

July 1, 2009

Mr. David Kotz  
Inspector General  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C.  
20549

Dear Mr. Kotz:

At the conclusion of my interview on April 17, you invited me to provide additional context or perspective concerning the Madoff matter and the work of the Office of Compliance Inspections and Examinations (OCIE), as well as information concerning the significant changes to examinations that we have implemented. I appreciate that opportunity, and hope that this information is helpful to you.

At the outset, I would like to underscore that SEC examiners are committed to protecting investors -- and to continuing to learn lessons from the Madoff fraud that may improve the examination process and facilitate early detection of fraud in general and ponzi schemes in particular.

As you know, I had very little first-hand information about the 2004 examination of Bernard L. Madoff Securities by OCIE. I had no first-hand information concerning the 2005 examination by examiners in the SEC's New York Office, and no first-hand information concerning the 2006 investigation conducted by the Division of Enforcement. I do have some perspective based in large part on the documents I have seen in recent months, and based on my experience with the SEC.

In terms of my experience, I have been a member of the staff of the SEC for more than twenty-three years, dedicated to attacking fraud and other conduct that can harm investors and to enhancing compliance in the securities industry. I have been the Director of OCIE since it was formed 1995 to provide increased focus on examination oversight of the securities industry. Prior to that, I served as Executive Assistant and Senior Advisor to Chairman Arthur Levitt. Prior to that, I was Associate Regional Administrator for Enforcement in the SEC's Los Angeles office, and held other positions in the SEC's Enforcement Division, where I investigated and brought many securities fraud cases on behalf of the SEC.

**Background: Examinations by the SEC**

As background, the SEC has legal authority to conduct examinations of firms that are registered with the SEC -- investment advisers and broker-dealers, as well as other types of firms. Examinations are conducted by examination staff in Washington, D.C. and in the SEC's regional offices.

Collectively, the SEC examination staff conduct over 2,000 examinations each year. Most examinations detect violations of the securities laws of some type, ranging from minor to very serious. Some discover indications of fraud (including ponzi schemes, overstated investment returns, misuse of client assets, sales of unsuitable investments and other types of fraud of a wide variety). Examinations that find indications of fraud or other serious violations are referred to the Division of Enforcement staff for further investigation. The Division of Enforcement has authority to conduct investigations of possible violations, and to make recommendations to the Commission itself with respect to taking enforcement actions.

Given the large number of firms subject to examination oversight by the SEC and the relatively small number of SEC staff examiners, the SEC does not conduct comprehensive examinations, and it does not examine all firms that are registered with SEC. Examiners generally work on a number of examination matters simultaneously, and seek to prioritize the highest-risk firms and issues that most warrant examination.

### **Examinations of the Madoff Firm**<sup>1</sup>

Bernard L. Madoff Investment Securities LLC was registered as a broker-dealer and operated as an apparently successful market-making firm for many years. OCIE's examinations of the broker-dealer firm over the years found a range of violations related to the market-maker business. Examinations of the Madoff firm's market-making operations generally resulted in deficiency letters noting the violations and requesting corrective actions. One examination of the market maker operation found apparently serious violations of the SEC's trading rules [the limit order display rule], and the examination findings were referred to the SEC's Enforcement Division in 2000.

It appears, however, that Madoff conducted and concealed his fraudulent scheme through his separate, unregistered investment advisory business. The advisory business was not registered with the SEC as an investment adviser until August 2006, and was not examined by the SEC in the time between August 2006, when it registered, and December 2008, when the fraud was revealed. The SEC does not have the resources to conduct routine examinations of all registered investment advisers.<sup>2</sup>

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<sup>1</sup> In light of the ongoing review being performed by your office, the staff in the Office of Compliance Inspections and Examinations has not yet conducted a separate review of these examinations. The information in this letter is derived from my review in recent months of the examination report and other limited documentation and is accurate as far as I am aware. I had very limited involvement in the 2004 examination and no involvement in the 2005 examination. I had no involvement in the 2006 enforcement investigation conducted by Division of Enforcement.

<sup>2</sup> Currently, there are more than 11,000 registered investment advisers and approximately 425 exam staff who examine advisers and mutual funds. In prior years, the SEC staff had sought to examine all newly-registered advisers within a year of their registration. This practice was discontinued in 2003 when the number of advisers registered with the SEC began to increase significantly and exceeded the staff's ability to examine all newly-registered advisory firms. More recently, the examination staff has sought to visit new registrants as time and resources allow.

When it did become registered as an adviser in August 2006, the Madoff firm stated in its registration form filed with the SEC that it had only 23 advisory accounts, primarily pooled investment vehicles (e.g., hedge funds). Based on the information contained in its registration form relative to the population of thousands of registered advisers, the firm was not subjected to a routine examination in this period of time.<sup>3</sup> This is important because, while it cannot be known with certainty, this type of routine investment adviser examination could have revealed the fraud. For example, a routine investment adviser examination generally includes a review of the firm's investment returns, how those returns were calculated, the firm's custodial arrangements and controls, its communications with clients, its trade records, and other areas. This type of routine investment adviser examination is broader than the review performed as part of the limited-scope "cause" examinations conducted in 2004 and 2005, which are described below.

In 2004 and 2005, the OCIE staff in Washington, D.C. and in New York conducted two examinations of the Madoff broker-dealer. In both examinations, examiners sought information concerning the firm's trading activities for hedge funds. It now appears likely that the documentation and information provided to examiners was falsified or fabricated.

These examinations were limited in their scope, and both were apparently triggered by allegations made in press reports and in other communications that Madoff was "front-running" – or trading for his hedge fund clients in advance of and with knowledge of large trades that the broker-dealer firm was executing as a market-maker for customer orders.

The records from these examinations that I have seen in recent months indicate that the examiners who conducted them were highly skeptical and suspicious of Madoff and his returns and that they were focused on the possibility that he was generating returns by front-running his market-making trades. The scenario suspected by examiners was that Madoff would receive a large customer order to purchase a stock, and before executing it, would first purchase the stock for his hedge fund accounts. The suspected scenario was that, when he then executed the large purchase order for the market-making accounts, the price of the stock would increase, thus benefiting his hedge fund accounts, and disadvantaging his market making customers. This is a form of fraud, and it is illegal.

Records from the examinations also indicate that both of these examinations were "cause" examinations – they were initiated by allegations or concerns about specific wrong-doing (in this instance, front-running). As such, they focused on the discrete issue of concern, and they did not include a broader-scope review of other aspects of the Madoff firm operations.

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<sup>3</sup> Given resource limitations, ten percent of registered advisers are examined routinely (every three years). Others may be examined for cause, randomly or as part of a sweep.

It appears from the records of the examinations that, when it was in a relatively early stage, the 2004 examination by the Washington, D.C. staff was combined with an examination that was being conducted by the New York Regional Office in 2005. As background, in this time period, OCIE's Office of Market Oversight, a group of about 20 staff, were juggling many examination matters (including the Madoff exam).<sup>4</sup> In early 2004, OCIE made it a priority to examine mutual funds' undisclosed payments to broker-dealers. This priority status followed an examination sweep concluded in late 2003 that had revealed that 15 broker-dealer firms had received payments from mutual fund companies in exchange for recommending those funds to their retail customers. Those examinations found that the broker-dealers had not disclosed these payments, and that the payments may have violated antifraud provisions of the securities laws. As a result, in early 2004, working collaboratively with Enforcement and other agency staff, the Office of Market Oversight initiated an examination sweep of mutual fund companies to determine how the payments were made, whether they diminished shareholder returns, and whether they were disclosed to the funds' shareholders and to their boards of directors. This was a large exam sweep (45 mutual fund companies) and approximately 16 staff examination staff, including the two staff examiners on the Madoff exam, were assigned from other examinations or asked to prioritize the mutual fund examinations in order to complete the examination sweep in a timely way.<sup>5</sup> It appears that records and other information from the 2004 examination of the Madoff firm were ultimately provided to the New York office in connection with its then-ongoing examination, and the New York office continued to focus on the issues raised by the Washington, D.C. staff.

It appears from the records of the 2005 examination conducted by the New York staff that examiners obtained and reviewed records of the firm including trade information, customer account statements, and a sample of firm employee emails. Among other things, the firm represented that 16 entities, primarily hedge funds, had allocated money to Madoff's trading strategy, and that all trade orders were executed in foreign markets by foreign brokerage firms. As noted above, it appears now that information provided to examiners during this examination was likely falsified or fabricated, including with respect to the firm's business, the number and type of clients, and its trading activities.

It appears from the records of the 2005 examination that the documents provided by the firm were reviewed for indications of possible front-running. Examiners did not find indications or evidence of front-running as had been alleged and suspected, though the examination ultimately found several violations relating to the firm's execution of

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<sup>4</sup> This examination group was also conducting examinations of exchange specialists for possible trading abuses, of broker-dealers' execution of customer orders and order routing practices for best execution, as well as inspections of the surveillance practices of the markets and stock exchanges.

<sup>5</sup> This examination sweep ultimately resulted in enforcement actions being brought by the Commission, disgorgement, reimbursements to affected mutual funds and/or other relief.

customer orders as a market maker. The examination concluded with a deficiency letter sent to the firm requiring corrective action of those violations in September 2005.<sup>6</sup> After the conclusion of the 2005 examination, it appears that Mr. Markopolos was in contact with the SEC staff with the allegations that Madoff was engaged either in front-running or a ponzi scheme that then gave rise to an Enforcement investigation in early 2006.

Since the Madoff fraud was revealed, the staff has made numerous changes to the examination process designed to facilitate the detection of fraud and to improve the oversight, efficiency and timeliness of examinations.

### **Changes to Examination Process**

Significant enhancements have been made to the examination process since the Madoff fraud was revealed in December 2008. These changes are designed to facilitate the detection of fraud of the type perpetrated by Madoff, as well as to improve the oversight, efficiency and timeliness of examinations. They include: enhanced training for examiners in fraud detection; enhancing examiners' expertise in complex financial products, trading and other areas; conducting examinations on firms with higher potential fraud profiles; providing improved tools to examiners to detect and investigate signs of fraud; improving surveillance and risk-based targeting; improving the handling of tips and complaints (an SEC-wide project); and enhancements to internal controls with respect to planning, conducting, documenting and concluding examinations. These changes are described below.

#### ***1. Enhanced Training for Examiners in Fraud Detection***

- **Joint Regulatory Training on Fraud Detection:** In August 2009, the SEC, FINRA and NASAA will sponsor a joint training program for examiners on strategies to detect and investigate indications of fraud of various types, including Ponzi schemes, offering frauds, manipulations and other types of fraud. Speakers will include experienced examiners and investigators, criminal investigators from the FBI, private consultants that conduct due diligence, and others.
- **Special Training in Basics and Exam Strategies Regarding Ponzi Schemes:** In March, OCIE's Training Branch held a special training for examiners on exam techniques and strategies to identify and investigate ponzi schemes, affinity frauds and related schemes.

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<sup>6</sup> As described in this letter, among the changes made to examinations post-Madoff is a more routine process for obtaining verification with independent third-party custodians and with advisory clients that assets exist as represented by the firm (even in situations where a ponzi scheme or other fraud is not suspected), as well as contacts with the firm's independent audit firm to understand the nature of its audit steps in this regard. In addition, in light of the Madoff fraud, the Commission proposed new rules that would require all advisers with custody of client assets to undergo an annual surprise verification of client assets by an independent accountant (this proposed rule is also described in this letter).

- **Certified Fraud Examiner Training:** More than 300 exam staff have signed up for training to become *Certified Fraud Examiners* (in addition to other privately-provided certifications, such as the *Chartered Alternative Investment Analyst*, *Certified Public Accountant*, *Certified Financial Planner*, *Chartered Financial Analyst*, and other certifications).

**2. *Enhanced Examiner Expertise in Complex Financial Products, Trading and Other Areas***

- **Recruiting Staff with Specialized Industry Experience:** *Senior Specialized Examiner* positions were recently created to bring and maintain specialized experience to the examination program, including, e.g., in trading, operations, portfolio management, options, compliance, valuation, new instruments and portfolio strategies, and forensic accounting. *Senior Specialized Examiners* will conduct examinations in the field and serve as a resource for other exam staff on issues within their experience.
- **Focused Training and Expertise:** Examiners will be provided with training and expertise in particular key areas – such as, for example, options, derivatives, trading, anti-money laundering, and financial and net capital issues. Examiner training was also increased to enable exams of firms that are registered as both broker-dealers and investment advisers -- so that issues that that overarch registrant “lines” are effectively examined.

**3. *Focused Examinations on Firms with Higher Potential Fraud Profiles***

Examination Material, Deliberative Process



**4. *Improved Tools for Examiners in Detecting Fraud and Leveraging the Work Performed by the Firm’s Independent Auditor***

- **Improved Standard Pre-Exam Work Methodology:** Pre-exam steps include more thorough research and due diligence of registrants, their affiliates, and related persons prior to fieldwork for all examinations, regardless of scope or exam-type. The objective is to obtain a better understanding of the firm’s business before examiners arrive, and to better utilize resources on-site.
- **New Fraud Module:** This module provides guidance for examiners in identifying red and yellow flags of fraud and strategies for additional

investigation. Examples of “red” and “yellow” flags highlighted include, for example: lack of separation of duties/dominant control person; self-custody or use of affiliates for custody/power of attorney over client accounts; aberrational performance claims; lack of independent audit, audit by obscure firm; dire financial condition of firm or principal; aggressive self-promotions; poor controls over outside business activities; unusual activity in error or inter-company accounts; and others.

- **Asset Verification:** To a greater extent, examinations include a routine verification with independent third-party custodians and with advisory clients that assets exist as represented by the firm (even in situations where a ponzi scheme or other fraud is not suspected), as well as contacts with the firm’s independent audit firm to understand the nature of its audit steps in this regard.
- **Examinations of the Entire Entity:** The staff is expanding exams of joint or dual registrants to assure that examiners have “eyes on” all activities, particularly advisers that use an affiliated broker-dealer for custody of advisory clients’ assets. Also, there is increased training for examiners to better facilitate exams of firms that are registered as both broker-dealers and investment advisers.

#### 5. *Improved Surveillance and Risk-Based Targeting*

- **Developing a Surveillance Program.** Oversight could be strengthened if on-site examinations were coupled with off-site monitoring and surveillance – to allow SEC staff to better identify and focus attention on those firms and issues presenting the most risk that warrant follow-up. OCIE and other agency staff (in the Office of Risk Assessment and in other offices and divisions) and FINRA are working to identify the key data points and technology that would facilitate an improved risk-based oversight methodology. In addition, the SEC is seeking funding for additional investments in its information systems to mine data from examinations, investigations, filings, tips, and to link it together, and combine it with data sources from outside the SEC to help determine which firms or practices raise red flags and deserve a closer look.

#### 6. *Improved Handling of Tips and Complaints*

- **New System for Handling Tips and Complaints.** The SEC receives over 700,000 tips and complaints each year. In February, the SEC retained the Center for Enterprise Modernization (a federally-funded research and development center) which began work immediately on a comprehensive review of internal procedures to evaluate tips, complaints, and referrals. The SEC is creating a system that will centralize this information so we can track it, analyze it and more effectively identify valuable leads for investigations or examinations.

## 7. Improved Oversight, Efficiency and Timeliness

- **New Policies, Procedures, Guidelines Implemented:** In 2007, the Office of Market Oversight implemented new controls to improve the timeliness of its work, and to assure greater controls in planning, conducting, documenting and concluding examinations (described in a June 5, 2009 memo from OCIE's Chief Counsel to you). Among other things, these enhancements were intended to reduce delay in examinations, to improve the documentation of work performed, and the supervisory oversight of the progress of the examination.

### New Rules for Advisers With Custody of Client Assets

In light of the Madoff fraud, on May 14, the Commission proposed new rules under the Advisers Act to improve the safekeeping of advisory client assets. (<http://www.sec.gov/rules/proposed/2009/ia-2876.pdf>).

Specifically, *all* registered investment advisers with custody of client assets would be required to engage an independent public accountant to conduct an annual surprise examination to verify client funds and securities. This surprise verification would seek to verify whether the assets held by advisers as represented to clients exist, and are actually held.

In addition, unless client accounts are maintained by an *independent* qualified custodian (*i.e.*, a custodian other than the adviser or a related person), the adviser would be required to obtain a written report from an independent public accountant that includes an opinion regarding the qualified custodian's controls relating to custody of client assets. This would help ensure that an adviser that uses an affiliate for custody (like Madoff did) has strong controls for the safekeeping of those funds and securities.

These rules would also provide the SEC staff with better information about the custodial practices of registered investment advisers (*i.e.*, the identity of the accounting firm, and the results of the surprise verification). This information would be very useful in risk assessment and in targeting advisers for examination.

The Commission stated that this new rule proposal is part of a comprehensive review of the rules regarding the safekeeping of investor assets to determine changes that the Commission could make to decrease the likelihood that client assets could be misused, or increase the likelihood that fraudulent activities would be discovered earlier and client losses could be thereby reduced.

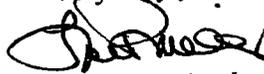
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Thank you very much for the opportunity to provide this information about examinations and the Madoff firm, as well as information concerning the significant improvements to the examination process to facilitate the detection of fraud and to improve the oversight,

efficiency and timeliness of examinations, and the Commission's proposed new rules to improve the safekeeping of advisory client assets. I am also gratified to understand through Bill Taylor that you found no question concerning my ethics or integrity.

I would like to underscore again that the SEC's examiners are committed to protecting investors, and to continuing to learn lessons from the Madoff fraud that may improve the exam process to facilitate the detection of fraud and other abuses for the protection of investors.

Very truly yours,

A handwritten signature in black ink, appearing to read "Lori A. Richards", written over a horizontal line.

Lori A. Richards