

**Testimony of  
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**Before the  
United States Senate Committee on Banking, Housing and Urban Affairs  
Concerning Examinations by the Securities and Exchange Commission and  
Issues Raised by the Bernard L. Madoff Investment Securities Matter**

**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:

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.

*See, Compliance, Office of Compliance Inspections and Examinations,*  
<http://www.sec.gov>.

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.<sup>1</sup> 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.

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<sup>1</sup> 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.

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 five 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% (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.<sup>2</sup>

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% of the registered community); 219 fund complex examinations (approximately 23%); and 135 transfer agent examinations (approximately 22%).<sup>3</sup> 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.<sup>4</sup> 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% of broker-dealers were examined.)

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<sup>2</sup> 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	2000 – 362	2003 – 399	2006 – 475	2009 – 425
1998 – 320	2001 – 365	2004 – 477	2007 – 425	
1999 – 353	2002 – 379	2005 – 489	2008 – 425	

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

<sup>4</sup> 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.

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. 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.<sup>5</sup>

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.<sup>6</sup>

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.<sup>7</sup>

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

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<sup>5</sup> See SEC, *2004-2009 Strategic Plan*, at 32.

<sup>6</sup> 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.

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

## 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 Database 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.

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% and 25% 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 *Compliance Alerts*, 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% of registered investment advisers are examined routinely, every three years.<sup>8</sup>

## **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 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

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<sup>8</sup> 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.

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.