



OFFICE OF  
INSPECTOR GENERAL

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

October 29, 2009

The Honorable Christopher J. Dodd  
Chairman, Committee on Banking, Housing, and Urban Affairs  
c/o Dawn L. Ratliff, Chief Clerk  
United States Senate  
Washington, D.C. 20510

Re: September 10, 2009 Hearing Entitled "Oversight of the Securities and Exchange Commission's Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance"

Dear Chairman Dodd:

During the course of the above-referenced hearing, you asked me to keep in contact with the Committee on Banking, Housing, and Urban Affairs and let the Committee know if the Securities and Exchange Commission (SEC) Office of Inspector General (OIG) had any legislative recommendations which would require action by the Congress.

As a follow-up to the hearing, I would like to inform you that the SEC OIG has the following four legislative recommendations arising out of our findings in our August 31, 2009 Report of Investigation entitled "Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme." These recommendations have also been made to Chairman Kanjorski of the U.S. House of Representatives Committee on Financial Services.

- (1) Extend the regulatory jurisdiction of the Public Company Accounting Oversight Board (PCAOB) to audit reports prepared by a domestic registered or foreign public accounting firm regarding issuers, broker-dealers, investment advisers and any companies subject to U.S. securities laws. The PCAOB's current responsibilities include the following: (a) registering public accounting firms; (b) establishing auditing, quality control, ethics, independence, and other standards relating to public company audits; (c) conducting inspections, investigations, and disciplinary proceedings of registered accounting firms; and (d) enforcing compliance with the Sarbanes-Oxley Act of 2002. The PCAOB is able to address many auditing problems through a combination of inspections and standards-setting. The PCAOB's supervisory model uses several tools to improve audit quality, correct

audit deficiencies, and promote compliance with applicable standards and laws. Where necessary, the PCAOB exercises its enforcement authority.

Extending the regulatory jurisdiction of the PCAOB would allow for increased oversight of these accounting firms and reduce the risks associated with unknown accounting firms that have been able to avoid scrutiny. We believe that H.R. 1212, as currently introduced, accomplishes many of these same goals, except that we would recommend that the legislation clarify that the PCAOB oversight be extended to audit reports prepared by a registered accounting firm which provides reports for investment advisers, investment companies and other registered entities, as well as registered broker dealers.

(2) Amending the Investment Advisers Act of 1940 (Investment Advisers Act) to require the use of independent custodians in a manner similar to Section 17(f) of the Investment Company Act of 1940 (Investment Company Act), which requires the use of an independent custodian by mutual funds. Section 17(f) of the Investment Company Act 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 for the protection of investors. See 15 U.S.C. § 80a-17(f)(1). In addition, Rule 17f-2(b) of the Rules and Regulations promulgated under the Investment Company Act requires that all such securities and similar investments be deposited in the safekeeping of, or in a vault or other depository maintained by, a bank or other company whose functions and physical facilities are supervised by Federal or State authority. The Rule further provides that investments so deposited shall be physically segregated at all times from those of any other person and shall be withdrawn only in connection with transactions of the character described in the Rule. This custodian requirement essentially removes the ability of an investment adviser to fraudulently use the proceeds invested by new investors to make payments to old investors.

Hedge funds are currently exempt from the Investment Company Act and are not subject to the independent custodian requirement. In addition, investment advisers who are also registered broker-dealers are currently permitted to clear their trades through their own broker-dealer firm. Thus, both investment advisers and hedge funds should be required to use an independent custodian.

We are aware that the SEC is currently proposing amendments to its custody rule under the Investment Advisers Act to require a written report from an independent public accountant that includes an opinion regarding the custodian’s controls relating to custody of client assets if the client

accounts are not maintained by an independent qualified custodian. However, we believe that a more direct way to remedy this statutory loophole would be to amend the Investment Advisers Act in conformity with the Investment Company Act.

(3) The Sarbanes-Oxley Act of 2002 requires ongoing certifications of certain reports by chief executive officers and chief financial officers of public reporting companies. Executives who knowingly file noncompliant reports face possible criminal prosecution including substantial fines and imprisonment.

Certifications have been determined to be effective controls to ensure compliance with particular requirements or guidelines. We would recommend imposing a requirement of certification by senior officers of registered investment advisers that shows they conducted adequate due diligence in connection with investments. This certification requirement should apply to all funds of hedge funds. The adequate level of due diligence required in accordance with the certification may be defined pursuant to a particular model of best practices, such as the Managed Fund Association (MFA) model or the Alternative Investment Management Association (AIMA) model, or could be developed by the SEC. Enforcing an adequate level of due diligence would ensure that investors have adequate information when investing through intermediaries.

(4) Bounty programs are an effective tool to encourage whistleblowers to come forward and would provide necessary incentives for outside entities to bring complaints about possible illegal activity. There is some evidence that the bounty program implemented by the Department of Justice (DOJ) has played a role in the increase of civil recoveries obtained by the DOJ over a 10-year period. The Internal Revenue Service (IRS) also has a system in place where it provides a bounty to individuals who present the IRS with information leading to the collection of federal taxes.

Although the bounty system has been in place at the SEC for more than 20 years, there have been relatively few awards made. The SEC program is limited to insider trading cases, and the stated criteria for judging bounty applications are broad, somewhat vague and not subject to judicial review.

Currently, Section 21A(e) of the Securities Exchange Act of 1934 (Exchange Act) [15 U.S.C. 78u-1(e)] authorizes the SEC to award a bounty to a person who provides information leading to the recovery of a civil penalty from an insider trader, from a person who "tipped" information to an insider trader, or from a person who directly or indirectly controlled an insider trader. All bounty determinations, including whether, to whom, or in what amount to make payments, are within the sole discretion of the

SEC, however, the total bounty may not currently exceed 10% of the amount "actually recovered" from a civil penalty pursuant to a court order.

We would recommend that the Exchange Act be amended to authorize the SEC to award a bounty for information leading to the recovery of a civil penalty from any violator of the federal securities laws, not simply insider trading violations. We would also suggest that the Exchange Act be amended to provide specific criteria for awarding bounties, including a provision that where a whistleblower relies upon public information, such reliance does not constitute an absolute bar to recovering a bounty. The statute should also require that the whistleblower be provided with status reports at certain milestones during the investigation or examination that was based on the tip.

We would be happy to discuss any of the above legislative suggestions with you or the Committee at your convenience.

Thank you again for your continued interest in our work.

Sincerely,

A handwritten signature in black ink, appearing to read "H. David Kotz". The signature is fluid and cursive, with a large initial "H" and "K".

H. David Kotz  
Inspector General