#### **TESTIMONY OF**

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## UNITED STATES SECURITIES AND EXCHANGE COMMISSION

#### Before the

United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises
Concerning Investor Protection and Securities Fraud

Wednesday, February 4, 2009

Chairman Kanjorski, Ranking Member Garrett, and members of the Subcommittee:

We appreciate the opportunity to appear today on behalf of the Securities and Exchange Commission ("SEC") to discuss the mission and mandate of the SEC, our critical work to protect investors, the work of our respective divisions and offices, and certain general information with respect to the alleged fraud perpetrated by Bernard L. Madoff and Bernard L. Madoff Investment Securities LLC. We are submitting this written testimony jointly on behalf of the Securities and Exchange Commission.

We assure the Subcommittee that the Commission and its staff take the alleged Madoff fraud very seriously. The losses incurred by investors as the result of Mr. Madoff's alleged fraud are tragic, and we appreciate the impact of those losses on the lives of investors.

Collectively, together with Chairman Schapiro and the Commissioners, we are committed to reducing opportunities for fraud, and to detecting it quickly, to best protect investors from those who would seek to prey on them.

The activities and conduct of Mr. Madoff and others are under active and ongoing investigation by criminal authorities, by the SEC's Enforcement Division and, with respect to past regulatory activities, by the SEC's Office of Inspector General. We are not authorized to provide specific information about matters under active investigation or past regulatory activities in this matter. We cannot jeopardize the process of holding the perpetrators accountable.

This testimony describes the mission, role, creation and operation of the SEC, including the functions of each of our divisions and offices, certain industry demographics, certain legal obligations of investment advisers and broker-dealers, information concerning tips and complaints provided to the SEC staff, and coordination among functional offices and divisions. This testimony also provides general information concerning the Madoff matter. Finally, this testimony describes generally some steps that the SEC is considering in light of the Madoff matter in order to make fraud less likely to occur in the future, to speed its detection and to provide American investors protection from fraud.

## The Mission of the SEC

The mission of the SEC is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.<sup>1</sup> The agency's staff is dedicated, hardworking, and committed to the mission of the SEC.

Our investor protection mission is more compelling than ever. As investors turn to the markets to help secure their futures, pay for homes, and send children to college, they must have confidence that their interests are being protected. Moreover, all Americans share a common interest in protecting their investments from fraud.

The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to basic facts about an investment prior to buying or selling it. To achieve this, the SEC requires public companies to disclose meaningful financial and other information to the public. This provides a common pool of knowledge for all investors to use to judge for themselves whether to buy, sell, or hold a particular security, and to allow people to make informed investment decisions.

The SEC also oversees the key participants in the securities world, including securities exchanges, securities brokers and dealers, investment advisers, and mutual funds. The SEC is concerned primarily with promoting the disclosure of important market-related information, maintaining fair dealing, and protecting against fraud.

Crucial to the SEC's effectiveness in each of these areas is its enforcement authority. Each year the SEC brings hundreds of civil enforcement actions against individuals and companies for violations of the securities laws. Typical infractions include insider

"The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and

Facilitates Capital Formation," available at www.sec.gov/about/whatwedo.shtml.

trading, accounting fraud, ponzi schemes, and providing false or misleading information about securities and the companies that issue them.

## **Creation of the SEC**

The SEC was created in 1934, following the stock market crash in October 1929. Public confidence in the markets plummeted, and large and small investors lost great sums of money in the ensuing Great Depression. There was a consensus that for the economy to recover, the public's faith in the capital markets needed to be restored. Congress held hearings to identify the problems and search for solutions.

Based on findings in those hearings, Congress passed the Securities Act of 1933. This law, together with the Securities Exchange Act of 1934, which created the SEC, was designed to restore investor confidence in our capital markets by providing investors and the markets with more reliable information and clear rules of honest dealing. The main purposes of these laws can be reduced to:

- Companies publicly offering securities for investment dollars must tell the public the truth about their businesses, the securities they are selling, and the risks involved in investing.
- People who sell and trade securities brokers, dealers, and exchanges must treat investors fairly and honestly, putting investors' interests first.

## **Organization of the SEC**

The SEC consists of the Chairman of the SEC, four other Commissioners, and approximately 3,500 employees. The SEC has 19 functional divisions and offices and is located in Washington D.C., and in eleven regional offices in New York, Boston, Philadelphia, Atlanta, Miami, Chicago, Ft. Worth, Denver, Salt Lake City, Los Angeles and San Francisco.

The SEC is organized functionally to, among other things: enforce the federal securities laws; interpret federal securities laws, subject to judicial review; issue new rules and amend existing rules; inspect registered firms for compliance with the law; review disclosures by public companies; oversee accounting and auditing rules; coordinate with foreign regulators; and provide a first-response to investor complaints and education for investors.

The functions of our respective divisions and offices are described below.

#### The Division of Enforcement

The Division of Enforcement conducts investigations of possible violations of the federal securities laws. Enforcement lawyers, accountants and investigators investigate possible violations, recommend that the Commission bring civil actions in federal court or before

an administrative law judge, and prosecute these cases on behalf of the Commission. The Enforcement staff obtains information about possible violations of the securities laws from many sources, including market surveillance activities, investor tips and complaints, other Divisions and Offices of the SEC, the self-regulatory organizations ("SROs") and other securities industry sources, and media reports. As an adjunct to the SEC's civil enforcement authority, the Enforcement Division works closely with law enforcement agencies in the U.S. and around the world to bring criminal cases when appropriate.

All SEC investigations are conducted privately. Facts are developed to the fullest extent possible through informal inquiry, interviewing witnesses, examining records, reviewing trading data, and other methods. Once the Commission issues a formal order of investigation, the Enforcement Division's staff may compel witnesses by subpoena to testify and produce books, records, and other relevant documents. Following an investigation, SEC staff may present their evidence to the Commission for its review. Based on that evidence, the Commission, where appropriate, authorizes the staff to file a case in federal court or bring an administrative action. Each year, the SEC brings enforcement cases involving all types of securities fraud, e.g., financial and accounting fraud, offering fraud (including ponzi schemes), insider trading, market manipulation and other types of violations. The Division of Enforcement has approximately 1,150 employees, roughly 80 fewer than at its peak in FY 2005. Enforcement personnel are located in Washington D.C. and in New York, Boston, Philadelphia, Atlanta, Miami, Chicago, Denver, Salt Lake City, Fort Worth, San Francisco, and Los Angeles.

## **■** The Office of Compliance Inspections and Examinations

The Office of Compliance Inspections and Examinations administers the SEC's nationwide examination and inspection program for registered self-regulatory organizations, broker-dealers, transfer agents, clearing agencies, investment companies, investment advisers, and rating agencies. The purpose of examinations is to detect fraud and other violations of the securities laws, foster compliance with those laws, and help ensure that the Commission is continually made aware of developments and areas of potential risk in the securities industry. The examination program plays a critical role in encouraging compliance within the securities industry, which in turn also helps to protect investors and the securities markets generally.

In examinations, examiners, accountants and lawyers review books and records and gather information that can indicate whether the firm is in compliance with the securities laws. Based on a variety of factors, examinations are focused on particular firms. Examinations are risk-focused on particular firms, and particular areas of conduct. When the Office finds deficiencies, it issues a "deficiency letter" identifying the problems that need to be rectified. Violations that appear serious are referred to the Division of Enforcement. The Office of Compliance Inspections and Examinations has 425 staff dedicated to examinations of registered investment advisers and mutual funds, and approximately 365 staff dedicated to examinations of registered broker-dealers. Notwithstanding the explosive growth in the firms it examines and inspects, the staff of the Office has 90 fewer positions than it had at its high-water mark in FY 2006.

Examiners are located in Washington, D.C. and in the Commission's eleven regional offices in New York, Boston, Philadelphia, Atlanta, Miami, Chicago, Denver, Salt Lake City, Fort Worth, San Francisco, and Los Angeles.

# The Division of Trading and Markets

The Division of Trading and Markets conducts regulatory activities on behalf of the Commission with respect to major securities market participants including: the securities exchanges; broker-dealers; self-regulatory organizations ("SROs") including the Financial Industry Regulatory Authority ("FINRA") and the Municipal Securities Rulemaking Board; clearing agencies that help facilitate trade settlement; transfer agents (parties that maintain records of securities owners); securities information processors; and credit rating agencies. The Division of Trading and Markets develops rulemaking recommendations concerning broker-dealers, SROs and other market participants for Commission consideration; responds to no-action requests and requests for exemptive relief; administers financial integrity rules for broker-dealers; reviews proposed changes to rules filed by the SROs; interprets laws and regulations for the public and SEC inspection and enforcement staff; and assists the Commission and its staff in enforcement matters involving broker-dealers and other market participants. The Division of Trading and Markets has approximately 170 staff, including lawyers, accountants, financial analysts, economists and technology specialists.

# **The Division of Investment Management**

The Division of Investment Management conducts regulatory activities on behalf of the Commission with respect to investment companies, including mutual funds, and investment advisers. The Division of Investment Management: reviews investment company disclosures for compliance with the federal securities laws; responds to no-action requests and requests for exemptive relief; develops rulemaking recommendations concerning investment companies and investment advisers for Commission consideration; interprets laws and regulations for the public and for SEC inspection and enforcement staff; and assists the Commission and its staff in enforcement matters involving investment advisers and investment companies. The Division of Investment Management has approximately 150 staff.

## The Office of the General Counsel

The General Counsel is the chief legal officer of the Commission, with overall responsibility for the establishment of agency policy on legal matters. The General Counsel's Office provides legal advice and guidance to members of the SEC's staff, and represents the SEC in civil, private, or appellate proceedings as appropriate, including appeals from the decisions of the federal district courts or the Commission in enforcement matters. Through its amicus curiae program, the General Counsel's Office files briefs in private appellate litigation involving novel or important interpretations of the securities laws, and the Office is responsible for coordinating with the Department of

Justice in the preparation of briefs in the Supreme Court on behalf of the United States involving matters in which the SEC has an interest. The General Counsel's Office also administers the SEC's ethics program through its Ethics Office, and is responsible for the review of proposed legislation. The General Counsel's Office has approximately 130 staff.

# **Industry Demographics**

The securities markets regulated by the SEC are large and diverse. There are approximately: 12,000 public companies whose securities are registered with the SEC; 11,300 investment advisers; 950 fund complexes (representing over 4,600 registered funds); 5,500 broker-dealers (including 173,000 branch offices and 665,000 registered representatives); and 600 transfer agents. There are also: eleven exchanges; five clearing agencies; ten nationally recognized statistical rating organizations; SROs such as the Financial Industry Regulatory Authority and the Municipal Securities Rulemaking Board; and the Public Company Accounting Oversight Board. The SEC has the authority to bring enforcement proceedings against these market participants, as well as for unregistered entities and individuals who may engage in securities law violations, including insider trading, market manipulation, ponzi schemes, and other types of fraud.

Segments of the securities markets have increased dramatically in the last decade: these include the number of branch offices of registered broker-dealers (in 2001, the number of branch offices of registered broker dealers was 75,000; that number grew to 173,000 in 2008) and the number of registered advisers (in 2002, there were 7,547 advisers registered with the SEC, and there are nearly 11,300 today). A large number of the new registrants have been advisers to hedge funds. In addition, there has been significant growth in structured financial products and credit derivatives in recent years. For example, the amount of outstanding asset-backed securities reached almost \$2.5 trillion in 2007, compared to just over \$1 trillion in 2000. More dramatically, the issuance of collateralized debt obligations globally reached a high of \$521 billion in 2006, up from \$157 billion just two years earlier. The CDS market has experienced similarly dramatic growth in recent years.

## **Select Laws and Regulations Governing Broker-Dealers and Investment Advisers**

## > Rules Applicable to Investment Advisers

An investment adviser (defined as any person in the business of advising others about securities for compensation) with more than \$25 million of assets under management generally must be registered with the SEC.<sup>2</sup> State securities authorities regulate smaller

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Certain persons or firms are excluded from the definition of an investment adviser, and these persons or firms need not register with the SEC (e.g., a broker-dealer whose provision of investment advisory services is "solely incidental" to its brokerage activities and who does not receive "special compensation" for its provision of investment advisory services) and persons or firms meeting the definition of investment adviser are not required to register in certain other situations (e.g., certain hedge fund managers).

advisers. There is no SRO for investment advisers, and the SEC provides primary oversight.

It is unlawful for an investment adviser to defraud clients or prospective clients. Investment advisers have a fiduciary duty to their clients to act in their best interest and to avoid conflicts of interest or to fully disclose them. The anti-fraud provisions apply to all persons and firms meeting the definition of an investment adviser, whether or not registered with the Commission.

Under the "compliance rule," all investment advisers registered with the Commission or required to be so registered must adopt and implement written policies and procedures designed to prevent violations of the law and rules. The adequacy and effectiveness of these policies and procedures must be reviewed annually. All such advisers also must designate a chief compliance officer who is responsible for administering the adviser's compliance policies and procedures.

Investment advisers must also maintain and preserve specified books and records, and make them available to Commission examiners for inspection. All records of such advisers are subject at any time, or from time to time, to such reasonable, periodic, special or other examination by representatives of the Commission as the Commission deems necessary or appropriate in the public interest or for the protection of investors.

Under the "custody rule," advisers that have custody of client securities or funds must implement a set of controls designed to protect those client assets from being lost, misused, misappropriated or subject to the advisers' financial reverses. In particular, funds and securities must be maintained by a "qualified custodian," which includes regulated banks, registered broker-dealers, registered futures commission merchants, and foreign financial institutions that meet certain conditions. Investment advisers may have self-custody (or use an affiliate as a custodian) if the adviser or affiliate is also registered as a broker-dealer, a futures commission merchant or is regulated as a bank. When an adviser has custody of client assets, periodic account statements must be sent to clients, directly from the qualified custodian, which permits clients to reconcile custodian statements with reports received from the investment advisers. In some cases custodians report only to the adviser, in which case the adviser must arrange for an independent public accountant to do a surprise verification of all funds and securities in the account at least once each year.

Advisers are also subject to a variety of requirements to provide disclosures to their clients and prospective clients. The "brochure rule" under the Advisers Act generally requires such advisers to deliver to each of its advisory clients and prospective advisory clients a written disclosure statement, or "brochure." The brochure describes the adviser's business practices and educational and business background and material information regarding its compensation. All such advisers also must disclose any legal or disciplinary events that are material to an evaluation of the adviser's integrity or ability to meet its contractual commitments to clients. All advisers that have custody or discretionary

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authority over client funds or securities must also disclose any financial conditions of the adviser that are reasonably likely to impair the ability of the adviser to meet contractual commitments to clients.

## > Rules Applicable to Broker-Dealers

Broker-dealers are subject to regulation and oversight by the SEC and by one or more SROs (including regulations for members, surveillance, routine and cause examinations and enforcement actions for violations). SROs perform routine examinations and oversight of their member firms.

Among the important regulatory requirements for broker-dealers are the financial responsibility rules imposing requirements with respect to capital, the safekeeping of customer securities and cash, making and maintaining books and records, and filing periodic financial statements and annual audit reports with the SROs and the Commission. These rules are described below.

The broker-dealer capital rule, known as the "net capital rule" is designed to ensure that a broker-dealer maintains sufficient liquid assets so that if it fails it can promptly liquidate and pay all claims of customers and other creditors without the need of a formal proceeding. The rule prescribes an absolute minimum amount of net capital a broker-dealer must have in order to be able to conduct a securities business.<sup>3</sup>

The "customer protection rule" is designed to safeguard customer securities and cash. The rule provides that a broker-dealer may not use customers' cash and securities for its own proprietary purposes. It requires that the broker-dealer hold fully-paid and excess margin securities in its possession and control; and it requires that the broker-dealer create a reserve fund equal to the net cash owed to customers. In combination, these requirements are designed to ensure that customers' cash and securities at a broker-dealer are kept safe and separate from the proprietary activities of the broker-dealer, and to keep these assets available for prompt return to customers in the event the broker-dealer fails.

The "books and records" rules specify minimum requirements with respect to the records that broker-dealers must make, and how long those records and other documents relating to a broker-dealer's business must be kept.

Most broker-dealers are also required to file annual audit reports with the Commission and with each SRO of which the broker-dealer is a member (broker-dealers are also required to file periodic financial reports with the SROs). These audit reports must contain statements of financial condition; income; cash flows; changes in stockholders' or partners' or sole proprietor's equity; and changes in liabilities subordinated to claims of general creditors.

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The minimum amount of net capital a broker-dealer must maintain is the greater of a fixed dollar amount and an amount calculated using one of two financial ratios.

Under the law, the annual audit conducted by the audit firm must be sufficient to provide reasonable assurance that any material inadequacies would be disclosed with respect to the broker-dealer's: (a) accounting system; (b) internal accounting controls; (c) procedures for safeguarding securities; and (d) the practices and procedures used in, for example quarterly securities examinations, counts, verifications and comparisons, complying with the requirement for prompt payment for securities, and in obtaining and maintaining physical possession or control of customer securities as required. If an accountant finds any material inadequacies as part of this review, a special report must be provided to the Commission.

With respect to the registration of broker-dealer auditors with the Public Company Accounting Oversight Board ("PCAOB"), the Sarbanes-Oxley Act of 2002 ("SOX") required auditors of registered broker-dealers to be registered with the PCAOB. SOX focused the PCAOB's responsibilities specifically on the auditors of public companies. Section 205 of SOX required the auditors of non-public broker-dealers to register, and the Commission understands that the PCAOB believes the statute does not give it the necessary authority to examine the auditors of non-public broker-dealers after they have registered or to discipline them for audit failures. The Commission had provided temporary exemptions from registration, which have now expired. The potential for legislative reform of the financial services regulatory structure provides an opportunity for clarification of Congressional intent in this area. The Commission's staff stands ready to provide any assistance the Subcommittee staff may require on this and other matters.

Generally, all broker-dealers registered with the Commission must be members of the Securities Investor Protection Corporation ("SIPC"). Under the law, SIPC may pay advances to compensate customers when the amount of securities and cash recovered from a failed firm is insufficient to make customers whole. These advances are limited to \$500,000 per customer, including a maximum of \$100,000 for cash claims. SIPC initially pays for customer advances and the administrative costs of SIPA liquidations out of the "SIPC Fund" (which is funded through member assessments). The Commission monitors the liquidation process and how the Trustee determines and satisfies customer claims (as set forth in the Securities Investor Protection Act). The Commission's staff is closely monitoring the Madoff liquidation proceedings.

## Protocols for Examinations of Investment Advisers and Broker-Dealers

During examinations, the SEC's staff will seek to determine whether a firm is: conducting its activities in accordance with the federal securities laws and rules adopted under these laws (including, where applicable, the rules of SROs subject to the SEC's oversight); adhering to the disclosures it has made to investors; and implementing supervisory systems and/or compliance policies and procedures that are reasonably designed to ensure that the firm's operations are in compliance with the law.

Examinations may be conducted on an announced or unannounced basis. When the examination is announced, the staff will send the firm a letter notifying it of the

examination and containing a request list that identifies certain information or documents that SEC examiners will review as part of the examination. In many examinations, the examiners will visit the firm to conduct examination work on-site. The scope of the examination will be tailored to the activities of the firm and its compliance risks. In formulating the findings of the examination, the examiners may consult with other staff within the SEC, including supervisory staff and staff in relevant offices and divisions, to ensure that the findings are consistent with SEC rules, regulations, and interpretations.

When an examination has been completed, the examiners will typically conduct an "exit interview" with the firm during which they will discuss the status of the examination and any issues identified during the examination. The firm will then be sent a written notification of the results of the examination, generally either: a "deficiency letter" that describes the issues identified, asks the firm to undertake corrective action and to provide the staff with a written response outlining those actions; or a letter stating that the examination has concluded without findings. If serious problems are found, the examination staff may also refer the problems to the SEC's Division of Enforcement, or to an SRO, state regulatory agency, or other regulator for possible action.

Broker-dealers are subject to primary oversight by an SRO that conducts periodic routine examinations of its broker-dealer members. The SEC conducts targeted examinations of broker-dealers to review specific risk issues, for cause, and to oversee the work performed by the SROs.

Investment advisers, mutual funds and other types of registrants are not subject to examination oversight by an SRO. For these firms, the SEC provides primary examination oversight.

Because only a small portion of registered firms can be examined each year, the process of selecting firms for examination and the area of the firm's activity for review is of crucial importance. The staff's methodology includes: 1) a risk-based methodology for selecting investment advisers for priority examination;<sup>4</sup> 2) a methodology for identifying higher-risk activities at registered securities firms; and 3) cause examinations to target firms where specific indications of wrongdoing have been identified, and sweep examinations that focus on examining a particular risk across firms.

## Tips, Complaints and Reports

The SEC staff receives hundreds of thousands of tips each year from various sources. Some are from credible sources that provide detailed information in support of the tip, and some are newspaper clippings or printed promotional material sent with no further explanation. Tips come from industry participants, investors, competitors, and present or former employees, and others are anonymous. Complaints, tips and referrals come to the

See SEC, 2004-2009 Strategic Plan, at 32. "Risk-Based Inspection Cycles: The SEC will fully implement a risk-based methodology for selecting and setting examination and inspection cycles for investment advisers and funds. Larger or higher risk entities will be examined more frequently to ensure that the agency quickly identifies problems before they affect large pools of savings."

SEC by telephone calls, handwritten letters, long reports, complaint forms from the Enforcement Division's Office of Internet Enforcement, newspaper articles with company names circled in red ink, formal referrals from other regulators, referrals from other Offices and Divisions of the SEC, notes from reformed fraudsters, and anonymous notes.

While the SEC does not have the resources to fully investigate all tips and complaints received, SEC staff use experience, skill and judgment to triage the complaints to devote attention to the most promising leads and the most serious potential violations. Each year, many enforcement actions are brought that first came to the attention of the staff through a complaint or a tip. In light of recent events, the Commission has made it a priority to improve the handling of complaints, tips and referrals to make optimal use of resources.

## **Coordination Among Divisions and Offices**

The staff is expected to actively coordinate in performing their functional responsibilities. For example, in conducting examinations or investigations, or in initiating enforcement actions, the examination and/or enforcement staff communicates with staff in the Division of Trading and Markets, Office of Risk Assessment, Office of the General Counsel, Division of Investment Management and other relevant divisions or offices.

With respect to the conduct of examinations, the staff has various processes through which they coordinate and share information. As an initial step in this process, the examination staff consults with other Divisions and Offices to obtain input on areas for examination focus (risk issues as well as the number and types of examinations that are planned for the upcoming year). Each year, the Division of Investment Management and the Division of Trading and Markets staff work with the exam staff as it develops the focus and priorities for examinations and coordinates on issues and questions raised in the inspection and examination of investment advisers, investment companies and broker-dealers. Among other things, exam reports and deficiency letter templates are also provided to relevant divisions for consideration and comment. During examinations, examiners communicate with staff from other Divisions to resolve specific interpretive issues. Finally, training is conducted for exam staff with participation from various other division and office staff. When violations of the law are discovered in examinations, the examination staff refers them to the Division of Enforcement staff for investigation, and then often works with Enforcement staff in the subsequent investigation.

With respect to enforcement investigations, the Enforcement staff often consults with relevant staff in the Divisions of Trading and Markets, Investment Management and the Office of General Counsel (and other relevant SEC offices or divisions) for advice concerning the legal issues raised. If matters are brought to the Commission for formal enforcement investigation or enforcement action, the enforcement staff and staff in the various divisions are expected to communicate and coordinate with respect to legal interpretations and other issues.

## **Enforcement Actions Involving Bernard Madoff**

On December 11, 2008, the SEC sued Bernard L. Madoff and his firm, Bernard Madoff Investment Securities, LLC, for securities and investment advisory fraud in connection with an alleged Ponzi scheme that allegedly resulted in substantial losses to investors in the United States and other countries. The alleged scheme is outlined in the Commission's complaint filed in the United States District Court for the Southern District of New York, captioned <u>United States Securities and Exchange Commission v. Bernard L. Madoff and Bernard L. Madoff Investment Securities LLC</u>, 08 Civ. 10791 (LLS) (S.D.N.Y. Dec. 11, 2008).

The Commission's complaint alleges that Mr. Madoff admitted to two senior employees of his firm that for many years he had been conducting the investment advisory business of his firm as a ponzi scheme -- using funds received from new investors to pay returns to previous investors -- and he estimated that the scheme has resulted in losses of approximately \$50 billion. The complaint further alleges that Madoff also informed these senior employees of his firm that he had approximately \$200-300 million left, which he planned to use to make payments to selected employees, family and friends before turning himself in to the authorities. The SEC immediately sought, and obtained, a preliminary injunction and other emergency relief to prevent the dissipation of any remaining assets. 6

The SEC's Enforcement Division is coordinating its ongoing investigation with that of the United States Attorney's Office for the Southern District of New York, which filed a parallel criminal action on December 11, 2008, in connection with Mr. Madoff's alleged ponzi scheme.

The two actions filed by the SEC and United States Attorney's Office could potentially result in billions of dollars in liability and decades of incarceration. Among the other remedies available to the SEC in civil enforcement actions are disgorgement of ill-gotten gains, permanent injunctive relief against violations of the federal securities laws, remedial undertakings, civil penalties, revocation of registration and investment adviser or industry bars. Criminal authorities have the power to seek incarceration, and other conditions on an individual's liberty, such as probation, denial of voting rights, mandatory curfew and house arrest.

The United States District Court for the Southern District of New York granted the application of SIPC for the liquidation of Bernard L. Madoff Investment Securities LLC and appointed a trustee. The SIPC trustee will marshall the assets and process the claims of customers and creditors of Madoff's firm in an equitable manner.<sup>7</sup>

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<sup>&</sup>lt;sup>5</sup> <u>SEC v. Bernard L. Madoff et al.</u>, 08 Civ. 10791 (S.D.N.Y. Dec. 11, 2008), Complaint at 2, 4-6.

SEC v. Bernard L. Madoff et al., 08 Civ. 10791, Order on Consent Imposing Preliminary Injunction, Freezing Assets and Granting Other Relief Against Defendants (Dec. 18, 2008).

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

## Past Enforcement Investigations and Examinations Relating to the Madoff Firm

For the reasons described above, in order to avoid compromising with ongoing criminal and civil investigations and in light of the ongoing inquiry by the SEC's Inspector General, we can provide only very limited information with respect to the SEC's past regulatory contacts with Madoff.

#### **Examinations**

The Madoff firm became registered as an investment adviser in September 2006. SEC staff did not examine the investment advisory operations of the firm.<sup>8</sup>

The Madoff broker-dealer operation was subject to routine examination oversight by the Financial Industry Regulatory Authority ("FINRA") and also to several limited-scope examinations by the SEC staff for compliance with, among other things, trading rules that require the best execution of customer orders, display of limit orders, and possible front-running, most recently in 2004 and 2005. These examinations were focused on the firm's broker-dealer activities.

## > Enforcement Investigations

The SEC's New York Regional Office commenced an investigation of Mr. Madoff and his firm in early 2006. Two years later, in January 2008, that investigation was closed without any recommendation of enforcement action.

With respect to earlier SEC enforcement investigations related to Mr. Madoff or his firm, the SEC filed two enforcement actions in 1992 alleging violations of the securities registration provisions in connection with offerings in which investors' funds were invested in discretionary brokerage accounts with an unidentified broker-dealer, who in turn invested the money in the securities market. The unidentified broker-dealer in these cases was Bernard L. Madoff Investment Securities. These cases are described below:

SEC v. Avellino & Bienes et al. In that case, two individuals, Frank Avellino and Michael Bienes, raised \$441 million from 3200 investors through unregistered securities offerings. They formed an entity, Avellino & Bienes ("A&B"), which offered investors notes paying interest rates of between 13.5% and 20%. A&B collected the investors' monies in a pool or fund that was invested in discretionary brokerage accounts with Mr. Madoff's broker-dealer firm, and the Madoff firm in turn invested the monies in the market. A&B received returns on the invested

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Approximately 10% of registered investment advisers are examined every three years. Other registered investment advisers are not subject to routine examinations on a cycle and may be examined in cause, sweep or random examinations.

funds from the Madoff firm, but kept the difference between the returns received from Madoff's firm and the lesser amounts of interest paid on the A&B notes.<sup>9</sup>

➤ SEC v. Telfran Associates Ltd., et al., was a spinoff from A&B and involved the creation of a feeder fund to A&B. In Telfran, two individuals who had invested in A&B, Steven Mendelow and Edward Glantz, formed an entity called Telfran Associates. Telfran raised approximately \$88 million from 800 investors through unregistered securities offerings over a period of three years. Telfran sold investors notes paying 15% interest, which they in turn invested in notes sold by A&B that paid between 15% and 19% interest. Since investor funds collected by A&B were invested with Mr. Madoff, the Telfran investor funds were also invested with the Madoff firm, albeit indirectly. 10

Although the SEC was initially concerned that these unregistered offerings might be part of a fraud on the investors, the trustee appointed by the court in the Avellino & Bienes case found that the investor funds were all there, and there were no apparent investor losses. In both cases, the SEC sued the entities offering the securities and their principals for violations of the securities registration provisions of the federal securities laws. The SEC also sought the appointment of a trustee to redeem all outstanding notes and the appointment of an accounting firm to audit the firms' financial statements.

## **Potential New Steps**

Finally, this testimony describes generally some ideas that the offices and divisions of the SEC are considering recommending to the Commission to explore in light of the Madoff matter, including both changes and improvements to regulation and oversight, which might make fraud less likely to occur and improve the ability to detect it. Among the issues being considered are the examination frequencies for investment advisers, the existence of unregistered advisers and funds, the different regulatory structures surrounding brokers and advisers, the existence of unregulated products, and the need to strengthen the custody and audit requirements for regulated firms. These ideas remain in the initial stages in the divisions and the Madoff matter remains under investigation, so these ideas are subject to refinement as more analysis is conducted and more facts are learned.

We are also looking at ways to improve the assessment of risk — and at the adequacy of information required to be filed by registered firms and used to assess risks and whether the risk assessment process would be improved with routine access to additional information. We are targeting firms for examinations of their custody of assets, and expanding our efforts to examine advisers and brokers in a coordinated approach to

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<sup>&</sup>lt;sup>9</sup> <u>SEC v. Avellino & Bienes et al.</u>, Lit. Rel. No. 13443 (Nov. 27, 1992); Lit. Rel. No. 13880 (Nov. 22, 1993).

<sup>&</sup>lt;sup>10</sup> <u>SEC v. Telfran Associates Ltd., et al.,</u> Lit. Rel. No. 13463 (Dec. 9, 1992); Lit. Rel. No. 13881 (Nov. 22, 1993).

reduce the opportunities for firms to shift activities to areas where they are not subject to regulatory oversight.

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

In conclusion, we reiterate our commitment, on behalf of the SEC and its staff, to the vigorous protection of American investors.