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Office of Audits

Review of the Commission's Processes for Selecting Investment Advisers and Investment Companies for Examination



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Report No. 470



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

MEMORANDUM

November 19, 2009

To: Mary L. Schapiro, Chairman
John H. Walsh, Acting Director, Office of Compliance Inspections
and Examinations
Robert Khuzami, Director, Division of Enforcement
Andrew J. Donohue, Director, Division of Investment Management

From: H. David Kotz, Inspector General, Office of Inspector General (OIG) *HDK*

Subject: *Review of the Commission's Process for Selecting Investment
Advisers and Investment Companies for Examination,
Report No. 470*

This memorandum transmits the U.S. Securities and Exchange Commission, OIG's final report detailing the results of our review of the Commission's process for selecting Investment Advisers and Investment Companies for examination. The review was conducted by the OIG as part of our continuous efforts to assess management of the Commission's programs and operations and was based on our audit plan.

This report contains 11 recommendations that were designed to strengthen the Commission's process for selecting Investment Advisers and Investment Companies for examination. The Office of Compliance Inspections and Examinations (OCIE) concurred with all 11 recommendations. OCIE's formal response is contained in Appendix V to this report. The Office of the Chairman and the Divisions of Enforcement and Investment Management also concurred with the partial recommendations that pertained to them but did not provide any formal response.

Within the next 45 days, please provide the OIG with a written corrective action plan that is designed to address the agreed upon recommendations. The corrective action plan should include information such as the responsible official/point of contact, time frames for completing the required actions, milestone dates identifying how you will address the recommendations cited in this report, etc.

Should you have any questions regarding this report, please do not hesitate to contact me. We appreciate the courtesy and cooperation that you and your staff extended to our auditor.

Attachment

cc: Kayla J. Gillan, Deputy Chief of Staff, Office of the Chairman
Diego Ruiz, Executive Director, Office of the Executive Director

Review of the Commission's Process for Selecting Investment Advisers and Investment Companies for Examinations

Executive Summary

Background. On August 31, 2009, the OIG issued a comprehensive, 450-plus page investigative report entitled, *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme*, Report No. 509. The investigation found that the SEC received more than ample information in the form of detailed and substantive complaints over a period of many years to warrant a thorough and comprehensive examination and/or investigation of Bernard Madoff (Madoff) and Bernard Madoff Investment Securities, LLC (BMIS) for operating a Ponzi scheme. However, despite three examinations and two investigations of Madoff and BMIS, a thorough and competent investigation or examination was never performed, and the SEC never identified the Ponzi scheme that Madoff operated.

The first Enforcement investigation and first examination were conducted in 1992 after the SEC received information that led it to suspect that Avellino & Bienes, a firm for which Madoff was managing money, was selling unregistered securities and conducting a Ponzi scheme. The SEC's investigation focused on Avellino & Bienes and did not investigate the possibility that Madoff was the one who was in fact operating the Ponzi scheme.

In 2004 and 2005, the SEC's examination unit, Office of Compliance Inspections and Examinations (OCIE), conducted two parallel cause examinations of BMIS. These examinations were conducted by OCIE's broker-dealer examination unit, rather than its investment adviser unit, notwithstanding that many of the issues in the complaints that precipitated the examinations related to BMIS's investment adviser operations. During the 2004 examination, the examiners raised the issue of whether BMIS was acting as an unregistered investment adviser. A member of the examination team drafted a memorandum about whether BMIS met the definition of investment adviser, but the memorandum was never finalized, and the team did not pursue or resolve the issue of BMIS's investment adviser status. Similarly, in the 2005 examination, examiners began researching the issue of whether Madoff should be registered as an investment adviser due to his investment discretion over certain hedge fund accounts, but the investment adviser registration issue was not pursued or resolved.

Enforcement formally opened an investigation of BMIS in January 2006, based upon a detailed complaint that Harry Markopolos (Markopolos), an independent fraud investigator, provided to Enforcement in 2005. Although Markopolos' complaint focused on why Madoff's returns could not be legitimate, the

Enforcement team investigating Markopolos' complaint decided to open the matter to investigate (1) whether BMIS, a registered broker-dealer, provided investment advisory services to large hedge funds in violation of the registration requirements of the Investment Advisers Act of 1940, and (2) whether BMIS engaged in any fraudulent activities in connection with these services.

During its investigation, the staff learned from an OCIE examiner that in the 2005 examination of BMIS by OCIE's broker-dealer examination staff, Madoff failed to disclose to the staff both the nature of the trading conducted in the hedge fund accounts and also the number of such accounts at BMIS.

When closing its investigation in 2007, the Enforcement staff stated that they found "that BMIS acted as an [unregistered] investment adviser to certain hedge funds, institutions, and high net worth individuals in violation of the registration requirements of the Advisers Act." The Enforcement staff also found that Madoff's largest hedge fund client, Fairfield Greenwich Group (FGG), "did not adequately disclose to its investors [BMIS's] advisory role and merely described [BMIS] as an executing broker to FGG's accounts."

As a result of this investigation and discussions with SEC staff, BMIS registered with the Commission as an investment adviser. BMIS filed Part 1 of its Form ADV with the Commission on August 25, 2006, and its registration as an investment adviser became effective on September 12, 2006. Further, FGG revised its disclosures to investors to reflect BMIS's advisory role. The Enforcement staff stated that BMIS's investment adviser registration was a "good result" because it would expose Madoff and his firm to "extra regulatory scrutiny." They further noted that BMIS's agreement to register as an investment adviser was "a positive development for law enforcement" because, inter alia, BMIS would "be subject to continued on-site inspections."

However, we found that until Madoff confessed to operating a Ponzi scheme in December 2008, OCIE never initiated an examination of BMIS even after BMIS was forced to finally register in August 2006. We conducted this review to determine OCIE's rationale for not performing an examination of BMIS's investment advisory business soon after the firm registered as an investment adviser in 2006 and to make recommendations to improve OCIE's process for selecting investment advisers and investment companies for examination.

Results. We found that OCIE assigns each registered investment adviser a "low," "medium," or "high" risk rating, which is initially based on each adviser's response to certain questions in Part 1 of the Uniform Application for Investment Adviser Registration (Form ADV). When BMIS registered as an investment adviser in 2006, BMIS was classified as "medium risk," based on its answers to the questions provided on its Form ADV Part 1. BMIS filed two subsequent Form ADVs in 2007 and 2008. Each of the three Form ADVs received by the Commission resulted in BMIS being assigned a "medium risk" designation in

2006, 2007, and 2008. We found that only firms categorized as “high risk” trigger routine OCIE examinations within three years of receiving the “high risk” rating.

To ascertain the Form ADV rating, OCIE uses an algorithm to calculate a numeric score for each firm based on certain affiliations, business activities, compensation arrangements, and other disclosure items that could pose conflicts of interest. Although the risk algorithm allows OCIE to determine an investment adviser’s relative risk profile, in the absence of an examination risk rating, it is potentially limited because it does not measure the effectiveness of the investment adviser’s compliance controls, which are designed to mitigate conflicts of interest or other risks that could harm investors.

OCIE may also develop a risk rating for an investment adviser based upon information obtained through an examination. The examination rating is weighted more heavily than the Form ADV rating since it is based upon more complete information. However, because OCIE’s investment adviser unit never conducted a formal examination of BMIS’s investment advisory business, notwithstanding the fact that OCIE’s broker-dealer unit and Enforcement analyzed numerous aspects of BMIS’s advisory business during their examinations and investigations, OCIE never developed a risk rating of BMIS based on an OCIE examination.

Therefore, OCIE’s rating of BMIS was “medium” – the same as BMIS’s Form ADV rating. We found this problematic because BMIS was examined and investigated by OCIE and Enforcement repeatedly, found to be operating as an (unregistered) investment adviser, and OCIE and Enforcement found that Madoff lied about BMIS’s advisory role. We found that BMIS’s registration as an investment adviser was prompted by an Enforcement investigation, which should have automatically led to BMIS receiving an initially higher risk rating than it would have received had its registration not been a condition of Enforcement closing its investigation. Moreover, findings from OCIE’s prior cause examinations of BMIS and from Enforcement’s investigations involving BMIS should have prompted OCIE to question BMIS’s “medium” Form ADV rating.

Enforcement stated that BMIS’s investment adviser registration was a “good result” because it would expose Madoff and his firm to “extra regulatory scrutiny.” However, there is no indication that anyone on the Enforcement staff ever suggested that OCIE’s investment adviser examination staff conduct a cause examination of BMIS. We found this fact to be troubling because the Enforcement investigation (which included the assistance of an OCIE broker-dealer examiner) revealed that Madoff did not fully disclose either the nature of the trading BMIS conducted in hedge fund accounts or the number of such accounts at BMIS, that BMIS commingled billions of dollars of equities among its investment advisory accounts and with its broker-dealer proprietary account, and that the investor disclosures of BMIS’s largest hedge fund client did not adequately describe BMIS’s advisory role. As some of the problems identified in

this investigation related to BMIS's investment advisory operations, we found that both Enforcement and OCIE's broker-dealer examination staff should have immediately notified OCIE's investment adviser examination unit. We further concluded that at that point, OCIE should have immediately scheduled a cause examination.

We found that Enforcement's and OCIE's broker-dealer examination unit's failures to communicate with OCIE's investment adviser unit led to OCIE's failure to conduct an examination of BMIS's advisory business. An OCIE Branch Chief testified that BMIS might have been subject to a "cause exam" immediately after it registered had the investment adviser examination staff been informed that Madoff had made misrepresentations to Enforcement and OCIE broker-dealer examination staff.

We also found that OCIE's risk rating process did not adequately weigh an investment adviser's level of assets under management and the number of clients that receive investment advisory services. We believe that advisers with more assets under management and more clients who receive advisory services should receive progressively higher risk scores.

As part of our review, we conducted an analysis of BMIS's 2006, 2007, and 2008 filings and found that had BMIS provided accurate information on its Form ADVs, it may have been classified as a "high risk" adviser and therefore subject to a routine OCIE examination within three years of receiving a "high risk" rating.

We found numerous lies and misrepresentations in Part 1 of BMIS's Form ADV that OCIE should have been aware of because of the examinations it conducted of BMIS. We found that Madoff, on behalf of BMIS, lied about the number of firms he solicited, the number of clients to whom he provided services, the types of clients he had, the amount of BMIS's assets, whether he had discretionary authority to determine the broker or dealer to be used for a purchase or sale of securities for a client's account, whether he had compensation any firms for client referrals and whether any firms had custody of his advisory clients' securities. In fact, nearly every substantive answer he gave on Part 1 of his Form ADV was a lie, and in nearly every case, OCIE's previous examinations of Madoff had revealed that Madoff's answers were false. Moreover, had OCIE utilized the information the SEC gathered from the examinations and investigations of BMIS in assigning risk weighting to BMIS's answers and thus, graded it on accurate information, BMIS's score would have been significantly higher. In that scenario, BMIS should have been subject to the three-year cycle for a firm rated as "high" risk.

Our review also found that Form ADV has not been substantively updated since 2000, when it was first required to be filed electronically with the Commission. We believe that OCIE could identify additional risk factors if registrants were required to include in Form ADV detailed information about the hedge funds they

advise, including the hedge funds' performance and auditor. Further, Form ADV should require a hedge fund's auditor to file its opinion with the Commission.

Further, we found that until 2000, investment advisers were required to file Parts 1 and II of Form ADV with the Commission in hard copy. Part II of ADV was required to be filed with the SEC until 2000 when the Commission adopted new rules under the Advisers Act requiring that registered advisers make filings with the Commission electronically through an electronic filing system known as the Investment Adviser Registration Depository (IARD) system. At that time, the Commission exempted advisers from submitting Part II to the Commission because the IARD was not ready to accept those filings. The exemption was intended to be temporary, but nine years later, investment advisers are still not required to file Part II of their Form ADV electronically or even file a paper copy with the Commission, absent a specific request from the Commission. Instead, advisers need only retain a copy of Part II of their Form ADV in their files. Currently, Part II is deemed to be "filed" with the SEC when advisers update the form and place a copy in their files.

We found that considering Form ADV Part II "filed" with the Commission when an adviser places it in his filing cabinet is an inadequate procedure and concluded that Part II of Form ADV should be electronically filed with the Commission. This document provides pertinent disclosures about an investment adviser's advisory services, fees, types of clients, types of investments on which the adviser offers advice, an adviser's other business activities, affiliates, conditions for managing accounts, and compensation information, among other things.

Finally, our review found that OCIE internal documentation identified a risk that hedge fund custodian statements could be fictitious and the assets may not be verifiable. Another risk stated that since investment advisers are not required to file Part II of Form ADV with the Commission, the SEC does not receive important information regarding potential conflicts of interest involving investment advisers. While these issues have been identified, we found that they have not been resolved.

Summary of Recommendations. Our report presents 11 specific and concrete recommendations designed to improve OCIE's process for selecting investment advisers and investment companies for examination.

We recommend that OCIE implement a procedure requiring, as part its process for creating a risk rating for an investment adviser, that OCIE staff perform a search of Commission databases containing information about past examinations, investigations, and filings related to the investment adviser.

We recommend that OCIE change the risk rating of an investment adviser based on pertinent information garnered from all Divisions and Offices of the Commission, including information from OCIE examinations and Enforcement

investigations, regardless of whether the information was learned during an examination conducted to look specifically at a firm's investment advisory business.

Further, Enforcement and OCIE should establish and adhere to a joint protocol providing for the sharing of all pertinent information (e.g., securities laws violations, disciplinary history, tips, complaints and referrals) identified during the course of an investigation or examination or otherwise.

We recommend that OCIE establish a procedure to thoroughly evaluate negative information that it receives about an investment adviser and use this information to determine when it is appropriate to conduct a cause examination of an investment adviser, and when it becomes aware of negative information pertaining to an investment adviser, it examine the investment adviser's Form ADV filings and document and investigate discrepancies existing between the adviser's Form ADV and information that OCIE previously learned about the registrant.

We further recommend that OCIE establish a procedure to thoroughly evaluate an investment adviser's Form ADV when OCIE becomes aware of issues or problems with an investment adviser.

We also recommend that OCIE re-evaluate the point scores that it assigns to advisers based on their reported assets under management and their reported number of clients to which they provide investment advisory services and assign progressively higher risk weightings to firms accordingly.

Further, we recommend that a Commission rulemaking be instituted that would require additional information to be reported as part of Form ADV and that the proposed rule providing for Amendments to Form ADV be finalized. We also recommend that OCIE develop and adhere to policies and procedures for conducting third party verifications, such that OCIE verifies the existence of assets, custodian statements, and other relevant criteria.

We believe that implementation of the recommendations contained in this report will significantly improve OCIE's operations and its process for selecting investment advisers and investment companies for examination.

TABLE OF CONTENTS

Executive Summary	ii
Table of Contents	viii
Background and Objectives	10
Findings and Recommendations	20
Finding 1: OCIE’s Risk Rating Process Did Not Provide for a Routine Examination of BMIS Because BMIS Was Classified As a Medium Risk Firm	20
Recommendation 1	25
Recommendation 2	25
Finding 2: OCIE Should Have Immediately Scheduled a Cause Examination of BMIS when BMIS Registered as an Investment Adviser	25
Recommendation 3	28
Recommendation 4	28
Recommendation 5	29
Finding 3: BMIS Made Misrepresentations on its Form ADV Filings, and OCIE Should Have Been Aware of These Misrepresentations	29
Recommendation 6	38
Recommendation 7	38
Recommendation 8	38
Finding 4: Form ADV Should Require Additional Information	39
Recommendation 9	40
Finding 5: Part II of Form ADV Should Be Filed with the Commission	41
Recommendation 10	42
Finding 6: OCIE Identified Certain Risks But These Risks Have Not Been Addressed	43
Recommendation 11	44

Appendices

Appendix I: Acronyms 45
Appendix II: Scope and Methodology 46
Appendix III: Criteria 48
Appendix IV: List of Recommendations 49
Appendix V: Management Comments 52
Appendix VI: OIG Response to Management Comments 56

Tables

Table 1: Investment Adviser Registrants and SEC Investment Adviser
and Investment Company Examination Staff 14
Table 2: Suggested Investment Adviser Risk Ratings According to Form
ADV and OCIE Examinations 23

Background and Objectives

Background

On December 11, 2008, the Securities and Exchange Commission (SEC) charged Bernard L. Madoff (Madoff) with securities fraud for a multi-billion dollar Ponzi scheme that he perpetrated on thousands of investors, including advisory clients of his firm. The complaint charged Madoff with violations of the anti-fraud provisions of the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940. On the same date, the U.S. Attorney's Office in the Southern District of New York indicted Madoff for criminal offenses. On March 12, 2009, Madoff pled guilty to all charges, and on June 29, 2009, a federal District Judge sentenced Madoff to serve 150 years in prison, which was the maximum sentence allowed.

By mid-December 2008, the SEC learned that credible and specific allegations regarding Madoff's financial wrongdoing were repeatedly brought to the attention of SEC staff, but were never recommended to the Commission for action. As a result, on the late evening of December 16, 2008, former SEC Chairman Christopher Cox contacted the SEC Office of Inspector General (OIG) and asked the OIG to undertake an investigation into allegations made to the SEC regarding Madoff, going back to at least 1999, and the reasons why these allegations were found to be not credible. Former Chairman Cox also asked that the OIG investigate the SEC's internal policies that govern when allegations of fraudulent activity should be brought to the Commission's attention. In addition, Cox requested that the OIG investigation include all staff contact and relationships with the Madoff family and firm, and any impact such relationships had on staff decisions regarding the firm.

On August 31, 2009, the OIG issued a comprehensive, 450-plus page investigative report, *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme*, Report No. 509. The investigation found that the SEC received more than ample information in the form of detailed and substantive complaints over a period of many years to warrant a thorough and comprehensive examination and/or investigation of Bernard Madoff and Bernard Madoff Investment Securities, LLC (BMIS) for operating a Ponzi scheme. However, despite three examinations and two investigations of Madoff and BMIS, a thorough and competent investigation or examination was never performed, and the SEC never identified the Ponzi scheme that Madoff operated.

Previously Issued OIG Audit Reports. On September 29, 2009, the OIG issued *Program Improvements Needed Within the SEC's Division of Enforcement*, Report No. 467. The review identified issues that prevented the Division of Enforcement (Enforcement) from accomplishing its mission to enforce the securities laws and protect investors and identified needed programmatic improvements. The report found that Enforcement staff lacked adequate guidance on how to appropriately analyze complaints. As a result, Enforcement did not conduct a thorough review of complaints brought to its attention prior to Madoff's confession.

On September 29, 2009, the OIG also issued *Review and Analysis of OCIE Examinations of Bernard L. Madoff Investment Securities, LLC*, Report No. 468. The report found that OCIE examiners made critical mistakes in nearly every aspect of their examinations of Madoff and BMIS and missed significant opportunities to uncover Madoff's Ponzi scheme. The report concluded that OCIE examiners did not properly plan or conduct their examinations of BMISf, and because of these failures, were unable to discover Madoff's fraud.

SEC's Oversight of Investment Advisers. The SEC regulates investment advisers, primarily under the Investment Advisers Act of 1940 (the Advisers Act).¹ One of the central elements of this regulatory program is that a person or firm meeting the definition of "investment adviser" under the Advisers Act must register with the Commission, unless exempt or prohibited from registration.

Generally, advisers that have \$25 million or more of assets under management or that provide advice to a registered investment company are required to register with the Commission. Smaller advisers may register under state law with state securities authorities.

A person or firm is required to register with the Commission if he or it is:

- An "investment adviser" under Section 202(a)(11) of the Advisers Act;
- Not excepted from the definition of investment adviser by Section 202(a)(11)(A) through (E) of the Advisers Act;
- Not exempt from Commission registration under Section 203(b) of the Advisers Act; and
- Not prohibited from Commission registration by Section 203A of the Advisers Act.

¹ Investment Advisers Act of 1940, 15 U.S.C. 80b-1 et seq.

An investment adviser is generally described as any person or firm that (1) for compensation; (2) is engaged in the business of; (3) providing advice, making recommendations, issuing reports, or furnishing analyses on securities, either directly or through publications. A person or firm must satisfy all three elements to be regulated under the Advisers Act.

The Commission's Division of Investment Management construes these statutory elements broadly. For example, "compensation" refers to the receipt of any economic benefit. With respect to the "business" element, an investment advisory business need not be the person's or firm's sole or principal business activity. Rather, this element is satisfied under any of the following circumstances: the person or firm holds himself or itself out as an investment adviser or as providing investment advice; the person or firm receives separate or additional compensation for providing advice about securities; or the person or firm typically provides advice about specific securities or specific categories of securities.

Moreover, the Division of Investment Management views a person or firm to have satisfied the "advice about securities" element if the advice or reports relate to securities. The Division has stated that providing one or more of the following also could satisfy this advice about securities element: advice about market trends; advice in the form of statistical or historical data (unless the data is no more than an objective report of facts on a non-selective basis); advice about the selection of an investment adviser; advice concerning the advantages of investing in securities instead of other types of investments; or a list of securities from which a client can choose, even if the adviser does not make specific recommendations from the list.

Form ADV. Investment advisers register with the SEC using the SEC "Form ADV," which is the "Uniform Application for Investment Adviser Registration." Investment advisers use Form ADV to register with the Commission, register with one or more state securities authorities, and to amend those registrations as required by Instruction No. 4 to Form ADV and Advisers Act rules.

Form ADV consists of three parts: Part 1A, Part 1B, and Part II. Advisers are required to submit Part 1A of this Form to the SEC annually. The SEC maintains the information submitted in Part 1A and makes it available to the public. Advisers are not required to provide a copy of Part II of Form ADV to the SEC, absent a specific request. Instead, advisers must retain a copy of Part II in their files. Currently, Part II is deemed to be "filed" with the SEC when advisers update the form and place a copy in their files. Advisers are required to retain Part II of Form ADV on-site and provide it (or a document containing the information therein) to new clients and offer it annually to existing clients.

The three parts of Form ADV are as follows:

- Part 1A asks for information about an investment adviser's business practices, the persons who own and control the adviser, and the persons who provide investment advice on an adviser's behalf. Part 1A also contains several supplementary schedules, which ask advisers to provide information about their direct owners and executive officers, indirect owners, and disciplinary events involving themselves and their affiliates. All advisers registering with the SEC or any of the state securities authorities must complete Part 1A.
- Part 1B asks for disclosure information that is required by state securities authorities. An adviser is required to complete Part 1B only if it is applying for registration with, or is registered as, an investment adviser with a state securities authority. If an adviser is only registered with the SEC, the adviser is not required to complete Part 1B. Part 1B is not utilized by the SEC for federally registered investment advisers.
- Part II of Form ADV requires an adviser to provide information related to its services and fees, types of clients, investment advice, methods for analysis, sources of information and investment strategies, other business activities, other financial industry activities or affiliations, conditions for managing accounts and its balance sheet. An adviser is required to keep the information in Part II current, deliver it to prospective clients, and annually offer it to current clients.

Filing of the Form ADV. Advisers file Part 1 of Form ADV electronically with the Commission through the Investment Adviser Registration Depository (IARD) system. The IARD is an electronic filing system that facilitates investment adviser registration, regulatory review, and the public disclosure of information from investment advisers. The Financial Industry Regulatory Authority (FINRA) developed and operates the IARD system.

Advisers are required to update Form ADV each year by filing an annual updating amendment within 90 days after the end of its fiscal year. In addition to an adviser's annual updated filing, an adviser must amend its Form ADV by filing additional amendments whenever an adviser's responses to certain questions on Form ADV become inaccurate. Failure to update a Form ADV is a violation of SEC Rule 204-1² and similar state rules and could lead to the revocation of an adviser's registration.

² 17 C.F.R. § 275.204-1.

If an adviser needs to withdraw its registration status with the SEC, the adviser is required to file Form ADV-W. For example, an adviser would file a Form ADV-W if its assets under management fell below \$25 million.

Exclusions from the Definition of Investment Adviser. Certain individuals or entities are excluded from the definition of an investment adviser, such as domestic banks and bank holding companies and lawyers, accountants, engineers and teachers, if their performance of advisory services is solely incidental to their professions. Brokers and dealers are also excluded from the definition of investment adviser if their performance of advisory services is solely incidental to the conduct of their business as brokers and dealers and they do not receive any special compensation for their advisory services.

The Advisers Act gives the SEC the authority to exclude, by rules and regulations or order, other persons and firms it determines not to be within the intent of the Adviser Act definition of investment adviser.

Number of Investment Advisers vs. SEC Examination Staff. As shown in Table 1, in FY 2009 there were 11,292 registered advisers and approximately 452 OCIE Investment Adviser and Investment Company examination staff.³ The number of registered advisers has steadily grown each year, from 7,686 in FY 2003. The examination staff of the Office of Compliance Inspections and Examinations (OCIE) has also grown since 2003, but the growth in examination staff has not kept pace with the growth in the number of registered advisers.

Table 1: Investment Adviser Registrants and SEC Investment Adviser and Investment Company Examination Staff

Year	Total Investment Adviser Registrants	SEC Investment Adviser and Investment Company Examination Staff
2003	7,686	399
2004	7,959	477
2005	8,535	489
2006	9,017	475
2007	10,662	425
2008	10,817	425
2009	11,292	452

Source: SEC's Office of Compliance Inspections and Examinations

Types of OCIE Examinations. OCIE examines investment advisers, investment companies, broker-dealers, transfer agents, clearing agencies, self-regulatory agencies, and nationally recognized statistical rating organizations. For

³ The same OCIE staff examines both investment advisers and investment companies.

investment advisers and investment companies, OCIE generally conducts three types of examinations: cause, routine and sweep.

Cause Examinations are conducted when staff have reason to believe that there have been violations of the federal securities laws. In these examinations, staff review irregular activity, determine if violations have occurred, gather supporting documentation, perform interviews and prepare analyses as evidence of violations. Cause examinations are conducted at both main and branch offices.

Routine examinations are conducted periodically and test an entity's compliance with applicable laws and regulations. In routine examinations, OCIE looks at compliance with the law in a specified number of areas. Because of the size and complexity of the investment management industry relative to SEC examination resources, OCIE has developed a risk-based methodology that is used to identify "high risk" advisory firms and funds that are selected for routine examinations. Using its risk-rating system, OCIE assigns a risk level to each adviser based on: (1) information contained in firms' annual registration filings (Form ADV); (2) assessment made during previous examinations of that entity; and/or (3) staff evaluations or other risk criteria. OCIE's Branch of Surveillance and Reporting was created to, among other things, help monitor registered entities and develop initial risk profiles based on certain quantitative inputs.

OCIE conducts routine examinations of investment advisers and investment companies classified as "high risk" on a cycle. Once an investment adviser or investment company is classified as "high risk, the firm is placed on a three-year examination cycle. Currently, OCIE is not able to meet its three year goal because of the work required during examinations and limited staff resources.

Sweep examinations scrutinize a specific activity, control, or compliance area at a number of firms. The purpose of these examinations is to determine the extent, scope, and danger of emerging risks in the regulated community. Sweep examinations allow the staff to obtain a more comprehensive view of a particular risk, assess the gravity of the risk, evaluate the compliance performance of individual firms and compare it with that of their peers, and recommend regulatory solutions.

Bernard Madoff Investment Securities, LLC (BMIS)

In September 2006, the Madoff firm, BMIS, was first dually registered with the Commission as a broker-dealer and as an investment adviser. It was registered as a broker-dealer on January 19, 1960 and as a registered investment adviser on September 12, 2006. BMIS has been a member of the NASD (now FINRA) since March 25, 1960. The firm was also a member of other self-regulatory organizations and the Securities Investor Protection Corporation (SIPC). The

firm was organized as a limited liability company and was almost wholly owned by its principal, Bernard L. Madoff, and members of his family. Many of the positions at BMIS, including legal and compliance positions, were staffed by Madoff's relatives. BMIS did not have an internal audit department. Any internal audits were conducted by the firm's own back office personnel. The firm's outside auditor was a small and relatively unknown firm.

Commission Examinations of Madoff. Prior to Madoff's admission that he was running a Ponzi scheme in December 2008, the SEC conducted two investigations and three examinations that could have revealed that Madoff was operating a Ponzi scheme. These investigations and examinations were based on detailed and credible complaints that raised the possibility that Madoff was misrepresenting his trading and could have been operating a Ponzi scheme.

After Madoff admitted to operating a Ponzi scheme, OCIE opened a cause examination of BMIS's investment advisory business.

First Enforcement Investigation and Examination

The first Enforcement investigation and first examination were conducted in 1992 after the SEC received information that led it to suspect that Avellino & Bienes, a firm for which Madoff was managing money, was selling unregistered securities and conducting a Ponzi scheme. The SEC's investigation focused on Avellino & Bienes and did not investigate the possibility that Madoff was the one who was in fact operating the Ponzi scheme.

During the course of its investigation of Avellino & Bienes, the SEC conducted an examination of BMIS. The examination was limited to verifying that BMIS was properly segregating Avellino & Bienes' October 1992 month-end securities positions in BMIS's segregated accounts at the Depository Trust Company (DTC). In conducting its examination, the examiners relied exclusively on DTC records produced by BMIS.

Two Parallel OCIE Cause Examinations

In 2004 and 2005, the SEC's examination unit, OCIE, conducted two parallel cause examinations of BMIS. The 2004 examination was initiated by a complaint that OCIE received from a manager of a hedge fund. OCIE focused its examination on the possibility that BMIS was front-running.⁴ However, the examination never determined if BMIS was in fact front-running, the examination was never officially closed, and OCIE did not produce an examination report.

⁴ Front-running is the practice whereby one executes a trade with advance knowledge of pending orders from other investors.

During the 2004 examination, the examiners raised the issue of whether BMIS was acting as an unregistered investment adviser. It appeared to the assistant director responsible for the examination that Madoff and his firm were attempting to evade investment adviser registration, and the examination was expanded to examine the investment adviser issue. A member of the examination team drafted a memorandum about whether BMIS met the definition of investment adviser, but the memorandum was never finalized and the team did not pursue or resolve the issue of BMIS's investment adviser status.

The 2005 examination was conducted by the SEC's New York Regional Office (NERO) based on the SEC's review of a series of internal e-mails between employees at another SEC registrant. An investment management examiner in NERO had been conducting a routine examination of an unrelated registrant when he discovered internal e-mails that raised questions about whether Madoff was involved in illegal activity involving managed accounts. These internal e-mails described the red flags the registrant's employees identified while performing due diligence on their Madoff-related investment, including Madoff's highly incredible fills for equity trades, his misrepresentation of his options trading, his secrecy, his auditor, his highly consistent and non-volatile returns over several years, and his fee structure.

Despite the allegations about Madoff's management of customer accounts, like the 2004 examination, the 2005 examination was focused on whether BMIS was front-running. Also similar to the conduct of the 2004 examination, NERO examiners began researching the issue of whether Madoff should be registered as an investment adviser due to his investment discretion over certain hedge fund accounts, but the investment adviser registration issue was not pursued or resolved. The supervisor of the examination determined that the examiners should not pursue the investment adviser issue because the examiners had already spent several months on the examination and the supervisor felt that Madoff would likely fall into the investment adviser exclusion for broker-dealers and not be required to register. Neither the 2004 nor the 2005 examination teams consulted with the Division of Investment Management regarding BMIS's investment adviser status. When the Division of Investment Management was contacted in 2006 during Enforcement's investigation of Madoff and his firm, the Division of Investment Management opined that BMIS did meet the definition of Investment Adviser and was required to register with the Commission.

In addition, there were initial significant delays in the commencement of both the 2004 and 2005 cause examinations. The scope of both examinations was narrowly focused on the possibility of front-running, with no significant attempts made to analyze the numerous red flags about Madoff's trading and returns.

Both examinations were open at the same time in different offices without either office knowing the other one was conducting an identical examination. In fact, Madoff himself informed one of the examination teams that the other examination team had already received certain requested information. Both examinations concluded with numerous unresolved questions and without any significant attempt to examine the possibility that Madoff was misrepresenting his trading and operating a Ponzi scheme.

2006 Enforcement Investigation

Enforcement formally opened an investigation of BMIS in January 2006, based upon a detailed complaint that Harry Markopolos, an independent fraud investigator, provided to Enforcement in 2005. Since 2000, Markopolos had been providing credible complaints to Enforcement analyzing why Madoff must be running a Ponzi scheme. Markopolos' 2005 Complaint was entitled "The World's Largest Hedge Fund is a Fraud" and detailed approximately 30 red flags indicating that Madoff was operating a Ponzi scheme, a scenario it described as "highly likely." The red flags included the impossibility of Madoff's returns, particularly the consistency of those returns, and the unrealistic volume of options Madoff represented that he had traded.

Although Markopolos' complaint focused on why Madoff's returns could not be legitimate, the NERO Enforcement team investigating Markopolos' complaint decided to open the matter to investigate (1) whether BMIS, a registered broker-dealer, provided investment advisory services to large hedge funds in violation of the registration requirements of the Investment Advisers Act of 1940, and (2) whether BMIS engaged in any fraudulent activities in connection with these services.

During its investigation, the staff learned from a broker-dealer examiner that during a recent examination of BMIS by NERO's broker-dealer examination staff, Madoff failed to disclose to the staff both the nature of the trading conducted in the hedge fund accounts and also the number of such accounts at BMIS.

When closing its investigation in 2007, the Enforcement staff stated that they had "found no evidence of fraud" but "did find, however, that BMIS acted as an [unregistered] investment adviser to certain hedge funds, institutions, and high net worth individuals in violation of the registration requirements of the Advisers Act." The Enforcement staff also found that Madoff's largest hedge fund client, Fairfield Greenwich Group (FGG), "did not adequately disclose to its investors [BMIS's] advisory role and merely described [BMIS] as an executing broker to FGG's accounts."

As a result of this investigation and discussions with SEC staff, BMIS filed Part 1 of its Form ADV with the Commission on August 25, 2006, and its registration as an investment adviser became effective on September 12, 2006. In addition, FGG revised its disclosures to investors to reflect BMIS's advisory role. In its Closing Recommendation, Enforcement stated that it recommended closing the investigation because both BMIS and FGG voluntarily remedied the violations that the Enforcement staff had identified, and the staff had determined that the violations were not so serious as to warrant an Enforcement action or further investigation.

BMIS's Form ADV Filings. BMIS filed its first Form ADV with the Commission on August 25, 2006, and this filing became effective on September 12, 2006. BMIS subsequently made an annual filing on January 24, 2007, an amended filing on March 8, 2007, and an annual filing on January 7, 2008.⁵ As described later in the report, these filings contained false information.

Objectives

In light of the findings in the OIG's August 31, 2009 Report of Investigation entitled "Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme," the OIG conducted a review of the Commission's process for selecting which investment advisers and investment companies to examine. The objectives of the review were to:

- Determine the Commission's rationale for not performing an examination of BMIS's investment advisory business soon after the firm registered as an investment adviser in 2006; and
- Make recommendations to improve OCIE's process for selecting investment advisers and investment companies for examination.

⁵ An Investment Adviser's first Form ADV filing is not effective upon filing. All subsequent Form ADV filings are effective on the filing date.

Findings and Recommendations

Finding 1: OCIE’s Risk Rating Process Did Not Provide for a Routine Examination of BMIS Because BMIS Was Classified As a Medium Risk Firm.

OCIE never initiated a routine examination of BMIS primarily because OCIE rated BMIS as a “medium risk” firm based on its answers to certain Form ADV questions. OCIE only examines a small portion of randomly selected firms that are designated as low and medium risk. BMIS was never randomly selected.

OCIE’s goal is to conduct routine examinations of “high risk” firms within three years of a firm’s receipt of such designation.

OCIE’s Risk Rating Classifications. OCIE assigns each registered investment adviser a “low,” “medium,” or “high” risk rating. OCIE started this practice in 2003 and fully implemented it in fiscal year 2004. The risk rating is initially based on each adviser’s response to certain questions in Form ADV Part 1 (Form ADV rating). Based on these answers, OCIE assigns a score for each answer. The answer to only one question on Form ADV has the potential to result in a negative point value. The cumulative value of all of the points culminates into an overall “low,” “medium,” or “high” risk rating. Ratings are assigned as follows:

OCIE assigns the risk scores to firms through an automated means, whereby each adviser’s Form ADV information is uploaded into a pre-formatted Excel spreadsheet. Using pre-calculated fields, once the Form ADV information populates the Excel spreadsheet, an adviser’s risk score for each pertinent question and an adviser’s overall risk score is calculated.

When BMIS registered as an investment adviser in 2006, BMIS was classified as “medium risk,” based on its answers to the questions provided on its Form ADV Part 1.⁶ BMIS filed two subsequent Form ADVs in 2007 and 2008. Both of these Form ADVs resulted in BMIS being assigned a “medium risk” designation⁷ in 2007 and 2008 as well. Only firms categorized as “high risk” trigger routine OCIE

⁶ BMIS made misrepresentations on several parts of Form ADV, as discussed in Finding 3 of this report.

⁷ The Commission does not disclose what risk rating a particular investment adviser or investment company has received.

examinations within three years of receiving the “high risk” rating. As discussed later in this report, BMIS made misrepresentations on its Form ADV filings and had it answered truthfully, BMIS may have been classified as “high risk.”

To ascertain the Form ADV rating, OCIE uses an algorithm to calculate a numeric score for each firm based on certain affiliations, business activities, compensation arrangements, and other disclosure items that could pose conflicts of interest.⁸ Examples include participation or interest in client transactions, managing portfolios for individuals, and receiving performance fees. OCIE determines the risk profile of all registered investment advisers every year using the risk algorithm.

Although the risk algorithm allows OCIE to determine an investment adviser’s relative risk profile in the absence of an examination risk rating, it is potentially limited because it does not measure the effectiveness of the investment adviser’s compliance controls, which are designed to mitigate conflicts of interest or other risks that could harm investors. Rather, it relies on information that serves largely as proxy measures of the firm’s compliance-related controls. OCIE has recognized these limitations and taken some steps to evaluate the effectiveness of its methodology.⁹ However, to date, OCIE has only made limited changes to its risk rating process to resolve this issue.

OCIE may also develop a risk rating for an investment adviser based upon information obtained through an examination (OCIE examination rating). The examination rating is weighted more heavily than the Form ADV rating since it is based upon more complete information. The examination rating may differ from the Form ADV rating in the following ways:

- Routine examination. A routine examination may cause an investment adviser’s examination rating to be higher or lower than or to stay the same as the Form ADV rating. OCIE represented that it is not uncommon for an examination rating to be lower than a Form ADV rating, especially if an OCIE examination finds that an adviser has good controls in place to mitigate risks.
- A “cause” or “sweep” examination. Because these examinations only have a narrow focus, OCIE will rarely lower a risk rating based on these examination results. A cause or sweep examination will only result in an examination rating being higher or the same as a Form ADV rating.

⁸ The risk algorithm, developed by OCIE and the SEC Office of Economic Analysis (OEA), is a formula using values of various factors to derive a relative ranking for the firm’s compliance risk.

⁹ General Accountability Office Report No. 07-1053: *Securities and Exchange Commission: Steps Being Taken to Make Examination Program More Risk-Based and Transparent*, August 2007, page 12.

Ultimately, staff in the regional office responsible for overseeing the activities of an adviser is able to adjust upward or downward the risk profile for an adviser. These determinations may be based on the staff's assessment of the adviser derived from various sources, both internal and external sources.¹⁰ Regional offices develop a final examination plan for each fiscal year. During the year, regional offices may interact with additional information that would cause a firm's risk level to be adjusted upward (i.e. a cause examination).

The largest investment advisers, based upon the dollar amount of assets under management, have an OCIE examination rating of "high" by default. The ratings of these firms based on Form ADV, however, may be different. According to Form ADV filings, the assets under management of some of the largest firms hit \$1.2 trillion in FY 2008.

BMIS Was Classified as a Medium Risk Investment Adviser. BMIS reported assets under management of \$11.7 billion, \$13.2 billion, and \$17.1 billion on its 2006, 2007, and 2008 Form ADV filings, respectively. As a result, BMIS was never automatically classified as "high risk."

Further, because OCIE never conducted a formal examination of BMIS's investment advisory business,¹¹ OCIE never developed a risk rating of BMIS based on an OCIE examination. Therefore, given the above, OCIE's rating of BMIS was "medium" – the same as BMIS's Form ADV rating. We found this problematic because BMIS was examined and investigated by OCIE and Enforcement repeatedly, BMIS was found to be operating as an (unregistered) investment adviser, and OCIE and Enforcement found that Madoff lied about BMIS's advisory role. Our review found that even though OCIE did not specifically examine BMIS's advisory business, OCIE should have assigned a higher examination rating to BMIS, based on the results of OCIE's and Enforcement's prior examinations and findings.

Risk Ratings of Registered Investment Advisers. Table 2 shows the risk ratings of the registered investment advisers as of September 30, 2008, according to Form ADV and OCIE examinations.

¹⁰ Sources of information that may be reviewed by the staff include, among others, SEC filings, relevant tips and complaints, publicly available news and media reports, as well as internally generated analysis of information prepared by OCIE and other SEC Offices and Divisions.

¹¹ OCIE never formally examined BMIS's investment advisory business prior to Madoff's confession that he was running a Ponzi scheme. However, OCIE and Enforcement did look at several aspects of BMIS's advisory business during their examinations and investigations. After Madoff's confession in December 2008, OCIE initiated a formal cause examination of BMIS's investment advisory business.

Table 2: Suggested Investment Adviser Risk Ratings According to Form ADV and OCIE Examinations

Risk Level	Per Filings (Form ADV)	Percent of Total	Per ADV and Supplemental Data (Including Exams)	Percent of Total
Low				
Medium				
High		9%		11%
Total	11,292	100%	11,292	100%

Source: OIG Generated based on OCIE information

OCIE’s Process for Examining Investment Advisers and Investment Companies. Between 1998 and 2003, OCIE routine examinations accounted for about 90 percent of OCIE examinations. During this period, OCIE generally tried to examine each firm at least once every five years. However, the growth in the number of investment advisers, from 5,700 to about 7,700, and the breadth of their operations, did not allow OCIE to maintain this routine examination cycle. Also, OCIE concluded that routine examinations were not the best tool for identifying emerging compliance problems because firms were selected for examination based predominately on the passage of time and not on their particular risk characteristics.¹²

Around 2004, OCIE began implementing a risk-based approach to examining investment advisers and investment companies. OCIE believes this approach better ensures that OCIE concentrates its resources on higher risk advisers and investment companies. OCIE shifted its focus from performing routine examinations of all registered investment advisers and investment companies, regardless of compliance risks, to attempting to examine advisers and investment companies that receive a “high risk” rating at least once every three years. Advisers rated as “high risk” comprise about ten percent of registered investment advisers.¹³

For the remaining “lower risk” advisers and investment companies (those classified as low and medium risk), each year OCIE coordinates with economists at the Commission to generate a random sample of advisers and investment companies for OCIE to potentially examine. All of the lower risk advisers that were registered as of September 2006, 2007 and 2008 and had not been recently examined were placed in separate pools for each year. From these pools, either the Commission’s Office of Economic analysis or its Office of Risk

¹² General Accountability Office Report No. 07-1053: *Securities and Exchange Commission: Steps Being Taken to Make Examination Program More Risk-Based and Transparent*, August 2007, page 9.

¹³ Examinations are initiated based on each adviser’s risk profile. Examinations of investment companies are conducted concurrently with examinations of their advisers. At a minimum, however, investment companies will be deemed “high risk” if the funds have not been examined within last seven years.

Assessment randomly selected 400-500 advisers for potential routine OCIE examinations. BMIS was included in the pools for each of the three years, but was never randomly selected.¹⁴ Even if BMIS had been randomly selected, there was no guarantee that Madoff's advisory business would have been examined on a routine basis; being part of the group of randomly selected advisers only signifies that these advisers are placed on a list for *potential* examination. According to OCIE, each year the regional offices conduct routine examinations of about 200 of the randomly selected firms.

The effectiveness of OCIE's risk-based approach depends on its ability to accurately assess the level of risk at individual firms because inaccurately categorizing firms as lower-risk could result in harmful practices persisting undetected.¹⁵

Conclusion

BMIS was classified as a medium risk firm on the basis of the answers it provided in its Form ADV. In addition, because OCIE had not conducted a formal examination of BMIS's advisory activities, BMIS's rating was deemed to be "medium risk," matching the "medium risk" rating per BMIS's Form ADV.

However, as discussed later in this report, BMIS's operations (including issues directly related to its investment advisory operations) had been examined numerous times by OCIE and Enforcement, BMIS was found to be operating as an (unregistered) investment adviser, and OCIE and Enforcement found that Madoff misrepresented BMIS's advisory role and activities.

BMIS's registration as an investment adviser was prompted by an Enforcement investigation, which should have automatically resulted in BMIS receiving an initially higher risk rating than it would have received had its registration not been a condition of Enforcement closing its investigation. Moreover, findings from OCIE's prior cause examinations of BMIS and from Enforcement's investigations involving BMIS should have prompted OCIE to question BMIS's "medium" Form ADV rating. Due to OCIE and Enforcement's prior examinations and investigations, OCIE should have scheduled a cause examination of Madoff immediately upon his registration as an investment adviser. As discussed later in the report, it appears that OCIE's investment adviser unit was not adequately informed of the multiple issues that arose with Madoff during prior OCIE examinations and Enforcement investigations.

¹⁴ BMIS's placement in the risk assessment process did not have an effect on the likelihood that BMIS would be chosen for a cause or sweep examination.

¹⁵ General Accountability Office Report No. 07-1053: *Securities and Exchange Commission: Steps Being Taken to Make Examination Program More Risk-Based and Transparent*, August 2007, pages 3-4.

Recommendation 1:

The Office of Compliance Inspections and Examinations (OCIE) should implement a procedure requiring, as part its process for creating a risk rating for an investment adviser, that OCIE staff perform a search of Commission databases containing information about past examinations, investigations, and filings related to the investment adviser.

Recommendation 2:

The Office of Compliance Inspections and Examinations (OCIE) should change the risk rating of an investment adviser based on pertinent information garnered from all Divisions and Offices of the Commission, including information from OCIE examinations and Enforcement investigations, regardless of whether the information was learned during an examination conducted to look specifically at a firm's investment advisory business.

Finding 2: OCIE Should Have Immediately Scheduled a Cause Examination of BMIS when BMIS Registered as an Investment Adviser.

BMIS registered as an investment adviser in 2006 as a condition of Enforcement closing its investigation. The Enforcement investigation that began in 2006 found that BMIS acted as an (unregistered) investment adviser to certain hedge funds, institutions, and high net worth individuals in violation of the registration requirements of the Advisers Act.

Enforcement stated that BMIS's investment adviser registration was a "good result" because it would expose Madoff and his firm to "extra regulatory scrutiny." However, there is no indication that anyone on the Enforcement staff ever suggested that OCIE's investment adviser examination staff conduct a cause examination of BMIS.¹⁶ This fact is troubling because the Enforcement investigation (which included the assistance of an OCIE broker-dealer examiner) revealed that Madoff did not fully disclose either the nature of the trading BMIS

¹⁶ OIG Investigative Report: *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme – Public Version*, Report No. 509, August 31, 2009 (hereinafter "OIG Investigative Report No. 509"), page 357.

conducted in hedge fund accounts or the number of such accounts at BMIS,¹⁷ that BMIS commingled billions of dollars of equities among its investment advisory accounts and with its broker-dealer proprietary account,¹⁸ and that the investor disclosures of BMIS's largest hedge fund client did not adequately describe BMIS's advisory role.¹⁹ Some of the problems identified in this investigation related to BMIS's investment advisory operations; therefore, both Enforcement and OCIE's broker-dealer examination staff should have promptly notified OCIE's investment adviser examination unit. At that point, OCIE should have immediately scheduled a cause examination.

Enforcement Investigation of Madoff. On January 4, 2006, Enforcement opened a formal investigation of BMIS. The investigation was instigated by a November 2005 detailed complaint from Harry Markopolos, an independent fraud investigator, who alleged that Madoff was running a Ponzi scheme and that the returns reported by BMIS's hedge fund clients were the result of fraud perpetuated by Madoff and his firm. Enforcement also learned from an OCIE broker-dealer examiner that BMIS did not fully disclose to OCIE examination staff the nature of the trading conducted in BMIS's hedge fund accounts or the number of accounts that BMIS operated.

According to the Enforcement team assigned to the investigation, the investigation was opened to determine (1) whether BMIS, a registered broker-dealer, provided investment advisory services to large hedge funds in violation of the registration requirements of the Investment Advisers Act of 1940, and (2) whether BMIS engaged in any fraudulent activities in connection with these services.

During its investigation, the staff learned from a broker-dealer examiner that during a recent examination of BMIS by NERO's broker-dealer examination staff, Madoff failed to disclose to the staff both the nature of the trading conducted in the hedge fund accounts and also the number of such accounts at BMIS.

When closing its investigation in 2007, the Enforcement team stated that it had "found no evidence of fraud" but "did find, however, that BMIS acted as an [unregistered] investment adviser to certain hedge funds, institutions, and high net worth individuals in violation of the registration requirements of the Advisers Act." The Enforcement team also found that BMIS's largest hedge fund client, FGG, "did not adequately disclose to its investors [BMIS's] advisory role and merely described [BMIS] as an executing broker to FGG's accounts."

¹⁷ Enforcement learned of this non-disclosure during a preliminary inquiry, prior to opening the 2006 Madoff investigation.

¹⁸ OIG Investigative Report No. 509, page 358.

¹⁹ FGG subsequently revised its disclosures to investors to reflect BMIS's advisory role.

As a result of the investigation and discussions with SEC staff, BMIS filed its first Form ADV with the Commission on August 25, 2006, and its registration as an investment adviser became effective on September 12, 2006. FGG also revised its disclosures to investors to reflect BMIS's advisory role.

In its Closing Recommendation, Enforcement stated that it recommended closing the investigation because both BMIS and FGG voluntarily remedied the violations that the SEC identified, and the SEC determined that the violations were not so serious as to warrant an Enforcement action or further investigation.

Enforcement stated that BMIS's registration as an investment adviser was a "good result" because it would expose BMIS to "extra regulatory scrutiny." However, there is no indication that anyone on the Enforcement staff ever suggested that OCIE's investment adviser examination staff conduct an examination of BMIS.²⁰ This fact is troubling because the investigation identified the following significant issues:

- Madoff did not fully disclose to SEC staff either the nature of the trading conducted in hedge fund accounts controlled by BMIS or the number of such accounts at BMIS.²¹
- BMIS commingled billions of dollars of equities among its investment advisory accounts and with BMIS's broker-dealer proprietary account. This commingling should have been of serious concern to the SEC because it is a violation of the custody rule for investment advisers.²²
- BMIS acted as an investment adviser to certain hedge funds, institutions, and high net worth individuals, in violation of the requirements of the Advisers Act.
- FGG's disclosures to its investors did not adequately describe BMIS's advisory role and described BMIS as merely an executing broker to FGG's accounts.²³

The 2006 Enforcement investigation of BMIS was comprised of staff at NERO who were assisted by one OCIE broker-dealer examiner who had previously conducted an examination of BMIS and identified numerous misrepresentations made by Madoff. Many of the problems identified in the Enforcement investigation related to BMIS's investment advisory operations; therefore, OCIE's

²⁰ OIG Investigative Report No. 509, page 357.

²¹ Enforcement learned of this non-disclosure during a preliminary inquiry, prior to opening the 2006 Madoff investigation.

²² OIG Investigative Report No. 509, page 358.

²³ FGG subsequently revised its disclosures to investors to reflect BMIS's advisory role.

advisory unit should have been provided with the information that was learned in the investigation upon BMIS's application for investment adviser registration. Once this information was brought to the attention of OCIE's adviser unit, OCIE should have immediately scheduled a cause examination of BMIS.

We believe that Enforcement's failure to communicate with OCIE's investment adviser unit and OCIE's broker-dealer examination unit's failure to communicate with its investment adviser examination unit is particularly troubling and led to OCIE's failure to conduct an examination of BMIS's advisory business. An OCIE Branch Chief testified that BMIS might have been subject to a "cause exam" immediately after it registered had the investment adviser examination staff been informed that Madoff had made misrepresentations to Enforcement and OCIE broker-dealer examination staff.²⁴

OCIE initiates cause examinations when firms are believed to be in violation of the federal securities laws. In these examinations, staff review irregular activity, determine if violations have occurred, gather supporting documentation, perform interviews, and prepare analyses as evidence of violations. OCIE's broker-dealer unit was already aware that BMIS had violated the Advisers Act, failed to disclose pertinent aspects of its business, and commingled accounts. This fact should have been communicated to OCIE's investment adviser unit as soon as Enforcement prompted BMIS to register as an investment adviser in 2006, and a cause examination should have been immediately scheduled.

OCIE finally opened up a cause examination of BMIS's investment advisory business after Madoff admitted to operating a Ponzi scheme in December 2008.

Recommendation 3:

The Division of Enforcement and the Office of Compliance Inspections and Examinations should establish and adhere to a joint protocol providing for the sharing of all pertinent information (e.g., securities laws violations, disciplinary history, tips, complaints and referrals) identified during the course of an investigation or examination or otherwise.

Recommendation 4:

The Office of Compliance Inspections and Examinations (OCIE) should establish a procedure to thoroughly evaluate negative information that it receives about an investment adviser and use this information to determine when it is appropriate to conduct a cause examination of an

²⁴ OIG Investigative Report No. 509, page 357.

investment adviser. OCIE should ensure its procedure provides for timely opening of a cause examination.

Recommendation 5:

When the Office of Compliance Inspections and Examinations (OCIE) becomes aware of negative information pertaining to an investment adviser, OCIE should examine the investment adviser's Form ADV filings and document and investigate discrepancies existing between the adviser's Form ADV and information that OCIE previously learned about the registrant.

Finding 3: BMIS Made Misrepresentations on its Form ADV Filings, and OCIE Should Have Been Aware of These Misrepresentations.

BMIS consistently made misrepresentations on its Form ADV filings, especially by understating its assets under management and the number of clients to whom BMIS provided investment advisory services. BMIS also misrepresented the nature of its advisory business and failed to disclose the entities that referred business to BMIS.

Prior to BMIS's first Form ADV Filing in August 2006, OCIE should have been aware that Madoff lied to OCIE and Enforcement staff during the course of their examinations and investigations. Further, an Enforcement investigation found that BMIS was acting as an investment adviser without being registered as such. As a result of this investigation, BMIS registered as an investment adviser. Nevertheless, OCIE did not adequately scrutinize any of BMIS's Form ADV filings. Had OCIE done so, OCIE should have concluded that BMIS made misrepresentations in the Form ADV filings.

Had BMIS provided accurate information on its Form ADVs, it may have been classified as a "high risk" adviser and therefore subject to a routine OCIE examination within three years of receiving a "high risk" rating.

We found that OCIE's risk rating process does not give adequate weight to an investment adviser's level of assets under management and the number of clients that receive investment advisory services. We believe that advisers with more assets under management and more clients who receive advisory services should receive progressively higher risk scores.

We reviewed Part 1 of BMIS's 2006, 2007, and 2008 filings. BMIS reported the same information in each filing with only two exceptions. In its 2006 filing, BMIS reported that it did not provide investment advisory services to any clients; in 2007 and 2008 filings, BMIS reported 11-25 clients for this category. In its 2006 through 2008 filings, BMIS reported assets under management of \$11.7 billion, \$13.2 billion and \$17.1 billion, respectively.

The SEC does not require registrants to file Part II of Form ADV with the Commission. The OIG obtained Part II from SEC examination staff.

The following is a summary of the lies and misrepresentations that we identified through discussions with Commission management.²⁵

Misrepresentations in Part 1 of Form ADV (2006, 2007 and 2008 filings)

- 1) Item 5 Part B(3) asks: "Approximately how many firms or other *persons* solicit advisory *clients* on your behalf?" BMIS selected "0."

In September 2009, Commission management told the OIG that the SEC had evidence of at least two other firms that referred business to BMIS. One client, Cohmad, referred business to Madoff at the time of BMIS's Form ADV filings. Avellino & Bienes referred business to BMIS in 1992, but no action was taken to determine if it or any successor firm referred business to BMIS at the time of BMIS's ADV filings.

Risk Rating Point Score

BMIS's risk score for this question would have been higher had it accurately disclosed its practices. BMIS was assigned [REDACTED] points for this answer. Had BMIS disclosed at least [REDACTED] clients, its risk score would have been [REDACTED].

- 2) Item 5 Part C asks: "To approximately how many *clients* did you provide investment advisory services during your most recently completed fiscal year?" BMIS selected "0" in the 2006 filing and "11-25" in the 2007 and 2008 filings.

If Part 1 of BMIS's 2006 ADV were to have been carefully reviewed, BMIS's answer to this question should have raised serious questions and concerns, because it would have immediately appeared to a reviewer to

²⁵ For purposes of this report, "Commission Management" is defined as "senior officials (SK-15 and above) such as Division Chiefs, Deputy/Associate/Assistant Directors, Office/Division heads, etc."

be facially inaccurate. Although BMIS represented that it had provided no clients with advisory services during the past fiscal year, in BMIS's response to the following question (Item 5 Part D), BMIS stated that its clients included high net worth individuals, banking or thrift institutions, pension and profit sharing plans, charitable organizations, and corporations or other businesses. BMIS also represented in response to Item 5 Part F that it had over \$11 billion in assets under management. Consequently, had BMIS's ADV been carefully reviewed, BMIS's response to Item 5 Part C would have appeared dubious and raised questions that required further investigation.

Moreover, on the face of its response, BMIS was taking the incredible position that it had provided no investment advisory services to clients in the past year – a position directly contrary to an express finding made by Enforcement. If Enforcement had made OCIE investment adviser examiners aware of its investigation and determination that BMIS did have advisory clients that BMIS had failed to disclose, then BMIS's response should have raised immediate red flags with investment adviser examiners.

In addition, OCIE broker-dealer examiners and Enforcement investigators had information as early as 2005 that could have been relied upon by investment adviser examiners to discredit BMIS's response to the above item. The information included the following:

- On May 27, 2005, OCIE examiners discussed a discrepancy involving a potential client of BMIS's called "Auriga International." In an e-mail exchange, one OCIE examiner said that Madoff stated that he was not familiar with Auriga International. The other OCIE examiner thought this was "weird" because "Bloomberg reports Auriga had discretionary accounts with B. Madoff."²⁶
- In late 2005 and early 2006, an Enforcement investigation (which was staffed with one OCIE examiner) found that Madoff lied about the number and identity of his firm's investors and withheld account information from the examination staff. Madoff did not disclose to the examination staff some of the accounts in which he implemented his trading strategy. Further, on June 7, 2006, an Enforcement staff person informed three other SEC staff persons that Madoff had produced a list of 86 "previously undisclosed" accounts, totaling \$336.5 million.²⁷

²⁶ OIG Investigative Report No. 509, page 208.

²⁷ OIG Investigative Report No. 509, pages 319 and 321.

clients he advised, the maximum number of points that could have been assigned to BMIS would have been [REDACTED] points.

- 4) Item 5 Parts F(1) and F(2): “Do you provide continuous and regular supervisory or management services to securities portfolios? If yes, what is the amount of your assets under management and total number of accounts?” BMIS reported assets under management of \$11.7 billion to \$17.1 billion in BMIS’s filings between 2006 and 2008. In each year, BMIS reported only 23 accounts.

As discussed in item number 2 above, as early as 2005, OCIE broker-dealer examiners believed that Madoff had under-reported the number of accounts that he managed, and in its 2005 investigation, Enforcement learned that Madoff had under-reported the number of accounts that he managed.

After BMIS admitted to operating a Ponzi scheme in December 2008, Commission Management stated that BMIS severely underreported BMIS’s assets and that BMIS had more than 4,000 active accounts (clients) and over \$60 billion in purported assets as of December 2008.

Risk Rating Point Score

[REDACTED] BMIS was assigned [REDACTED] points for its answer, [REDACTED]

OCIE assigns a limited number of points to all investment advisers that report at least \$1 in assets under management. We believe this method is problematic because advisers with \$100,000 in assets under management carry the same risk weight as those with significantly higher assets under management.

[REDACTED] We believe this method is problematic because advisers that carry \$100,000 in assets under management carry the same risk weight as those that carry up to \$277 billion. To illustrate this point, the 20 largest firms, by assets under management, receive an automatic risk rating of “high,” regardless of their individual scores. The twenty-first largest firm reported \$273 billion in assets under management. This firm was assigned [REDACTED] points and rated a “medium” risk. Clearly, this firm appears to be riskier and pose more of a

risk to the investing public than a firm that manages only \$100,000 in assets.

- 5) Item 8 Part C(3): “Do you or any *related person* have *discretionary* authority to determine the broker or dealer to be used for a purchase or sale of securities for a *client’s* account?” BMIS said “no.”

OCIE had information as early as 2005 that it could have relied upon to discredit BMIS’s answer to this question.

During a 2005 examination of BMIS, an OCIE broker-dealer examiner recalled that Madoff said he executed trades after hours in London, England.²⁸ Further, when an OCIE broker-dealer examiner drafted a list of questions to ask Madoff, he included a question requesting clarification about which “markets in London” Madoff was using to clear trades and how the associated securities settled.²⁹ An OCIE broker-dealer examiner informed Enforcement staff about Madoff’s representation that he executed trades for hedge funds in Europe.³⁰

In September 2009, Commission management told the OIG that BMIS’s answer to this question was illogical, because if Madoff was supposedly executing trades with foreign brokers overseas, then BMIS was exercising some discretion regarding which foreign broker(s) to trade through. If BMIS’s answer was truly “no,” this fact would have meant that BMIS had no discretion regarding which broker-dealers to trade through.

Risk Rating Point Score

[REDACTED], BMIS’s risk weighting would have been unaffected.

- 6) Item 8 Part F: “Do you or any *related person*, directly or indirectly, compensate any *person* for *client* referrals?” BMIS said “no.”

OCIE had information as early as 2005 that it could have relied upon to discredit BMIS’s answer to this question.

A 2005 OCIE examination found that Cohmad’s June 30, 2005 FOCUS Report (Form X-17A-5 Part III) identified the existence of a related-party

²⁸ OIG Investigative Report No. 509, page 192.

²⁹ OIG Investigative Report No. 509, page 204.

³⁰ OIG Investigative Report No. 509, page 277.

entity, owned by a minority shareholder that provided 90% of Cohmad's revenues. Further, OCIE broker-dealer examiners identified substantial monthly checks from Madoff to Cohmad. The examiners never received a satisfactory response from Madoff as to why the checks were made to Cohmad and described Madoff's explanation as "odd."³¹

In September 2009, Commission Management told the OIG that BMIS did in fact compensate persons for such referrals, (e.g., BMIS compensated Cohmad Securities Corporation, an SEC-registered broker-dealer - Madoff was a minority owner of Cohmad). Further, the SEC's investment adviser rules require one to disclose when compensation is paid for referrals.

Risk Rating Point Score

BMIS's risk score for this question would have been significantly higher had it accurately disclosed its practices. BMIS was assigned [REDACTED] points for his answer. Had BMIS told the truth, BMIS's risk score for this question would have been [REDACTED] points.

- 7) Item 9 Part B(2): "Do any of your *related persons* have *custody* of any of your advisory *clients'* securities?" BMIS said "no."

Madoff told the SEC examination and investigation staff different stories about where the equity trades for his investors were executed and cleared.³² During the 2005 NERO examination, Madoff informed the examination staff that his London affiliate, Madoff Securities International Limited (MSIL), was settling the orders, and Barclays Capital in London was clearing the equity trades.³³ In September 2009, Commission management told the OIG that this response was false as Madoff was contending that a UK affiliate had custody of certain assets.

Risk Rating Point Score

BMIS's risk score for this question would have been significantly higher had it accurately disclosed its practices. Madoff was assigned [REDACTED] points for his answer. Assuming Madoff lied in his Form ADV response, BMIS's risk score for this question should have been [REDACTED] points.

³¹ OIG Investigative Report No. 509, pages 177-178.

³² OIG Investigative Report No. 509, page 315.

³³ OIG Investigative Report No. 509, page 315.

Misrepresentations in Part II of Form ADV (2008 filing)

Investment Advisers do not file Part II of Form ADV with the Commission, and therefore OCIE does not assign any risk weighting to the answers provided by advisers in Part II of Form ADV.

- 8) Item 3 Part A(2) states: "Types of Investments. Applicant offers advice on the following: (check those that apply)." BMIS was engaged in OTC options trading, but BMIS did not check the box related to options. However, BMIS did check an "other" box and disclosed that BMIS traded index-based options.

OCIE had information as early as 2005 that it could have relied upon to discredit BMIS's response to the above item.

A December 13, 2005, e-mail exchange between an Enforcement investigator and a broker-dealer examiner stated that Madoff lied to the examination staff by telling the staff that he stopped using options as part of his trading strategy in January 2004. Yet, BMIS's client account statements showed trading in the S&P 100 Index options throughout 2004 and up to October 2005, the last month for which data was produced.³⁴ Enforcement staff further discussed this fact in e-mails dated December 15, 2005. The Enforcement investigation was closed without the receipt of a complete (or convincing) explanation from Madoff about the discrepancy.³⁵

Further, while Madoff claimed to have had billions of dollars invested in undocumented OTC options contracts, on January 23, 2006, Madoff told Enforcement that he had no documentation of options contracts other than what was produced (e.g., no written contract between purchaser and counter-party).³⁶

In September 2009, Commission management told us that BMIS should probably have checked the box on Form ADV related to options and possibly another box called "securities traded over-the-counter."

- 9) Item 7 Part C: This item pertains to other business activities. BMIS checked a box that states: "The principal business of applicant or its principal executive officers involves something other than providing investment advice."

³⁴ OIG Investigative Report No. 509, page 271.

³⁵ OIG Investigative Report No. 509, pages 272-273.

³⁶ OIG Investigative Report No. 509, page 285.

According to Commission management, this response implies that BMIS was principally a market maker and secondarily an investment adviser. In reality, BMIS's principal business was its advisory business, which was the business within which it operated the Ponzi scheme.

OCIE had information in 2004 upon which it could have relied to show that BMIS's response was, at best, misleading. In both the 2004 and 2005 OCIE cause examinations, OCIE broker-dealer staff learned that BMIS's advisory business was making significantly more money for BMIS than was its market making business. In fact, examiners conducting the 2005 examination discovered that without the advisory business, BMIS would have been losing \$10-20 million per year.³⁷

- 10) Item 13B asks: "Does the applicant or a related person have any arrangements, oral or in writing, where it directly or indirectly compensates any person for client referrals?" BMIS answered "no."

Commission management told the OIG that BMIS was providing such compensation. For example, BMIS compensated Cohmad Securities, a registered broker-dealer that referred business to BMIS and in which Madoff had a minority interest.

- 11) Commission management told the OIG that the narrative portions of BMIS's Form ADV (Part II) contained "lies on their face" in reference to the description of BMIS's business.

BMIS's Overall Risk Score Would have Been Higher Had BMIS Accurately Completed its Form ADV or Had OCIE Verified the Information. An analysis of misrepresentations by BMIS with respect to all of the above items of Part 1 of Form ADV demonstrates that BMIS's risk-weighted score would have been significantly higher had BMIS accurately completed Part 1 of Form ADV or had SEC staff verified the information on BMIS's Form ADV and identified the misrepresentations. BMIS's score based on accurate answers to Form ADV questions may have given it a high risk rating. Thus, BMIS may have been designated a "high risk" firm and subject to an OCIE examination within three years of such a rating.

BMIS's score was [REDACTED] based on its 2006, 2007, and 2008 Form ADV responses. Were BMIS to have provided accurate answers, it would have received as many as [REDACTED] additional points, bringing its overall score to [REDACTED]. A score of [REDACTED] or higher equates to a "high risk" firm. Thus, BMIS may have been designated a "high risk"

³⁷ OIG Investigative Report No. 509, pages 103-04, 214.

firm had BMIS accurately completed Part 1 of Form ADV or had OCIE verified the information on BMIS's ADV.

While OCIE generally cannot take responsibility for investment advisers that make misrepresentations on their Form ADV, in this case, due to the numerous examinations and investigations already conducted either by OCIE or with the assistance of OCIE, OCIE should have been aware that many of the statements made by BMIS in its ADV contradicted the information they had learned about his operations. In addition, since Enforcement actually concluded in its investigation that Madoff failed to disclose to the examination staff both the nature of the trading conducted in the hedge fund accounts and also the number of such accounts at BMIS, BMIS's Form ADV should have been carefully scrutinized for lies and misrepresentations.

Had OCIE adequately reviewed any of BMIS's Form ADVs, or even simply relied upon the information about BMIS's lies and misrepresentations that were discovered during previous examinations and investigations, OCIE should have learned that BMIS was a "high risk" firm that, at a minimum, should have been subject to the three-year examination cycle.

Recommendation 6:

The Office of Compliance Inspections and Examinations (OCIE) should establish a procedure to thoroughly evaluate an investment adviser's Form ADVs when OCIE becomes aware of issues or problems with an investment adviser. OCIE should document areas where it believes a Form ADV contains false information and initiate appropriate action, such as commencing a cause examination.

Recommendation 7:

The Office of Compliance Inspections and Examinations (OCIE) should re-evaluate the point scores that it assigns to advisers based on their reported assets under management. OCIE should assign progressively higher risk weightings to firms that have greater assets under management.

Recommendation 8:

The Office of Compliance Inspections and Examinations (OCIE) should re-evaluate the point scores that it assigns to firms based on their reported number of clients to which they provide investment advisory services. OCIE should assign progressively higher risk weightings to investment advisers that serve a larger number of clients.

Finding 4: Form ADV Should Require Additional Information.

Form ADV has not been substantively updated since 2000, when it was first required to be filed electronically with the Commission. We believe that OCIE could identify additional risk factors if registrants were required to include additional information in Form ADV about funds that the adviser manages, including information about fund performance and fund auditor. Further, the fund's auditor should be required to file its opinion with the Commission.

Performance Information. Investment advisers are not currently required to report to the SEC information regarding the performance of funds under management for the current year or any prior years. [REDACTED]

[REDACTED] BMIS never provided performance information [REDACTED] thus, the Commission never received performance information from BMIS.

If investment advisers were required to report performance information for the current and prior years of operation, OCIE could analyze this information to determine which investment advisers' performance consistently fell outside the normal parameters. OCIE could subsequently assign progressively higher risk weights to performance outliers, in accordance with how far off a firm's performance was from established parameters.

BMIS was a performance outlier in that the returns it reported to investors were consistently and significantly higher than any of the benchmark indexes. Moreover, unlike the market and its competitors, BMIS rarely reported negative returns.

Information about Hedge Funds. Currently, the Commission is only able to gather a limited amount of information about hedge funds. According to Commission management, the risk of fraudulent activities is greatest with hedge funds, and most Ponzi schemes occur through hedge funds. It could be beneficial if investment advisers were required to report on Form ADV information about their hedge funds' service providers, custodians, auditors, and administrators. If OCIE detected a problem with one of these entities, OCIE could then electronically review additional Form ADVs to determine which investment advisers were using the same entities and take appropriate action.

Further, investment advisers should report on Form ADV current auditors and amend the form when an auditor is changed. OCIE could review this information to determine whether a firm's auditor is from a reputable accounting firm.

BMIS's auditor was part of a small, unknown firm and was alleged to be a related party to Madoff. The OIG investigation regarding why the SEC failed to uncover Madoff's Ponzi scheme concluded that BMIS's auditor was not independent; and therefore, there was no assurance that BMIS's audits were properly conducted. After Madoff confessed to running a Ponzi scheme, a New York staff attorney in Enforcement investigated Madoff's accountant, David Friebling. Within a few hours of obtaining the work papers, the staff attorney determined that no audit work had been done and testified that there were red flags, which included the absence of any formal work papers, the work papers that were produced did not comply with generally accepted auditing standards, and there was almost nothing indicating that any audit work had been performed.³⁸

Finally, an investment adviser's auditor should file information with the SEC relaying the auditor's opinion. This filing would provide OCIE with independent information regarding the safety of client assets.

If this additional information was included in Form ADV and properly analyzed, it would allow OCIE to more readily identify red flags associated with investment advisers.

Recommendation 9:

The Office of Compliance Inspections and Examinations (OCIE) should recommend to the Chairman's office that it institute a Commission rulemaking that would require the following additional information to be reported as part of Form ADV:

- Performance information;
- A fund's service providers, custodians, auditors and administrators, and applicable information about these entities;
- A hedge fund's current auditor and any changes in the auditor; and
- The auditor's opinion of the firm.

³⁸ OIG Investigative Report No. 509, page 95.

Finding 5: Part II of Form ADV Should Be Filed with the Commission.

Up until 2000, investment advisers were required to file Parts 1 and II of Form ADV with the Commission in hard copy. In 2000, advisers began filing Part 1 of Form ADV electronically with the Commission and were no longer automatically required to provide a copy of Part II to the Commission.

Part II of Form ADV contains pertinent disclosures about an investment adviser's advisory services, fees, types of clients, the types of investments on which the adviser offers advice, an adviser's other business activities, affiliates, conditions for managing accounts, and compensation information.

Part II of ADV was required to be filed with the SEC until 2000 when the Commission adopted new rules under the Advisers Act requiring that registered advisers make filings with the Commission electronically through the IARD system.³⁹ At that time, the Commission exempted advisers from submitting Part II to the Commission because the IARD was not ready to accept those filings.⁴⁰ The exemption was intended to be temporary, but nine years later, investment advisers are still not required to file Part II of their Form ADV electronically or even file a paper copy with the Commission, absent a specific request from the Commission. Instead, advisers need only retain a copy of Part II of their Form ADV in their files. Currently, Part II is deemed to be "filed" with the SEC when advisers update the form and place a copy in their files.

It appears to the OIG that considering Form ADV Part II "filed" with the Commission when an adviser places it in his filing cabinet is an inadequate procedure. The phantom nature of the filing process is highlighted by the fact that the Commission must make a formal request to an adviser to be furnished with Part II. In addition, there is no requirement that information from ADV Part II be made widely available to investors through either the adviser's website or the IARD system. The current requirements (or lack thereof) create the potential for fraud and other abuses.

Our review found that Part II of Form ADV should be filed with the Commission. This document provides pertinent disclosures about an investment adviser's

³⁹ See SEC Rule: Electronic Filing by Investment Advisers; Amendments to Form ADV, IA Release No. 1897 (Sept. 12, 2000), 65 FR 57438 (Sept. 22, 2000).

⁴⁰ See SEC Proposed Rule: Amendments to Form ADV, IA Release No. 34-57419, 73 FR 13958, March 14, 2008.

advisory services, fees, types of clients, types of investments on which the adviser offers advice, an adviser's other business activities, affiliates, conditions for managing accounts, and compensation information, among other things.

On March 3, 2008, the Commission proposed a rule to amend Part II of Form ADV.⁴¹ The rule proposed that registered investment advisers fill out Part II of Form ADV in a narrative form using "plain English" and file it electronically with the Commission. The rule also proposed that Part II of Form ADV describe an adviser's services, fees, business practices, and conflicts of interest with clients.

This rule has not been finalized, nor is it currently on the Commission calendar for finalization. To finalize a rule, the Commission must consider all public comments that pertained to the proposed rule and incorporate these comments into a final rule, which is adopted by vote of the full Commission. Once adopted, the rule becomes a part of the official rules that govern the securities industry.

Neither the proposed rule, nor SEC technology, currently provide for an efficient means to analyze the narrative data. Electronically tagging the narrative data could assist OCIE with this task. Given the more than 11,000 registered investment advisers, it would be extremely beneficial if OCIE had the means to efficiently analyze narrative data in the aggregate.

Recommendation 10:

The Commission should finalize the proposed rule titled *Amendments to Form ADV* [Release No. IA-2711; 34-57419]. In finalizing this rule, the Commission should consider what, if any, additional information investment advisers should include in Part II of Form ADV by consulting with the Office of Compliance Inspections and Examinations (OCIE) and the Division of Investment Management (IM). Further, the Commission, in consultation with OCIE and IM, should consider provisions that would assist OCIE to efficiently and effectively review and analyze the information in Part II of Form ADV.

⁴¹ See SEC Proposed Rule: Amendments to Form ADV, IA Release No. 34-57419, 73 FR 13958, March 14, 2008.

Finding 6: OCIE Identified Certain Risks But These Risks Have Not Been Addressed

OCIE internal documentation identified a risk that hedge fund custodian statements could be fictitious, and the assets may not be verifiable. Another risk stated that since investment advisers are not required to file Part II of Form ADV with the Commission, the SEC does not receive important information regarding potential conflicts of interest involving investment advisers. While these issues have been identified, neither issue has been resolved.

In 2006, OCIE developed a written Action Plan that summarized key risks identified by the OCIE staff. The Action Plan contained 48 risks, listed in the order of importance (the most significant risk was listed first, etc.). For each risk, the Action Plan included OCIE recommended actions to mitigate the risks, actions taken to address the risks, OCIE's plans for further action, and the risk level. The risk levels ranged from tier I (highest risk) to tier III (lowest risk). Per OCIE's documentation, risks rated as Tier I required immediate action, those rated as Tier II required action in due course and risks rated as Tier III did not require any action at the time the risks were identified.

This document identified the following risks:

Hedge Funds – Custody Misappropriation

OCIE recorded risk number eight as follows:

Advisers to hedge funds have custody of client assets, with sole discretion over the disposition assets and custodian statements being delivered to an insider at the adviser. Any custodian statements that are provided to customers may not be verifiable, be fictitious, or may be prepared by a non-US custodian. Furthermore, the statements may not be audited by a legitimate, independent auditor. If the auditor has provided a negative opinion or no opinion, investors in the fund may not be notified.

OCIE rated this risk as a Tier I risk. To address this risk, in 2005, OCIE recommended, among other actions, adding staff, commencing a rule-making process, examining this area across many investment advisers, initiating a staff study, and raising awareness. As a matter of practice, however, prior to Madoff's confession that he was running a Ponzi scheme, OCIE did not obtain third party

verifications. OCIE said that obtaining third party verifications was difficult and time-consuming. In some cases, the SEC has no regulatory authority over third parties, which has resulted in third parties not responding to the SEC. Further, OCIE's staff resources have not kept pace with the growth in the number of registered investment advisers. In light of the Madoff scandal, however, OCIE has now begun incorporating third party verifications into its examinations.

Form ADV Part II

OCIE recorded risk number 35 as follows:

Customers are not receiving important disclosures, and examiners have little access to such disclosures, because Form ADV Part II is difficult to read and is not available online. Part II should be written in plain English and made available online. This would permit it to be readily reviewed by examiners, either during the risk-targeting process or on-site.

As discussed in finding 5 above, our review found that Part II of Form ADV should be filed with the Commission. This document provides pertinent disclosures about an investment adviser's advisory services, fees, types of clients, types of investments on which the adviser offers advice, an adviser's other business activities, affiliates, conditions for managing accounts and compensation information, among other things.

On March 3, 2008, the Commission proposed a rule to amend Part II of Form ADV.⁴² The rule proposed that registered investment advisers fill out Part II of Form ADV in a narrative form using "plain English" and file it electronically with the Commission. The rule also proposed that Part II of Form ADV describe an adviser's services, fees, business practices, and conflicts of interest with clients.

This rule has not been finalized, nor is it currently on the Commission calendar for finalization. Recommendation 9 in Finding 5 pertains to finalizing this rule.

Recommendation 11:

The Office of Compliance Inspections and Examinations (OCIE) should develop and adhere to policies and procedures for conducting third party verifications, such that OCIE verifies the existence of assets, custodian statements, and other relevant criteria.

⁴² SEC Proposed rule: Amendments to Form ADV, Release No. 34-57419, 73 FR 13958, March 14, 2008.

Acronyms

Advisers Act	Investment Advisers Act of 1940
BMIS	Bernard Madoff Investment Securities, LLC
DTC	Depository Trust Company
Enforcement	Division of Enforcement
FGG	Fairfield Greenwich Group
FINRA	Financial Industry Regulatory Authority
Form ADV	Uniform Application for Investment Adviser Registration
IARD	Investment Adviser Registration Depository
IARD system	Investment Adviser Registration Depository system
IM	Division of Investment Management
Madoff	Bernard L. Madoff
MSIL	Madoff Securities International Limited
NASD	National Association of Securities Dealers
NERO	Northeastern Regional Office
OCIE	Office of Compliance, Inspections and Examinations
OEA	Office of Economic Analysis
OIG	Office of the Inspector General
SEC or Commission	U.S. Securities and Exchange Commission
SIPC	Securities Investor Protection Corporation

Scope and Methodology

This review was not conducted in accordance with the government auditing standards.

Scope. The scope includes of a review of SEC's Examinations conducted on Madoff dating from 1992 to 2006. Specifically, the scope consists of a review of Enforcement's investigation and examination conducted in 1992, OCIE's Cause Examinations conducted in 2004 and 2005, and Enforcement's January 2006 investigation on Madoff. Also, we examined the BMIS Form ADV filings and reviewed the OIG investigative report *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme*, Report No. 509.

Methodology. To address the review's first objective to determine whether the Commission's rationale for not performing an examination of BMIS' investment advisory business soon after the firm registered as an investment adviser in 2006, we interviewed staff from OCIE and Enforcement. We also reviewed:

- BMIS' Form ADV filings;
- OCIE's process for rating investment advisers as "low," "medium," and "high;"
- OCIE's process for identifying risks related to investment advisers; and
- OCIE's process for examining investment advisers.

To address the review's second objective to develop recommendations to improve OCIE's process for selecting investment advisers and investment companies for examination, we:

- Reviewed and analyzed relevant information from OIG's investigative report *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme*, Report No. 509;
- Examined OCIE's process for choosing investment advisers and investment companies for examination;
- Interviewed OCIE officials to determine why OCIE did not initiate an examination of BMIS after BMIS filed its first Form ADV with the Commission in August 2006; and
- Interviewed Enforcement and the Division of Investment Management staff.

Prior OIG Coverage. On August 31, 2009, the OIG issued *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme*, Report No. 509. This report analyzed the reasons why the Commission did not believe that the allegations and tips the Commission received about Madoff were credible. The investigation found that the SEC received more than ample information in the form of detailed and substantive complaints over a period of many years to warrant a thorough and comprehensive examination and/or investigation of Madoff and BMIS for operating a Ponzi scheme. Despite three examinations and two investigations of BMIS, a thorough and competent investigation or examination was never performed, and the SEC never identified the Ponzi scheme that Madoff operated.

On September 29, 2009, the OIG issued *Program Improvements Needed Within the SEC's Division of Enforcement*, Report No. 467. The review identified issues that prevented Enforcement from accomplishing its mission to enforce the securities laws and protect investors and identified needed programmatic improvements. The report found that Enforcement staff lacked adequate guidance on how to appropriately analyze complaints and did not conduct a thorough review of the complaints brought to its attention prior to Madoff's confession.

On September 29, 2009, the OIG issued *Review and Analysis of OCIE Examinations of Bernard L. Madoff Investment Securities, LLC*, Report No. 468. The report found that OCIE examiners made critical mistakes in nearly every aspect of their examinations of Madoff and BMIS and missed significant opportunities to uncover Madoff's Ponzi scheme. The report concluded that OCIE examiners did not properly plan or conduct their examinations of Madoff, and because of these failures, were unable to discover Madoff's fraud.

Criteria

Form ADV: Uniform Application for Investment Adviser Registration.

Investment advisers are required to file this Form with the SEC at least annually.

SEC Proposed Rule: Amendments to Form ADV, Release No. 34-57419, 73 FR 13958, March 14, 2008. Proposes requiring investment advisers registered with the SEC to deliver to clients and prospective clients a brochure written in plain English and to file electronically Part II of Form ADV with the SEC.

SEC Rule 204-1: 17 C.F.R. §275.204-1. Requires investment advisers to update Form ADV on an annual basis and as warranted, in accordance with instructions to Form ADV.

List of Recommendations

Recommendation 1:

The Office of Compliance Inspections and Examinations (OCIE) should implement a procedure requiring, as part its process for creating a risk rating for an investment adviser, that OCIE staff perform a search of Commission databases containing information about past examinations, investigations, and filings related to the investment adviser.

Recommendation 2:

The Office of Compliance Inspections and Examinations (OCIE) should change the risk rating of an investment adviser based on pertinent information garnered from all Divisions and Offices of the Commission, including information from OCIE examinations and Enforcement investigations, regardless of whether the information was learned during an examination conducted to look specifically at a firm's investment advisory business.

Recommendation 3:

The Division of Enforcement and the Office of Compliance Inspections and Examinations should establish and adhere to a joint protocol providing for the sharing of all pertinent information (e.g., securities laws violations, disciplinary history, tips, complaints and referrals) identified during the course of an investigation or examination or otherwise.

Recommendation 4:

The Office of Compliance Inspections and Examinations (OCIE) should establish a procedure to thoroughly evaluate negative information that it receives about an investment adviser and use this information to determine when it is appropriate to conduct a cause examination of an investment adviser. OCIE should ensure its procedure provides for timely opening of a cause examination.

Recommendation 5:

When the Office of Compliance Inspections and Examinations (OCIE) becomes aware of negative information pertaining to an investment adviser, OCIE should examine the investment adviser's Form ADV filings and document and investigate discrepancies existing between the adviser's Form ADV and information that OCIE previously learned about the registrant.

Recommendation 6:

The Office of Compliance Inspections and Examinations (OCIE) should establish a procedure to thoroughly evaluate an investment adviser's Form ADVs when OCIE becomes aware of issues or problems with an investment adviser. OCIE should document areas where it believes a Form ADV contains false information and initiate appropriate action, such as commencing a cause examination.

Recommendation 7:

The Office of Compliance Inspections and Examinations (OCIE) should re-evaluate the point scores that it assigns to advisers based on their reported assets under management. OCIE should assign progressively higher risk weightings to firms that have greater assets under management.

Recommendation 8:

The Office of Compliance Inspections and Examinations (OCIE) should re-evaluate the point scores that it assigns to firms based on their reported number of clients to which they provide investment advisory services. OCIE should assign progressively higher risk weightings to investment advisers that serve a larger number of clients.

Recommendation 9:

The Office of Compliance Inspections and Examinations (OCIE) should recommend to the Chairman's office that it institute a Commission rulemaking that would require the following additional information to be reported as part of Form ADV:

- Performance information;
- A fund's service providers, custodians, auditors and administrators, and applicable information about these entities;
- A hedge fund's current auditor and any changes in the auditor; and
- The auditor's opinion of the firm.

Recommendation 10:

The Commission should finalize the proposed rule titled *Amendments to Form ADV* [Release No. IA-2711; 34-57419]. In finalizing this rule, the Commission should consider what, if any, additional information investment advisers should include in Part II of Form ADV by consulting with The Office of Compliance Inspections and Examinations (OCIE) and the Division of Investment Management (IM). Further, the Commission, in consultation with OCIE and IM, should consider provisions that would assist OCIE to efficiently and effectively review and analyze the information in Part II of Form ADV.

Recommendation 11:

The Office of Compliance Inspections and Examinations (OCIE) should develop and adhere to policies and procedures for conducting third party verifications, such that OCIE verifies the existence of assets, custodian statements, and other relevant criteria.

Management Comments

MEMORANDUM

TO: David Kotz
Inspector General, Office of Inspector General

FROM: John Walsh *JHW by RG*
Acting Director, Office of Compliance Inspections and Examinations

RE: Office of Compliance Inspections and Examinations' Response to the Office of Inspector General's Report, *Review of the Commission's Processes for Selecting Investment Advisers and Investment Companies for Examination*

DATE: November 17, 2009

I. Introduction

The Office of Compliance Inspections and Examinations ("OCIE") submits this memorandum in response to the Office of Inspector General's ("OIG") draft report entitled *Review of the Commission's Processes for Selecting Investment Advisers and Investment Companies for Examination* ("Report"). Thank you for the opportunity to respond to the Report.

You have requested that we indicate whether we "concur" or "non-concur" with each recommendation. In no case do we "non-concur." However, several of the recommendations directed to OCIE will require the deployment of significant staff resources or the resolution of antecedent policy issues. In those cases we have indicated that we agree with the principal of the recommendation and describe the steps we will take to follow-up on your recommendation. Otherwise, we state that we "concur" and describe how we intend to implement your recommendation.

II. Recommendations Directed to OCIE

Recommendation 1: *The Office of Compliance Inspections and Examinations (OCIE) should implement a procedure requiring, as part of its process for creating a risk rating for an investment adviser that OCIE staff perform a search of Commission databases containing information about past examinations, investigations, and filings related to the investment adviser.*

OCIE agrees that risk ratings would be enhanced by utilizing information about past examinations, investigations, and filings related to investment advisers. Indeed, collecting and analyzing such information is a standard procedure that examiners follow prior to conducting individual examinations. However, programmatically incorporating all such information from Commission databases into the risk assessment process for thousands of entities (currently more than 11,000) would require a Commission-wide data warehousing effort so that the names of entities, individuals, and so on could be accurately linked and associated. OCIE does not currently possess the resources necessary to gather this information through manual research. We understand that such a Virtual Data Warehouse is among the agency's information technology priorities. We look forward to deployment of the Virtual Data

OCIE's Response to *Review of the Commission's Processes for Selecting Investment Advisers and Investment Companies for Examination*
November 17, 2009

Warehouse and believe it would permit OCIE and the Office of Information Technology to begin development of tools that would fulfill this recommendation.

Recommendation 2: *The Office of Compliance Inspections and Examinations (OCIE) should change the risk rating of an investment adviser based on pertinent information garnered from all Divisions and Offices of the Commission, including information from OCIE examinations and Enforcement investigations, regardless of whether the information was learned during an examination conducted to look specifically at a firm's investment advisory business.*

OCIE agrees that the risk profile of an investment adviser should be subject to change based on information garnered from all Divisions and Offices of the Commission. Indeed, examiners currently have the ability to change an adviser's risk rating based on information that has come to their attention from any source. As noted above, however, in response to Recommendation 1, programmatically obtaining such information for use in the risk ratings of thousands of entities (currently more than 11,000) would require the antecedent development of a Commission-wide data warehousing effort. We look forward to deployment of the Virtual Data Warehouse and believe it would permit OCIE and the Office of Information Technology to begin development of tools that would implement this recommendation.

Recommendation 3: *The Division of Enforcement and the Office of Compliance Inspections and Examinations should establish and adhere to a memorandum of understanding providing for the sharing of all pertinent information (e.g., securities laws violations, disciplinary history, tips, complaints and referrals) identified during the course of an investigation or examination or otherwise.*

OCIE agrees that staff in the Division of Enforcement and the Office of Compliance Inspections and Examinations should share information identified during the course of investigations or examinations or otherwise. Indeed, enforcement staff and examiners regularly share such information. Nonetheless, to enhance this sharing and implement this recommendation, we will work with the Division of Enforcement to formalize this process of sharing.

Recommendation 4: *The Office of Compliance Inspections and Examinations (OCIE) should establish a procedure to thoroughly evaluate negative information that it receives about an investment adviser and use this information to determine when it is appropriate to conduct a cause examination of an investment adviser. OCIE should ensure its procedure provides for timely opening of a cause examination.*

OCIE agrees that material negative information about investment advisers should be thoroughly evaluated and used to determine whether a cause examination is appropriate. We note that the SEC examination program frequently initiates cause examinations of investment advisers based on negative information. The Commission's current initiative to centralize the handling of tips, complaints and referrals should permit the staff to better assess all incoming information. We look forward to deployment of the agency's new tips, complaints, and referral system and believe it will implement this recommendation.

OCIE's Response to Review of the Commission's Processes for Selecting Investment Advisers and Investment Companies for Examination
November 17, 2009

Recommendation 5: *When the Office of Compliance Inspections and Examinations (OCIE) becomes aware of negative information pertaining to an investment adviser, OCIE should examine the investment adviser's Form ADV filings and document and investigate discrepancies existing between the adviser's Form ADV and information that OCIE previously learned about the registrant.*

OCIE agrees that when it becomes aware of material negative information about an adviser, it should examine the adviser's Form ADV in light of the negative information. Indeed, this process is a regular part of investment adviser examinations. Moreover, the Commission's current initiative to centralize the handling of tips, complaints and referrals should permit the staff to better assess all incoming information material negative information. We look forward to deployment of the agency's new tips, complaints, and referral system and believe it will implement this recommendation.

Recommendation 6: *The Office of Compliance Inspections and Examinations (OCIE) should establish a procedure to thoroughly evaluate an investment adviser's Form ADVs when OCIE becomes aware of issues or problems with an investment adviser. OCIE should document areas where it believes a Form ADV contains false information and initiate appropriate action, such as commencing a cause examination.*

Please see our response to recommendation 5.

Recommendation 7: *The Office of Compliance Inspections and Examinations (OCIE) should reevaluate the point scores that it assigns to advisers based on their reported assets under management. OCIE should assign progressively higher risk weightings to firms that have greater assets under management.*

OCIE agrees that the possible impact of a compliance problem should be considered in its risk ratings. Indeed, OCIE currently considers this impact through an assessment of advisers' assets under management. We will reevaluate the point scores assigned to firms based on their reported assets under management.

Recommendation 8: *The Office of Compliance Inspections and Examinations (OCIE) should reevaluate the point scores that it assigns to firms based on their reported number of clients to which they provide investment advisory services. OCIE should assign progressively higher risk weightings to investment advisers that serve a larger number of clients.*

OCIE agrees that the possible impact of a compliance problem should be considered in its risk ratings. Indeed, OCIE currently considers this impact through an assessment of advisers' assets under management. We will reevaluate the point scores assigned to firms based on their reported number of clients.

Recommendation 9: *The Office of Compliance Inspections and Examinations (OCIE) should recommend to the Chairman's office that it institute a Commission rulemaking that would require the following additional information to be reported as part of Form ADV:*

OCIE's Response to *Review of the Commission's Processes for Selecting Investment Advisers and Investment Companies for Examination*
November 17, 2009

- *Performance information;*
- *A fund's service providers, custodians, auditors and administrators, and applicable information about these entities;*
- *A hedge fund's current auditor and any changes in the auditor; and*
- *The auditor's opinion of the firm.*

OCIE agrees that additional information would be useful to the examination program. OCIE has identified to the Office of the Chairman and the Division of Investment Management additional information that would assist OCIE in its surveillance and risk assessment efforts, including possible additions to Form ADV. We believe this recommendation has been implemented as to OCIE.

Recommendation 10: *The Commission should finalize the proposed rule titled Amendments to Form ADV [Release No. IA-2711; 34-57419]. In finalizing this rule, the Commission should consider what, if any, additional information investment advisers should include in Part II of Form ADV by consulting with The Office of Compliance Inspections and Examinations (OCIE) and the Division of Investment Management (IM). Further, the Commission, in consultation with the Office of Compliance Inspections and Examinations (OCIE) and Division of Investment Management, should consider provisions that would assist OCIE to efficiently and effectively review and analyze the information in Part II of Form ADV.*

OCIE defers to the Commission in regards to the portion of this recommendation regarding finalization of the proposed rule. OCIE has provided the Division of Investment Management with provisions that would assist OCIE in its surveillance and risk assessment efforts. We believe this recommendation has been implemented as to OCIE.

Recommendation 11: *The Office of Compliance Inspections and Examinations (OCIE) should develop and adhere to policies and procedures for conducting third party verifications, such that OCIE verifies the existence of assets, custodian statements, and other relevant criteria.*

OCIE concurs with this recommendation. OCIE has implemented written procedures for verifying assets with third parties during examinations. OCIE also recently required all examiners to attend training sessions on third-party asset verification techniques and procedures. We believe this recommendation has been implemented.

OIG Response to Management's Comments

The Office of Inspector General (OIG) is pleased that the Office of Compliance Inspections and Examinations (OCIE) agreed with all 11 recommendations in this report. We believe that these recommendations are crucial to ensuring that necessary improvements are made to OCIE's process for selecting investment advisers and investment companies for examination.

As the August 31, 2009 OIG Report entitled "Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme" detailed, the SEC Enforcement Division (Enforcement) concluded its formal investigation into Harry Markopolos' complaint in 2006, finding that Bernard Madoff Investment Securities, LLP (BMIS) acted as an unregistered investment adviser to certain hedge funds, institutions, and high net worth individuals in violation of the registration requirements of the Advisers Act. The Enforcement staff also found that BMIS's largest hedge fund client, Fairfield Greenwich Group, did not adequately disclose to its investors BMIS's advisory role and merely described BMIS as an executing broker to Fairfield Greenwich Group's accounts.

The Enforcement staff closed the examination when BMIS agreed to register with the Commission as an investment adviser. The Enforcement staff stated that BMIS's investment adviser registration was a "good result" because it would expose Madoff and his firm to "extra regulatory scrutiny." They further noted that BMIS's agreement to register as an investment adviser was "a positive development for law enforcement" because BMIS would "be subject to continued on-site inspections." However, despite the accumulated evidence that the SEC had regarding Madoff's misrepresentations and possible fraud, OCIE never conducted an examination of BMIS.

We believe that OCIE should take immediate steps to implement these recommendations. We are encouraged that OCIE is acknowledging that significant improvements must be made with respect to its processes and that it intends to deploy sophisticated technologies to address the issues raised in our report. We strongly encourage OCIE and the Commission to make available the necessary resources to ensure that OCIE is better able to select investment advisers and investment companies for examination and better equipped to conduct comprehensive examinations of these entities. The strength of our capital markets relies on investor confidence, which in turn depends on vigorous regulatory oversight. Investors will only have confidence in our capital markets when they believe that the SEC's oversight is vigorous and competent. Thus, it is critical that OCIE take the necessary steps to improve its operations forthwith.

The OIG plans to follow up to ensure that all 11 recommendations are implemented in full and report back to the Congress on the status of these efforts. We also plan to conduct a follow-up audit to determine whether the changes to OCIE's operations are having the desired and appropriate effect.

Audit Request and Ideas

The Office of Inspector General welcomes your input. If you would like to request an audit in the future or have an audit idea, please contact us at:

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Office of Inspector General
Attn: Assistant Inspector General, Audits (Audit Request/Idea)
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Hotline

To report fraud, waste, abuse, and mismanagement at SEC, contact the Office of Inspector General at:

Phone: 877.442.0854

Web-Based Hotline Complaint Form:
www.reportlineweb.com/sec_oig