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Expert Analysis

What Will the SEC Do Differently in the Aftermath of the Madoff Scandal?

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The Bernard Madoff scandal has been acutely embarrassing to the Securities and Exchange Commission. According to his voluntary confession, Madoff was engaged in the world's biggest Ponzi scheme, involving \$50 billion in possible investor losses. Yet Madoff had been repeatedly investigated by the SEC at least as far back as 1992, with the latest investigation opened and closed in early 2006.

According to internal SEC documents obtained by the Wall Street Journal, the agency's New York office opened its 2006 investigation in early January and took sworn testimony at one of the Madoff feeder funds from Madoff and personnel.¹ The agency then closed the investigation three weeks later after finding no evidence of fraud — an unusually short period given that most SEC enforcement investigations often run for many months, if not years.

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Former Madoff competitor Harry Markopolos reached a very different conclusion years earlier. Markopolos told the House of Representatives' Financial Services Committee at a Feb. 4 hearing that he initially shared his suspicions that Madoff was a fraud with the SEC's Boston office in 2000. Subsequently, he dealt with the SEC's New York office and the Office of Risk Assessment in Washington and compiled a written report in 2005 to back up his suspicions. Yet Madoff's fraud only finally came to light in December 2008, when Madoff, apparently realizing that his scheme was about to collapse as he was faced with mounting customer redemption requests, confessed to his decades-old scheme.

Soon after news of Madoff's scheme burst on the scene, then-SEC Chairman Christopher Cox expressed his grave concern about "the apparent multiple failures over at least a decade to thoroughly investigate the allegations [about

Madoff] or at any point to seek formal authority to pursue them.”² Cox further directed the SEC’s inspector general, David H. Kotz, to examine these apparent failings in detail, an assignment put at the top of his priority list, according to his recent congressional testimony.

The SEC senior staff has cited Kotz’s ongoing investigation as justification for not discussing the Madoff case, a position that outraged members of Congress and others who regarded the invocation of the pending investigation as an excuse to duck hard questions about the SEC’s failings.

The staff also has asserted the SEC is inundated with tips (more than 100,000 each year), is understaffed, and cannot be expected to detect and prevent ongoing fraud schemes before they collapse.³

But the Madoff scandal was not the product of under-inspection or lack of investigation by the SEC. Rather, Madoff was investigated — repeatedly — yet SEC investigators failed to detect the fraud.

Programmatic Changes

In Madoff’s wake, the SEC will likely undertake a variety of measures to improve the effectiveness of its examination and enforcement efforts. SEC Chair Mary Schapiro took steps in that direction Feb. 6 when she announced the elimination of the agency’s “penalty pilot experiment,” which required enforcement staff to obtain pre-approval from the commission before negotiating the size of civil monetary penalties in investigations of public companies.⁴ She also announced the lowering of the burden imposed on the enforcement staff seeking a formal order of investigation granting them subpoena authority. Going forward, a formal order can be authorized by a single SEC commissioner acting as “duty officer,” a change from prior practice when the full commission would have to approve a formal order.

In addition, Schapiro’s recent selection of people from outside the SEC but with deep enforcement and securities backgrounds for two key positions — Robert Kuzami, nominated as chief of the Enforcement Division, and David Becker as general counsel — further suggests that the agency is preparing to take fresh looks and new approaches to old problems.

The Madoff scandal is also likely to lead to additional procedural or programmatic changes for the SEC and other financial regulators.

More Resources

Because of the current financial crisis and the overall decline in enforcement resources over the past four years, the SEC and other regulatory agencies will likely see an expansion in the hiring of enforcers to police the financial industry. An early sign is proposed federal legislation recently introduced in the Senate that would authorize the expenditure of \$110 million for the hiring of 500 additional FBI agents to pursue white-collar cases, along with additional assistant U.S. attorneys and SEC enforcement attorneys.⁵

But this expansion (or restoration)⁶ of resources is likely to be part of a much more comprehensive reorganization plan.

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More Experienced Examiners

In his congressional testimony Markopolos attributed the SEC’s failings to the fact that its staff lacks the necessary financial knowledge and experience. While the 3,500 current SEC employees have a broad range of skills, expect to see a new emphasis on hiring staff who have a stronger grounding in financial markets. In principle, it should not be difficult to find experienced personnel, given the massive Wall Street layoffs of recent months. Moreover, and for similar reasons, it would not be surprising to see hires of (now-former) business journalists as investigators.

Focus on New York

In addition to more experienced examiners and investigators, there seems to be a push to relocate more SEC resources to the New York metropolitan area. U.S. Sen. Charles Schumer, D-N.Y., for instance, has argued for the relocation of the SEC’s inspection program — the Office of Compliance Inspections and Examinations — from the agency’s home office in Washington to New York.

Such a move could make it easier for the SEC to recruit qualified examiners because it could draw from a bigger and more sophisticated labor pool. But the current New York office of more than 400 is by no means small (not surprisingly, it is the largest SEC regional office), and there are good reasons to keep senior OCIE managers in Washington along with other senior SEC managers.

And, in addition to the likely redeployment of additional OCIE resources, expect to see an effort to increase the number of SEC inspections carried out each year. For instance, former SEC Chairman Harvey Pitt has said he would like to see everyone regulated by the SEC examined with far greater frequency: every year for larger financial firms, every other year for the smaller firms.⁷

But, according to OCIE head Lori Richards' recent congressional testimony, there are only 425 SEC employees available to inspect the 11,300 currently registered investment advisers, and only 10 percent of registered advisers are inspected every three years.⁸ There would therefore have to be a dramatic expansion in the number of hires and inspection resources to come anywhere near meeting Pitt's goal.

Less Compartmentalization

Finally, and as part of a larger regulatory reform initiative, expect to see an effort to eliminate compartmentalization within the SEC and between financial regulatory agencies. The Financial Industry Regulatory Authority's role in the Madoff investigation, which was addressed in some detail during the recent congressional hearings, provides one example.

As the self-regulatory organization responsible for overseeing the nation's broker-dealers, FINRA inspected the Madoff broker-dealer operation. Yet the staff could not and did not examine the Madoff investment adviser unit — allegedly at the heart of Madoff's fraud scheme — even though the unit was housed in the same office building on an adjacent floor.

As the interim head of FINRA acknowledged during recent congressional testimony, "FINRA regulates broker-dealers, but not investment advisers, even though they provide services that are virtually indistinguishable to the average consumer."⁹

Going forward, FINRA, the SEC, Congress and the Obama administration are likely to propose a

consolidation of financial regulatory functions in an effort to reduce opportunities for the Madoffs of the financial world to use regulatory compartmentalization to game the system to their advantage.

Expect to see a new emphasis on hiring staff who have a stronger grounding in financial markets.

In addition, the Madoff experience suggests there should be greater integration of enforcement matters across SEC offices. Some of the SEC's failings in discovering the Madoff scheme will likely be attributed to the fact that the matter was investigated by different offices at different times and that no one SEC staffer ever "owned" the matter.

Going forward, expect to see a greater emphasis on regulatory ownership and accountability. Managerial practices successfully used by the Department of Justice may provide a useful model, as the many former federal prosecutors already on or soon to join the SEC staff can attest. In particular, assistant U.S. attorneys and trial lawyers are effectively given authority over cases from the initial investigation through indictment, trial and appeal. The SEC should consider importing portions of that model for its examinations and enforcement divisions.

Conclusion

The Madoff scandal has been a blow to the SEC's reputation. But it also presents opportunities for change at the 75-year-old agency. How well the new SEC chair, her fellow commissioners and the SEC staff avail themselves of those opportunities will be seen in the coming months.

Notes

- ¹ Case Closing Recommendation, SEC Division of Enforcement (Nov. 21, 2007), available at http://online.wsj.com/public/resources/documents/Madoff_SECRecommend_20081217.pdf.
- ² Press Release, SEC, Statement Regarding Madoff Investigation (Dec. 16, 2008), available at <http://www.sec.gov/news/press/2008/2008-297.htm>.
- ³ *Assessing the Madoff Ponzi Scheme and Regulatory Failures: Hearing Before the H. Fin. Servs. Comm.*, 111th Cong. (Feb. 4, 2009) (Statement of Linda Thomsen, Director, SEC Division of Enforcement), available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/sec_joint_testimony.pdf.

- ⁴ Mary Schapiro, Chairman, SEC, Address to Practising Law Institute's "SEC Speaks in 2009" Program (Feb. 6, 2009), available at <http://www.sec.gov/news/speech/2009/spch020609.mls.htm>.
- ⁵ See, e.g., Zachary A. Goldfarb, *Senators Call for Fraud Probes; Schumer, Shelby Propose More Spending on Investigations*, WASH. POST, Jan. 23, 2009, available at <http://www.washingtonpost.com/wp-dyn/content/article/2009/01/22/AR2009012203629.html>.
- ⁶ See, e.g., Posting of Evan Perez to the Wall Street Journal Washington Wire Blog, http://blogs.wsj.com/washwire/2009/02/10/senators-want-to-beef-up-ranks-of-sec-fbi-investigators/?mod=rss_WSJBlog (Feb. 10, 2009).
- ⁷ Posting of Dan Slater to the Wall Street Journal Law Blog, <http://blogs.wsj.com/law/2009/01/23/harvey-pitt-former-sec-chairman-discusses-steve-jobs-health-factor/> (Jan. 23, 2009).
- ⁸ *Assessing the Madoff Ponzi Scheme and Regulatory Failures: Hearing Before the H. Fin. Servs. Comm.*, 111th Cong. (Feb. 4, 2009) (Statement of Lori Richards, Director, SEC Office of Compliance Inspections and Examinations), available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/sec_joint_testimony.pdf.
- ⁹ *Assessing the Madoff Ponzi Scheme and Regulatory Failures: Hearing Before the H. Fin. Servs. Comm.*, 111th Cong. (Feb. 4, 2009) (Statement of Stephen Luparello, Interim CEO, Fin. Indus. Regulatory Auth.), available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/luparello020409.pdf.

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The logo features the word "CURTIS" in a large, bold, serif font. A thick, dark grey swoosh underline starts under the "C" and curves around the "S".

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