement Division as opposed to other Divisions, Enforcement has traditionally constituted by far the largest component of the SEC's budget and we anticipate that Enforcement's relative share of the SEC budget will likely increase over the next several years.

Q.2. Handling Tips: Former SEC Chairman William Donaldson in a speech to the Securities Industry Association on November 3, 2003, in the wake of the Commission staff's failure to act promptly on tips alleging that mutual funds had engaged in late trading and market timing, stated, "I have ordered a reassessment of our policies and procedures on how tips are handled. Tips from whistleblowers are critical to our mission of pursuing violations of the Federal securities laws. I want to be sure that there is appropriate follow through on this type of information and that they are given expedited treatment."

Please describe the policies since 2003 that the Commission established and has observed governing how the staff and the Commission review unsolicited allegations of violations of the Federal securities laws or "tips" that it receives.

A.2. As a preliminary matter, the Enforcement Division notes that the complaint from Mr. Markopolos was investigated. The SEC's New York Regional Office commenced an investigation of Mr. Madoff's investment advisory business in 2006. That investigation continued for 2 years until it was closed.

In addition, it should be noted that in 2009 the SEC retained an independent consultant to assist in the development of new policies and procedures to address the handling of complaints, tips and referrals-not only in Enforcement, but throughout the agency. The consultant has completed the first of three anticipated phases of work, and will likely recommend and implement a centralized system of intake, triage and disposition of all complaints, tips and referrals throughout the agency.

In general, with respect to the period from 2003 to the present, the SEC receives hundreds of thousands of complaints per year. While we appreciate and examine every lead we receive, we simply do not have the resources to fully investigate them all. We use our experience, skill and judgment in attempting to triage these thousands of complaints so we can devote our attention to the most promising leads and the most serious potential violations. Because the process necessarily involves incomplete information and judgment calls made in a tight timeframe, we are also continually working on ways to improve our handling of complaints, tips and referrals to make optimal use of our limited resources.

There are a number of major channels through which complaints, tips and referrals flow in to the Enforcement Division. First, there are calls and letters that are processed and screened by the Office of Investor Education as complaints, tips and referrals or "CTRs."

The most promising of these are forwarded to attorney staff in the Enforcement Division. Second, on the SEC's Web site, there is an Electronic Complaint Center that allows members of the public to record complaints and tips on simple online forms. The online complaints are reviewed and triaged by the professional staff of the Enforcement Division's Internet Enforcement Group, which refers them to staff for further investigation based on subject matter or geography.

Yet another group of staff within the Division reviews and evaluates hundreds of "Suspicious Activity Reports" or "SARS" that are filed with Federal banking regulators by banks and financial institutions nationwide. SARS that potentially involve securities are forwarded to the SEC. After screening by experienced staff, promising referrals based on SARS are sent to enforcement staff throughout the country.

FINRA and stock exchanges (referred to as "Self-Regulatory Organizations" or "SROs") are another source of referrals. The SROs provide continual and cutting-edge computerized surveillance of trading activities in their respective markets. They regularly report suspicious activities and trading anomalies to the Enforcement Division's Office of Market Surveillance through a variety of periodic reports. They also provide referrals regarding particular suspicious trades that may show possible insider trading ahead of a publicly announced transaction, such as a merger or acquisition. The SEC's Office of Market Surveillance automatically opens a preliminary investigation of each such referral and then forwards it to appropriate staff, generally based on geographic location of the issuer or suspected traders. The staff then becomes responsible for further inquiries that will either lead to the opening of a full investigation or the closure of the preliminary investigation.

The Enforcement Division also receives referrals of potential securities law violations from other Offices and Divisions within the Commission. These referrals are either taken up directly by the Regional Office where the complaint was discovered or arose, or are directed to staff having appropriate expertise regarding the particular type of complaint. For example, referrals involving accounting issues are directed to the Office of the Chief Accountant in the Enforcement Division for further evaluation and referral to staff as appropriate. Similarly, referrals from throughout the Commission regarding over-the-counter stocks, potential microcap fraud and securities spam are directed to the Trading and Markets Enforcement Group, which has extensive experience in this market segment, for further evaluation and possible referral to staff.

It is important to note that many complaints, tips and referrals are made directly to staff in the Office nearest the complainant and are investigated or addressed by that office. Among the options available to staff receiving a tip or lead are further investigation of the lead, declining to pursue the lead for lack of apparent merit, transfer of a potentially viable lead to an office with a closer geographical connection to the alleged misconduct, or referral of the lead to subject matter experts for further evaluation and possible assignment to staff.

The primary consideration in determining whether to pursue any particular tip depends on whether, based on judgment and experience, the tip provides sufficient information to suggest that it might lead to an enforcement action involving a violation of the Federal securities law. This determination requires the exercise of judgment regarding, among other things: the source of the tip; the nature, accuracy and plausibility of the information provided; an assessment of how closely the information relates to a possible violation of Federal securities law; the validity and strength of the legal theory on which a potential violation would be based; the nature and type of evidence that would have to be gathered in the course of further investigation; the amount of resources the investigation might consume; and whether there are any obvious impediments that would prevent the information from leading to an enforcement action (for example, the conduct complained of is not securities-related).

Q.3. In the hearing, Senator Merkley asked how many unsolicited tips of misconduct the agency receives that include the detail and sophisticated analysis of the Harry Markopolos document entitled "The World's Largest Hedge Fund Is a Fraud." Please respond to Senator Merkley's question for the record.

A.3. We are not in a position to respond precisely to this question, but we note that Enforcement Division receives hundreds of thousands of tips each year. Many tips are from insiders and other sophisticated industry professionals and it is not unusual to receive a tip in the form of a multi-page document that features extensive and sophisticated factual analysis. As an approximation, the Director of Enforcement personally receives by mail a very small portion of all complaints, tips and referrals received by the SEC-probably on the order of perhaps 10–15 complaints per week. Of these, approximately 2–5 complaints may be comprised of lengthy documents (often presented as bound folios with tabbed and annotated exhibits) and contain extensive analysis of the facts presented. Accordingly, the Director of Enforcement alone likely receives more than 100 complaints, tips and referrals each year that are similar in length, complexity and analysis to that presented by Mr. Markopolos.

Q.4. Please describe how the Commission staff processed or reviewed the information that analyst Harry Markopolos provided regarding the conduct of Bernard Madoff and Bernard L. Madoff Investment Securities Inc. and his conclusion that it was a Ponzi scheme, including its determination not to bring an enforcement action for violations of the antifraud provisions of the securities laws?

A.4. As a preliminary matter, the Enforcement Division investigated Mr. Markopolos' complaint. The SEC's New York Regional Office commenced an investigation of Mr. Madoff's investment advisory business in 2006 that continued for 2 years, until it was closed without recommendation of further enforcement action in 2008. The Enforcement Division appreciates and shares the widespread concern about the Division's failure to detect the fraud perpetrated by Bernard Madoff. Because the investigation of this matter has been undertaken by the SEC's Office of the Inspector General, however, the Enforcement Division is not yet in a position to explain what happened or precisely what went wrong. The Inspector General specifically requested that the Enforcement Division not conduct its own inquiry during his investigation. Accordingly, the question cannot be answered at this time due the pendency of the Inspector General's investigation of this subject and due to the potential risk of compromising ongoing inquiries and litigation related to Mr. Madoff's fraud.

Q.5. Disclosure of Information About an Auditor: The Madoff fraud reportedly amounted to $50 billion and the firm was audited by an extremely small accounting firm that does not appear to have had sufficient expertise or staff to conduct a proper audit of the Madoff firm. Ms. Richards testified that she was looking at "whether the risk assessment process would be improved with routine access to information such as, for example, the identity of the advisor's auditor." Do you feel that regulators would be better able to protect investors if examiners in similar situations obtained and reviewed data about the size of an audit firm?

A.5. The question refers to Ms. Richards' testimony regarding routine access to information in connection with examinations, and therefore the Division of Enforcement would defer to the views of the Office of Compliance Inspections and Examinations on this subject. In general, the Enforcement Division favors the greatest possible transparency regarding the operations and financial status of businesses operating in the securities industry.

Q.6. SEC Staff: Analyst Harry Markopolos said that he felt that Bernard Madoff was operating the "world's largest Ponzi scheme" and over many years provided information to the Commission staff substantiating his view. He indicated that specific staff members in the Commission's Boston office recognized the seriousness of the situation and advocated Commission action. Mr. Markopolos was correct in his views and it is unfortunate that the efforts of these staff members did not result in action to stop the fraud at that time. In light of recent revelations about the fraud, has the Commission elevated these staff members who recognized the gravity of the conduct into appropriate positions of responsibility, so that the Commission can benefit from their good judgment?

A.6. Most of the individuals in the Commission's Boston Office who dealt with Mr. Markopolos were already in relatively senior positions within the Enforcement Division and none of them have been further promoted. The Commission is indeed fortunate to have benefited from their good judgment, and continues to so benefit.

Q.7. Market Surveillance: Does the Commission staff as a matter of policy regularly review and evaluate responsible financial press articles that suggest or allege misconduct or violations of the Federal securities laws? Please describe the relevant Commission policy and practices. Would the Commission's policies or practices have triggered a staff awareness of and review an article like "Don't Ask, Don't Tell" which appeared in Barron's May 7, 2001?

A.7. The Commission's staff regularly reviews and evaluates responsible financial press articles. In particular, the 1000 investigators in the Division of Enforcement continually review daily news reports in search of credible allegations of potential violations of the securities laws. Indeed, at times, multiple offices simultaneously seek to open an investigation based on a credible press article suggesting potential misconduct. News clips regarding the SEC, financial regulation and potential securities law violations are distributed throughout the agency on a daily basis. In addition, various regional offices of the Enforcement Division and the agency's centralized Office of Risk Assessment conduct additional surveys of credible press articles, as well as academic literature, suggesting possible securities violations. Without speculating as to staff's awareness or review of the particular Barron's article from 2001 cited in the question, the Enforcement Division recognizes Barron's as a credible news source and the agency occasionally circulates Barron's articles to all staff as part of the daily news clipping services.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FOR LINDA C. THOMSEN BY ROBERT KHUZAMI

Q.1. In a statement last month, former SEC Chairman Cox stated that the staff had "credible and specific allegations regarding Mr. Madoff's financial wrongdoing, going back to at least 1999," but the staff never even asked the Commission for subpoena power. Instead, the staff relied on information voluntarily supplied by Mr. Madoff.

In the face of credible and specific allegations, why didn't the Division of Enforcement staff feel it necessary to obtain subpoena power and pursue the investigation further, particularly after learning that Mr. Madoff had lied to them?

How does the SEC's enforcement staff normally respond when it catches a person attempting to mislead the staff in this way?

A.1. As noted above, the Division of Enforcement is not yet in a position to provide a response with regard to the particular investigative steps undertaken in the 2006 investigation. The Inspector General specifically requested that the Enforcement Division not conduct its own review of the 2006 investigation while his investigation is ongoing. In general, the Division of Enforcement seeks a Formal Order of Investigation ("Formal Order") to obtain subpoena power when the facts and circumstances of a particular investigation indicate that subpoena power may be necessary to obtain documents or information the Division is seeking in the investigation.

A Formal Order and the related subpoena powers are not necessary in every investigation. Most individuals and firms from whom the Division requests documents or information voluntarily comply with the Division's requests. In particular, entities and individuals that are registered with the Commission, such as broker-dealers, generally cooperate fully with such requests because they are subject to ongoing independent SEC books and records obligations that require them to produce certain books and records to the SEC on request and within a very short time frame. Accordingly, subpoenas are often unnecessary with respect to registered entities. If a registered entity refuses to comply with an SEC information request, they may face sanctions for violation of the SEC's books and records requirements, which may include, in appropriate cases, revocation of their registration with the Commission.

When, however, the Enforcement staff has reason to believe that any individual or entity, whether registered or not, is uncooperative, or will not fully comply with a request for documents or information on a voluntary basis, they will not hesitate to seek a Formal Order and related subpoena powers. The issue of whether to seek subpoena power depends on all of the relevant facts and circumstances, including among other things the alleged violation, the nature and scope of the requests for documents or information and the responses thereto, whether the staff believes there are any omissions of material documents or information from the respondent's production, and the staff's past experience in obtaining documents and information from the respondent through voluntary requests or by subpoena. When confronted with an obvious omission from the documents or information produced, the staff's first step would likely be to request further production on a voluntary basis. If further production is not forthcoming, staff may obtain subpoena power.

When the staff believes a respondent has lied to them, the staff will naturally be more cautious—if not highly skeptical—in assessing the respondent's credibility. Staff will also seek to either confirm or disprove the respondent's representations by seeking further verification, from the respondent, and when possible and appropriate, from other sources as well. Under these circumstances, the staff is generally quick to seek subpoena power, but the staff's response in any specific situation will depend upon all of the relevant facts and circumstances. Staff may consider, among other things, the nature of, and the motive or purpose for, the alleged lie, whether the respondent has provided other information from which the true facts can be ascertained, what remedies are available to the staff based on the true facts and the respondent's conduct when confronted with the true facts. Based on all of the facts and circumstances, the staff may seek subpoena power to compel further production. Alternatively, staff may decide that a subpoena is unnecessary or would serve no purpose, as, for example, when the respondent voluntarily produces all of the documents or information sought, or when staff already has access to the withheld documents or information from another source, or when the respondent voluntarily agrees to a settlement providing all relief the staff could possibly obtain through exercise of subpoena power and subsequent litigation. Finally, when appropriate, the staff may refer false statements to criminal authorities for prosecution under 18 U.S.C. § 1001.

Q.2. Ms. Thomsen, the New York office of the SEC conducted the 2006 investigation of Madoff. I understand that you have entrusted the current Madoff investigation to not only the same regional office, but the same associate director who supervised the staff in that prior investigation.

Why did you not assign the Madoff matter to the home office or another regional office to ensure a fully objective and thorough investigation?

Are you concerned that the personnel who failed in the first instance have an interest in covering or mitigating that failure at this point in time?

A.2. When new facts arise in cases previously investigated by staff, the Division of Enforcement generally assigns matters arising out of the new facts to the same staff who originally investigated the matter, as they are the individuals with the most experience in dealing with a particular respondent, and who are most familiar with the general facts and circumstances based on their prior investigation of the matter. Using at least some of the same staff generally expedites the investigation of new facts and maximizes our limited resources because of the important knowledge about the investigation or the party being investigated that the staff may have. If one or more of the responsible staff members has left the Commission by the time new facts are discovered, the Division will assign new staff as necessary to fill the vacancies. If the scope of the initial investigation has changed, the Division may also assign new staff to ensure adequate staffing. If the initial investigation did not lead to the discovery of the newly disclosed facts, and there is any concern that the personnel might attempt to cover up or mitigate their initial failure to discover these facts, the Division may assign new staff to work on the matter and may assign an independent supervisor to ensure that the investigation pertaining to the new facts is thorough, complete and unbiased by the prior investigation.

Most of the staff members assigned to the Madoff investigation in December 2008 had no previous involvement with earlier investigations by the SEC into Madoff. In December 2008, with the sole exception of the Associate Director, the Enforcement Division assembled an entirely new and expanded team of Enforcement staff who had no prior involvement in any investigation of Mr. Madoff or his firm. The Division also assigned a high level Associate Director for Enforcement from the Chicago Regional Office who had no prior involvement in any such investigation to ensure independent oversight and to serve as an additional supervisory resource.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR JOHNSON FOR LINDA C. THOMSEN BY ROBERT KHUZAMI

Q.1. The Madoff Ponzi scheme is one of the largest financial frauds in U.S. history. From each of your points of view, how did the Madoff Ponzi Scheme fall through the cracks of the U.S. regulatory system?

A.1. The SEC's Enforcement Division is mindful that this panel—and the public—is deeply concerned about the Division's failure to detect the fraud perpetrated by Bernard Madoff. Because the investigation of this matter has been undertaken by the SEC's Office of the Inspector General, however, the Enforcement Division is not yet in a position to explain precisely what went wrong. The Inspector General specifically requested that the Enforcement Division not conduct its own inquiry while his investigation was pending. The Enforcement Division assures this panel that we will work toward preventing such a failure in detection from happening again. We also ask that you consider this failure in the context of the Division's history of successful enforcement and vigorous efforts to protect investors, and the many talented and committed members of the enforcement staff who work very hard every day on behalf of investors. We also want to make clear that we have not been waiting for the IG's report to begin making potential improvements to our processes, whether or not they are directly related to the agency's handling of the Madoff investigation. We have begun to make substantial changes and have undertaken numerous initiatives aimed, in part, at addressing potential issues related to the Madoff matter.

Q.2. There were numerous instances in which individuals and the press raised serious questions about the integrity of the Madoff business prior to December 11, 2008. How does the SEC determine which complaints are worthy of investigation?

A.2. As a preliminary matter, as set forth in former Enforcement Director Thomsen's testimony before this panel, the Enforcement Division determined that complaints about Mr. Madoff's investment advisory business, including the complaint by Harry Markopolos, were worthy of investigation. The SEC's New York Regional Office commenced an investigation of Mr. Madoff and his investment advisory business in 2006, and that investigation was closed without a recommendation of enforcement action in 2008.

More generally, the SEC receives hundreds of thousands of complaints per year. While we appreciate and examine every lead we receive, we simply do not have the resources to fully investigate them all. We use our experience, skill and judgment in attempting to triage these hundreds of thousands of complaints so we can devote our attention to the most promising leads and the most serious potential violations. Because the process necessarily involves incomplete information and judgment calls made in a tight timeframe, we are also continually working on ways to improve our handling of complaints, tips and referrals to make optimal use of our limited resources.

There are a number of major channels through which complaints, tips and referrals flow in to the Enforcement Division. First, there are calls and letters that are processed and screened by the Office of Investor Education as complaints, tips and referrals or "CTRs." The most promising of these are forwarded to attorney staff in the Enforcement Division. Second, on the SEC's Web site, there is an Electronic Complaint Center that allows members of the public to record complaints and tips on simple online forms. The online complaints are reviewed and triaged by the professional staff of the Enforcement Division's Office of Internet Enforcement, which refers them to staff for further investigation based on subject matter or geography.

Yet another group of staff within the Division reviews and evaluates hundreds of "Suspicious Activity Reports" or "SARS" that are filed with Federal banking regulators by banks and financial institutions nationwide. SARS that potentially involve securities law violations are forwarded to the SEC. After screening by experienced staff, promising referrals based on SARS are sent to enforcement staff throughout the country.

FINRA and stock exchanges (referred to as "Self-Regulatory Organizations" or "SROs") are another source of referrals. The SROs provide continual and cutting-edge computerized surveillance of trading activities in their respective markets. They regularly report suspicious activities and trading anomalies to the Enforcement Division's Office of Market Surveillance through a variety of periodic reports. They also provide referrals regarding particular suspicious trades that may show possible insider trading ahead of a publicly announced transaction, such as a merger or acquisition. The SEC's Office of Market Surveillance automatically opens a preliminary investigation of each such referral and then forwards it to appropriate staff, generally based on geographic location of the issuer or suspected traders. The staff then becomes responsible for further inquiries that will either lead to the opening of a full investigation or the closure of the preliminary investigation.

The Enforcement Division also receives referrals of potential securities law violations from other Offices and Divisions within the Commission. These referrals are either taken up directly by the Regional Office where the complaint was discovered or arose, or are directed to staff having appropriate expertise regarding the particular type of complaint. For example, referrals involving accounting issues are directed to the Office of the Chief Accountant in the Enforcement Division for further evaluation and referral to staff as appropriate. Similarly, referrals from throughout the Commission regarding over-the-counter stocks, potential microcap fraud and securities spam are directed to the Trading and Markets Enforcement Group, which has extensive experience in this market segment, for further evaluation and possible referral to staff.

It is important to note that many complaints, tips and referrals are made directly to staff in the Office nearest the complainant and are investigated or addressed by that office. Among the options available to staff receiving a tip or lead are further investigation of the lead, declining to pursue the lead for lack of apparent merit, transfer of a potentially viable lead to an office with a closer geographical connection to the alleged misconduct, or referral of the lead to subject matter experts for further evaluation and possible assignment to staff.

The primary consideration in determining whether to pursue any particular tip is whether, based on judgment and experience, the tip provides sufficient information to suggest that it might lead to an enforcement action involving a violation of the Federal securities law. This determination requires the exercise of judgment regarding, among other things: the source of the tip; the nature, accuracy and plausibility of the information provided; an assessment of how closely the information relates to a possible violation of Federal securities law; the validity and strength of the legal theory on which a potential violation would be based; the nature and type of evidence that would have to be gathered in the course of further investigation; the amount of resources the investigation might consume; and whether there are any obvious impediments that would prevent the information from leading to an enforcement action (for example, the conduct complained of is not securities-related).

When we determine that we have a promising tip, we investigate. We follow the evidence where it leads and will pursue and develop evidence regarding the liability of a full array of persons and entities—from the central players to the peripheral actors. In commencing an investigation, we usually do not know whether the law has been broken and, if so, by whom. We have to investigate, and our investigation may or may not lead to the filing of an enforcement action. We are resource constrained. The approximately 3,500 employees of the SEC (of whom approximately 1000 are in the Enforcement Division) are charged with regulating and policing an industry that includes over 11,300 investment advisers, 4,600 registered mutual funds, over 5,500 broker-dealers (with approximately 174,000 branch offices and 676,000 registered representatives), as well as approximately 12,000 public companies. Every investigation we pursue, or continue to pursue, entails opportunity costs with respect to our limited resources. A decision to pursue one matter means that we may be unable to pursue another. No single case or investigation can ever be considered in a vacuum, but rather must be viewed as one of thousands of investigations and cases we are or could be pursuing.

With that in mind, immediately upon her arrival at the Commission earlier this year, Chairman Schapiro asked her staff to conduct a comprehensive review of internal procedures used to evaluate the hundreds of thousands of tips, complaints, and referrals the SEC receives each year. In early March, the SEC announced that it enlisted the services of the Center for Enterprise Modernization, a federally funded research and development center operated by The MITRE Corporation, to help the SEC establish a centralized process that will more effectively identify valuable leads for potential enforcement action, as well as areas of high risk for compliance examinations. The MITRE Corporation helped the SEC to scrutinize the agency's processes for receiving, tracking, analyzing, and acting upon the tips, complaints, and referrals from outside sources. Having recently completed this review, the MITRE Corporation is now in the process of helping the SEC identify ways it can begin immediately to improve the quality and efficiency of the agency's current procedures, and to help the agency acquire and implement technology solutions to assist the SEC staff in more effectively managing, analyzing and utilizing tips, complaints, and referrals.

Q.3. How does the SEC intend to restore confidence to the investors it is designed to protect after its failure to detect the Madoff scheme?

A.3. Since the Madoff fraud came to light in December 2008, a new Chairman, Mary Schapiro, has been appointed to the Commission and she named me, Robert Khuzami, as the new Director of Enforcement. Under my leadership and that of Chairman Schapiro, the Enforcement Division has undertaken a broad range of initiatives aimed at restoring investor confidence.

First and foremost, the Enforcement Division will restore investor confidence by continuing to bring securities enforcement actions to protect the interests of U.S. investors. Ponzi schemes—the form of fraud committed by Mr. Madoff—have always been aggressively pursued when detected by the Division of Enforcement. However, such schemes are notoriously difficult to detect because investors are reluctant to question what appears to be a steady stream of investment returns and, typically, the scheme is perpetrated by only a small group of insiders who go to great lengths to avoid detection. Nonetheless, in the 2 years before the Madoff scheme became public, the Division brought enforcement actions to halt more than 70 such schemes. Since the Madoff fraud became public, the Division has intensified its efforts with respect to Ponzi schemes, filing more than two dozen such cases in the last 6 months.

While the Enforcement Division best serves the investing public by bringing enforcement actions year in and year out, the Division is also considering ways it may be able to detect fraud better and sooner. At my direction, the Enforcement Division has undertaken a broad reexamination of its internal operations with the objective of becoming smarter, swifter, more strategic and more successful. The Division has assembled a number of internal advisory groups comprised of both senior management and line staff to propose specific changes with respect to various aspects of the Division's operations that will further that overall objective. Among the changes under consideration is a proposal to reorganize at least part of the Enforcement Division into specialized units to best utilize the Division's existing expertise and to foster the development of further expertise. In addition, the Division is considering streamlining its management structure to create a more nimble organization with fewer managers, and a correspondingly greater percentage of its personnel serving as frontline investigators pursuing fraud and wrongdoing. The Division is also actively seeking additional resources, particularly for information technology, which will lend a great advantage to the Division across the entire spectrum of its operations.

The SEC has also retained an independent consultant to assist in the development of new policies and procedures to address the handling of complaints, tips and referrals—not only in Enforcement, but throughout the agency. In addition, the SEC is an active participant in the ongoing dialogue about regulatory reform in the financial services industry. In that regard, the SEC has already independently made a number of regulatory rule changes intended to remedy problems and abuses exposed by the ongoing financial crisis. For example, the SEC recently proposed a rule that would require that independent third parties maintain custody of client assets managed by an investment advisor, as a check against the advisor's misrepresentation or dissipation of client assets.

It is important to bear in mind that neither the SEC nor any other regulator is a guarantor against fraud. Nonetheless, the SEC continually seeks to improve its use of all available resources to detect and stop fraud at the earliest possible moment.

Q.4. Would either of you suggest changes in the SEC's relationship with either the PCAOB or FASB to facilitate better transparency and accountability?

A.4. With respect to the issues raised in this question, the Enforcement Division defers to the views of the Commission and the Office of the Chief Accountant.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR JOHANNS FOR LINDA C. THOMSEN BY ROBERT KHUZAMI

Q.1. Who knew about Mr. Markopolos' report? At what date/time were they made aware? How far up the chain did the report make it? Were any investigatory actions taken?

A.1. The Enforcement Division appreciates and shares the widespread concern about the Division's failure to detect the fraud perpetrated by Bernard Madoff. Because the investigation of this matter by the SEC's Office of the Inspector General is ongoing, however, the Enforcement Division is not yet in a position to explain what happened or precisely what went wrong. Indeed, the Inspector General specifically requested that the Enforcement Division not conduct its own inquiry during the pendency of his investigation. In her testimony, former Enforcement Director Thomsen described all prior Enforcement investigations of Mr. Madoff or his firm prior to 2006, as these are already matters of public record.

With respect to past SEC enforcement investigations related to Mr. Madoff or his firm, two enforcement actions were filed by the SEC's New York Regional Office in 1992 alleging violations of the securities registration provisions in connection with offerings in which the 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. The first matter was entitled *SEC v. Avellino & Bienes, et al.* [1] 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 percent. 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 Mr. Madoff in turn invested the monies in the market. A&B received returns on the invested funds from Mr. Madoff, but kept the difference between the returns received from Mr. Madoff and the lesser amounts of interest paid on the A&B notes.

The second matter, *SEC v. Telfran Associates Ltd., et al.,* was a spinoff from A&B and involved the creation of a feeder fund to A&B. [2] 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 3 years. Telfran sold investors notes paying 15 percent interest, which they in turn invested in notes sold by A&B that paid between 15 and 19 percent interest. Since investor funds collected by A&B were invested with Mr. Madoff, the Telfran investor funds were also invested with Mr. Madoff, albeit indirectly.

Although the SEC was initially concerned that these unregistered offerings might be part of a huge fraud on the investors, the trustee appointed by the court in Avellino & Bienes found that the investor funds were all there. The returns on funds invested with Mr. Madoff appeared to be exceeding the returns the promoters had promised to pay their investors, so there were no apparent investor losses. [3] 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

[1] *SEC v. Avellino & Bienes et al.,* Lit. Rel. No. 13443 (Nov. 27, 1992).
[2] *SEC v. Telfran Associates Ltd., et al.,* Lit. Rel. No. 13463 (Dec. 9, 1992).
[3] Randall Smith, Wall Street Mystery Features A Big Board Rival, *Wall St. J,* Dec. 16, 1992 at C1.

sought the appointment of a trustee to redeem all outstanding notes and the appointment of an accounting firm to audit the firms' financial statements.

Both cases were settled by the promoters' consent to reimburse each investor the full amount of their investment and to submit to an audit by an accounting firm, and their further consent to be permanently enjoined from further unregistered offerings in violation of the Federal securities laws. In addition, each of the companies making the unregistered offerings agreed to pay a penalty of $250,000, and each of the principals in those companies agreed to pay a civil penalty of $50,000.[4] By executing the SEC's consent orders, Avellino & Bienes, Telfran and their respective principals agreed to cease offering unregistered investment opportunities to the public. Because the court-appointed trustees in Avellino & Bienes concluded the investor funds were all there and all investor funds in both cases were ultimately reimbursed to the investors, the SEC did not pursue fraud charges in those cases. Neither Mr. Madoff nor his firm was named as a defendant in either case.

Because its existence had already been widely reported in the press, Ms. Thomsen also confirmed that the SEC's New York Regional Office commenced another investigation of Mr. Madoff in early 2006, which was closed 2 years later, in January 2008, without any recommendation of enforcement action.

Ms. Thomsen also described to this Committee the pending litigation with respect to Mr. Madoff and his firm. 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 the Ponzi scheme that resulted in substantial losses to investors in the United States and other countries. See *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 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 of Mr. Madoff's alleged Ponzi scheme.

In the pending litigation, Mr. Madoff admitted liability for securities fraud and agreed to a permanent bar from the securities industry. In the criminal action, he forfeited virtually all of his assets and was recently sentenced to 150 years in prison. Mr. Madoff's attorney reportedly stated that Mr. Madoff has not yet determined whether to appeal his criminal sentence. In addition, the amount of any disgorgement or penalty to be paid by Mr. Madoff in the civil action filed by the SEC has yet to be determined.

Aside from the developments related to Mr. Madoff personally, the SEC filed two actions on June 22, 2009, against Mr. Madoff's marketing solicitors and against an investment advisor who oversaw three feeder funds that invested all of their assets with Madoff. Previously, on March 18, 2009, the SEC charged the auditors of Mr. Madoff's broker-dealer firm with securities fraud for representing they had conducted legitimate audits, when in fact

[4] *SEC v. Avellino & Bienes et al.,* Lit. Rel. No. 13880 (Nov. 22, 1993); *SEC v. Telfran Associates Ltd., et al.,* Lit. Rel. No. 13881 (Nov. 22, 1993).

they had not. The United States Attorney's Office also filed a similar criminal action against the auditors. The SEC's investigation is ongoing.

Q.2. It has been noted that much of the referral of new investors to Madoff's funds was done informally, by friends, or through a group of large independently managed feeder funds. Is there going to be an investigation into these fund-of-fund pros?

A.2. The SEC's investigation of the overall Madoff Ponzi scheme is continuing. In general, the SEC's enforcement investigations address the conduct of any individual or entity that may have had any role in the perpetration of the fraud. Though some issues in the litigation regarding Mr. Madoff himself have been resolved by his admission of criminal and civil liability, criminal asset forfeiture and criminal sentencing to 150 years in prison, the SEC, the United States Attorney's Office and the SIPC trustee have continued to investigate the facts regarding the Madoff Ponzi scheme and others who may have been involved in the fraud. After months of work, the SEC recently filed two new enforcement actions in connection with the Madoff fraud. On June 22, 2009, the SEC filed an action against Mr. Madoff's marketing solicitors—Cohmad Securities Corporation, its principals Maurice J. Cohn and Marcia B. Cohn, and registered representative Robert M. Jaffe—in connection with their marketing of investments with Madoff, despite knowing or recklessly disregarding facts indicating that Mr. Madoff was operating a fraud. In a separate complaint filed the same day, the SEC also sued Stanley Chais, a California-based investment adviser who oversaw three feeder funds that invested all of their assets with Madoff, for misrepresenting his role in the management of the funds' assets and distributing account statements to investors that he should have known were false.

Q.3. What options from the Treasury's Blueprint for Regulatory Reform would you implement?

A.3. The Division of Enforcement defers to the views of the Chairman and Commissioners on the implementation of any options set forth in the Treasury's Blueprint for Regulatory Reform.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM STEPHEN I. LUPARELLO

Q.1. Please describe the scope, extent and limits of the authority of FINRA and of each of its predecessor entities—the National Association of Securities Dealers (NASD) and New York Stock Exchange Regulation (NYSER) (and its predecessor organizational unit within the New York Stock Exchange) B to examine the books, records, activities and premises of member broker-dealers during the past decade under (1) membership rules and policies of these regulators (*e.g.,* NASD Rule 8210) and (2) the Federal securities laws and rules thereunder (*e.g.,* Exchange Act Sections 15A(g)(3)(A), 17(d)(1)(A), 17(k)(3), 19(g)(1)).

A.1. FINRA (and each of our predecessor entities) has authority to examine the books, records, activities and premises of a broker-dealer to the extent that they concern the firm's business as broker-dealer or municipal securities dealer. Thus, for example, we examine the sales practices of registered representatives and securities trading operations of broker-dealers for compliance with the Securities Exchange Act of 1934 and FINRA rules. However, we lack the authority to examine a firm for compliance with the Investment Advisers Act of 1940 or other laws outside of our jurisdiction. Thus, for example, our jurisdiction does not extend to the sale practices of employees of a broker-dealer acting in their capacity as investment adviser representatives in assessing compliance with the Investment Advisers Act.

Q.2. Does FINRA, and did its predecessor entities, as a matter of policy require appropriate staff to review and evaluate responsible financial press articles that suggest or allege misconduct or violations of rules over which FINRA has jurisdiction? Would these policies have triggered a review of, for example, an article like "Don't Ask, Don't Tell" which appeared in Barron's May 7, 2001?

A.2. FINRA and its predecessors (NASD and NYSE member regulation) evaluate certain financial press articles related to the securities industry that suggest or allege misconduct or violations of rules for which FINRA has jurisdiction and has commenced investigations based on this type of information.

Since the events surrounding the fraud by Bernard Madoff, FINRA has considered how it could better integrate the use of press articles as well as other potentially pertinent publicly available information into its regulatory programs. Enhanced procedures for pre-examination information gathering are among several new elements FINRA has designed for its examination program. This new exam element enhances FINRA's information gathering related to a firm's ownership and affiliate relationships and identifies potential concerns and conflicts of interest. The procedures include verification of information obtained, investigation into any potential conflicts of interest, and reconciliation of any discrepancies noted between information reported to FINRA and certain publicly available information. This will include a mandatory review of Form ADV and all other relevant findings.

Q.3. We understand that some fraud victims had invested with Madoff for decades and that during some of these years, Mr. Madoff served as Chairman of Nasdaq (at that time an affiliate of the NASD) and members of his family served on committees of the NASD. Some observers have speculated that NASD employees may have been reluctant to rigorously examine a firm founded and controlled by a person of influence within the self-regulatory organization for fear of retaliation. How would you respond to such speculation? How does FINRA protect its examiners and staff who find regulatory violations from concerns about potential retaliation by representatives of member broker-dealers who occupy positions of influence within the self-regulatory organization?

A.3. FINRA, like other regulators, seeks out the expertise of participants in the securities markets. This communication allows us to be more effective regulators. We are not bound in any way by the views of these market participants. FINRA's oversight of the Madoff broker-dealer was not affected by the fact that the Madoffs were known to some in our organization. Had we known evidence of this fraud, we would have vigorously investigated the firm. If our investigation indicated that fraud existed in the investment advisory operations, we would have promptly referred the matter to the SEC, which regulated the advisory operations. FINRA received and investigated 19 complaints against the Madoff broker-dealer since 1999.

FINRA consistently has demonstrated that it is willing to discipline a firm for wrongdoing, regardless of how well-known, well-respected or active it is. FINRA has taken action against the firms of sitting of former board members on several occasions. In fact, in one case that bears resemblance to the Madoff situation, FINRA's predecessor organization, NASD, sanctioned a former Board member who was CEO of a major market making firm, and two others associated with his firm, for supervisory failures and improper sales practices.

On April 17, 2007, a NASD hearing panel found that Kenneth Pasternak, former CEO of Knight Securities, L.P. (now known as Knight Equity Markets, L.P.), and John Leighton, former head of the firm's Institutional Sales Desk, committed supervisory violations in connection with fraudulent sales to institutional customers. The hearing panel imposed a 2-year suspension in all supervisory capacities and a $100,000 fine upon Kenneth Pasternak, and a bar in all supervisory capacities and a $100,000 fine upon John Leighton.

In a 2-1 decision, the panel found that Pasternak and Leighton failed to adequately supervise the trading of the firm's leading institutional sales trader, Joseph Leighton, John Leighton's brother. The ruling states that Kenneth Pasternak's response to numerous red flags was "woefully inadequate," that Kenneth Pasternak and John Leighton "never questioned Joseph Leighton's activities or confirmed he was providing his customers with best execution and a fair price," and that the overall supervisory void "allowed Joseph Leighton to take advantage of his customers over a 21-month period by filling orders at prices that netted Knight unreasonably high profits."

In April 2005, Joseph Leighton agreed to a bar from the securities industry and a payment of more than $4 million to settle charges by the SEC and NASD that he made millions of dollars from fraudulent trades with Knight's institutional customers. In December 2004, Knight paid more than $79 million to settle SEC and NASD charges against the firm arising from Joseph Leighton's conduct. More than $3.3 million of Joseph Leighton's monetary sanction and more than $66 million of the firm's monetary sanction was paid into a Fair Fund established by the SEC to compensate investors harmed by Joseph Leighton's fraud.

A fundamental tenet of FINRA's organizational structure is that regulatory staff of FINRA and its subsidiaries conduct their duties and responsibilities with autonomy and independence. Undertakings imposed by the SEC on NASD in 1996 concerning NASD's regulatory functions specifically provide that NASD's regulatory staff has sole discretion with respect to matters to be investigated and prosecuted

Corporate bylaws of FINRA and FINRA Regulation prohibit FINRA Governors or FINRA Regulation Directors from participating directly or indirectly in any matter if the Governor or Director has a conflict of interest or bias or if circumstances otherwise exist where his or her fairness might reasonably be questioned (See FINRA Bylaws Article XV, Sec. 4(a) and FINRA Regulation Bylaws Article IV, Sec. 4. 14(a)). FINRA's Board has adopted Corporate Governance Guidelines that urge Governors to direct questions and issues concerning FINRA's operations to FINRA's senior management and corporate secretary. Those Guidelines also direct Governors to ensure that any contact with FINRA staff's appropriate and non-disruptive to FINRA's business operations. FINRA trains its examiners and staff to ignore and escalate as appropriate any attempt by a firm under examination to intimidate or attempt to influence, and FINRA's Code of Conduct and ethics training focus on staff members avoiding any conflict of interest or any appearance of a conflict of interest.

To protect its staff from retaliation or impermissible influence, FINRA has adopted policies that protect any staff member reporting concerns in good faith, including FINRA's Code of Conduct, and FINRA operates internal and anonymous reporting systems to collect, analyze and investigate any claim of violative behavior. FINRA has also voluntarily adopted a policy designed to apply the requirements of Section 307 of the Sarbanes-Oxley Act of 2002, which does not otherwise apply to FINRA, so that FINRA attorneys who become aware of evidence of a material violation of law affecting FINRA (including any act or failure to act by any of FINRA's officers, Governors or employees) must report such violation to FINRA's Executive Vice President and General Counsel (Corporate) or, in certain instances, to FINRA's Audit Committee.

Q.4. Section 13(c) of the Securities Investor Protection Act provides that, subject to limited exceptions: "The self-regulatory organization of which a member of SIPC is a member or in which it is a participant shall inspect or examine such member for compliance with all applicable financial responsibility rules." Pursuant to this authority, describe the examinations that FINRA performs of member broker-dealers.

A.4. The key financial responsibility rules include the SEC's Net Capital Rule (SEC Rule 15c3-1), Customer Protection Rule (SEC Rule 15c3-3), and Books and Records Rules (SEC Rules 17a-3 and 17a-4). All FINRA-regulated firms are subject to these rules. The net capital rule requires firms to maintain a certain minimum amount of net capital, based upon the type of business conducted. Firms that fail to maintain sufficient net capital are not permitted to conduct a securities business until they are once again in net capital compliance. Firms file financial reports monthly (or quarterly for firms involved in less complex business activities). Irrespective of reporting requirements, all firms must prepare monthly financial statements. FINRA conducts onsite financial examinations that review financial statements. The frequency of these examinations depends on the firm's size, business model and an assessment of the firm's risk. Broker-dealers that carry, or custody, customer assets receive financial examinations more frequently than those firms who do not carry customer accounts. Presently, examinations of firms that do carry customer accounts are generally done annually. FINRA's examination includes a review of the accuracy of the firm's financial statements and its most recent net capital computation. If a broker-dealer is determined to have been "under net capital" during this most recent time period, the staff expands its review.

The Customer Protection rule prohibits firms from co-mingling customer assets with proprietary assets or otherwise using customer property to finance the broker-dealer's activities. For the Customer Protection Rule, FINRA examiners will determine that clearing firms maintain proper possession or control of all fully paid or excess margin customer securities and that these firms maintain a Reserve Account bank balance sufficient to cover net balances due to customers. This is computed pursuant to a formula in the SEC's Customer Protection Rule. At introducing firms, examiners verify that the member firm is not holding any customer cash or securities. All broker-dealers must have sufficient books and records to support their financial statements and regulatory computations. For example, broker-dealers should maintain bank statements and reconciliations, statements from depositories, and statements from clearing firms for introducing broker-dealers. FINRA staff will verify a firm's financial records and computations made pursuant to SEC Rule 15c3-1 and 15c3-3 with these supporting documents.

Q.5. You testified that "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." Did those examinations cover the entire premises of the Madoff brokerage firm, including the areas from which the Ponzi scheme was run? If not, please explain why they did not.

A.5. During examinations of Bernard L. Madoff Investment Securities, LLC ("BLMIS"), a broker-dealer regulated by FINRA, examination staff conducted onsite reviews of various aspects of the broker-dealer's business, which engaged in wholesale market making. Those reviews encompassed, among other areas: supervision, supervisory controls, net capital adequacy, financial operations, internal controls, insider trading, trading risk controls, and trade reporting. Examination staff reviewed books and records related to the Madoff broker-dealer' s activities and areas of our examination focus. BLMIS did not record any of Madoff's investment advisory business on its books and records. Consequently, those books and records did not indicate that Madoff was engaged in a Ponzi scheme through his separate advisory business.

Q.6. Please respond to the following hypothetical situation. If FINRA examiners are on the premises of a broker-dealer and want to examine certain records located there, and the firm CEO asks FINRA not to look at the records because they relate to investment advisory activities, would FINRA leave that part of the premises without determining or verifying the nature of the documents? If so, please clarify how examiners can detect when such a representation is inaccurate or records on the premises actually relate to an improper activity by the broker-dealer, such as misappropriating client funds?

A.6. Pursuant to FINRA Rule 8210, FINRA staff has the right to inspect all books, records and accounts of a regulated broker-dealer firm as part of an examination. If a regulated firm also engages in investment advisory business, the FINRA staff would generally not examine that business line further—unless we were aware of red flags that the firm was misrepresenting it to be part of the broker-dealer—as FINRA has no jurisdiction to examine or enforce the Investment Advisers Act or the rules thereunder. FINRA staff would determine whether a denial of access was with or without merit. In this regard, a firm that denied access would be required to show that the documents related to the investment advisory activity rather than the brokerage business. In any event, should FINRA's examiners become aware of potential misconduct by the investment adviser through the course of our examination, FINRA would promptly refer that matter to the SEC or state regulator, as appropriate.

Q.7. If the NASD in 2005 or earlier had received a credible allegation that the owner of a broker-dealer was running a Ponzi scheme from the firm premises, would the NASD have had the legal authority to examine the broker-dealer premises to determine whether it was a channel for a Ponzi scheme?

A.7. If FINRA received an allegation that the owner of a broker-dealer was running a Ponzi scheme from the firm's premises, FINRA would promptly and vigorously investigate the allegation and pursue the investigation to the limits of its jurisdiction. If the owner was running a Ponzi scheme through a separate investment advisory business, FINRA would promptly refer the matter to the SEC or appropriate state regulator.

Q.8. We understand that SIPC provides insurance coverage for customers of broker-dealers but not of investment advisers. The SIPC has determined that some Madoff fraud victims were broker-dealer customers for purposes of insurance under the Securities Investor Protection Act. You indicated that FINRA and its predecessor did not examine the activity that constituted the Madoff Ponzi scheme because it was deemed to be an investment advisory activity, which would seem to mean that fraud victims were investment advisory customers. If this is correct, please explain why the same fraud victims were treated by SIPC as Madoff broker-dealer customers and by FINRA and its predecessor as investment advisory and not broker-dealer customers.

A.8. As we testified, our exams showed no customer accounts of the broker-dealer. While FINRA is not privy to SIPC's legal analysis, it appears as though Madoff's money management customers were led to believe that they were customers of a broker-dealer, irrespective of the fact that there was no record of them being customers of the registered broker-dealer.

Q.9. Mr. Harbeck testified that "FINRA and the SEC presented SIPC with evidence that, at the very least, the Madoff brokerage firm owed customers $600,000,000 worth of stock that it did not have on hand. That was the factual predicate for the exercise of SIPC's jurisdiction." Do you agree with this representation? If so, please identify the FINRA unit that presented this evidence to SIPC and provide the text of this communication to SIPC as well as the analysis that formed the basis of the conclusion. Please also explain why FINRA told SIPC that the brokerage firm owed customers stock that it did not have when FINRA has said that the transactions occurred within an investment advisor, which it lacked authority to examine, and not in the broker-dealer.

A.9. At the request of the SEC and SIPC, FINRA provided approximately 5 examiners from its Member Regulation Department to assist the SEC's New York office in reviewing records during the first 3 weeks after the fraud came to light, including records that had not been made available during our prior examinations of the broker-dealer business. The information gleaned in the review process was provided to the SEC, and may have been used to arrive at the $600,000,000 figure.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM STEPHEN I. LUPARELLO

Q.1. Former SEC Chairman Cox directed the SEC's Inspector General to conduct a review of the SEC's failure to detect and stop the Madoff fraud. Is FINRA considering initiating a similar internal investigation into its oversight of the Madoff firm?

A.1. FINRA's Board of Governors is currently conducting a review of FINRA's examination program as it relates to the detection of fraud, specifically Ponzi schemes, including that operated by Madoff. However, FINRA's internal review differs significantly from the SEC Inspector General's investigation in that FINRA, unlike the SEC, only had jurisdiction over Madoffs broker-dealer activity, and not the investment advisory business where the fraud took place. The special review committee is chaired by former U.S. Comptroller General Charles A. Bowsher.

Q.2. FINRA, and before it, the NASD, was the self-regulatory organization responsible for overseeing the brokerage operations of the Madoff firm and, as part of that oversight, conducted examinations of the Madoff firm.

Is it your position that FINRA examiners could not have asked any questions about the connections between Mr. Madoff's money management activities and the firm's brokerage operations that were reported in the press? Does it make a difference that Mr. Madoff himself considered his money management activities to fall within the brokerage business?

A.2. If FINRA had been aware of red flags at the time of its examinations that Madoff was misrepresenting his money management business to customers and leading them to believe they were customers of the broker-dealer, we could have pursued information related to those concerns to the extent of our authority. Unfortunately, Federal law deprives FINRA of jurisdiction to enforce the principal statute that applies to the advisory business of a broker-dealer. Section 15A of the Securities Exchange Act of 1934 authorizes FINRA to enforce compliance with the Exchange Act, FINRA rules, and the rules of the Municipal Securities Rulemaking Board. FINRA lacks jurisdiction to examine for or to enforce compliance with the Investment Advisers Act of 1940 and the SEC rules under that Act, and we lack the authority to adopt our own rules under the Act. This is true even when the advisory business occurs in the same legal entity as the broker-dealer.

While FINRA examiners at times see investment advisory customer accounts reflected on the books and records of a dually registered broker-dealer, this was not the case with the Madoff firm. Madoff's broker-dealer was a wholesale market maker and Madoff did not record any of his investment advisory business on the books and records of the broker-dealer. We were unaware at the time of our examinations that Mr. Madoff considered his money management activities as part of the broker-dealer. All books and records of the broker-dealer represented a contrary view.

Q.3. Other fraudsters may feel emboldened by FINRA's public statements that it is not authorized to hold fraudsters like Mr. Madoff accountable.

What steps did FINRA take after learning of the Madoff fraud to ensure that other large broker-dealers are not similarly defrauding customers or do you believe that, under your current statutory authority, you cannot take any additional steps to prevent and detect such frauds?

A.3. Since learning of Mr. Madoff's arrest, FINRA has undertaken several initiatives to gather information and determine ways to enhance the ability of our regulatory programs to identify fraud within our jurisdiction. Those initiatives include:

- Conducting reviews of custody issues in dually registered broker-dealer/investment advisers and the role of broker-dealers as feeders to money managers;
- Developing enhancements to our examination programs and procedures for the purpose of better detecting fraud during routine examinations;
- Initiating a FINRA Board committee review of FINRA's examination programs with regard to fraud detection;
- Developing training programs aimed at fraud detection;
- Reviewing our rules to identify potential changes that could assist us in detecting misconduct that could be indicative of fraud;
- Participating in discussions with other regulators about ways to improve fraud detection; and
- Establishing FINRA's Office of the Whistleblower to expedite the review of high-risk tips by FINRA senior staff and ensure a rapid response for tips believed to have merit.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR JOHNSON FROM STEPHEN I. LUPARELLO

Q.1. The Madoff Ponzi scheme is one of the largest financial frauds in U.S. history. From your point of view, how did the Madoff Ponzi Scheme fall through the cracks of the U.S. regulatory system?

A.1. The fragmented system of financial regulation prevents FINRA from providing an additional component of protection for investment advisory customers—whether or not those services are provided within the same legal entity as the broker-dealer. We have long expressed our concerns regarding a firm's ability to avoid our jurisdiction by engaging in abusive practices through an advisory business. This case, in particular, highlights what can happen when a regulator like FINRA is only allowed jurisdiction with respect to one side of the business. There is little doubt that Madoff and others have cynically designed their schemes to fit between the jurisdictional cracks to decrease the likelihood of detection.

Q.2. Are there any new authorities that FINRA could use to prevent this type of fraud from happening again?

A.2. In our view, it is of paramount importance that investors are given consistent protections regardless of product or the registration of their financial services professional. We think that providing investment adviser customers with the same level of oversight that broker-dealer customers receive is an important part of achieving that consistency. FINRA believes the regulatory regime for investment advisers should be expanded to include an additional component of oversight by an independent regulatory organization, similar to that which exists for broker-dealers. We believe that regular and frequent exams are a vital component of effective oversight of financial professionals, and that the absence of FINRA-type oversight of the investment adviser industry leaves investors without that critical component of protection.

Q.3. Bernie Madoff held many advisory positions with NASD and its affiliates during his career. Could he have used his influence on these boards and committees to influence actions (or lack thereof) by NASD (now FINRA) regarding his company or influence regulations affecting his company?

A.3. FINRA, like other regulators, seeks out the expertise of participants in the securities markets. This communication allows us to be more effective regulators. We are not bound in any way by the views of these market participants. FINRA's oversight of the Madoff broker-dealer was not affected by the fact that the Madoffs were known to some in our organization. Had we known evidence of this fraud, we would have vigorously investigated the firm. If our investigation indicated that fraud existed in the advisory operations, we would have promptly referred the matter to the SEC, which regulated the advisory operations. FINRA received and investigated 19 complaints against the Madoff broker-dealer since 1999.

FINRA consistently has demonstrated that it is willing to discipline a firm for wrongdoing, regardless of how well-known, well-respected or active it is. FINRA has taken action against the firms of sitting or former board members on several occasions. In fact, in one case that bears resemblance to the Madoff situation, FINRA's predecessor organization, NASD, sanctioned a former Board member who was CEO of a major market making firm, and two others associated with his firm, for supervisory failures and improper sales practices.

On April 17, 2007, an NASD hearing panel found that Kenneth Pasternak, former CEO of Knight Securities, L.P. (now known as Knight Equity Markets, L.P.), and John Leighton, former head of the firm's Institutional Sales Desk, committed supervisory violations in connection with fraudulent sales to institutional customers. The hearing panel imposed a 2-year suspension in all supervisory capacities and a $100,000 fine upon Kenneth Pasternak, and a bar in all supervisory capacities and a $100,000 fine upon John Leighton.

In a 2-1 decision, the panel found that Pasternak and Leighton failed to adequately supervise the trading of the firm's leading institutional sales trader, Joseph Leighton, John Leighton's brother. The ruling states that Kenneth Pasternak's response to numerous red flags was "woefully inadequate," that Kenneth Pasternak and John Leighton "never questioned Joseph Leighton's activities or confirmed he was providing his customers with best execution and a fair price," and that the overall supervisory void "allowed Joseph Leighton to take advantage of his customers over a 21-month period by filling orders at prices that netted Knight unreasonably high profits."

In April 2005, Joseph Leighton agreed to a bar from the securities industry and a payment of more than $4 million to settle charges by the SEC and NASD that he made millions of dollars from fraudulent trades with Knight's institutional customers. In December 2004, Knight paid more than $79 million to settle SEC and NASD charges against the firm arising from Joseph Leighton's conduct. More than $3.3 million of Joseph Leighton's monetary sanction and more than $66 million of the firm's monetary sanction was paid into a Fair Fund established by the SEC to compensate investors harmed by Joseph Leighton's fraud.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR JOHANNS FROM STEPHEN I. LUPARELLO

Q.1. What options from the Treasury's Blueprint for Regulatory Reform would you implement?

A.1. Treasury's Blueprint for Regulatory Reform recommends that Congress adopt "statutory changes to harmonize the regulation and oversight of broker-dealers and investment advisers offering similar services to retail investors." It further recommends that investment advisers be subject to a self-regulatory regime similar to that of broker-dealers. (Blueprint, pp. 118–126.) FINRA fully supports implementation of these recommendations.

As the SEC has noted, the population of registered investment advisers has increased by more than 30 percent since 2005. Investment advisers now number 11,300—more than twice the number of broker-dealers. 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. Consider the contrast: FINRA oversees nearly 4,900 broker-dealer firms and conducts approximately 2,500 regular exams each year. The SEC oversees more than 11,000 investment advisers, but in 2007 conducted fewer than 1,500 exams of those firms. The SEC has said recently that in some cases, a decade could pass without an examination of an investment adviser firm.

We believe that regular and frequent exams are a vital component of effective oversight of financial professionals, and that the absence of FINRA-type oversight of the investment adviser industry leaves investors without that critical component of protection.

In our view, it simply makes no sense to deprive investment adviser customers of the same level of oversight that broker-dealer customers receive.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM STEPHEN P. HARBECK

Q.1. SIPC Chairman Armando Bucelo at his Banking Committee confirmation hearing on May 16, 2006, testified that "Our Board is committed to maintaining adequate resources to fulfill SIPC's statutory mission. SIPC's fund now stands at well over $1.3 billion, a historic high. As Chairman, I have initiated a Board-level Investment Committee to make sure that SIPC continues the prudent management of the fund.

Following the Madoff situation, has the Board discussed or reviewed how to maintain adequate resources in its fund? Will it consider measures such as raising the fees on stock brokerage firms from its current level of $150 per year or charging different amounts of fees based on the amount of assets held by a firm or the risk posed by the firm?

A.1. As noted above in my response to Senator Shelby, because it is possible that the SIPC Fund created by SIPA may fall below $1 billion in the near future, SIPC's Board, pursuant to the Corporation's By-laws, has reinstituted assessments on SIPC member brokerage firms at the rate of ¼ of 1 percent of each member's net operating revenues. That assessment begins on April 1, 2009. The assessment based upon net operating revenue replaces a flat fee of $150 which had been charged to each member annually, from 1996 through 2008. The Board has not considered charging members based upon perceived risk.

Q.2. Please describe the basis on which SIPC determined that some Madoff fraud victims are eligible to receive SIPC insurance benefits.

A.2. The persons protected under SIPA are "customers." That is a defined term in the statute. It includes persons who deposited money with a SIPC member brokerage firm for the purpose of purchasing securities. Generally, these would be investors who directly dealt with the brokerage firm, and who had the right to exercise control over an account.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM STEPHEN P. HARBECK

Q.1. Mr. Harbeck, I understand that SIPC has approximately $1.7billion in assets, another $1 billion available through a Treasury line of credit, and an additional commercial line of credit.

Do you expect these funding sources to be depleted? If so, what steps do you plan to take to address that possibility?

A.1. I do not expect that the assets available to SIPC will be depleted as a result of SIPC's financial obligations to customers in the Madoff case. Nevertheless, because it is possible that the SIPC Fund created by the Securities Investor Protection Act ("SIPA") may fall below $1 billion in the near future, SIPC's Board, pursuant to the Corporation's Bylaws, has reinstituted assessments on SIPC member brokerage firms at the rate of ¼ of 1 percent of each member's net operating revenues. That assessment begins on April, 2009. The assessment based upon net operating revenue replaces a flat fee of $150 which had been charged to each member annually, from 1996 through 2008.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR JOHNSON FROM STEPHEN P. HARBECK

Q.1. The Madoff Ponzi scheme is one of the largest financial frauds in U.S. history. From your point of view, how did the Madoff Ponzi Scheme fall through the cracks of the U.S. regulatory system?

A.1. Certainly the regulatory regime should have identified the Madoff fraud long ago. But I simply cannot explain why Madoff was not stopped at an earlier point. I expect that the SEC Inspector General's investigatory report relating to Madoff will provide some insight. SIPC's experience is that the present regulatory regime does in fact identify the theft of customer property at a relatively early stage.

In SIPC's 39-year history, there have been 322 brokerage firm failures requiring SIPC to intervene. In 294 such cases, the cost to SIPC of satisfying customer claims and paying administrative expenses was less than $5 million in each such case. Indeed, in 235 of those cases, the cost to SIPC was less than $1 million in each such case. I ascribe two reasons to this: First, SIPC and trustees appointed under SIPA are aggressive in seeking out wrongdoers and holding them financially responsible, thereby potentially deterring such future crimes. However, a second reason is there as well: the regulators usually locate, identify, and halt the theft at a relatively early stage. Compared with the foregoing historical statistics, the Madoff situation has no precedent.

Q.2. Can you provide details on how the claims process will work for those investors affected by the Madoff Ponzi Scheme? How will SIPC conduct its liquidations of the Madoff firm? Does SIPC have the needed tools and resources to conduct this claims process?

A.2. In some instances, such as the collapse of Lehman Brothers, Inc. ("LB!"), it is possible to transfer customer accounts in bulk to a solvent brokerage firm so that customers can gain prompt access to the assets in their accounts. This was not possible in the Madoff case as it now appears that all assets were stolen. Furthermore, the pervasiveness of the fraud in Madoff has made it necessary to reconstruct and scrutinize every account as to which a claim is filed.

The forensic accounting required to properly assess claims in the Madoff case is detailed and time consuming. The trustee responsible for this process is working from non-Computerized records, under the control of the United States Attorney, at a crime scene. The fraud was under way for decades.

In addition to publishing notice of the liquidation proceeding, the trustee mailed claim forms to all known customers and made the claim form available on the Internet. The claim forms are being returned to the trustee. The documentation submitted by the claimants is compared with the available records of the defunct firm. The claimants are analyzed on a “net claim” basis: Each claim will be evaluated on a “money in less money removed” from the scheme. Payment of “easy” claims has begun. However, the process is far more time consuming than in any other major case, where the debtor brokerage firm’s records bear a relation to the reality of what the brokerage firm has in its possession. SIPC has begun to advance funds to the trustee to pay approved claims.

I believe SIPC and the trustee have the tools and resources to conduct the liquidation proceeding. Moreover, the liquidation of LBI under SIPA, which began in September, 2008, is proceeding well. SIPC’s ability to deal simultaneously with the LBI and Madoff failures demonstrates that SIPC’s essential structure can withstand a very rigorous test. Any future restructuring of the regulatory system to deal with the failure of a large financial institution should recognize the inherent strength of the SIPA program.

Q.3. Do you have any suggestions for needed changes to SIPC in light of the current situation?

A.3. SIPC’s Board will review the adequacy of the minimum target balance of the SIPC Fund, which is currently $ 1 billion, and the adequacy of SIPC’s line of credit with the United States Treasury, which is $1 billion.

Litigation arising from the case may give rise to other suggested changes.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR JOHANNS FROM STEPHEN P. HARBECK

Q.1. When Mr. Madoff was arrested, he disclosed to authorities that his Ponzi scheme lost an estimated $50 billion. Is there any way to obtain an accurate figure?

A.1. Mr. Madoff’s reported estimate, and a subsequent higher estimate used in his criminal plea allocution, includes the fictitious profits he reported to his victims. The trustee will be reconstructing the actual amounts entrusted to the brokerage firm, and amounts withdrawn by each investor, from the Debtor’s records, bank records, and documents submitted by the claimants.

Q.2. How are you going to be able to distinguish between actual and phantom profits when the records are unreliable and in disarray at best and non-existent at worst?

A.2. The trustee has noted that since there were no securities transactions done on behalf of the brokerage firm’s clients for at least the last 13 years of the Ponzi Scheme, there were in fact no real profits. All profits were fictional. As noted above, the sources for verifying the money deposited with the firm will be the Debtor’s records, bank records, and documents submitted by the claimants.

PREPARED STATEMENT OF HARRY MARKOPOLOS

CHARTERED FINANCIAL ANALYST, CERTIFIED FRAUD EXAMINER

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 9 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 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 U.S. Army airborne ranger infantry officer with intelligence gathering experience, is the North American President for U.K.-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 9 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 1 month a reported minus 0.55 percent, 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 percent 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 U.S. 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 percent 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 two-thirds of the market's return with only one-third 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 percent of his portfolio totaling 100 percent of his stock portfolio (33 stocks x 3.03 percent invested in each stock = 100 percent 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 percent for that month [$\frac{1}{33}$ = 3.03 percent]. The odds of a 30–35 stock portfolio not experiencing heavy single stock losses over a 7¼ 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 percent of the S&P 500's return with less than 22 percent of the risk. More alarmingly, his returns only had a 6 percent correlation to the S&P 500 Stock Index when I would have expected to see something like a 50 percent correlation and wouldn't have questioned any correlation figures between 30 percent–60 percent. A 6 percent correlation was so low as to signal "FRAUD" in flashing red letters. The easiest explanation for why a 6 percent 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 percent resemblance in a situation where, due to the price limiting performance of the put and call options, one would expect a 30–60 percent 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 percent 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 through 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 4 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 percent–60 percent, 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 and 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 online 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 3 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 p.m.). 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 5 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 proper 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 1 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 3¼ 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 3-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 U.S. 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 U.S. 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 percent 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 percent of their money invested in hedge funds. To investment professionals, a proper allocation to hedge funds would range between 0 percent–25 percent, 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 percent 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

Late 1999	Frank Casey "discovers" Bernie Madoff (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 U.S. 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 4 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 and 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 overlawyered. 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 percent of relevant post-graduate education courses with 1 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 sizable 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 work-ers, 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 percent 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 sizable 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 percent 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 multimillion 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 3 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 percent between its outstanding debt which pays an average of 6 percent interest and its equity which has a 14 percent cost associated with it and the mix between debt and equity is 50/50 [(.5 x 6 percent) + (.5 x 14 percent) = 10 percent cost of capital]. Assume that ABC Company is a Defense Contractor and bids "cost plus 3 percent" on an Iraqi War contract yet the company's cost of capital is 10 percent. 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 percent when a firm's cost of capital is 10 percent would quickly lead the firm into bankruptcy since that contract would be costing the firm a minus 7 percent 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 U.S. 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 and 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 9-11s, 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 1 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 1 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 U.S. 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, online 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 decisionmaking 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 Web site 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 percent to any one investment manager, never put 100 percent 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 percent–25 percent 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 blowups 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 percent of fraud schemes at public companies whereas external audits account for a meager 4.1 percent 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 U.S. Treasury.

The IRS offers bounty payments to whistleblowers of 15 percent–30 percent for cases that lead to successful recoveries to the U.S. 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 percent 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 10 percent (10 percent) of the penalty amount to the whistleblower (triple damages x 10 percent maximum bounty award = 30 percent 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 U.S.C. 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. To date 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 U.S. 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.

PREPARED STATEMENT OF PAUL HILLER

CHIEF FISCAL OFFICER, TOWN OF FAIRFIELD, CONNECTICUT

I am Paul Hiller and I have had the privilege of serving as the Chief Fiscal Officer for the Town of Fairfield Connecticut for the past 10 years. Fairfield is a predominantly suburban community located on Long Island Sound and approximately 55 miles east of New York City. It proudly serves as the home to 2 outstanding Universities—Fairfield and Sacred Heart Universities—and is the home for the world headquarters of General Electric. Fairfield has a long and proud heritage dating back to its founding in 1639. It has the unique distinction of being one of the very few towns or cities throughout our nation granted the cherished triple a (AAA) rating by all 3 major rating agencies.

In June 1997 our Pension Board made an initial investment, based upon a recommendation of our Pension Advisor, to make an initial investment of pension assets into the Broad Market Fund sponsored by Tremont Advisors. This investment into this Fund was followed by additional allocations of pension assets in 2000, 2001, and 2003. These investments which totaled a little over $21 million eventually increased to a "reported" level of $41,885,901.22 as of November 30, 2008. Throughout this entire time, the Pension Board were cognizant that these funds were supposed to be administered and managed by the Tremont organization and then later by the Maxam organization who hired their own investment manager and their own auditors. The Pension Board was aware that both these funds hired Bernard L. Madoff and his firm to be the investment manager for these funds. None of the fund's legal documents or partnership agreements disclosed the identity of these securities firm. It was assumed by the Pension Board that all securities trades and the custody of all securities was being managed properly by the fund managers and properly audited and that the Pension Board advisors performed due diligence to monitor these investments.

The Pensions for the Town of Fairfield cover 971 active employees in a Defined Benefit Plan and 595 retired beneficiaries or vested pensioners. All of these past and present employees have contributed from their earnings into the Plan. And, in addition, the Town of Fairfield contributed general funds into this Plan. The Pension Funds of Fairfield have since 2000 been in an enviable status of being overfunded on an actuarial basis, with assets totaling over $350,000,000 until this past year and this apparent fraud. This comes as a result of decisions made by the Pension Board, upon recommendations by Pension advisors over the years, and quality management by varied money managers. The Pension Board always had an investment policy which required diversification and never invested more than 10 percent of the Fund with any investment management firm.

On December 11, 2008, our Pension Board and I were shocked to learn through press reports of this apparent massive fraud. The Pension Board has recently hired attorneys to seek to recover lost funds through any means possible. The apparent loss of this investment because of alleged fraud has caused significant adverse impact on our pension fund and our community. The Pension Board works very hard to protect the retirement funds set aside for government employees. We hope that these hearings will shed light on this entire situation and we thank you for your time.

LETTER FROM BARBARA ROPER

DIRECTOR OF INVESTOR PROTECTION, CONSUMER FEDERATION OF AMERICA

CFA **Consumer Federation of America**

January 26, 2009

The Honorable Christopher Dodd
Chairman, Committee on Banking,
Housing and Urban Development
U.S. Senate
Washington, D. C. 20510

The Honorable Richard Shelby
Ranking Member, Committee on Banking,
Housing and Urban Development
U.S. Senate
Washington, D.C. 20510

Dear Chairman Dodd and Ranking Member Shelby:

We understand you are planning a hearing this week that will look into how and why securities regulators failed to uncover the multi-billion-dollar Ponzi scheme apparently operated for decades by Wall Street financier Bernard L. Madoff. The failure of regulators to uncover such a long-running and massive fraud calls into question their ability to fulfill their oversight functions and erodes public confidence in the safety of their investments. Your hearing can play an important role in identifying the causes of that failure and, in so doing, can help to identify the legislative or regulatory fixes necessary to ensure more effective oversight of investment professionals in the future.

Among the most pressing issues on the public's mind is why the SEC failed to follow up effectively on a series of tips it received about potential problems in the Madoff operation. But the SEC was not alone in failing to uncover this fraud. Investors and policymakers also need to understand the reasons behind FINRA's failed oversight of one of its member firms. While former FINRA President and newly appointed SEC Chairman Mary Schapiro provided some brief answers to questions on this topic during her confirmation hearing, her suggestion that a "stove-piped" approach to regulation of brokers and investment advisers was at fault does not fit the publicly available information.

1) **The failure to detect the Madoff fraud cannot reasonably be attributed to lack of NASD/FINRA jurisdiction over his advisory activities.**

Chairman Schapiro stated that, "FINRA had jurisdiction over Madoff's broker-dealer activities but not over its investment advisory activities. The investment advisory activity did not run through the books of the broker-dealer, which is what FINRA was examining." According to at least one account, however, Madoff had insisted prior to a 2005 SEC investigation that his money management accounts were not investment advisory accounts because he was compensated through commissions on trades rather than through fees. This would suggest that, prior to that time, Madoff was relying on the broker-dealer exclusion from the Investment Advisers Act to escape regulation as an investment adviser. If that is the case, then those money management activities would have been considered brokerage activities subject to NASD/FINRA oversight for most of the lifespan of the fraud. Only after the SEC adopted its fee-based brokerage account rule, which defined all discretionary accounts as advisory accounts regardless of compensation method, would Madoff have lost the ability to claim the broker-dealer exclusion from Adviser's Act regulation.

- If this account is accurate, then the problem to be solved is the opposite of that identified by Chairman Schapiro: not that NASD/FINRA was precluded from overseeing Madoff's investment advisory activities, but that his money management activities were until recently exempt from investment adviser oversight.

That Madoff relied on the broker-dealer exclusion is just one possible scenario. Public information about the Madoff case is admittedly limited and sometimes contradictory. While the above scenario seems to provide the most likely explanation for Madoff's failure to register as an investment adviser until 2006, there are other possible explanations. One such explanation is that Madoff did not have, or claimed not to have, enough advisory clients to require registration. The issue for policymakers to consider in that case would be the wisdom of providing a de minimis exemption from registration, particularly when large dollar amounts are under management. If on the other hand the justification offered was that Madoff's advisory services were provided exclusively to hedge funds, then the issue to consider would be the need for greater oversight of these unregulated entities and, in particular, the feeder funds that apparently played such a prominent role in attracting clients for Madoff's money management services.

None of these possible scenarios supports the contention that a "stove-piped" approach to regulation of brokers and investment advisers, under which NASD/FINRA was prevented from overseeing the advisory activities, is a plausible explanation for this regulatory failure. Not only was the firm exclusively regulated as a broker-dealer over most of the lifespan of the fraud, but NASD/FINRA rules grant that agency broad authority to gather information about and provide some oversight of activities that are related to the firm's brokerage activities. FINRA Rule 3030, for example, requires an associated person of a broker-dealer to report any outside business activities to the firm, and Rule 3040 requires the firm to supervise any "private securities transaction" engaged in by an associated person. Under this rule, an associated person who gets paid for advising accounts away from the broker-dealer must submit all his or her advisory activities to the broker-dealer's supervision. If it is true that Bernard L. Madoff Investment Services, LLC (BMIS) books show no indication of Madoff's well-publicized money management activities, it seems clear that this should have at least triggered questions from NASD/FINRA about whether that activity was being conducted in violation of the above noted rules. FINRA has not been hesitant in other cases to pursue such inquiries. On the contrary, it is our understanding that FINRA recently sought and won access to a hedge fund affiliated with a broker-dealer on the grounds that the hedge fund's activities were related to the broker-dealer.

What is clear is that, until policymakers understand the reason Madoff was able to operate a Ponzi scheme in the guise of a money management business without regulatory oversight apparently for decades, they will not know how to prevent a recurrence of that problem.

2) Earlier regulation as an investment adviser might have resulted in earlier detection of the fraud.

The custody rule under the Investment Advisers Act specifically requires that an adviser use a qualified custodian. This can include a bank or a registered broker-dealer, such as BMIS. The rule requires that the adviser notify clients in writing of the custodian's name, address and manner of custody when the account is opened. The adviser must have a reasonable basis for believing that the custodian is sending quarterly account statements to clients showing the securities and funds held and transactions during the reporting period. Or, if the adviser provides the account statements, an independent public accountant must conduct an examination of the funds and securities annually pursuant to a surprise audit. Had Madoff been required to register his money management business as an investment adviser from the outset, instead of relying on the broker-dealer exclusion or some other exemption from the Advisers Act, he would have been subject to regulatory oversight for compliance with these requirements. Given that the fraud appears to involve the disappearance of assets, effective regulatory oversight of custody requirements might have either prevented the fraud or resulted in its much earlier detection. This too suggests that it is not FINRA's lack of investment adviser oversight, but the existence of a broker-dealer exemption from the Advisers Act, that is the primary regulatory gap policymakers should consider filling to prevent a recurrence of similar problems.

3) After Madoff registered as an investment adviser, there were red flags that should have triggered greater regulatory scrutiny.

Effective Advisers Act oversight could have uncovered the fraud, but it did not in this case. The primary fault here appears to be the SEC's, as that agency failed to conduct either the initial inspection it is supposed to conduct of all newly registered advisers within six months of registration or subsequent routine inspections. This is inexcusable in light of the number of red flags that existed in this case. Madoff's chief compliance officer was his brother, and the auditor of the firm was a small, unknown accountant with few if any other clients. Madoff charged only commissions, an unusual arrangement for a money manager with such a large asset base. Finally, Madoff's prestige as a former NASDAQ Chairman and widely respected figure in the money management world is precisely the sort of factor that might awe both internal compliance personnel and even FINRA investigative staff, thereby weakening the thoroughness of their oversight. The SEC purports to use risk factors in determining its inspection schedule for investment advisers. Under any reasonable risk-based approach, an adviser with billions in assets under management, who takes custody of client funds, who exercises discretionary control over client accounts, and who has both a family member as compliance office and an unknown auditor should be at the top of the list for frequent and rigorous inspections.

That the primary fault at this point was the SEC's – and that the SEC further erred by not sharing its tips regarding Madoff with FINRA – does not, however, let FINRA entirely off the hook. As noted above, FINRA has broad authority to examine any business activities that are related to the broker-dealer. The same red flags that should have triggered closer SEC scrutiny should also have served as a warning to FINRA. Moreover, press accounts going as far back as 2001 had questioned the credibility of Madoff's claimed investment results, so even absent information from the SEC about the tips it had received, FINRA should have been aware of potential problems.

Chairman Schapiro has testified that there was no evidence on BMIS's books of its executing trades or issuing account statements for Madoff's advisory accounts, suggesting that BMIS was not the qualified custodian used by Madoff (assuming he had one at all). However, once Madoff registered as an investment adviser, and given the central role FINRA plays in ensuring compliance with custody requirements, FINRA should at least have asked who the custodian was for the $17 billion in reported advisory assets and requested some documentary support, including customer statements sent by the custodian or, if customer statements were sent by Madoff, the independent accountant's report. The broad reach of FINRA's jurisdiction over member firms would have made this a reasonable request well within its authority. It is possible that FINRA did this and was shown false documents, but that has not to our knowledge been reported. Instead, FINRA and Chairman Schapiro have argued that it was a lack of regulatory authority that prevented the fraud's detection.

* * *

Hard as it is to comprehend that a fraud this massive could have gone undetected for so many years, the simply truth is that, if a Ponzi scheme is sufficiently sophisticated and efficiently operated, it is possible to hide the scam from even a careful inspection. The goal of policymakers should be to determine whether correctable problems existed that allowed the fraud to go undetected in this case. Only a correct diagnosis of the problem, however, will lead to appropriate and effective remedies. The diagnosis offered to date by Chairman Schapiro for FINRA's failures of oversight – that it lacked necessary authority over Madoff's investment advisory activities – simply do not match the publicly available information about the fraud. For most of the period during which the fraud was perpetrated, Madoff appears to have been subject exclusively to broker-dealer regulation. Even after BMIS registered as an investment adviser, FINRA retained authority over the broker-dealer activities, and the fraud continued to implicate fundamental broker rather than advisory regulatory concerns.

Possible regulatory failings in verifying the information provided by Madoff, and possible regulatory gaps related to the broker-dealer exclusion from the Advisers Act, the de minimis rule, and hedge fund regulation may also have contributed. It is in these areas that we believe the Committee should focus its attention in working with the SEC and FINRA to develop an appropriate legislative and regulatory response.

Respectfully submitted,

Barbara Roper

Barbara Roper
Director of Investor Protection