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.

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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

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