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*1st Session*

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MEETING ON

# ASSESSING THE MADOFF PONZI SCHEME AND THE NEED FOR REGULATORY REFORM

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

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# ASSESSING THE MADOFF PONZI SCHEME AND THE NEED FOR REGULATORY REFORM

**Monday, January 5, 2009**

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
*Washington, D.C.*

The committee met, pursuant to notice, at 2:08 p.m., in room 2128, Rayburn House Office Building, Hon. Paul Kanjorski presiding.

Members present: Representatives Frank, Kanjorski, Maloney, Watt, Ackerman, Sherman, Meeks, Capuano, Hinojosa, McCarthy of New York, Lynch, Miller of North Carolina, Scott, Green, Cleaver, Hodes, Klein, Perlmutter, Donnelly, Foster, Speier, Childers; Bachus, King, Paul, Manzullo, Biggert, Capito, Hensarling, Garrett, Neugebauer, McCarthy of California, and Heller.

Mr. KANJORSKI. [presiding]. The committee will come to order. Without objection, the rules of the House and of the Committee on Financial Services for the 110th Congress will apply to today's proceeding. The committee is meeting today to discuss assessing the Madoff Ponzi scheme and the need for regulatory reform. Without objection, all members' opening statements will be made a part of the record.

Mr. BACHUS. Mr. Chairman, reserving the right to object, I do not intend to object. And I am glad you raised the issue of process because the 110th Congress has officially concluded and the new Congress will not be sworn in until tomorrow. Today's proceeding is being held in what I would call a parliamentary grey area because the Financial Services Committee as a technical matter does not exist. Any record of today's proceedings will not count as an official record of the committee. And while all of us want to get to the bottom of the Madoff scandal as quickly as possible—and I commend the chairman for calling for this hearing.

In fact, immediately following the stories breaking about it, I asked Chairman Frank to hold a hearing as soon as possible after the 111th Congress convened. And we all also want to follow regular order if at all possible and operate in a way that does not cast doubt on the legitimacy of our proceedings. For that reason, I wish we had waited until after tomorrow's swearing-in of the new Congress and for the formal organization of the committee to hold this hearing.

But having said that, I don't object to conducting today's proceeding as if it is an official hearing of the committee, and I therefore withdraw my objection to the committee's unanimous consent request.

The CHAIRMAN. Mr. Chairman, I reserve the right to object, although if—I am not sure of the procedure, given what the gentleman said. Reserving the right to object would appear to be in a positive sense with just a bunch of guys talking, and women. But I am glad we are because that is important.

First of all, I don't see any possible harm that could come from having this meeting. I don't see even the suggestion of procedural irregularity. The gentleman said regular order. We are a group of members, we are voluntarily members. Those who don't want to participate can leave. He says that the record will have no formal role. Frankly, I haven't seen that it has had yet, even though we have hearings. I am not sure what it would be unless you were trying to prosecute someone for perjury, and we have never sworn people in during the chairmanship here.

The other thing I would say is this, as the gentleman said, wait, here is the real point I wanted to make. In January of 2007, we were not officially constituted as a committee with our new members until January 31st; that is, we would not have overcome the obstacle the gentleman raised to it being the regular committee if we had waited until tomorrow or the day after because the swearing-in of the members does not constitute the committee under the rules of the House. We don't yet know who the new members will be on our side. I am not sure—I am told on the Republican side they may not pick their new members until next week. So I want to say this was the initiative of the gentleman from Pennsylvania who was chairman of the Capital Markets Subcommittee in the last Congress, and I will go on and predict will be chairman of that subcommittee in the next Congress, although I acknowledge that is an open question.

I don't want to prejudice things, but I think he is well in the lead now for that job. And if we had not done it today at his initiative, we would not have been able to do it for several weeks, possibly, to meet that requirement. So for that reason, I just wanted to say that I think what the gentleman from Pennsylvania did was very appropriate, and nothing here will prevent us from reconvening at a later time or convening as the official committee for whatever we want to do.

Mr. WATT. Would the gentleman yield on his—

The CHAIRMAN. Yes.

Mr. WATT. I would just observe that everybody else here is overdressed for this occasion. It is obvious that I thought it was less than formal, so—

The CHAIRMAN. Taking back my time, could I get a testimony from the gentleman, in writing, that I showed up overdressed?

Mr. WATT. I think I would ask unanimous consent that we recognize that.

The CHAIRMAN. I thank the gentleman and I withdraw my reservation.

Mr. BACHUS. Yes. Mr. Chairman, I would like unanimous consent to introduce my letter of December 17th calling for a hearing, not a meeting. But having said that, I think the meeting is great.

Mr. KANJORSKI. Without objection, it will be entered into the record.

But a little note on the gentleman from Alabama's question. It is the intent of the Chair that, as soon as our committees are constituted, to make the appropriate motions to incorporate by reference this meeting today to make it have the full force and effect of a committee hearing. I think that is possible under the rules. So we were aware of the fact, but quite frankly and in all honesty, I was hoping we didn't lose the time, that there seems to be a great deal of information that could be gained now and a lot of insight if we start very early. That is why we took these unusual steps.

I think we are also proving to the American people that the Congress has the capacity to work even when we are not officially constituted as a body or as a committee.

Mr. BACHUS. Thank you. Mr. Chairman, all I was pointing out is that technically, the hearing is just not a hearing.

Mr. KANJORSKI. It will be in the future.

Mr. BACHUS. And I commend the chairman for calling this meeting.

Mr. KANJORSKI. Thank you. We meet today to begin to understand how Bernard Madoff allegedly swindled thousands of innocent investors, effectively stole billions of dollars and evaded securities regulators already tipped off about this unprecedented alleged Ponzi scheme.

The allegations that Mr. Madoff stands at the center of a $50 billion scam simply shocked the conscience. These deeply disturbing events have raised even more troubling questions about the effectiveness of our regulatory system. I have long stressed a need for pursuing comprehensive regulatory reform and I have convened hearings to advance these initiatives in the past. But before we act on legislation in the 111th Congress to restructure the regulatory system for the financial services industry and enhance investor protection, we need to understand how Mr. Madoff organized his many business operations and how he perpetrated his alleged fraudulent acts.

Today, we will hear from experts in the financial world, including the Inspector General, the head of the Securities Investor Protection Corporation, and academics. They will help Congress begin to unravel this tangled web. We will also hear from a Madoff victim to help us all understand the dire implications this ruse has had for individual investors, charitable organizations, and pension funds.

This meeting to discuss the Madoff affair will also be the first of several public proceedings. At future hearings, we will hear from senior officials of the Securities Exchange Commission and from Harry Markopolos, who has asked us to temporarily postpone his testimony so that he can better prepare for our questions.

We will need to hear from other financial services regulators as well. We also need to hear from auditors and their overseers to this elaborate Ponzi scheme that fell through the cracks of our regulatory system. From what we have all learned in the press, it now appears that regulators should have detected the Madoff wrongdoing earlier because of red flags raised by others. Authorities received information about potential problems when outsiders like Mr. Markopolos could not create a model that matched the results of Mr. Madoff's purported strategy. Others published articles as

early as 2001 raising questions about Mr. Madoff's firm. Other red flags included unrealistically steady investment returns and an auditor the size of a mouse examining a fund the size of an elephant.

Perhaps most shocking, after Mr. Madoff misled government examiners and after he was then forced to register as an investment adviser, the Commission did not conduct any subsequent inspections. Moreover, in its prior examinations, the Commission failed to effectively use its subpoena powers to obtain any records other than those voluntarily offered.

In the wake of this unprecedented financial crisis, we now know that our securities regulators have not only missed opportunities to protect investors from massive losses from the most complex financial instruments like derivatives, but they have also missed the chance to protect them against the simplest of schemes, the Ponzi scheme. Clearly, our regulatory system has failed miserably and we must rebuild it now.

As we resurrect our regulatory structure we must ensure that regulators have the resources they need to get the job done. A former Chairman of the Commission, Arthur Levitt, has noted that the agency's enforcement unit is chronically understaffed. Whereas it had 433 people in the Office of Compliance and Examinations, looking at 8,000 advisers 2 years ago, today it has 400 people looking at 11,000 advisers and thousands of mutual funds. Moreover, the number of investment advisers subject to the Commission's oversight has doubled since 1997.

While we do not know if the Commission's oversight in this case can be blamed on a lack of resources, we can certainly work to make sure adequate staff and powers are available in the future.

As an adjunct to that comment, may I point out—and this is done for the purposes of our recognition—that sometimes our overzealousness has caused us a major problem. And that overzealousness was caused in 2001 when this committee entertained legislation and adopted that legislation at the committee level, sent it to the House and passed it, where we cut appropriations and fees paid to the Commission over 10 years of $14 billion when it was said by the Majority at that time that these funds were not necessary, that there was sufficient staffing at the Securities and Exchange Commission and now we see that is not the case.

I point that out not from a blame standpoint or a political standpoint, but I point it out that all of us better check our memories and remember what we did these last 10, 12 or 15 years and how this committee, perhaps even the Congress, but certainly some people who are responsible for oversight and control, perhaps missed the boat in this situation. I hope we don't do that again and that is the reason I want us to consider that.

We must also take action to better protect all investors, from elderly widows to sophisticated market participants. There are many ideas on how we can accomplish this objective. The Congress will review these options. In the Madoff case, legal authorities will be tasked with finding a way to help the aggrieved investors.

Finally, it is important to note that this is a real crisis with real victims. I for one was saddened to learn of a gentleman who, because he lost the money of his family and his clients in the Madoff

financial scandal, took his own life. Life is always more precious than money. I therefore hope we will see no more tragic fallouts from this messy sort of affair.

In closing I thank our witnesses and my colleagues for joining me here today. Together, I hope that we can learn from this terrible event, figure out how we can improve our regulatory structure and undertake the most substantial rewrite of the laws governing the U.S. financial markets since the Great Depression.

The gentleman from Alabama is recognized for 5 minutes.

Mr. BACHUS. I thank the chairman for convening this meeting to begin the committee's examination of an alleged $50 billion Ponzi scheme perpetrated by Bernard Madoff. The Ponzi scheme designation in connection with his activities is not a recent coinage. It was first used by Harry Markopolos some 10 years ago in a complaint to the SEC. And it would have only taken one staffer pursuing that claim to have uncovered quite a lot of fraud.

Let me respond to one thing that the chairman said and that is about a reduction of money for the SEC. There was no reduction of money for the SEC. That money had been diverted by the Appropriations Committee to the general fund. So the money was not getting to the SEC. It didn't get to the SEC before that action. In fact, the year after that action, the SEC received greater funding than they did the year before that action.

So this is not a question of funding. One thing we do know about the Madoff affair and one agreement that I have with the chairman and the chairman of the full committee is that the Madoff affair is yet another indication that what is needed is a statutory and regulatory structure for the 21st Century. We don't have that. If we had that in place, I think we may not have been having this hearing today. And I hope this hearing will not only be about the Madoff affair, but it will also be about a new regulatory structure.

As we learned earlier this decade when the Enron episode was followed in short order by WorldCom and other corporate scandals, events like Mr. Madoff's scam do not typically occur in isolation. More recently, the troubles at Bear Stearns were indicative of similar troubles at other investment banks. We were told it was a one-firm event. It obviously wasn't, and there is no reason to think that this time is different. It seldom is, and therefore there is every reason to believe that other cases of fraudulent investment schemes may exist.

At a time when the government is trying to stabilize markets, the Madoff affair and concern that other similar frauds lurk over the horizon or under the surface threaten to further undermine investor confidence. It is for that reason that I wrote Chairman Frank 4 days after the scandal broke to request that the committee convene hearings early in the 111th Congress to examine the effectiveness of government in self-regulatory efforts to protect investors and police fraud. And every day brings more news of devastating impact of the Madoff affair on charities, private foundations, and government entities as well as individual and corporate investors.

Although every detail about the Madoff scandal has yet to emerge, enough is known at this time to conclude that the factor that allowed his alleged fraud to continue as long as it did was the differential regulatory treatment of broker-dealers and investment

advisers. The Financial Industry Regulatory Authority, FINRA, inspected Madoff's broker-dealer which supported his market making and proprietary trading operations at least every other year beginning in 1989. But because FINRA's jurisdiction is limited to broker-dealers, it had no authority to inspect his affiliated investor adviser, and that shop is where the fraud was perpetrated and operated from. And while the SEC has authority to inspect investment advisers it typically inspects only a small percentage of the 11,000 federally registered firms in any given year. In fact, Mr. Madoff's firm was never subjected to such an examination. And that is despite the fact that Mr. Markopolos had in some detail described to the SEC the operation as a Ponzi scheme.

And in the Blueprint for Regulatory Reform issued last March, the Treasury Department highlighted, "The rapid and continued convergence of the services provided by broker-dealers and investment advisers and the resulting regulatory confusion due to a statutory regime reflecting the brokerage and investment advisory industries of long ago"—and they asked for change in statutory changes from this committee and from others.

Independent studies have reinforced this conclusion, finding that many investors simply cannot distinguish between the obligations and responsibilities of brokers, investment advisers, financial planners, financial advisers or consultants.

As part of its consideration of reforms to our financial regulatory structure, this committee should examine whether the Madoff scandal argues for harmonizing the regulation of broker-dealers and investment advisers so that schemes such as the Madoff scheme do not go undiscovered, and are limited in their scope, before causing such catastrophic consequences. All parties must commit to making every good-faith effort to see that this alleged fraud of epic proportions is not repeated.

Chairman Cox should be commended for immediately commissioning an investigation into the SEC's handling of this matter. And we look forward to hearing today from the Inspector General who is conducting that probe. One of the Inspector General's tasks will to be assess the performance of the SEC's Office of Compliance, Inspections and Examinations, which appears to have missed several red flags that might have led to earlier detection of the alleged fraud.

The fact that the accounting firm responsible for auditing Madoff's $50 billion enterprise of complex trading activities was a three-person shop operating out of a suburban New York storefront should have been one very large red flag.

Let me conclude, Mr. Chairman, with a word of caution. While the failures of regulatory and private sector due diligence exposed by the Madoff matter are obvious, they do not lead me to conclude at this stage of the inquiry that what is needed are broad new legislative or regulatory mandates on the rest of the securities industry. What we may have in the Madoff case is not necessarily a lack of enforcement and oversight tool, but a failure to use them. What we certainly have is yet another indication, as I said in my earlier statement, that what is needed is a statutory and regulatory structure for the 21st Century, one that the Minority has urged for 2 years now.

I thank our witnesses for being here today. We look forward to your testimony.

Mr. KANJORSKI. Thank you very much. Now, we will hear from the chairman of the full committee, Mr. Frank of Massachusetts.

The CHAIRMAN. Thank you, Mr. Chairman-to-be. I would note that since we are into procedural regularity here, I have in fact been selected by the Democratic Caucus as the chairman of the committee, even though I will concede that I do not at this point technically have a committee to chair, but I anticipate one very soon in the regular order.

First, I want to elaborate on the position of Harry Markopolos, who appears to be the hero in this, who is a man who early on notified the Boston office of the Securities and Exchange Commission of the problem. And maybe with a little provincial pride on behalf of my fellow New Englanders on the panel, I will note that Mr. Markopolos reports that the Boston office responded appropriately, that they took him seriously and forwarded it on, and at some point later on there was a failure.

I also want to say, because I have spoken to people who are in the enforcement division of the SEC in the Boston office and elsewhere, no one should infer from this terrible situation that the working personnel at the SEC were at fault. There is no suggestion that any of them were less than diligent. There were some structural flaws here, but in my experience it would not be appropriate to blame any of them. And we will be talking further about the funding situation.

I will note that in 2003, when I became the ranking member on the Minority side of the full committee, we had just passed, and President Bush had signed into law, the Sarbanes-Oxley bill which came out of this committee under the chairmanship of Mr. Oxley, and we felt there wasn't adequate funding for it. And we had, frankly, some partisan fights on the Floor in 2003 and 2004 in which several of us tried to add funding for SEC enforcement. We were defeated a couple of times.

Finally, I believe in 2005—Mr. Wolf was then the chairman of the appropriations subcommittee with jurisdiction here—agreed. So there was then a further move up. I also just want to note that we invited, of course, Mr. Markopolos to be here, and he had originally said he was going to do it. And I will frankly say that I was pleased that he indicated that he thought coming to this committee to have these conversations was a useful way to advance his interest, that he felt that we would be a hospitable and useful forum for the conversations. And as my two colleagues have mentioned, our focus here is not so much to find out who is to blame for what happened—there will be other institutions of the government that will do that. Our main job is to do what we can to see that this doesn't happen again.

We are a legislative body and our goal will be in part to see whether the mistakes—and you have to look at why it happened to be able to prevent it from repetition. But that is what we are working on. But Mr. Markopolos did write back and say, first of all, that he is understandably physically a little bit worn down. We will release his letter. He has been through a great deal of stress.

He also has been talking to lawyers and this is a very complex subject, and he asked for more time to prepare. Actually, the staff of the gentleman from Pennsylvania did respond to him to assure him that we would be completely cooperative in meeting these conditions.

As I read Mr. Markopolos' letter and our conversations, he will be testifying. And I want to make that clear. This is not a refusal to testify. But on a subject of this importance, he wants to make sure that he is in good condition himself and that he has been able to do the appropriate amount of preparation.

Finally, I will say that there had been arguments previously in our public policy that investor protection could be confined to people of lower income, not directly relevant, but analogous. When we talked about hedge funds for example, the main defense we have had in place legally regarding hedge funds has been the requirement that you had to have at least $1 million to invest to be eligible to invest in hedge funds. That was an SEC rule. Mr. Cox explained that. The theory was for others, the principal caveat investor could apply if people had more than a million dollars. What we have seen here and we saw it also—sadly, although not in nearly as negative an impact in the auction rates securities market, that it is not simply people who have less than $1 million to invest who need to have rules put in place by the government that ensure fairness. Investors are at risk and they have to make judgments about what is or isn't a good idea. But it is not reasonable to expect them in every individual case to be the detectors of fraud.

So there is a requirement, I believe, if the system is to work, for the government to act. And I will just add, finally, this Madoff situation is an example of why regulation done properly is very pro-market. The Madoff damage inflicted on so many innocent people, and in turn on many of the causes that many of these innocent people who were very charitable tried to help out—clearly we have people who are worried about investing anywhere. This country will not work if we are not able to restore the confidence of investors, that there are places that they can put their money that will be both remunerative to them and productive to the society, allowing the money to be put in productive places. So this is one more example of why we need to adopt in this coming Congress a set of rules that will give investors in America the confidence that many of them have lost, unfortunately, because of these scandals, and which has to be restored if we are to have a return to the prosperity that the market functioning well can give us.

Mr. KANJORSKI. I now recognize the gentleman from Texas for 2 minutes, Mr. Paul.

Dr. PAUL. Thank you, Mr. Chairman. The ranking member made some important points early on about the timing of these hearings, but nevertheless I am glad we are having these hearings because it gives me an opportunity to make a few points regarding this whole system and the tragedies that we have faced here in this past year especially. And, of course, symbolically the Madoff scandal is a glaring example of something seriously wrong. But unfortunately, I don't think too many people will gather the same answer from this problem that I and others have gotten. And that is for a good many years now since the 1930's, every time a problem like

this comes up, like in the Depression, we think that it is a lack of regulations. We introduce regulatory agencies like the SEC. And like after Enron, that was a major problem. So we appropriate more money and hire more people. It doesn't do any good. But this circumstance I think really makes my point that the approach is completely wrong, that the regulatory agencies and preempting people from doing bad things just doesn't work. There are millions and millions and millions of transactions; you can't do it. All they do is give a false sense of security. This is a perfect example of it.

The SEC was involved with Madoff over the last decade. And that sort of gives the stamp of approval: Oh, it must be okay. So everybody's guard is let down. This creates the moral hazard that allows people to make these mistakes and not to assume responsibility for themselves.

Does that mean that we should ignore the problem? No. The problem comes because people commit fraud and fraud laws are on the books. All the people involved with Enron were prosecuted under State laws of fraud and the market took care of the stocks. But just adding on new regulations and spending millions and millions if not billions of dollars on regulating enterprise doesn't do any good. It contributes to it. It is the problem. We should look more to how the atmosphere is created by the Congress.

If you look at the principle of fractional-reserve banking, that in a way is a Ponzi scheme. This gets people doing things and building a mountain of debt. Debt on debt is done in this manner. Also, if you really want to look at a big Ponzi scheme—and it is said too often that people end up doing what governments do if we set examples—and believe me, everybody knows that the Social Security system is a Ponzi scheme. So, yes, $50 billion is horrendous. But what about an $8 trillion loss in the stock market? So what do we do? We rush and pump in $8 trillion. Where do we get the money? We create it out of thin air.

Furthering this whole idea of moral hazard and believing that we can create an unmanageable system is not the fault of the individuals at the SEC. They have an impossible job and they have to pretend they are doing something to feel relevant, the same way we do here in the Congress. We have to feel relevant in this. Instead of saying what we need is the market to work, we need to get rid of the bad policies, the monetary system and these mountains of debt. We say, we are relevant because we are going to hire more bureaucrats and we are going to appropriate more money that we don't have and we are going to solve all our problems. We have been doing this for 78 years and we will do it again. But believe me, this will not solve our problems.

We need to think about eliminating this whole regulatory process. And actually, we don't need the SEC at all and we could thrive even better and we would dwell on self-reliance, self-policing, and the idea that people can't commit fraud but that the government should not commit fraud either. We should not set an example. I yield back.

Mr. KANJORSKI. The gentleman from New York, Mr. Ackerman, is recognized for 2 minutes.

Mr. ACKERMAN. Thank you, Mr. Chairman, or whatever you are. Bernard Madoff's victims collectively paid hundreds of millions of

dollars in Federal and State taxes. Yet the Federal Government did not use any of this tax or any other tax dollars to properly oversee or discover any deceitful, fraudulent activity in the Madoff empire in time to mitigate potential losses or to protect investors. In fact, the government stands to become the ultimate beneficiary of ill-gotten gains.

After having failed to protect the American public from Mr. Madoff's scheme, while simultaneously taxing the phantom profits on unreal investments by real people and charities, many whose life savings, whose actual lives and dreams are now in ruins. So you thought your brokerage account was insured for $500,000? Wrong. With the collapse of Madoff's Ponzi scheme, thousands of investors lost that half-million dollar bet along with their life savings, and along with millions of others of Americans, their trust in their government.

Under SIPC's liquidation plan, claims related to Madoff's fraudulent scheme may be limited to only those investors who can prove they sent money to Madoff after December 11, 2007. The SIPC plan is simply inadequate.

Forget the Steven Spielbergs and Kevin Bacons who are not worrying that the bank is going to foreclose on their house at the end of the month. What about people like Allan Goldstein who is testifying before our committee today? The Allan Goldsteins of our country, who lost everything to Mr. Madoff, aren't billionaires with seaside villas or tropical islands or more money than anyone could spend in a lifetime. The Allan Goldsteins of this country put their entire life savings, their diversified—they thought—account for years, dependent on their dividends that they received to pay for their mortgages and their medical bills.

Mr. Chairman, the inability of the SEC to detect any wrongdoing at Madoff Securities for well over a decade undoubtedly has had a significant impact on investor confidence at an already difficult time in our financial markets. The SEC's failure and the inequity of SIPC's plan, the refusal or the inability by SIPC or the Federal Government to provide comprehensive fair insurance to the victims of the fraud will only serve to exacerbate cynicism among the investors and further discourage our economy and its recovery.

I thank you for calling this meeting today and I look forward to hearing from all of our witnesses. I yield back the balance of my time.

Mr. KANJORSKI. The Chair thanks the gentleman from New York and will now hear from the gentleman from Illinois, Mr. Manzullo, for 2 minutes.

Mr. MANZULLO. Thank you, Mr. Chairman. As I go over and review exactly what happened here, at least what I think happened, there are plenty of red flags. There are plenty of indications that there were problems going on, but somebody just didn't do their job. You can add resources and personnel and money, but when the red flags were there and people weren't doing their jobs, how do we know they will do their jobs in the future if you just throw money at the situation? You can't create competence by spending money. That is not the issue.

Perhaps the issue here, or the larger issue, is with a myriad of organizations and commissions, government entities that are sup-

posedly involved in protecting the investor. Perhaps we need to take a look at the big picture from the eyes of the investor and not from the eyes of the investment house to see how the protection of the investor can be made paramount to trying to accommodate the investment houses, even though it is possible to do the same.

So I hope that we have the opportunity in this committee or meeting, or whatever we want to call it today, to begin a new look at how we do the regulatory process. And that is all we need on top of the fact that we have a crushing economy, 11½ percent unemployment in the largest city of my congressional district; the Chrysler plant that really is smarting, with thousands of people who look to Washington for guidance each day. Perhaps we can straighten this out in a matter consistent with the fundamentals of free enterprise and also protect the small investors who are out there.

Mr. KANJORSKI. The gentleman from California, Mr. Sherman, is recognized for 2 minutes.

Mr. SHERMAN. Thank you, Mr. Chairman. The Madoff scheme would still be in operation today and perhaps for decades into the future had it not been for the meltdown on Wall Street that brought it to public notice.

Chairman Arthur Levitt announces that the SEC should be a law enforcement agency or have a law enforcement agency. This is a proposal that he resisted when he was Chairman of the SEC and all of his successors continue to oppose. Four-fifths of the Commissioners in the SEC insist upon staying on, even after the SEC failed with regard to mortgage-backed bonds and now has failed with regard to Madoff. You would think that all the members of the SEC would at least offer President Obama a resignation and have him decide whether this agency needs a complete change.

There is a myth that Madoff's only falsehoods were on the 17th floor in its investment adviser business. Nothing could be further from the truth. His broker-dealer business filed financial statements with the SEC and with FINRA every year and they were off by about $17 billion. The SEC has briefed me privately and has said for many years, the Madoff broker-dealer operation filed annual statements with both the SEC and FINRA. These financial statements showed $17 billion in assets, and a one-man accounting official. That means that if somebody glanced at that statement for even a couple of minutes, the fraud is there on its face, because there are ethics rules dealing with public accountants that say that if they are going to be regarded as independent public accountants, they can't get more than 5 or 10 percent of their revenue from any one client. So to look at this financial statement, you would have to believe that somebody can audit a $17 billion enterprise, one guy can do it in a couple of weeks. Either that is true or the statements are fraudulent on their face. But the SEC never bothered to read the financial statements, not even for half an hour. Neither did FINRA.

SIPC is with us today. They are well known because you go into your broker's office and you see that you are protected by SIPC up to half a million dollars. I know that for many of the Madoff clients that may be a problem, but I have investors in my district, $10,000, $20,000 or $30,000 at the broker-dealer. What they are not told by

that decal is that SIPC has virtually zero net worth. You are insured by an insurance company that has nothing in the safe. Because while they had $1.5 or $1.6 billion, virtually all of that is going to be wiped out by the Madoff claims. And, of course, if some individual investors are able to claim it, the SIPC may owe them many billions more. I yield back to the chairman.

Mr. KANJORSKI. The gentleman from New Jersey, Mr. Garrett, is recognized for 3 minutes.

Mr. GARRETT. And I thank the chairman for holding this important hearing this afternoon. I also want to thank Ranking Member Bachus for his diligence in requesting that this hearing be held as soon as this issue came to light. I think it is safe to say that Mr. Madoff put together the largest Ponzi scheme in history. I doubt that even the Ponzi scheme's namesake, who is Charles Ponzi, ever foresaw that someday somebody would be hoodwinking investors to the tune of $50 billion. Maybe it is appropriate that due to the breadth, size and longevity of the scheme, we change the name of the Ponzi scheme that we all use in the future to the "Madoff scheme."

Unfortunately, the media has portrayed the story as one that has only affected the wealthy, multi-millionaires and those who socialized with the Madoffs at lavish charity events and such. As we heard before and will hear today at this committee hearing, that is unfortunately not the case. And I have heard it personally at home as well.

On Friday, I received a call from a constituent. Her 86-year-old mother suffering from illness has had her life savings invested with Mr. Madoff. Now, due to how long it may take to unwind this matter, she faces the very real possibility of never receiving any of it. And what is most unfortunate is that the SEC regulators had numerous chances to uncover the scheme and that they continually either didn't see the multiple warning signs, didn't follow up on them, or simply chose to ignore them.

I think there are three takeaways that you can take from what is about to happen in the committee in going forward in Congress on this. First of all, to those who will advocate that there is a need for increased Federal regulations in the hedge fund industries from this occurrence, let me remind them that there were a number of hedge funds that did in fact become victims of this. So I think it is a stretch to believe that the same SEC regulators who were directly tasked with overseeing Mr. Madoff's firm would have been able to uncover this scheme had they been simply reviewing the books of those very same hedge funds.

Furthermore, to those who advocate, as we have heard here already, for more regulation and increased budget and increased spending—you know there was an article just the other day in the Wall Street Journal that addresses this. They say in there, how can it be that if the two sons of Mr. Madoff apparently did not become aware of this, despite the fact that they were working in the firm for some 2 decades, if they were not aware of it, how then can we call for increased regulations and think that some outside regulator would have been able to become aware of it?

The third takeaway is from the comment made by the chairman of the committee when he says that he finds no fault with SEC per-

sonnel, specifically with regard to this situation. While I certainly sit here and hope that is not the case, quite honestly I think it is premature for any of us to jump to any conclusions as to who is or who is not responsible for failure to act on the red flags that came up numerous times.

In conclusion, I look forward to our witnesses' testimony today and learning more on this scheme and how it was able to continue for so long. But also, very importantly, I look forward to figuring out just how we can help those people, those poor—not poor, but those middle-class people such as the elderly lady I mentioned, how they can recoup as much as they can as quickly as possible. I yield back the balance of my time.

Mr. KANJORSKI. Thank you. The gentlelady from New York, Mrs. Maloney, is recognized for 1 minute.

Mrs. MALONEY. Thank you very much.

In contrast to the seeming ease with which Bernard Madoff vastly overstated the contents of his clients' account, it would be almost impossible to overstate the pain his scheme has caused. The loss accrues not only to Madoff's client, but to literally millions of others, who in one way or another had depended on the false promise of his financial stewardship.

I just came back from meeting with unions that invested their pension funds. I would like to place in the record letters from constituents who lost their entire life savings, investors large and small.

Two have taken their lives and I—my sympathy really goes out today to one of our witnesses, Mr. Goldstein, a retired New Yorker who also lost his life savings. I believe that markets run as much on confidence as they do on capital and this is a serious blow to investors' confidence at a critical time in our economic challenges. I thank you for holding this hearing and I look forward to working with you for better oversight and regulation.

Mr. KANJORSKI. Thank you, Mrs. Maloney.

The gentleman from New York—or I am sorry. The gentleman from Nevada, Mr. Heller, for 3 minutes.

Mr. HELLER. Thank you very much, Mr. Chairman, and to the ranking member for holding today's meeting and focusing our attention on this issue, the Madoff scandal.

This scandal has serious effects, not only on affected investors, but the enforcement and oversight failures also rattled the confidence of investors everywhere when our financial system is already racked with problems.

I see three major failures here. First, clearly, the SEC had a major failure of huge proportions. According to testimony, the SEC was warned about this problem and ignored it for years if not decades. In fact, I took a look back at their highest profile investigation for 2008, and it was a $750,000 inside trading case; $750,000 was the biggest case that I am aware of or at least the highest profile case for the SEC last year. That versus a $50 billion Ponzi scheme was the decision I can only assume someone on the SEC does not like the Dallas Mavericks.

Second, State regulators. They call themselves the local cops on the beat. They like to take a tremendous amount of credit for the work they do. And some of them—and most of them do a great job,

but they also failed. And my question is, why were they not doing their job?

And finally, not all individual investors did their due diligence. Manners and expensive suits do not necessarily equate to honesty and integrity, and we must always trust but verify, and clearly, that failed.

Like all Ponzi schemes, this one crashed, even if it took decades. I would like our witnesses to suggest how these three levels—Federal, State, and individuals—can work to prevent scandals like this one in the future.

Thank you. I look forward to the testimony, and I yield back.

Mr. KANJORSKI. Thank you very much, Mr. Heller.

The gentleman from New York, Mr. Meeks, is recognized for 2 minutes.

Mr. MEEKS. Thank you, Mr. Chairman. I thank you and the ranking member for conducting this hearing today. I guess we can call it a hearing.

To me, what we are confronted with today is a situation, first of all, when we talk about the Madoff scandal, what we are really dealing with is a crook. We are dealing with an individual who took people's money and lost it. He is a crook. He deserves to go to jail. And to the degree that we can make any individuals whole who lost their money, as in any other fraud case, we need to figure out how we get that done. That is the bottom line here.

Now, in the course of that investigation, and what I am looking to hear and why I think these hearings that we are having are tremendously important, is, what can we learn from it? As in any kind of crime that has been committed, there should be something that we can learn from it so that we can prevent it from happening again and to make sure that we shore up our rules and laws and regulations if it will help prevent it. You don't get rid of the laws. If somebody commits bank robbery, you don't say, okay, we are going to get rid of all the laws with reference to bank robberies. We don't do that. We figure out how we make them stronger so that we don't have another bank robber. And that is what we are dealing with here today.

We have to figure out and listen. Now, if there is an investigation and we find that someone within the SEC was complicit with it, then that person is a crook and needs to go to jail. But if we find that there is some other—that they were not properly trained or they were inexperienced or we didn't put the appropriate amount of money in there, then it is our job as Members of the United States Congress to fix that. If we find, through the hearing and listening and learning from people, what takes place, that there are new rules and regulations that we can put in place so that no one else is scandalized again, it is our jobs to do that. And the only way to do that, because I know I am not the ultimate expert, is to have the kind of witnesses that the chairman has decided is necessary to be here today so that we can listen, we can learn, we can evaluate, and we can do something intelligent to try to make sure that a crook like Madoff can't get away with it again.

I yield back.

Mr. KANJORSKI. The gentleman from Missouri, Mr. Scott.

Mr. SCOTT. Thank you very much, Mr. Chairman. I am delighted you are having this meeting.

I think the fundamental issue has to be, what went wrong, how it went wrong, and what we are going to do about it. But I think that we have to look at these red flags that just came: First, the stability of getting 10 to 12 percent of return when the economy is going up and down. The fact that they use relatively obscure small auditing firms when most sizable brokerages use auditors that are sanctioned by the public accounting oversight, another red flag. Mr. Madoff himself kept several books, false documents. He even lied to regulators when they questioned him in previous examinations of his firm.

Why did investigators never use subpoena powers to obtain truthful information? Instead, they only relied upon the information voluntarily produced by Mr. Madoff. That is sort of like asking a thief if he is stealing. The thief is going to tell you, no, I am not stealing. It just begs the question of time after time after time when the SEC was looking at these things, even the case down in Florida with two accountants that had called, there was a possibility of a $400 million fraud case there. They looked at it, gave a wink and a nod, and it was gone. We have a credibility problem with the SEC. We have to find out exactly what happened.

The American people are expecting the confidence. Confidence is the key buzzword going forward. We have to get confidence and reclaim our economic system. And this is a way to start, Mr. Chairman. I appreciate this hearing, and I look forward to the questions as we go forward.

Mr. KANJORSKI. Thank you very much, Mr. Scott.

The gentleman from Florida, Mr. Klein, is recognized for 2 minutes.

Mr. KLEIN. Thank you, Mr. Chairman, and I thank the ranking member for holding this committee meeting today and certainly reflect on a lot of the good comments that have already been made.

I come from a part of the country, south Florida, which was hit particularly hard. Mr. Madoff spent a lot of time down there and preyed through his social engagements on a lot of people who bought into what he was doing and, unfortunately, a lot of charitable organizations. We had a large group called the Picower Foundation that had over a billion dollar of assets that funded everything from educational philanthropies, school systems, science, all the things that everyone in this country believes in and knows that government can't do everything, but we rely on philanthropy to help with that; it is now closed. And there are many other organizations which I think we are all familiar with.

And I think the question is, not what was lost, we understand that or are beginning to understand that, but why, what went wrong? I think, as you have already heard, and I certainly agree with this and my background is as a securities lawyer, there were red flags that were presented to the SEC, probably red flags to investors as well. The question, of course, that has been raised is, why did the SEC not follow up on these? The SEC has admitted that it received credible allegations about fraud 9 years ago, but nothing was really done with them.

So if there is anything we have learned from the Madoff scandal, we certainly know that in a global economic crisis as we have right now, we need smarter regulation and greater oversight to restore confidence of investors in the market. This doesn't mean that government will be checking up on every move of every investor or every seller of an investment, but this does mean that someone like Madoff should never, ever, be able to get away with this type of activity again.

And finally, there is the human question of how much money can Bernie Madoff's victims expect to recover? A couple that I know from Boynton Beach, Florida, who lost their retirement savings from Madoff and now have only enough money to live on by Social Security, they are saying, how much, and when? These are obviously scary times, and I think we do need to get to the bottom of this, not only for what went wrong in the past, how much money can be recovered and how much money can be given back to the people who lost it in the charitable organizations, but also what we can do to prevent it in the future.

Thank you, Mr. Chairman.

Mr. KANJORSKI. Thank you, Mr. Klein.

Now, the gentleman from Texas, Mr. Green, is recognized for 1 minute.

Mr. GREEN. Thank you, Mr. Chairman, for hosting this hearing.

Mr. Chairman, I don't know what should happen to members of the SEC. But I do know what would happen to members of the District Attorney's Fraud Division, Welfare Fraud Division, if welfare mothers were able to perpetrate a similar kind of circumstance. My suspicion is that members of the Welfare Fraud Division, not having caught welfare mothers perpetrating fraud, they would be dismissed.

I don't want to prevent investors from investing. I don't want to make it difficult for them. I do want to make it difficult for criminals to steal. We make it difficult for welfare mothers to steal. I think we have to make it difficult for people who perpetrate these kinds of fraud to do it.

I yield back the balance of my time.

Mr. KANJORSKI. Thank you very much.

And now, finally, for 1 minute, Mr. Perlmutter of New Hampshire.

Mr. PERLMUTTER. Thanks, Mr. Chairman.

In Colorado, we had—our fire and police pension fund was one of the entities that lost money, and they were an investor through Fairfield Greenwich. So when Congressman Paul was talking about the enforcement side of this doesn't make sense and we really don't need it, lots of money from many, many individual investors, policemen, firemen from Colorado into another fund into this and without an enforcement mechanism that is really solidly in place, the confidence, as Mr. Heller said, in the system as a whole is shot.

Now, obviously Mr. Madoff was a confidence man. He gained the confidence of many investors and he gained the confidence of the regulators. The regulators have to have the tools, and they have to be no-nonsense, and they have to be regulators, and they can't be conned, as we see so many other entities were. So I hope the testimony we are going to hear from you gentlemen today talks about

putting some teeth back into this regulatory system so people aren't conned in the way they were this time.

With that, I yield back.

Mr. KANJORSKI. Thank you, Mr. Perlmutter.

I just want to assure you that I know you are from Colorado, but I got confused on the great skiing in New Hampshire.

Mr. PERLMUTTER. New Mexico is a nice State, too.

Mr. KANJORSKI. The gentleman from New Hampshire, Mr. Hodes.

Mr. HODES. Thank you, Mr. Chairman. And I thank you and the ranking member for holding this hearing.

Ponzi schemes aren't new and neither are crooks and shysters. What is new, I think, are the conditions under which this Ponzi scheme occurred. We have the complexity of modern securities markets and an explosion of global wealth combined with our regulators, who over the past few years haven't been doing their jobs.

Arthur Levitt in the Wall Street Journal argues persuasively today that risk assessment must be central to the SEC's efforts. There has to be robust oversight and inspection capability and effective enforcement, which requires a commitment of appropriate resources.

And without going into the numbers of what those appropriate resources are, I am interested to hear my colleagues on the other side of the aisle apparently arguing that we don't need more regulations or oversight. I don't know what world they might be living in because in the world we are living in with the global financial collapse, people who have lost their life savings, the Madoff scandal is really like the cherry on a bad sundae. And it is time that we have a 21st Century regulatory scheme for the 21st Century.

So I look forward to the testimony which will enlighten us about how and what we need to do in the SEC, and then we are going to move on to what we need to do for the rest of the financial markets.

Thank you.

Mr. KANJORSKI. I thank the gentleman from Colorado.

I think that is fair.

Mr. HODES. New Hampshire, New Mexico, Colorado, they all have snow, Mr. Chairman.

Mr. KANJORSKI. The chairman makes the point, Mr. Obama carried them all.

I will now introduce the panel and thank you all for appearing before the committee today.

Without objection, your written statements will be made a part of the record. You will each be recognized for a 5-minute summary of your statement.

First, we have Mr. David Kotz, Inspector General of the U.S. Securities and Exchange Commission.

Mr. Kotz.

## STATEMENT OF H. DAVID KOTZ, INSPECTOR GENERAL, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. KOTZ. Good afternoon. Thank you for the opportunity to testify today before this committee on the subject of assessing the

Madoff Ponzi scheme as the Inspector General of the Securities and Exchange Commission.

I appreciate the interest of the chairman as well as the other members of this committee and the SEC and the Office of Inspector General. In my testimony today, I am representing the Office of Inspector General, and the views I express are those of my office and do not necessarily reflect the views of the Commission.

I would like to begin my brief remarks this afternoon by discussing the role of my office and the oversight efforts that we have undertaken since I was appointed as the Inspector General of the SEC approximately 1 year ago in late December 2007. The mission of the Office of Inspector General is to promote the integrity, efficiency, and effectiveness of the critical programs and operations of the SEC. I firmly believe that this mission is best achieved by having a vigorous and independent Office of Inspector General to investigate and audit Commission activities and to keep the Commission and Congress informed of significant issues and findings.

The office has staff in two major areas: audits; and investigations. Our audit unit conducts, coordinates, and supervises independent audits and evaluations relating to the Commission's internal program and operations. The office's investigative unit responds to allegations of violations of statutes, rules, and regulations and other misconduct by Commission staff and contractors.

I am proud to report that, notwithstanding a small staff, the Office of Inspector General at the SEC has issued numerous reports over the past year involving issues critical to SEC operations and the investing public. Two examples of recent audit reports are an analysis of the Commission's oversight of the SEC's Consolidated Supervised Entity Program, which included Bear Stearns, Goldman Sachs, Morgan Stanley, Merrill Lynch, and Lehman Brothers, that provided a detailed examination of the adequacy of the Commission's monitoring of Bear Stearns, including the factors that led to its collapse, and a review of the Commission's Broker-Dealer Risk-Assessment Program.

We also have a vibrant and vigorous investigative unit that is conducting or has completed over 50 comprehensive investigations, several of which involve senior-level Commission employees and represent matters of great concern to the Commission, congressional officials, and the general public.

It is with this background in mind that I wish to discuss our planned efforts to investigate matters related to Bernard Madoff and affiliated entities.

On the late evening of December 16, 2008, SEC Chairman Christopher Cox contacted me and asked my office to undertake an investigation into allegations made to the SEC regarding Mr. Madoff going back to at least 1999 and the reasons that these allegations were found to be not credible.

The Chairman also asked that we investigate the SEC's internal policies that govern when allegations of fraudulent activity should be brought to the Commission, as well as staff contact and relationships with the Madoff family and firm and any impact such relationships had on staff decisions regarding the firm.

Early on December 17, 2008, we opened an official investigation into the Madoff matter. Since then, we have been working at a

rapid pace to begin this important work. On December 18, 2008, we issued a document preservation notice to the entire agency, informing them that we had initiated an investigation regarding all Commission examinations, investigations, or inquiries involving Bernard Madoff and any related individuals or entities. We formally requested that each employee and contractor in the Commission preserve all potentially responsive electronic and paper records in their original format.

Over the next few days, we met with senior officials from the Commission's Division of Enforcement and the Office of Compliance Inspections and Examinations, known as OCIE, to ensure their cooperation in our investigation and our ability to gain access to their files and records. We also met with the Chairman's office to seek information and documentation relevant to the investigation.

On December 24, 2008, we sent comprehensive document requests to both the Division of Enforcement and OCIE, specifying the documents and records we required to be produced for the investigation. In addition, we made several formal expedited requests to the SEC's Office of Information Technology for searches of the e-mails of former and current employees for information relevant to the investigation, both at headquarters and at the New York and Boston regional offices, and have already received and are in the process of reviewing these e-mails.

We have also begun identifying the particular issues that need to be investigated and are reviewing and updating daily the list of witnesses that we plan to interview. We intend to begin conducting these interviews immediately and, for example, have already scheduled a meeting with Harry Markopolos for later this month for an in-depth interview on the record. We have also already met and spoken with numerous individuals informally as part of our initial investigative efforts.

It is our opinion that the matters that must be analyzed may go well beyond the specific issues that Chairman Cox has asked us to investigate. And we believe our oversight efforts must include an evaluation of broader issues regarding the overall operations of the Division of Enforcement and OCIE that would bear on the specific questions we are examining and provide overarching and comprehensive recommendations to ensure that the Commission fulfills its mission and goals.

At this early stage, I thought it would be useful to identify the specific issues related to Bernard Madoff that, as a preliminary matter, we intend to investigate or review. Obviously, as the investigative efforts are just beginning, I am not in a position to provide any conclusions or findings with respect to the allegations that have been raised and do not wish to make any preliminary judgments before we have had a chance to analyze all the information. In addition, as underlying evidence could also be relevant to the pending criminal or SEC investigations into possible violations of the securities laws, I am being mindful not to comment on anything that may affect or interfere with those investigations.

The following are specific issues that we currently intend to investigate:

One, the SEC's response to all complaints it received regarding the activities of Bernard Madoff. We plan to trace the path of these

complaints through the Commission from inception, reviewing what, if any, investigative or other work was conducted with respect to these allegations and analyze whether the complaints were handled in accordance with Commission policies and procedures and whether further work should have been conducted.

Two, allegations of conflicts of interest regarding relationships between any SEC officials and members of the Madoff family and whether such relationships in any way affected the manner in which the SEC conducted its regulatory oversight of Bernard Madoff.

Three, the conduct and examinations and/or inspections of Bernard Madoff's firm by the SEC and an analysis of whether there were red flags that were overlooked by SEC examiners that could have led to a more comprehensive or timely examination.

And four, the extent to which the reputation and status of Bernard Madoff and the fact that he served on SEC advisory committees, participated on securities industry boards and panels, and had social and professional relationships with SEC officials may have affected Commission decisions regarding investigations and examinations of his firm.

In addition to these specific issues and depending upon the information that we learn during the course of our investigation, we plan to consider analyzing the following broader issues, as well:

One, the complaint handling procedures of the Division of Enforcement, including a review of how complaints are processed, internal incentives that may affect the decision whether to take action with respect to a complaint, an analysis of which complaints are brought to the Commission's attention, and whether tangible and specific complaints are actually being reviewed and followed up on appropriately.

Two, the OCIE examination and inspection procedures, including an analysis of what policies and procedures were then and are currently in place, whether these policies and procedures are being followed, and/or whether there are gaps in these policies and procedures relating to operations involving private investment pools such as hedge funds because they are subject to limited oversight by the SEC and whether any such gaps may lead to fraudulent activities not being detected.

And three, the relationships between different divisions and offices within the Commission and whether there is sufficient interagency collaboration between the agency components to ensure comprehensive oversight of regulated entities.

Obviously, this is an ambitious investigative agenda, but I firmly believe that the circumstances surrounding the Bernard Madoff matter may very well dictate a more expansive analysis of Commission operations.

Moreover, it is my view that at the end of these investigative efforts there needs to be more than just the potential identification of individuals who may have engaged in inappropriate behavior or potentially failed to follow up appropriately on complaints, but rather an attempt to provide the Commission with concrete and specific recommendations to ensure that the SEC has sufficient systems and resources to enable it to respond appropriately and effectively to complaints and detect fraud.

Of course, even with the limited staff and many of our auditors and investigators already engaged in ongoing matters, I understand that it is critical that our investigative efforts be conducted expeditiously. I fully understand that it is crucial for the Commission, the Congress, and the investing public that answers be given to the very serious questions regarding the SEC's efforts relating to Mr. Madoff in a prompt and swift manner.

For this reason, I am mobilizing additional resources to ensure that our office makes every possible effort to conclude our investigations and reviews as soon as possible. We are considering preparing reports on a rolling basis, assuming that we can identify discrete issues that may be resolved separately and expeditiously, so that some conclusions may be provided very shortly.

Finally, I can assure you that our investigation and review will be independent and as hard-hitting as necessary. While we approach these efforts with an open mind, and at this stage of the investigation we have not reached any conclusions or made any findings, the matters that have been brought to our attention require careful scrutiny and review. We will conduct our work in a comprehensive and thorough manner. And if we find that criticism of the SEC is warranted and supported by the facts, we will not hesitate to report the facts and conclusions as we find them. I think that if you review the reports issued by our office over the past year, you will see that, where we have found that criticism of the SEC or SEC officials was warranted, we have reported our findings and concerns in a frank manner.

In conclusion, we appreciate the chairman's and the committee's interest in the SEC and our office. I believe that the committee's and Congress' involvement with the SEC is helpful to strengthen the accountability and effectiveness of the Commission. We intend to conduct our investigative efforts promptly and thoroughly.

Thank you.

[The prepared statement of Mr. Kotz can be found on page 102 of the appendix.]

Mr. KANJORSKI. Thank you very much, Mr. Kotz.

And next, we will hear from Mr. Stephen P. Harbeck, president of the Securities Investor Protection Corporation.

Mr. Harbeck?

**STATEMENT OF STEPHEN P. HARBECK, PRESIDENT AND CEO, SECURITIES INVESTOR PROTECTION CORPORATION (SIPC)**

Mr. HARBECK. Thank you, Mr. Chairman.

Chairman Kanjorski, Chairman Frank, Ranking Member Bachus, and members of the committee, thank you for the opportunity to appear before you today to discuss the work of the Securities Investor Protection Corporation, which is known as SIPC.

My name is Stephen Harbeck, and I have been the president and CEO of SIPC for the last 6 years. I have worked at SIPC for 33 years and was general counsel prior to becoming the president and CEO.

SIPC was created by an act of Congress, the Securities Investor Protection Act of 1970; it is known as SIPA. It provides financial protection to customers of failed broker-dealers. Although created by a Federal statute, SIPC itself is not a government organization.

The statute provides that we are a membership corporation, the members of which are all brokerage firms, virtually all brokerage firms, which are registered as such with the Securities and Exchange Commission. Membership is not voluntary; it is required by law.

In terms of our funding, we currently have a fund of $1.6 million of Treasury obligations. We have a commercial line of credit. And we have a $1 billion line of credit with the United States Treasury, which we have never used.

SIPC has no authority to examine or investigate its members. We receive information from the Securities and Exchange Commission and from FINRA. And when either one of those organizations or, for that matter, a State regulator informs us that a brokerage firm has failed to meet its obligations to customers, we initiate a very specialized form of bankruptcy. SIPC uses funds to replace cash and securities missing from customer accounts within statutory limits. We can advance up to $500,000 per customer, of which as much as $100,000 can be based upon a claim for cash.

I think it is important to note that no customer funds are ever used for payment of administrative expenses, lawyers' fees, accountants' fees, or the fees of a trustee in one of these specially narrow-focused bankruptcies.

2008 was unlike any previous year in SIPC's history. In addition to starting three small brokerage firm liquidations, we initiated the liquidation of Lehman Brothers. The holding company for Lehman Brothers filed for bankruptcy on September 15th. The holding company owned the SIPC-member brokerage firm Lehman Brothers, Inc. And on September 19th, in order to facilitate the transfer of customer accounts to other brokerage firms, including Barclays Bank's brokerage firm arm, SIPC initiated a liquidation proceeding for Lehman Brothers, Inc.

I am very pleased to report that, over the weekend—we initiated the proceeding on a Friday. The matter was immediately removed to a bankruptcy court for the Southern District of New York. And we transferred, over the weekend, pursuant to a bankruptcy court order, $142 billion worth of customer securities. And those customers had a rather seamless event, with respect to the failure of Lehman Brothers. Much remains to be done, but I am very proud of the initial opening situation there.

With respect to Madoff, the situation could hardly be more different. Where Lehman Brothers began as a result of a systemic failure in the subprime securities markets, the Madoff failure is theft, pure and simple, and nothing more, nothing less. As a result, no transfer of customer accounts, as occurred in Lehman Brothers, was possible.

I am pleased to report the trustee and SIPC have collaborated and published a claim form and a notice, which are available today, to the customers who have been victimized in the Madoff situation. Those claim forms are available on the trustee's Web site, at SIPC.org, on our Web site, and we urge customers to fill them out and return them to the trustee immediately.

This fraud was of a completely different order of magnitude of anything in SIPC's history. We won't know the extent or the call on SIPC's resources for some time. The trustee has identified $29

million which he has recovered from a bank and further identified an additional $830 million that he seeks to recover in fairly short order. I can assure the committee that SIPC and trustees appointed under the Securities Investor Protection Act are exceedingly aggressive in recovering assets from wrongdoers.

With respect to the claim form in the Madoff case, I would like to speak specifically to Congressman Ackerman, because he mentioned something that was widely reported in the New York Post, and that report was in error.

When we went to the United States Bankruptcy Court for permission to publish a notice and send a mailing to customers, we received what we call a housekeeping order which grants us authority and instructs the trustee to make a mailing to every customer who had done business with the firm during the last calendar year.

It was first reported in the New York Post and later misreported once again that there would be a limit on returns to customers only to people who did business with the Madoff firm in the last 12 months. That is absolutely incorrect, and I just wanted to assure you and your constituents that is the case.

The effects on SIPC of the Madoff case will be profound. I look forward to working with Congress and keeping Congress in touch with what we perceive as the ongoing matters in the case. And I would be pleased to take any questions from the committee.

[The prepared statement of Mr. Harbeck can be found on page 99 of the appendix.]

Mr. KANJORSKI. Thank you very much, Mr. Harbeck.

I will start the questions. In some respects, I may be a little too reserved here. I think I speak for all my colleagues on the committee, and I certainly speak for my constituents. They are absolutely shocked by this scandal. They want action. And I think I speak for that, too.

Mr. Kotz, I applaud your methodical approach. You have analyzed what has to be done and the schedule on which it will be done.

And, Mr. Harbeck, you sort of talk of it that way too.

But I am not sure that, with a $50 billion price tag, with literally tens or hundreds of thousands of people who will suffer—but not only those directly that have lost their money. Think about all the charities that aren't going to finance their research at labs and universities all over this country to cure everything from Alzheimer's to cancer and, ultimately, the thousands of people who will suffer or die because of this activity. It seems to me, it seems to me what is being asked for is out of regular order, that they don't expect the cop on the beat to take the normal process.

And let me give you an example of what I am speaking to. The other day, I had the occasion to talk to one of our enforcement agencies on the environment. And there is an illegal occurrence going on somewhere in this country that was brought to my attention by affidavit form. So it was my obligation to forward it to the agency to see how this could be handled.

After they had it for a few days and I hadn't heard from them, I called the person who had the complaint, and I said, "How long will it take you to examine this and determine what is there?" He said, "I think we will have an answer in 2 years." And I don't know

if that is what I am hearing from your agencies. I think, under normal order, we will have a real bound volume of a study, an examination made 6 months or a year from now or 2 years from now. But really, gentlemen, I want to impress upon you, I don't think the American people are going to want that. I, myself, don't want that.

The question I am directing to you, what can this Congress do to give you additional authority or additional funds to get this thing done as quickly as possible? And how fast is that "quickly as possible?" When do you think you can adequately complete these examinations so that we can start knowing what happened and when it happened?

Because I think the ranking member pointed it out, and I fundamentally believe it, that if it were done in this instance when the water of the recession is still going down, the flood is going down, we are going to find a lot of disasters across this country. And it will be a lot more people, probably not as wealthy a group of people, who will be seriously hurt. We have to find out what is there, so that we can do our jobs, as Mr. Meeks pointed out earlier, and make sure that the laws and the authorities are in place and the funding is in place to see that this never happens again.

Mr. Kotz, what is your answer to that?

Mr. KOTZ. Sure. Certainly with respect to my area, which is looking at the SEC, looking at the potential red flags that were in place and how these things could have been missed, I absolutely agree that this matter has to be dealt with very expeditiously. There is nothing ordinary or normal about it, and we are acting in that manner. We are bringing in new people simply for this task.

In terms of those issues, looking at the SEC's different divisions, looking at the enforcement division as to complaints that came in, looking at the compliance division as to examinations, I believe we can do that with the resources we have in a swift manner. I would not think it would take 2 years to come up with some large—

Mr. KANJORSKI. What do you think it will take?

Mr. KOTZ. I am hesitant to give you an exact amount of time because we just started the investigation. We have come up with a very long list of potential witnesses, we have a lot of documents to review. It has only been a couple of weeks. But I would hope that we would be able to get something out in a matter of months, certainly not years.

As I said, we are looking to try to issue reports on a rolling basis, so that if we can identify a particular discrete issue, we can have a report on that issue without waiting for something that is 500 pages that comes out years from now.

Mr. KANJORSKI. As you get these issues resolved, very quickly I assume, will you provide that information to this committee and to the Congress so we can act to close those loopholes or those problem areas or enforce and provide the funding for better enforcement at the SEC?

Or do you anticipate that we are going to have—most studies—I have to be honest with you. I have been in Congress a few years now. Most studies come back that we make requests on urgent material, and it takes several years for us to get the study back to find

out what the Congress is expected to do to solve the problem. I don't think the American people will tolerate that.

Mr. KOTZ. I agree with you, absolutely. That is not the case in my office. It hasn't been the case in the reports we have issued previously. That won't be the case here. So, absolutely, as we can identify issues and we can thoroughly investigate them and come to a conclusion, we will absolutely issue a report.

So I understand, definitely, that this is not something that can sit and we can work on for years and years and years and then issue some 500-page report many years down the road. I understand absolutely that this is a matter that has to be dealt with immediately.

I think we have made progress already in 2 weeks, given that those 2 weeks included the week between Christmas and New Year's. So I understand very much this matter has to be looked at very carefully but also very quickly, and we intend to do that.

Mr. KANJORSKI. Okay. I know my time has expired. But to both of you gentlemen, are you appointees of the President, and will the change of Administration affect your position? Or can we rely on the fact that you will be there?

Mr. KOTZ. No, I am not. The change in Administration won't affect my position.

Mr. KANJORSKI. Mr. Harbeck?

Mr. HARBECK. SIPC is not a government organization, and I will be here as long as the board of directors allows me to serve.

Mr. KANJORSKI. Very good.

So I am going to turn it over to our hound dog from Alabama, the ranking member.

Mr. BACHUS. Thank you.

Inspector General, let me ask you about four areas for investigation. The first one, to me—I described it as a three-person shop but it is actually only one accountant who is employed by the auditor for Madoff. Will you be looking at whether that should have been a red flag?

Mr. KOTZ. Absolutely. That is one of the most central issues here that we have to look at, which is, was that information known to SEC officials? And, if so, what did they do about it? How could it possibly be that they became aware of that—there have been certain reports about just Googling it would be able to find out that information. So that is something that we will absolutely look at very carefully and try to figure out how it could be possible that, if they were aware of that information, that wouldn't have been a matter that they would have acted upon immediately.

Mr. BACHUS. I appreciate that, because you couldn't have a fraud of this magnitude without involvement of auditors or accountants.

You have asked for document and e-mail preservation not only by Madoff but also by their contractors and related parties. Would that include the auditors?

Mr. KOTZ. We are initially asking for SEC documents, so SEC employees and contractors. But, yes, we would certainly look to obtain other documents—

Mr. BACHUS. Yes. I would ask you—again, I would urge you to, as soon as possible, to expand that to contractors, related parties or associates.

Mr. KOTZ. Sure, absolutely.

Mr. BACHUS. Because that can obviously get away from you in a hurry.

The custodial relationship was very odd, in that you had the same person functioning as a broker-dealer and as an investment adviser. Is that a red flag?

Mr. KOTZ. Yes, that is something that we have to look at as well. There were forms that were filled out that identified specific information, including information related to that, from what I understand, and we need to look at to see whether those were something that should have immediately jumped out at you and required further review based on the examination work that was done.

So, that is something, again, that, it seems on its face to be something that requires very careful scrutiny.

Mr. BACHUS. It appears that is a red flag. And then when you couple that with the fact that, although he was an investment adviser obviously known to everyone, that he was managing billions of dollars worth of assets, he didn't register, although he was managing, by public information, hundreds of times the assets which would have required him to register.

So my next question was, is that not a red flag when you catch someone who has failed to register, although the operation would dictate him to register, obviously? Is there not an audit or examination at that time by people who failed to register?

Mr. KOTZ. I think the issue of aggressive oversight, was there aggressive oversight in place such that, if information was brought to the attention of the examiners and auditors, action was taken immediately, the question of whether they took this individual's word for it or whether they followed up appropriately.

And, as I indicated, we are also going to look at whether Mr. Madoff's stature and reputation had any impact. Was there a question of, "This is Bernard Madoff, and so we don't have to worry about him not following up and giving us the documentation?"

Mr. BACHUS. Right. I guess that would be my last red flag, in that Madoff claimed to do something that very few people claimed publicly to do, and that is a guaranteed high rate of return. And yet the SEC had people who actually laid out to them that this was impossible to do. And if you look at it, just the number of puts and calls that he was utilizing, the whole flow or the whole market for him was insufficient to have minimized a downturn.

Are there people at the SEC who have the expertise and maybe what we might call "trading expertise" to realize that what he was claiming is impossible if you just looked at those documents published every day or those facts published in the Wall Street Journal on a daily basis?

Mr. KOTZ. In my personal view, there should be folks at the SEC who have that expertise. And, as we look at it, we may look at the issue of whether there is that expertise or training in place and perhaps make recommendations for further training and to ensure that expertise.

There has to be a situation in the SEC where those folks would be able to see the information that was provided and make determinations. And so we will look carefully, following complaints that were brought to the SEC's attention and looking at how the SEC

dealt with it, who dealt with it, what was the expertise level of the individuals who dealt with it, and why the actions that were taken or not taken happened.

Mr. BACHUS. I appreciate that.

Do you have the authority to contact former employees as well as former Commissioners or Chairmen of the SEC? Or are your powers only to interview those people who are presently with the SEC?

Mr. KOTZ. We could certainly contact and have on many occasions contacted former employees. We don't have subpoena power per se to require them to appear like we do with current employees. But, generally, folks have been willing to cooperate. And there are certainly investigative methods you could use to ensure their cooperation.

Mr. BACHUS. I hope you will, because some of this would extend back at least 10 years.

Mr. KOTZ. Right.

Mr. BACHUS. Mr. Harbeck, have you been able to identify any legitimate documents which are going to allow you to help process claims in this matter?

Mr. HARBECK. One of the first things that we did with respect to this was to modify our standard claim form to make sure that we asked the claimants themselves what evidence they had in terms of money in and money out, because that is going to be one of the critical factors. In one of these situations where the books and records are completely unreliable, that is our best source. So we have urged people to give us as much documentation as they can.

Mr. BACHUS. Have Madoff or his associates or the firm supplied you with what you would call legitimate documents?

Mr. HARBECK. The trustee has taken over the books and records of the brokerage firm. And, by the way, the investment adviser and the brokerage firm were one legal entity. So we have the records of what was actually in the securities inventory, and we also have some semblance of an idea of what the customers thought they had, at least in aggregate figures if not in individual accounts.

Mr. BACHUS. When they are one entity, does that create some opportunities for mischief?

Mr. HARBECK. I am not an examiner; I am a bankruptcy attorney. I think you may be right, however.

Mr. BACHUS. Okay. Thank you.

You have a $1 billion line of credit with the Treasury?

Mr. HARBECK. Yes, we do.

Mr. BACHUS. You have had that since 1970, obviously. Is that—

Mr. HARBECK. Adjusted for inflation—the number has never changed since 1970. Adjusted for inflation using the Consumer Price Index, that number would be somewhere in the vicinity of $4.3 billion. When you take into account the vast expansion of the securities markets themselves since 1970, that is certainly something we will look at as we determine how deep into SIPC's resources this event will take us.

Mr. BACHUS. Thank you.

Mr. KANJORSKI. Thank you very much.

Something the ranking member brought up, the broker-dealer being required to register, they were using an auditing firm that is registered with the PCAOB, expired on December 31st of last year. I understand now that the broker-dealer must be audited by a registered firm, but there is no enforcement authority by the PCAOB for auditors of nonpublic broker-dealers.

Are you aware of this, Mr. Kotz? And, if so, what do you think about it?

Mr. KOTZ. Yes, I know that there has been an issue that has been raised of the limited authority of the PCAOB. And that is something that we would look into, as well.

Mr. KANJORSKI. Isn't this the very point, though, that the three-man auditing group that Mr. Ackerman talked about, that if they had to be registered, they wouldn't have been allowed to be a party to this thing?

Mr. KOTZ. Yes, it would certainly seem that, if the PCAOB had this information, that they would have been able to take action—

Mr. KANJORSKI. But the SEC gave an exemption since 2003 three or four times.

Mr. KOTZ. Right. No, absolutely there is an issue there about: number one, what was the reason for that rule; but also, number two, whether the SEC, even without the PCAOB, should have been able to see these red flags and take appropriate action.

Mr. KANJORSKI. I understand. But what I am not gathering is, if you or your predecessor knew of this, isn't the Inspector General supposed to notify the Chairman of the Commission that there is a failure here in the law as it is drafted and it will allow some important parties to escape registration? And if no action is taken or no request for additional change or authority of the Congress, wouldn't you come to Congress and say, we have a gaping hole here, we have people with billions and billions and billions of dollars who don't have a registered auditor?

Mr. KOTZ. I can only speak for the time I was the Inspector General. But I agree that, certainly, if, in the context of this investigation and our audit that we conduct, we identify gaping holes like that, we would certainly put that in our report, and that would be brought to Congress' attention. So I agree with you.

Mr. KANJORSKI. But this gaping hole has existed for 5 years, and an exemption has been given 3 times, and nothing ever happened until this thing hit. If it had been changed, if the exemption weren't there, it seems to me this couldn't have happened.

Mr. KOTZ. Yes, we have not looked carefully at that specific exemption issue, so it is difficult for me to comment. But I do agree with you that we need to look carefully at the regulatory gaps. And if there are regulatory gaps that we have looked at carefully and we have reviewed and find that they exist, that it would absolutely be incumbent upon us to bring that to your attention.

Mr. KANJORSKI. The gentlelady from New York, Mrs. Maloney.

Mrs. MALONEY. Thank you very much.

My district is home to many of Madoff's victims. And as a Representative from a State with millions of jobs dependent on the financial sector, I am mindful that protecting this industry's reputation and integrity from predators and thieves like Madoff is absolutely crucial to maintaining our country's economic leadership.

Some of our country's most sophisticated investors were duped by Madoff. This leads me to ask you a few questions.

Madoff's firm was unusual in that it performed custody, trade clearing, and statement generation functions in addition to managing clients' funds. If custodial clearing and statement reporting were done by a reputable third party or parties, would this not have made it far more difficult for Madoff to dupe his clients and to fool regulators?

Mr. KOTZ. Yes, I think that is something that we would look at very carefully as part of our review. I don't know that I could answer that question today before having completed the audits and investigations. But that is something, certainly, that must be carefully scrutinized.

Mrs. MALONEY. Also, it has been suggested that Madoff's tiny and little-known auditor was a red flag. What minimum standards should we set for qualifications of accountants to the money management business?

Mr. KOTZ. Yes, I understand the point. And, as I indicated, we are going to look not only at the specific situation, but what rules we could recommend or policies such as you mentioned to ensure that where there are red flags potentially or information that is out there that they are responded to immediately. So I agree with you.

Mrs. MALONEY. Now, additionally, many people threw up red flags. One of them was that Madoff's returns typically hovered between 10 and 12 percent. People even wrote articles about "Don't Ask, Don't Tell," raising concerns about his investment strategy. One in May 2001 by Erin Arvedlund, which was in Barron's, it should have thrown up a red flag to investigators, to the SEC, to the general public. Why didn't these questions that she raised alert the regulators?

In addition, Harry Markopolos, he was in regular communications with the SEC, raising red flags, asking questions. He contacted them in 2000. In 2005, he sent the SEC a 19-page report entitled, "The World's Largest Hedge Fund is a Fraud." Why in the world didn't anyone respond to his allegations? What happened to his report? And did the SEC investigate his allegations?

Mr. KOTZ. Yes, that is exactly what I intend to find out. Certainly, the articles that you mentioned initially are things that we have to look at to see if the SEC examiners were aware of the articles, reviewed the articles, how they viewed the articles, and whether they factored that into their determinations. Or if they weren't aware of the articles, why weren't they aware of the articles?

And certainly Mr. Markopolos, who, as I said, I am meeting with later this month, we need to trace that complaint through the different offices that it went to, to determine what individuals dealt with that, what were their determinations that were made, why was it that they took the action they took.

So I will tell you that my investigation and audit efforts will get to the bottom of exactly those issues.

Mrs. MALONEY. And when the key regulator is totally asleep, even when whistleblowers are calling and trying to alert them, as was the case before us with the Madoff case, we would like to think that there were some checks and balances in our complex regu-

latory system that would alert other regulators, the Administration or Congress. Why did that not happen in this case?

Mr. KOTZ. Yes, absolutely. We need to look at what was the information that the individuals within the SEC were aware of, and why was it that they took or didn't take the appropriate actions. So that is going to be the focus of my efforts.

Mrs. MALONEY. Many of us have lost confidence in the SEC. It is pretty pathetic when a major newspaper, major periodicals, when whistleblowers issue reports and warnings when they have a system that they won't explain to anyone and an auditor that no one ever heard of, that this should be raising some concerns.

So my question is, for those of us who don't trust the SEC anymore, what additional authority should be given to other regulators to provide a better safeguard against the sort of agency failure that occurred with the SEC?

What is so frustrating about this, we could not do anything as a government to prevent 9/11. We could have prevented this if we responded to whistleblower complaints, articles raised by other investment bankers, and a model that no one understood and an auditor that no one ever heard of.

So where can we go to get the proper oversight? I do not believe we got it in the past from the SEC. I don't have trust in them for the future.

Mr. KOTZ. I can certainly understand the concerns. And my efforts will be to find out exactly what happened, how it could be that where it was spelled out in such a way, the world's biggest Ponzi scheme, that wouldn't be sufficient information to look into a potential Ponzi scheme.

So I can understand the concern about the credibility. All I can do is find out what happened, report back in terms of what failures were caused in this case, and then determine or make recommendations about what action should be taken as a result.

Mrs. MALONEY. I look forward to your report—my time has expired—on why no one read the report on the world's largest Ponzi scheme and now we have the world's largest Ponzi scheme.

Mr. KANJORSKI. Thank you, Mrs. Maloney.

And now, we will recognize the gentleman from Texas, Mr. Paul.

Dr. PAUL. Thank you, Mr. Chairman.

I would like to follow up on my opening comments to Mr. Kotz. The contention is that the system didn't work. It didn't work. I don't think there is any argument about it. But I go one step further, and I maintain it can't work because it is a flawed system.

The argument goes that, if we have to use a system, what we have to do is get more money, more people, and more efficiency. So the money will come, the people will come, and you will promise more efficiency, and the Congressmen will say we have to be more efficient.

But my argument is that the approach is completely wrong. There is always a cost that we don't talk about. There is a money cost, but of course there is a cost to regulation that injures businesses. In the Depression, the SEC actually helped prolong the Depression. Sarbanes-Oxley didn't do anything to prevent this from happening. And we have been in a slump for a long time. So regulations aren't the solution.

But does that mean that we have to be soft on fraud? No. Fraud we have to really crack down on, which we seem to ignore. But too often we have these regulations out there that sort of protect us, that say, "Oh, the SEC will take care of us. We don't really have a responsibility."

A good analogy to this is where people are safe is in their homes. The least safe place in this country is where the most laws are and the most policemen are, in the inner city. The people who are the safest are the ones who assume responsibility for themselves, have their own weapons in their home and live in rural areas, and there is no policemen within miles. So that whole attitude is completely different.

But the point I want to make and get you to respond on is, in some areas, we don't do it this way. We don't preempt with regulations. If we deal with habits or religious cults or intellectual pursuits, we are very protective of the first amendment and say, "Oh, yes, a lot of harm can come of it, but we are never going to regulate you." When it comes to the press, the press can do a great deal of harm to any one of us. And frequently, politicians suffer from libel and slander. But we never go and say, "What we need is prior restraint to make sure that nobody is ever injured." We don't do that. We assume there is a recourse, and we don't because there is a cost: There is a loss of liberty, in that sense. Because if we have people snooping around on everybody's habits and anticipating it, then we have lost something.

But on economic issues, all of a sudden we say, "Oh, this is okay. We can do this, and there is never a downside." But what I don't understand is, why don't we treat economic liberty the same as we do with personal liberty and religious liberty, intellectual liberty? We even have the first amendment split in two. We talk about intellectual freedom of speech. But commercial freedom of speech needs regulation. Why is this not a unit?

And so my question to you is, don't you have any doubts whatsoever that regulations aren't the answer? Why is it that we couldn't monitor ourselves and our system with a determination to prevent fraud and deal with the fraud and the corruption and the Ponzi schemes within our own system?

And pyramiding debt contributes to this, the financial system that we manage is—our fiat system contributes to it. All of the insurance programs that we have, it teaches people that it is okay and that we allow this moral hazard to occur.

So instead of this being the answer, I see this as the problem, the cause, and not in a personal sense because I think people who work at the SEC are probably as determined as anything, but I think you have an impossible task. You might say, "Oh, no," and you might be able to come up with some examples: "We did A, B, C, and we protected such and such." But we could do that if we monitored religion and said, "Look at what we prevented."

Do you have a comment on this and why we couldn't treat everything equally?

Mr. KOTZ. Sure. I don't go into this with any preconceived notions that increased regulation or increased resources or increased individuals is the answer. What we need to look at is a holistic and

comprehensive view as to whether the SEC can respond appropriately.

So I certainly wouldn't go into the process thinking that the answer is a particular matter, whether it is increased regulation or increased individuals. We need to look at the process, as you say, and see if the SEC is able to do the job that it needs to do.

Dr. PAUL. The budget for the SEC probably doubled in the last 7 or 8 years. I think in 2001 it was about $400 billion, and now it is over $900 billion. And the personnel went up about 20 percent, but we had, like, a 100 percent increase in the budget.

Where did that money go if we didn't hire more people? Do you have a general idea on where most of that money went if it wasn't for hiring more personnel?

Mr. KOTZ. I am not that familiar with the overall budget of the SEC. I could talk more about our office. But, certainly, we need to look at where money went and whether there were additional people or what was used with the resources.

Dr. PAUL. Do we do contracting out? Could that have been hiring individuals where they were not called government employees? Do you think that might have been part of it?

Mr. KOTZ. There is some contracting out in the SEC, yes.

Dr. PAUL. I yield back. Thank you.

Mr. KANJORSKI. Thank you, Mr. Paul.

The gentleman from North Carolina, Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman.

Mr. Kotz, were you in the Inspector General's office prior to becoming the Inspector General?

Mr. KOTZ. No.

Mr. WATT. Okay. Is there anything that you, during your tenure, or your predecessor could have done that you can suggest to us that might have prevented this?

Mr. KOTZ. I am not aware specifically. Obviously, I think it is the job of the Inspector General to be aggressive in their oversight and to be vigilant to the agency. And there have been reports that we have issued over the past year that—

Mr. WATT. Yes, but on this issue, is there anything that you or your predecessor could have done? For example, could you have made sure that Mr. Madoff and his company didn't exercise these exemptions that they were getting from the Investment Advisors Act?

Mr. KOTZ. Yes, I don't believe—

Mr. WATT. Would that have been an appropriate role for the Inspector General?

Mr. KOTZ. I am not—I don't believe that there is something specifically we could have been done. Now, we could have done an audit of a particular area, and if we had done an audit of a particular area, we could have made recommendations regarding that area.

Mr. WATT. Okay. I am not trying to blame you for any of this, but it just seems to me that everything that you have talked about today is kind of "I am going to take a look at the horse after the horse is gone from the barn." And I am trying to find out what somebody could have done to have stopped this from happening.

Mr. Harbeck, I take it that your agency is pretty much like the FDIC of brokers?

Mr. HARBECK. There are analogies, and there are also differences.

Mr. WATT. Okay, I understand that. But you get appointed by the members that you supervise, right?

Mr. HARBECK. No. First of all, we do not supervise anyone.

Mr. WATT. Who is on your board?

Mr. HARBECK. Our board of directors is composed of seven individuals, five of whom are Presidential appointees. Three must be in the securities industry; two are not permitted to be in the securities industry. There are also representatives from—

Mr. WATT. Okay. Is there anything that came to your attention over the last 5 to 10 years about Mr. Madoff's operation? Do you all do any audits of the people that you insure?

Mr. HARBECK. No, sir, we do not.

Mr. WATT. You are not required to do any audits—

Mr. HARBECK. We are not permitted to.

Mr. WATT. —or you are not expected to do any audits?

Mr. HARBECK. We are not expected to or permitted to under the statute we administer. That role falls to the SEC and to FINRA.

Mr. WATT. Okay. What happens if you exceed the $1 billion in—I think you testified that you have $1 billion in a Treasury account and a line of credit of $1.5 billion. What happens if the extent of the claims exceed that amount?

Mr. HARBECK. I believe this committee would be among the first to know that. But we have $1.6 billion in treasuries. Our commercial line of credit is currently $1 billion. And then we also have a line of credit with the Treasury. We will not know—

Mr. WATT. I am not asking you how much the claims will be. I know you don't know that. But if you exceed the amount of assets that you have, what will be the recourse that you have?

Mr. HARBECK. Speaking to your point about who is on our board of directors, we also have a director from the Treasury and from the Federal Reserve. And we—

Mr. WATT. That is not the question I asked you, Mr. Harbeck.

Mr. HARBECK. —will go there.

Mr. WATT. That was the prior question. I am asking you a new question now. What will happen if the legitimate documented claims exceed the assets that you have?

Mr. HARBECK. We will come to Congress.

Mr. WATT. And so the taxpayers will end up being responsible for whatever that overage is on the claims, is that correct?

Mr. HARBECK. That would be the case if we did come to Congress. We have not done so for 38 years and have never used government funds.

Mr. WATT. Okay. But under the statute, is there either an explicit or an implicit guarantee by the Federal Government of what you do?

Mr. HARBECK. There is nothing explicit beyond the $1 billion line of credit with the Treasury that is currently in the statute.

Mr. WATT. Is there anything implicit or has anything been written about that over the years?

Mr. HARBECK. There really has not, and the reason is that this event is such a remarkable outlier in terms of its expense. We have liquidated 317 brokerage firms over 30 years—

Mr. WATT. I appreciate you volunteering all that information, but I am trying to—would it be a good idea to give your agency audit authority or some kind of authority since you are writing the check if somebody ends up doing something like Mr. Madoff did, you have to write the check to cover it? What would be the downside of giving your agency the authority and responsibility for going in and policing these accounts? Doesn't FDIC have that authority?

Mr. HARBECK. Yes. And they are a regulator.

Mr. WATT. Okay. All right. So is there a downside that you see to doing that?

Mr. HARBECK. The question you have asked was asked in 1970—

Mr. WATT. I didn't ask you that now, Mr. Harbeck. I am already out of my time. I am saying, can you articulate for me a downside of doing what I just suggested?

Mr. HARBECK. I don't think we could do any better job than the people who are currently assigned to do it. We would hire—

Mr. WATT. Which is the SEC? You are saying you couldn't have done a better job, even though your money and taxpayer money was on the line, you couldn't have done a better job in this case than the SEC did?

Mr. HARBECK. I would have hoped anybody could have done it. But I am not confident, since it is outside our current area of expertise, that we could have done it.

Mr. WATT. Thank you, Mr. Chairman. I yield back.

Mr. KANJORSKI. Thank you, Mr. Watt.

Mrs. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman.

Mr. Kotz, looking over the number of the years that something came up, from 1999, 2004, again in 2005, and then November of 2005, and then in 2006, it really troubles me. We have that the SEC investigators in New York meet with Harry Markopolos and has a 21-page presentation, which then seems like nothing happens to that. I think it troubles me and probably others that, how could we be sure that the SEC is really going to be able to accomplish an investigation now?

Is there something in the protocol where if there is somebody outside of the examiners looking into a—or when they are looking at a group such as this, that they don't take into account the outside information?

Mr. KOTZ. I think we need to look at both of those issues. First of all, how could it have been that this information was brought to the SEC's attention, to trace it throughout the process but also to look at what the policies and procedures were?

I do think it is important to look at what were the policies and procedures in place at the time, were they violated. If they were violated, clearly we have to take action with respect to that. And if they were not violated, then the question is, why weren't the policies and procedures different at the time in order to ensure that this be done correctly?

Mrs. BIGGERT. In your testimony you say that, "Where allegations of criminal conduct are involved, we notify and work with the Department of Justice and the FBI as appropriate."

Wouldn't you think that the—first of all, do the FBI and the Department of Justice have the expertise to investigate and prosecute securities funds?

Mr. KOTZ. When I mentioned that, I was talking about my office, the Office of Inspector General. For example, if we were to do this investigation that we are currently undertaking and we were to find criminal conduct on the part of someone in the SEC, vis-a-vis the Madoff matter, we would follow up with the FBI and the Department of Justice.

I do believe that the Division of Enforcement, which is the entity that does investigations, such as what was brought to their attention by Harry Markopolos, does also coordinate with the FBI and the Justice Department. I couldn't speak to what they do vis-a-vis the Justice Department and the FBI.

Mrs. BIGGERT. Do you think they should be more involved in this investigation then? Wouldn't it help if it seems to be that we have talked about you don't have the people to do it, they don't have the expertise.

Mr. KOTZ. The investigation that the SEC Division of Enforcement is undertaking with regard to the criminal case against Mr. Madoff, certainly the FBI and the Department of Justice should be more involved.

With respect to our investigation that we are undertaking with respect to what the SEC did or didn't do when the Madoff allegations came in, we would certainly bring them in if there was a criminal-type issue that they would be able to assist us. I certainly would like to get assistance from whoever I could to try to unravel the situation.

Mrs. BIGGERT. Thank you.

Mr. Chairman, may I suggest that we invite the FBI and Department of Justice to testify before this committee about their efforts related to securities fraud as well as other forms of financial fraud? For example, mortgage fraud last year grew by 42 percent. Since 2000, it has grown by an astounding 1,200 percent. I think that this might be something that would be of value to us, and I would request that.

Mr. KANJORSKI. I think that is an excellent suggestion, and we will certainly take it under consideration.

Mrs. BIGGERT. Just one other question. The focus about the relationship between the SEC staff and Mr. Madoff and his family, does the SEC have current rules and procedures governing permissible relationships and standards of conduct?

Mr. KOTZ. Yes, I believe they do. And we have to look very carefully at those rules to see if any rules were violated; and again, even if rules were not violated, to see whether those rules must be supplemented.

There are allegations in this case regarding potential conflicts of interest, and one of the areas that we will look at very closely is were there conflicts of interest, were the rules in place sufficient to deter those conflicts of interest, and whether further rules are necessary?

Mrs. BIGGERT. Thank you.

I yield back.

Mr. KANJORSKI. Thank you very much.

And next, Mr. Ackerman of New York.

Mr. ACKERMAN. Thank you, Mr. Chairman.

I am trying to figure out what we have here. We have the president of the Securities Investor Protection Corporation. He has been that for the last 6 years, Security Investor Protection. It seems to me he hasn't protected any of the security investors. And we have the Inspector General of the Securities and Exchange Commission, which is the inspector of the watchdog agency that didn't watch out for anything, which makes you the Jacques Cousteau of the Keystone Cops. And looking at this whole program that we and so many investors thought that they had some modicum of protection, with some official eyes upon it with something called the Securities Investor Protection Corporation, I want to know who is responsible for protecting the security investor? Because I want to tell that person or those people whose job it is that they suck at it. So whose job is it to protect the security investor?

Mr. HARBECK. Congressman, the Securities Investor Protection Corporation becomes involved only after it has been determined that a brokerage firm has failed. We have no role prior to that.

Mr. ACKERMAN. So you are not protecting the consumer; so you are not protecting the security investor is what you just told me. And it was not until Mr. Madoff turned himself in or had his children turn himself in that you discovered that people were being defrauded and one of the members of the corporation that you are the president of this, whatever it is.

Mr. HARBECK. With respect, I disagree with your characterization that we are not protecting—

Mr. ACKERMAN. I have $50 billion of investors who would disagree with you, but go ahead.

Mr. HARBECK. And we will use the maximum extent of the law to return funds to them.

Mr. ACKERMAN. What funds?

Mr. HARBECK. From SIPC funds.

Mr. ACKERMAN. How much money is there in SIPC?

Mr. HARBECK. We have $1.6 billion.

Mr. ACKERMAN. I have $50 billion to cover. How are you going to do it? Do you have a scheme?

Mr. HARBECK. A great deal of those funds are false profits that never existed.

Mr. ACKERMAN. False profits?

Mr. HARBECK. Yes, sir.

Mr. ACKERMAN. So the government has been taxing people on false profits?

Mr. HARBECK. I think your point is very well taken, and I believe there are tax remedies for people who pay taxes on those funds. I am not a tax expert.

Mr. ACKERMAN. Mr. Inspector General?

Mr. KOTZ. Yes. I could certainly understand what your concern is, and I am going to ask those very same questions. If the facts are as—

Mr. ACKERMAN. What do you do before the Bernie Madoffs and the mini-Madoffs turn themselves in?

Mr. KOTZ. We need to make sure that the SEC has enforcement and examination divisions in place.

Mr. ACKERMAN. Do they?

Mr. KOTZ. That is what my investigation will determine.

Mr. ACKERMAN. You don't know that they have it or not?

Mr. KOTZ. I don't know.

Mr. ACKERMAN. You have been doing this for over a year, and someone else has been doing it for a year before you and years and years before that, and we still don't know if they have the ability do what we are paying them to do with taxpayer dollars?

Mr. KOTZ. I can certainly say that if the allegations are as they say, then there is great concern that they do, I will report that back and—

Mr. ACKERMAN. After the fact, we will know if you were able to do your job all these years and the SEC was able to do their job.

This is worse than a nail in the coffin; this is a spike in the heart of investment communities that makes America run at a time that we can ill afford it. Confidence in government and its agencies are at stake here.

Now, you had Mr. Madoff turn over a list of all of his assets. There are people with $50 billion worth of claims. Whether these are false profits or not, they are certainly real investments that built up to $50 billion, maybe more, maybe less. We don't know the extent. This may be the tip of the iceberg besides how many other icebergs that might be floating that you won't know about until someone confesses to the crime.

Now, in the assets that you had him turn over on December 31st, at midnight, while much of America had no champagne bottles to pop, how much assets did he turn over that you have sealed, and why haven't you turned that over to the bankruptcy court so that people can see what is happening as in normal bankruptcies?

Mr. KOTZ. I didn't have anything to do with the instructions about the assets. That was the—

Mr. ACKERMAN. Good. Would you turn that over to this committee?

Mr. KOTZ. I don't have that information. But certainly everything that will be in my report I will seek to—

Mr. ACKERMAN. Mr. Harbeck, do you have it?

Mr. HARBECK. I know that the Securities and Exchange Commission has it. SIPC itself does not have the—what I can tell you, sir, is that the trustee will work with the SEC and get those assets, and we are very aggressive about liquidating assets.

Mr. ACKERMAN. Will you turn it over to this committee? The public has a right to know. There is a bankruptcy which is a very public thing. There are legitimate investors who have a right to know what this is, what they might reasonably expect to have if they can do the math and divide by the number of them and the number of dollars.

Mr. HARBECK. I can promise to you that if it is the committee's pleasure to have that report, I will get it to you as soon as I receive it.

Mr. ACKERMAN. I am making that request. Will you get it to me and the committee as soon as you can?

Mr. HARBECK. Yes, sir.

Mr. ACKERMAN. Can you do that in a week, or have you turned it over to the court already?

Mr. HARBECK. If the SEC has not given it to me, they will.

Mr. ACKERMAN. And you will give it to us within a week?

Mr. HARBECK. Yes, sir.

Mr. ACKERMAN. Now, what happens to this clawback thing that is making a lot of people petrified? Why is there a difference between an investor who invested 6 months ago or 8 months ago and an investor who invested 6 years ago? Are we going to see the government go after them? I represent the north shore of Long Island, made famous in many novels as the gold coast, and I probably represent more people than—I know dozens of people who are absolutely destitute now who were the biggest philanthropists in this country, making the world of charity work, who now don't know what to do. One guy called me up with tears in his eyes, his wife is dying of cancer, his kid has a debilitating disease. He is going to get through this somehow, but what is going to happen to the hospital he promised $12 billion to in his next contribution, a children's hospital?

Mr. HARBECK. Your question with respect to clawbacks is that under the law, all customers participate in what is known as a pool of customer property. It is the trustee's duty to expand that pool and distribute it equitably. If a customer has received many times more than the customer put in, he is far more advantaged than someone who, for example—and this is a true example—someone who put in $10 million last week.

Mr. ACKERMAN. My constituent put in $10 million the day before Mr. Madoff turned himself in, and people are telling him it doesn't exist anymore. Does he get his money back?

Mr. HARBECK. He is part of that common pool, and unfortunately, he will not get his $10 million back any more than someone who put it in—

Mr. ACKERMAN. Is there a government clawback for his $10 million?

Mr. HARBECK. No, those funds are already in the Madoff enterprise.

Mr. ACKERMAN. The insurance that people have with SIPC, the $500,000 insurance that they think that they have, if they have put in $500,000, regardless of when, can they expect their money back? And you are going to hear a witness—if you care to stay here after you testify, you are going to hear a witness who can't pay his mortgage next month.

Mr. HARBECK. I have heard many such stories. The answer to your question is—

Mr. ACKERMAN. Two and a half years.

Mr. HARBECK. No, faster than that.

Mr. ACKERMAN. Can he make his mortgage payment before he loses his house and has to go live with his children and grandchildren?

Mr. HARBECK. If he can demonstrate that he put money in and did not take money out, we will get money back—

Mr. ACKERMAN. I ask unanimous consent with the witness-to-come's permission, which I have, to put his statement of this last month in the record in its entirety.

Mr. KANJORSKI. Without objection, it is so ordered.

Mr. ACKERMAN. I yield back whatever time I may have.

Mr. KANJORSKI. The gentleman from Nevada, Mr. Heller, for 5 minutes.

Mr. HELLER. Thank you very much, Mr. Chairman. And I want to thank the witnesses for attending. I know this can't be easy at times.

Inspector General, could you explain what a split-strike conversion strategy is?

Mr. KOTZ. That is unfortunately not in my area of expertise.

Mr. HELLER. Do you anticipate someone in your agency would know what a split-strike—

Mr. KOTZ. Absolutely. There are certainly the areas within the agency, not the watchdog office, that would be involved in those matters, but unfortunately that is not me.

Mr. HELLER. Because I believe this is the basis of it. I can't ask you the question then if you don't understand the strategy. Let me move in another direction.

Besides marrying into the family, are you aware of any SEC employees who ever worked for Madoff Security Investments?

Mr. KOTZ. I am not at the moment, but again, that is something we need to look at in the investigation and determine whether that happened. So that is something that is certainly within the list of matters we are going to look into.

Mr. HELLER. Are you aware if there is a cool-down period for SEC employees working in the industry?

Mr. KOTZ. I believe that the standard rules, standards of conduct apply to SEC employees like every other employee in the Federal Government. I am not specifically aware of special rules for the SEC; I am not an ethics officer. One of the things that we do need to look at, and one of the things that we already looked at, is that relationship between SEC employees when they leave SEC and when they go into private industry and the questions of whether their relationships caused by that have an impact on what the SEC folks do.

And so as I said, we are going to look at the stature of Mr. Madoff, whether his reputation had any effect on the actions that were done here, and whether the different employees within the SEC had any expectations or even wished to go to private firms that could have impacted their decisions.

Mr. HELLER. Right. I appreciate that comment, and I would hope that you would take a good, close look at that.

I want to talk about your auditing process. What do you, in your opinion, consider to be an ideal period of time between audits of an investment adviser or a securities firm? Is it every 2 years, every 4 years? Does the SEC or does your office have a goal?

Mr. KOTZ. Our office is the watchdog Office of the Inspector General, so we don't do audits of investment advisory firms. I know that there is an issue in this matter about the frequency of those audits and examinations. One of the things we are going to look at is how does the office that does those audits and examination—

what is their frequency; and is that an issue of resources, that they don't have enough resources in order to do more frequent examinations, but also whether these examinations are done appropriately, so that even if you have further resources and you could do more examinations, if the examinations aren't yielding the results, then additional examinations aren't done.

So that is not something our office does, but it is something we will look at to see what is the frequency of the audits and whether the frequency should be changed and the audits should be changed.

Mr. HELLER. You are anticipating that you would propose some level of audit standards or frequency of audits in the future?

Mr. KOTZ. Yes. We would make recommendations regarding the office's policies potentially about the frequency of audits if we determined that those examinations or audits are fruitful. First, I think we need to determine that the examinations would find what they were supposed to find, and then if that becomes the issue, that it is just a matter of frequency, then we would make recommendations that they increase the frequency.

Mr. HELLER. Thank you. I yield back.

Mr. KANJORSKI. The gentleman from California, Mr. Sherman.

Mr. SHERMAN. Thank you.

Mr. Harbeck, I want to thank you for pointing out that we are dealing with one legal entity, because there is this myth that the 16th floor was cool; the 17th floor was where the fraud was going on. The fact is it is one entity, one fraudulent entity, and that entity was filing financial statements with the SEC and with FINRA every year for many years. Those financial statements were obviously false on their face because they involved large amounts of money being reported by a tiny accounting firm or tiny auditing firm. And so I want to thank you for pointing that out.

A number of my colleagues are questioning why you didn't do the enforcement job. And as I understand it, you are basically like my life insurance company. You are not going to keep me alive, but if I die, you are supposed to pay off.

Mr. HARBECK. That is correct, sir.

Mr. SHERMAN. In contrast, it is FINRA and the SEC that are supposed to be doing the enforcing. They are the ones who received these financial statements that were obviously false on their face. They are the ones that the intelligent tipsters went to. They didn't come to you and say, hey, there is fraud going on at Madoff. They were sophisticated enough to know they should go to the SEC.

I look forward, Mr. Chairman, to bringing the SEC enforcement people and FINRA before this subcommittee.

But, Mr. Harbeck, the one thing I count on my life insurance company to do is to stay solvent so they can pay off when I do die. I look to other people to keep me alive.

Now, mentioning your lines of credit, but the right to borrow money is not net worth. Your net worth is about $1.5 billion, minus what you lose on this Madoff case. And do you have any reason to think that—we talked about this earlier. You are going to lose, under even a conservative estimate, a billion dollars off the Madoff case.

Mr. HARBECK. It all depends on the claims we haven't yet received, Congressman.

Mr. SHERMAN. But everybody who has one of these statements where they directly invested in Madoff, and they are secure—and the positions are here listing the securities they are supposed to have—is insured up to half a million dollars, correct?

Mr. HARBECK. They are protected. We don't use the word "insurance" because of the fact that we don't protect against the underlying value of a securities portfolio.

Mr. SHERMAN. But you do perform an insurance company function, and any insurance company regulator in this country who looked at the fact that you are standing behind well over a trillion dollars worth of accounts, and you have after this Madoff thing well less than a billion dollars, would close you down in a second as being an undercapitalized insurance company. There is no more obvious fraud than somebody selling insurance or claiming to be providing insurance who doesn't have any capital to pay anybody off.

Should your members put an asterisk by that decal that they all have on their in window saying, yes, SIPC Corporation provides the protection, but there is virtually no net worth. And we can argue here whether your net worth is $500 million or $800 million or negative $17 billion. Your net worth is trivial or negative compared to the well over a trillion dollars of security that you are supposed to be providing the investors in all of our districts, right?

Mr. HARBECK. We look at the issue of our solvency every board meeting, and what I can tell you is—

Mr. SHERMAN. I am not asking for solvency, I am asking for your net worth, your assets minus your liabilities, including the liabilities you have on the Madoff situation. Your net worth is less than a billion, and we have over a trillion dollars of accounts with securities brokers here in the United States, and I am only counting the ones under the half-million-dollar limit.

Mr. HARBECK. The answer to your question is that historically these frauds have been found before it cost SIPC net $1 million in any given case.

Mr. SHERMAN. That is ancient history. Now we are in the new history. The history of thousand-point drops in the markets on occasion, the history of Madoff at $50 billion losses to investors. And you have decals all over the 27th district telling my constituents that they have protection. And I am not asking you to be a law enforcement agency, that is other agencies; but you are supposed to write the checks to protect them, and your net worth is under a billion dollars.

Mr. HARBECK. The first thing that happens when our fund falls below $1 billion is we automatically institute assessments on the securities industry based on their net operating—

Mr. SHERMAN. But you haven't done that yet even though you are clearly going to lose at least $500 million out of this Madoff thing. You are below a billion dollars, you just haven't told your members that.

Mr. HARBECK. I would expect our board will move on that in January, sir.

Mr. SHERMAN. In January. Okay. Let me shift to Mr. Kotz. You are going to write this great report, and it will take you months or years to do it, but a couple of things are already obvious. One

is that the SEC did not do a good job when it got tips from outsiders, very sophisticated tips. And zero percent of the tips about Madoff were handled correctly. What assurances do you have as Inspector General that at least half of the tips that the SEC receives are handled correctly?

Mr. KOTZ. That is right. And we are planning to not just look at the tips in the Madoff case, but the whole process.

Mr. SHERMAN. We don't know whether half of them are handled correctly or maybe zero percent. Right now, you don't know.

Mr. KOTZ. Right, and so we need to look at all the tips and the process.

Mr. SHERMAN. Do you know whether the SEC even today is giving an extra half-hour scrutiny to financial statements where the auditor is not a PCAOB audit firm?

Mr. KOTZ. I don't know.

Mr. SHERMAN. I would sure like to find out.

I yield back to the chairman.

Mr. KANJORSKI. The gentleman from Alabama.

Mr. BACHUS. Thank you.

Mr. Harbeck, I want to compliment you on good work over a very difficult year, first with Lehman and now with Madoff.

I think it is important—you don't insure against market loss.

Mr. HARBECK. That is correct.

Mr. BACHUS. And a lot of what has been lost as far as assets by investors will be due to market loss; will it not?

Mr. HARBECK. We are looking at this as a missing asset case, because assets were put in; the assets aren't there. So that is the kind of thing that we can protect people against. What we can't protect people against is a 99 percent decline in any particular stock.

Mr. BACHUS. He has acknowledged that he actually stole money from investors.

Mr. HARBECK. Yes, he has.

Mr. BACHUS. I think it is going to be very difficult and complex because you have no records. You don't have accurate records. That is almost acknowledged in this case; is it not?

Mr. HARBECK. Certainly, the records don't match one hand with the other in terms of the actual securities inventory with what the customers expect to receive.

Mr. BACHUS. Do you have auditors or forensic experts on staff?

Mr. HARBECK. The trustee has hired forensic accountants and computer experts and attorneys who specialize in this kind of asset recovery to make sure that we know exactly what we have and what went where.

Mr. BACHUS. All right. I guess it is going to be very hard in just a matter of weeks to start processing claims; is it not?

Mr. HARBECK. It will be hard, and we are going to do it.

Mr. BACHUS. What?

Mr. HARBECK. It is going to be hard, and we are going to do it. That is why I certainly have urged customers to give us as much information as they can. If they do that, we will be able to move very rapidly.

Mr. BACHUS. So there is some expectation on your part that some can start getting reimbursed within a matter of weeks?

Mr. HARBECK. We have a meeting with the Securities and Exchange Commission Division of Trading and Markets later in the week to hammer out exactly how best to do this, because I want their support as well.

Mr. BACHUS. Small investors may actually have more promise of getting at least all or a greater percentage of their investments?

Mr. HARBECK. The investors who are going to have the easiest trail are the people who have been in the scheme for the shortest amount of time.

Mr. BACHUS. Okay. And let me close by asking you this: Mr. Ackerman asked you to share records with us, but this is a judicial proceeding that you are involved in akin to bankruptcy; is that right?

Mr. HARBECK. It is a bankruptcy, and certainly if it is filed under seal, I cannot produce them.

Mr. BACHUS. Not only that, but I think you also couldn't produce it to us before you produce it to the court; could you not?

Mr. HARBECK. I don't know under what terms the Securities and Exchange Commission was given the authority to receive this report.

Mr. BACHUS. I will point out the fact that the judicial proceeding is going to limit you somewhat, I would think.

Mr. HARBECK. I will get it to the committee as soon as I legally may.

Mr. BACHUS. Thank you.

Mr. KANJORSKI. Mr. Meeks, the gentleman from New York.

Mr. MEEKS. Thank you, Mr. Chairman.

Let me find out from Mr. Kotz. I was recently looking, and we saw that Bayou Management, a Connecticut hedge fund that collapsed in the scandals of 2005, as well as Enron and others, they used nearly 900 offshore entities, mostly in the Cayman Islands, to conceal bogus trades and accounting fraud. And I know that some Federal prosecutors are looking more and more at some of the offshore business to see whether or not this is a mechanism that makes it easy or easier for individuals to conduct schemes to defraud the public.

So I was wondering if, in fact, you could let us know or let this committee know whether or not the SEC has the capacity, first, to monitor the use of offshore fund operations, and also as to your knowledge of how many enforcement and oversight actions the SEC has taken to ensure investor protections from the manipulation of offshore fund operations since 2001.

Mr. KOTZ. I can certainly look into what the SEC does vis-a-vis these offshore operations, and that is—I appreciate the information in order to follow up on that. But I could determine whether in this case the Enforcement Division had any issues related to offshore operations, or whether generally the Enforcement Division of the SEC treats accordingly and appropriately those kinds of issues.

Mr. MEEKS. But you can't—have you done any internal investigations thus far of the SEC with how they are currently monitoring some of the offshore funds and whether or not—giving them any guidelines or guidance to looking into whether or not they are doing it correctly, whether they are undermanned, or whether they

have the proper training or not? Have you as the Inspector General done that at all?

Mr. KOTZ. I have not looked at that specific issue, no, but I certainly can.

Mr. MEEKS. You are saying that is something you will do in the future, but it hasn't happened in the past?

Mr. KOTZ. Right.

Mr. MEEKS. Also, if you look at the SEC's annual report, the SEC cites that there have been 671 enforcement actions in Fiscal Year 2008. Insider trading actions increased by 25 percent, and market manipulation actions increased by 45 percent. And between 2004 and 2008, the SEC has ordered $12.9 billion of penalties and disgorgements. The largest group of this 3,500 employees assigned to enforcement, and then after that compliance, and then corporate compliance with Federal securities lawsuits.

Given the explosive growth of the financial sector in both the United States and abroad, and the level of global financial market interconnectivity, and the rise of infractions and fraud, can you give us your opinion on whether the SEC is adequately prepared to face the challenges of the new millennium marketplace?

Mr. KOTZ. I can't today as we are sitting here. Part of the process of the investigation and audits that we are going to undertake is to look at the overall complaint procedures and the enforcement operations and to determine that very question, whether it is a question of resources, that they simply don't have sufficient resources in order to look at all those issues given the multiplication that you indicated, or whether the process simply is broken such that, even with additional resources, it wouldn't make a difference.

Mr. MEEKS. So all of this will be what you are looking at now, and you will come back with us, Mr. Sherman has indicated, but we don't know when, whether it is a month or 2-year process, because this is the kind of information, I think, that I know that we need in trying to determine whether or not there needs to be some new resources or what kind of regulation we should be putting in place. We need that kind of information.

What about the fact that you look at the interconnecting individuals from various firms that go from one firm to another. Some say because of the status of Mr. Madoff, because he was the former this or—that had something to do with that people just accepted his reports without looking any deeper than they should have. Have you as the Inspector General looked into any interconnectiveness with reference to people in the industry who have gone from one position to the other and whether they just check off because they know somebody personally?

Mr. KOTZ. That is an issue that has come up in other specific investigations, and that is an issue that has to be looked at very carefully. I think that is a great concern about the relationship of certain individuals. But there have been situations where we have issued reports where we have felt like the reputation of individuals had an impact on how the SEC did its job. We have reported that. We recommended action in those types of cases. And if we find that in the Madoff case, we find that generally we will do the same thing.

Mr. MEEKS. One last question, Mr. Harbeck. I know that in your testimony you have indicated that because of the Lehman Brothers holding, you discussed the liquidation and how you have protected a lot of the people that they control their portfolios. But as you know that in the Lehman Brothers procedures, there are still over—some say $700 billion stuck, because it hasn't been so smooth in London where United States citizens and various funds are stuck there. Have you—and I am asking—I sent letters to the SECs inquiring about them because there are a number of individuals who have invested whose money is still stuck in London. Have you looked into that, or do you have any suggestions or recommendations how they can get access to their portfolio in London in that bankruptcy proceeding?

Mr. HARBECK. The bankruptcy proceedings of LBIE, which is the European subsidiary of Lehman Brothers, are completely different and separate, but the trustee for Lehman Brothers, Inc., and the trustee for Lehman Brothers Holding meet frequently with the Lehman Brothers European branch conservators, I believe they are called, to try to iron this thing out.

Those offshore funds were simply not under the control of either the Lehman Brothers holding company or the Lehman Brothers brokerage firm. So I don't have a lot of hope that they can untangle the British scheme as fast as we were able to untangle the American.

Mr. KANJORSKI. The gentleman from Texas, Mr. Hinojosa.

Mr. HINOJOSA. Thank you, Mr. Chairman. Chairman Kanjorski, I want to thank you for holding this meeting. And I would like to take the opportunity to acknowledge all the work that your staff has done over the years to try to ensure that our capital markets remain vibrant and strong. I particularly want to thank you for holding this meeting in a solid effort to determine what changes your subcommittee or the full committee should make to the financial services regulatory system to ensure that this type of Ponzi scheme is detected much sooner than that of Mr. Madoff and his company.

At this point, Mr. Chairman, I ask unanimous consent to enter into today's record a copy of the complaint of the United States of America against Bernard L. Madoff.

Mr. KANJORSKI. Without objection, it is so ordered.

Mr. HINOJOSA. I would also like to insert into the record a copy of today's Bloomberg, Wall Street Journal and Financial Times articles on this Ponzi scheme.

Mr. KANJORSKI. Without objection, it is so ordered.

Mr. HINOJOSA. Thank you.

I have a question for Mr. David Kotz. Does your Office of Inspector General need extra Federal funding to ensure that this type of scheme is detected sooner rather than later?

Mr. KOTZ. Our office is the one that looks at what happened with respect to whether these things were detected appropriately. So we don't feel that I have asked for and I have received additional resources for our office to conduct the investigation. One of the things that we will determine in our investigation is whether the Division of Enforcement would require additional funds in order to detect these things, or whether the compliance divisions of the SEC would

require additional funds in order to identify issues, or whether it is a question of the processes that are in place that are simply broken and such that additional resources wouldn't help.

So in my office, in terms of my investigative component, we don't need additional resources to conduct the investigation.

With respect to whether the SEC as a whole needs additional resources in order to do its job, that is something we would look at in our report.

Mr. HINOJOSA. I am sure you will do a good job, but as my colleagues pointed out, it will take time, maybe several months. It is odd that the organization, the entity that dropped the ball, which is the SEC, is investigating itself. How can we rely on them investigating themselves? Tell me about that.

Mr. KOTZ. Sure. I think if you look at the track record of my office, Office of Inspector General, over the past year, you will see we issued critical reports where appropriate. There have been numerous occasions where we have issued reports that were very critical of the SEC; audit reports about the CSE program, Consolidated Supervised Entity programs, that found that there were flaws in the process involving the Bear Stearns collapse, that there were red flags that were not followed up on by the SEC. We have issued investigative reports that were very critical of the SEC employees and officials.

I think if you look at what we have done over the years, you can be assured our office does not pull any punches. Our office is very aggressive, and our office issues candid and sometimes very critical reports.

At the next stage, the effort will need to be to ensure that the SEC follows appropriately with respect to the reports that we issue, but our track record is very strong in terms of the reports we have issued that have pulled no punches and simply told the facts as we found them. And that is what we intend to do in this case. I can assure you that we will report the facts exactly as we find them. Then it will go to the SEC in order to implement those.

Mr. HINOJOSA. At this point, Mr. Kotz, since you have already seen some of the information, are you aware of any collaboration between the SEC employees and Mr. Madoff that resulted in him managing to conduct his business as usual despite it being a Ponzi scheme?

Mr. KOTZ. Yes. We haven't gotten to the stage of the investigation that I can say definitively either way. I can say that is an issue that we will look at very carefully to see what the potential collaboration there was between SEC employees and Mr. Madoff's firm. And if we find that was the case, we will recommend the strictest form of disciplinary action, potentially criminal action if we find that appropriate, whether it is existing employees or former employees.

So these matters are very serious. We take them very seriously. We will not hesitate to recommend termination, refer matters for criminal prosecution, follow up on criminal prosecution to ensure, if the facts warrant, those who engaged in inappropriate actions pay for what they did.

Mr. HINOJOSA. My time has run out, and I yield back.

Mr. KANJORSKI. Thank you very much.

Mrs. McCarthy of New York.

Mrs. MCCARTHY OF NEW YORK. Thank you, Mr. Chairman.

Mr. Kotz, the question I want to ask you is—because an awful lot of questions I was thinking of have already been asked and answered to some extent—how large was the corporation of Madoff? How large of a corporation was it?

Mr. KOTZ. I wouldn't know the answer to that question.

Mrs. MCCARTHY OF NEW YORK. Ten, fifteen, twenty employees?

Mr. KOTZ. I wasn't involved in any of the issues relating to any actions taken against Mr. Madoff.

Mrs. MCCARTHY OF NEW YORK. All right. With that being said, say it was a fairly large corporation, being that it seems to have an awful lot of money and customers, are there any SEC rules about the ruling of an accounting firm doing an accounting of the firm itself?

Mr. KOTZ. Yes—

Mrs. MCCARTHY OF NEW YORK. From what I understand, he only had a small firm with one or two people.

Mr. KOTZ. I think there are some serious questions about whether the information about the accounting firm was known to the SEC officials, and, if that was the case, why they didn't take any action. So absolutely, as I said, we are going to look into how it could possibly be that such a large entity involving so many dollars, high-level volume of dollars, could have an accounting firm that was so small without there being a red flag that would be clearly obvious to all who could see that it was an issue that needed to be further investigated. And if we find that, we will certainly report, as we have done in the past, that the SEC failed to follow up on a red flag.

Mrs. MCCARTHY OF NEW YORK. I want to say thank you for your patience in front of this committee, and to the second committee, second panel that will be coming up. Unfortunately, I will have to leave, but the testimony of Mr. Metzger is excellent, and I advise people to actually read it.

So basically both of you actually come in after the fact; after a crime has been done or a fraud has been done, you come into the investigation at that point.

Mr. KOTZ. That is correct. The Office of Inspector General looks at matters after they have occurred to try to find lessons learned to ensure these things don't happen again.

Mrs. MCCARTHY OF NEW YORK. I think what is going to be interesting as we go forward, my husband worked for a brokerage firm most of his life. He was actually in compliance for a long time, and one of his biggest beefs was as he went around the country looking at the different brokerage firms is how much corruption was going on. His feeling was nobody should get a commission; pay them a good salary, but the commissions make you buy and sell and actually cheat the investor one way or the other.

One of the other things which is common sense is if it sounds too good, it usually is too good. So you had an awful lot of smart people investing in this firm. When he was talking about 9, 9.5 percent constantly, no one, especially the SEC who had to know that he was giving out these particular amounts of money, saw or even felt there was something wrong?

Mr. KOTZ. Right. Absolutely, that is a very significant issue, and one could look at an investor perhaps not wanting to ask too many questions, not finding information. But certainly the SEC's job is to find that information. The SEC's job is to look at things that are too good to be true and to make that determination that if it is too good to be true, we have to audit, examine, and investigate it to determine that it is truly true.

So it is something that is logically hard to understand, and that is why we need to look very carefully to see how the facts are as they say; how it could have happened that these returns, that this information which was—to the extent it was brought to the SEC's attention, how could it have not have triggered an immediate, full-blown, full-scale investigation, audit and examination, all the tools that the SEC has in order to see how this could have happened.

Mrs. MCCARTHY OF NEW YORK. My concern is being that this went on for so many years, how many other organizations, firms are actually doing the same thing and just haven't gotten caught yet?

Mr. KOTZ. Yes. As was indicated, the market collapse obviously had a lot to do with the circumstances at the end. So clearly—which is why we need to not just look at the Madoff matter, but we need to look at whether this situation could replicate itself. And if a situation like this that seemingly on its face was obvious in terms of red flags, we need to look at if there were other problems that occur as well.

So we plan to do a comprehensive overview of both the enforcement division and the compliance unit to ensure that we don't just at the end of the day say—have some findings with respect to Mr. Madoff, but that we look at the whole system in place to see if it can adequately detect fraud.

Mrs. MCCARTHY OF NEW YORK. I think that also, as we go forward on the full committee and the subcommittees, obviously the SEC, even Wall Street and the investors, I don't even think anybody knew the extent not only of this particular case, but the whole collapse. It looks like we are going to have to modernize or somehow look at the whole financial system, because nobody expected this, nobody.

I yield back.

Mr. KANJORSKI. The gentleman from Massachusetts.

Mr. LYNCH. Thank you.

With the greatest respect for my colleagues, let me just pick up from that point that nobody saw this coming, we have to modernize. The short sellers saw this coming. The short sellers saw this coming, and they invested in it, and they made billions.

What is troubling here is that—and as you say, Mr. Kotz, it is the SEC's job to find the information. In this case, though, in this case the SEC was given the information. The SEC had repeated reports. The SEC had a whistleblower with a very long analysis. We had repeated attempts to contact the SEC, and the analysis was all given to it, but in the end they really did nothing until it was too late. I don't think you have to stay up late to figure out whether or not there were other occasions of this.

There was a case earlier in the year, within the last year, so while you were there, Gradient Analytics came up and reported

about Washington Mutual's problems. They pointed out that WAMU, over a year before it got in trouble, was not setting aside sufficient assets. A lot of short sellers came into the market, bet against them. AIG, their own auditor, Pricewaterhouse, again, long before problems developed there, they reported that the company had "significant shortcomings" because of the way they were valuing their credit default swaps. They reported it to the SEC. It was public information.

That is the most troubling aspect of this for me. The cops were informed, the law enforcement was informed, and yet nothing happened. That is the difficult part.

I am wondering, I have met with former SEC officials to ask them what is the real problem here. Some have suggested to me that they are overlawyered at the SEC, and they don't have enough financial people.

The short sellers, financial people, were able to diagnose this, bet on it in significant ways, and make a killing here, billions of dollars. And yet the SEC, with the same information, refused to act, and that is troubling.

Some former SEC officials also suggested to me that in many cases the investigators are right out of school, very new, inexperienced, and they were simply—in this case with Mr. Madoff, they were overmatched. The guy was on the SEC Advisory Board. That must be very intimidating for those newer investigators coming into that situation.

Now you have been there a year and have seen how the investigation goes, you know the personnel, and you know who is doing the investigations and how much experience they have. Are they lacking in experience? Is this one of the shortcomings we have? Do we have to shore this up? God knows there will be drastic change here. The SEC will be totally reformed, or maybe it is going to go away or will be merged with something else, because it is just inexcusable. Is that something that we have to look at? Are these investigators inexperienced, and is that costing us in the long run?

Mr. KOTZ. I think that is absolutely something we need to look at. That is a major issue that we are going to consider ourselves, which is the expertise level: Are they equipped, and do they have the expertise and the training and ability to keep up with this? And it is very alluring sometimes to be dealing with somebody who is on this panel and that panel, very famous, very rich. One aspires to be like that person. The person is a junior-level SEC attorney, he sees this very impressive individual, and it is very easy to even subconsciously think this guy couldn't be lying to me, this guy is a great man, he has made all this money, he is a genius. And so we need to look at whether they are equipped to ask the tough questions.

Mr. LYNCH. Let me ask you one other thing, Mr. Kotz. In your investigations, a couple of weeks ago, we had five billionaires sitting at that table. A lot of them had made a lot of money, Mr. Paulson and others, on short selling against these type of deals. They recognized the weakness in the market in these firms and basically through credit-default swaps were able to make a killing.

Have you thought about pulling in short sellers? They are really much more informed and seem to be investigating the strength of

these firms to a level of detail that I wish the SEC was investigating them. Did you ever think of pulling some of these people in? I am sure they would cooperate. Some of them would. Some of them are making too much money, but I am sure some of them we could lure away to help us strengthen this market, because we have lost our credibility here. This is all about restoring trust in the markets. That is your job, and that is our job.

I do want to say I thank you for your patience in coming before the committee and helping us voluntarily, because this isn't an official committee hearing. I do appreciate both of you gentlemen coming to help us with our work.

I yield back, Mr. Chairman.

Mr. KANJORSKI. Thank you very much, Mr. Lynch.

Mr. Scott of Georgia.

Mr. SCOTT. Thank you, Mr. Chairman.

Mr. Kotz, I have been sitting here trying to get my hands around what really seems to me to be the big problem, and that is the credibility of the SEC. It is amazing for anybody to sit here and think that there is not some level of complicity in this with the SEC. This is plain as the nose on your face. You have a situation here where 29 red flags came up, not one or two, but over and over again. This guy has been examined 8 times in the last 16 years, and every time you go in, you ask questions about this. You ask him a question, are you stealing? No, I am not stealing. And there is no further investigation of this. He knows the loopholes. He says he is a hedge fund operator and not a business investment adviser, and you accept that. He trades on foreign markets at certain amounts of time. You say, oh, yes, that is true, too. Okay, that is fine.

How sure are you that it is not some complicity with an inside person or persons at the SEC that has enabled this man to do this?

Mr. KOTZ. Yes, I am not sure, absolutely not. And that is something we will look at. I can tell you that when we complete our investigation, I will have the answers to those questions. But you are right; on its face, it certainly looks as if there may be that possibility. That is something that we have to look into. We have to look into the question of how it was that it seems as though the word of Mr. Madoff was taken; what were the tools that were used; why wasn't subpoena power used, for example; why was it all voluntary, and whether that was because of his reputation or simply lack of aggressiveness or perhaps complicity, as you say. Those are answers that I am looking to provide.

Mr. SCOTT. Also in each of the reports, when the SEC looked at some of this stuff, none of that was made public.

So I think that there is something with this. I think that—and I would hope—I think one of the greatest justices that you can do at least—we may not be able to get all of the money back, and I want to ask you about that in my follow-up question, Mr. Harbeck, about the money—but there needs to be a singular effort to get the heads that enabled this guy to do this at the SEC. He could not have done it without some complicity with some people who work at the SEC. It goes in line with the greed of Wall Street that has been one of the primary factors as to why we are in the economic condition that we are in now. That needs to be the first order of

business of the SEC to get the confidence of the American people: Get the culprits. You have some folks working for you in the SEC who worked with Mr. Madoff to allow this to happen. Their heads have to roll.

Now, Mr. Harbeck, let me ask you about the ability of trying to get some restoration for the investors. Is it an accurate figure of $50 billion? Is that an accurate figure?

Mr. HARBECK. It is far too early to say. We believe the $50 billion figure includes the inflated profits that Mr. Madoff said. The best example I can give you is that Yeshiva University put $14 million into this scheme. This is publicly available knowledge. And the records that they had indicated that they held a securities portfolio of $110 million. So there is a gigantic gap between when was put in and reflected on the statements. Of course, the longer you were in this deal, the bigger that gap was.

So having said that, and having said that the $50 billion figure is probably quite high, whatever it is, we will find it. The administrative expenses of that will not come out of customer property to find those assets, to find the accurate dollar amount, and then we will go try to get whatever we can.

Mr. SCOTT. So we are talking about ill-gotten gains. We are talking about loss and gains that to some degree may be fakes. In the Ponzi scheme—I want to get this right—what happens is that he takes one investor's money and uses that investor's money to give some return to the investment on the other fellow's money without it going through a trading process. Is that—

Mr. HARBECK. That is correct. And the way this was perpetuated for so long is people did not withdraw their funds from this Ponzi scheme. They just kept letting him roll over the supposed profits into even further supposed profits.

Mr. SCOTT. Now, there is a management firm for what is left of these assets. There is somebody that you have engaged or somebody is engaged to determine these, and I think the figure that is put on that expense has been about $28 million.

Mr. HARBECK. No. The trustee has received $29 million back from a bank account. Some of that will be used for administrative expenses, but if that is determined to be customer money, SIPC will reimburse it.

Mr. SCOTT. Is this the recovered liquidation cost?

Mr. HARBECK. Yes. And that is not all costs that have thus far been incurred. That is more than what is thus far.

Mr. SCOTT. So that is a false figure that is out there.

Mr. HARBECK. It is somewhat correct in that is the amount of money that has been returned to the trustee from a bank account.

Mr. KANJORSKI. Mr. Scott, your time has expired.

Mr. SCOTT. Thank you, sir.

Mr. KANJORSKI. The gentleman from Texas, Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman. Again, I thank you for hosting this event.

Mr. Kotz, permit me to ask you a few questions, and I want to say from the outset I have had an opportunity to peruse your resume. It is quite impressive. You were with the Peace Corps before coming to this current position, and you have an outstanding record as a scholar and student of jurisprudence.

Let us start, if we may, with your comment that you investigate after the fact. I think you need to bring some clarity to what "after the fact" means because you received a letter from Senator Grassley on April 2nd asking that you look into Bear Stearns, and there has been no arrest or reported crime as it relates to Bear Stearns; is this correct?

Mr. KOTZ. Yes. We were asked to do an audit of Bear Stearns to determine whether the SEC missed red flags in their oversight of Bear Stearns.

Mr. GREEN. Exactly. Which means that you can receive intelligence from sources about inappropriate conduct at the SEC, and as a result you can look into whether or not the SEC is properly conducting itself, true?

Mr. KOTZ. Right.

Mr. GREEN. Is it true or not true that your office received some degree of intelligence prior to the arrest of Mr. Madoff with reference to reports that were sent to the SEC concerning the so-called Ponzi scheme?

Mr. KOTZ. No, to my knowledge it is not true. There was never a complaint. We actually searched our records going back years beyond when I was there. There is no record of any complaint filed with our office about Madoff. In fact, the investigation that was begun, from what I understand, was not brought to the Commission's attention. But certainly, nothing was brought to our office's attention.

Mr. GREEN. The investigation that was begun with respect to Mr. Madoff was never brought to the attention of the SEC?

Mr. KOTZ. There is an enforcement investigation, not an investigation that our office does.

Mr. GREEN. I understand, but you said that the investigation that was begun with reference to—and I am adding "with reference to"—Mr. Madoff was not reported to the SEC, meaning the SEC Commissioners?

Mr. KOTZ. Right. What the Chairman stated in his request for me to conduct an investigation was the concern—one of the things we have to do is determine whether that is true—but the concern that he had that the Madoff matter that was looked at by the Enforcement Division had been not been brought to his, the chairman, and the other Commissioners' attention.

Mr. GREEN. And the Enforcement Division of which you speak is one other than the Enforcement Division that you happen to head?

Mr. KOTZ. Yes. I have the Office of Inspector General. That is separate from the Enforcement Division.

Mr. GREEN. So the Enforcement Division of the SEC received its complaint, made its investigation, but did not give a report to the Commission itself.

Mr. KOTZ. That is the allegation that the Chairman asked me to look into and what we will confirm, if it turns out to be the case, in our report.

Mr. GREEN. So the allegation is made by whom?

Mr. KOTZ. The Chairman of the SEC. When he asked me to conduct the investigation, he stated that one of the things he wanted me to look at was why or whether if the information—

Mr. GREEN. There is a difference between "why" and "whether."

Mr. KOTZ. You are correct, sir.

Mr. GREEN. Which was it?

Mr. KOTZ. Why. He asked why was it—in his view he did not believe that the information regarding the Madoff investigation conducted by the Enforcement Division was brought to his attention and therefore the other Commissioners' attention. So he asked me to look at this specific question in the Madoff case, and in general why enforcement cases are decided not to be brought to the larger attention of the Commissioners and the Chairman.

Mr. GREEN. To your knowledge, has there been any report or complaint, I should say, against the SEC with reference to the Madoff scheme that was forwarded to your agency?

Mr. KOTZ. Yes, certainly there have been reports that Mr. Markopolos met with folks from the SEC to report information about Mr. Madoff.

Mr. GREEN. And did Mr. Markopolos give his report—his report forwarded to your agency?

Mr. KOTZ. To the agency in which I work, yes. Not my office, but agency.

Mr. GREEN. This is not about you personally. It came to the attention of your office.

Mr. KOTZ. The agency.

Mr. GREEN. Your agency. All right, I am sorry. I will get my diction correct, because sometimes it is not superb.

If it came to the attention of your agency, and all of things that you today contend were red flags for the SEC, why were not these things red flags for the watchdog of the watchdog? You are the watchdog for the SEC. The SEC is the watchdog for the public, the investors.

Mr. KOTZ. Right.

Mr. GREEN. Why were they not red flags for your office or your agency?

Mr. KOTZ. Because we were never made aware of them. In other words, the SEC can't undertake action—

Mr. GREEN. You said that you received the report—the same report that we are contending the SEC should have acted upon, you have just indicated that your agency received that same report.

Mr. KOTZ. My office never did.

Mr. GREEN. Not your office, your agency.

Mr. KOTZ. Right. It is a large agency. Because a particular division of the agency received a report wouldn't mean that anyone in my office received it. The watchdog of the watchdog wouldn't receive something before it happened. Once a complaint is brought to our attention, we can look into it.

Mr. GREEN. So your office never received a report from Mr.—

Mr. KOTZ. No, we didn't receive it until now.

Mr. ACKERMAN. Could I ask unanimous consent that the gentleman have 1 more minute so that the witness can clarify and make a distinction to us and the public the difference between the Inspector General's Office and the enforcement office, because I think that is what we all assumed you were, or some of us assumed. You are not the enforcement office?

Mr. KOTZ. Correct.

Mr. ACKERMAN. It went to the inspector—

Mr. GREEN. I will yield that 1 minute that you have asked that I receive to you.

Mr. ACKERMAN. I was just following up on your excellent, excellent question. So when you say your office, your office has nothing to do and the Inspector General doesn't ever see these complaints?

Mr. KOTZ. Right. Right. No, we are not the enforce—

Mr. ACKERMAN. So they go to the enforcement, which is something completely different, which is basically an in-house—you are the outside auditor. Is it fair to characterize it, you are the outside auditor?

Mr. KOTZ. Yes.

Mr. ACKERMAN. And the enforcement guys are inside players with the SEC?

Mr. KOTZ. Right.

Mr. ACKERMAN. And they can decide to just bury the darn thing and not show it to you?

Mr. KOTZ. Right. We would never see a document that suggests that there was securities fraud or a violation of securities laws. That would never come to us. That would come to the enforcement division, which is a very large, several thousand people division.

Mr. ACKERMAN. Mr. Chairman, I would suggest that there is confusion here on the committee, that we would hope that you would initiate some legislation that could possibly require any complaints that are made in house to the inspectors, because the public doesn't know who to complain to. Obviously they complained to somebody who had no interest, because they found nothing wrong in a $50 billion scheme until the guy who did it confessed to it, that they share it with the outside auditors in effect and share that with the Inspector General's office.

Mr. KANJORSKI. I think it is a very good point taken, Mr. Ackerman.

Mr. ACKERMAN. I yield the gentleman back his time.

Mr. GREEN. Thank you. And I would adopt the comments of the gentleman. I have one final question, Mr. Chairman, just to make this absolutely clear. Your office, by whatever name, never received any report from Mr. Harry Markopolos?

Mr. KOTZ. Right. Not that I—no. That is correct. We have now because we have initiated the investigation.

Mr. GREEN. But prior to this investigation, Mr. Harry Markopolos or no other person concerning the Ponzi scheme of which we are here to investigate or look into today, no one ever gave—sent to your office any information concerning that?

Mr. KOTZ. That is my understanding, right.

Mr. GREEN. Thank you.

Mr. KANJORSKI. The gentleman from Missouri, Mr. Cleaver.

Mr. CLEAVER. Thank you, Mr. Chairman. Most of the questions that I was going to raise have already been raised. Actually, the follow-up was by Mr. Ackerman to Mr. Green's comments is exactly where I was going to go with regard to some clarity. Though I understand that—and I think the frustration you hear is because people out in the world are angry and we actually probably would be better if we had SEC members in here instead of the Inspector General. But you are here and so this is the frustration of the pub-

lic. P.T. Barnum once said, there is a sucker born every minute. And I am not a linguist, but that seems a little unfair.

He is saying the victims are suckers and in most instances, particularly with Wall Street, the victims are the suckees and the Madoffs are the suckers. And we are trying to find out why the SEC seems soft on suckers. And it is not going to be answered by you. We need them here and it creates at least some frustration for me because they are not here to answer the question. And I don't know—neither of you can probably answer the main question that I want to ask, which is do you believe that all of the SEC members ought to resign? I understand. Next question. You mentioned—is it Mr. "Kotz"—

Mr. KOTZ. "Kotz."

Mr. CLEAVER. We need a holistic and comprehensive approach, you said earlier. Give me an alternative for what you think. You are there, you have been looking at what is going on. What do we need? If there is one thing you would like for Congress to do to empower someone, you or someone to do something differently that might eliminate the damage done to the suckees?

Mr. KOTZ. I would rather be able to answer that question after conducting my investigation and review. I think once I do that, I will come up with more than one matter that could be done. I think we need to look very carefully at what happened. We need to look very carefully at the whole operation of the SEC and then make determinations. It is a little premature at this stage—the investigation just began 2 weeks ago—to make that determination.

Mr. CLEAVER. How long do you think the investigation is going to last? Of course, I guess it is difficult to know how long it is going to last because what I am curious about is how do you do an asset search on in this issue?

Mr. KOTZ. Yes. I understand the need for the investigation to be conducted very quickly, and so I do plan to do that. It is hard to give you a definitive timeline on how long our investigation will take place. Our investigation will yield recommendations about the SEC. Reviewing the assets would be what the enforcement division would do and for that I couldn't speak to.

Mr. CLEAVER. Mr. Harbeck, do you have any idea how you assess the assets? It seems to me like that is almost like unraveling these subprime loans.

Mr. HARBECK. One of the first things the trustee for the liquidation did was get subpoena power for a wide variety of witnesses who will be testifying as to what happened to the assets. He has received these subpoenas and he has sent them out.

Mr. CLEAVER. How do we find out who is owed what?

Mr. HARBECK. On the who is owed what, the best source of information is the claimants themselves.

Mr. CLEAVER. All right. Thank you, Mr. Chairman.

Mr. KANJORSKI. Thank you very much Mr. Cleaver. The gentleman from Colorado, Mr. Perlmutter.

Mr. PERLMUTTER. Thanks, Mr. Chairman. Mr. Harbeck, the question was asked of Mr. Kotz whether he knew what a split strike strategy was. Do you know what a split strike strategy is?

Mr. HARBECK. The only options trading I am familiar with is covered calls. So the answer is no.

Mr. PERLMUTTER. I guess kind of what we are talking about here and Mr. Paul sort of talked about personal responsibility. There is the personal responsibility piece, there is the government oversight piece. I am a bankruptcy lawyer as you are. And a lot of times people come up with terms. I have been hearing terms these last few weeks on this committee that I have never heard of before. So you have to say what is that, really, that is the personal responsibility side of this. Am I just getting a bunch of gobbledygook and they are quoting some kind of gambling strategy with some kind of terminology that nobody really understands which is what a Ponzi scheme is.

I have a little black box, I am not going to tell you what is in the black box, but boy, it has great returns and the money comes out the other end. And that is what this Ponzi scheme was about. So there is a personal responsibility piece, but Mr. Ackerman, he has his retiree who is in trouble, I have firefighters and police officers who may have lost substantial amounts with respect to their pensions. I don't know what the exact amount is. And my firefighters may be fighting with his retiree to take from this pool that your bankruptcy trustee is going to try to gather and then spread it out evenly among everybody. In your bankruptcy—and I know you didn't have a specific amount, but I saw some numbers in there. Do we have any idea at this point what the liquid assets were that are in the bank that could be taken by the trustee and then any other kind of portfolio stocks that could be liquidated?

Mr. KOTZ. The liquid assets, as far as we know, are in the neighborhood of $830 million to $850 million. Those have not yet all been secured, but the trustee is working on that. After that, it becomes a job of hunting them down to see source and application funds.

Mr. PERLMUTTER. And just let us talk about the claw back and then I would like to move to Mr. Kotz really quickly. "Claw back" meaning if somebody—let us say they put $100,000 into Mr. Madoff's investments and they received over time $50,000 back. Is the claw back going to take that $50,000 away from them even though they haven't even gotten their investment back?

Mr. HARBECK. The fraudulent transfer preference and the insider preference provisions of the Bankruptcy Code apply to that fund of customer property. So to take a more extreme example, someone who put in $1 million and took out $5 million over time may, within the statute of limitations, be called upon to pay back so that someone who put in $1 million and got back nothing would have something to share. It is a matter of equity. That has been the law since the case of Cunningham versus Brown which was the original Ponzi scheme case on fraudulent preferences and transfers.

Mr. PERLMUTTER. So my firefighters who got nothing back—I don't know what the status is. Let us say they got zero back. Mr. Ackerman's constituent to—this retiree has received payments over time may end up being at odds?

Mr. HARBECK. That is what the law is. The statute of limitations helps those retirees in one respect and the rule of reason also applies as well.

Mr. PERLMUTTER. All right. Next question. Does your agency ever talk to the SEC about fears that you see from an underwriting kind

of a context about wait a second, what is a split strike strategy? We never heard of this stupid thing.

Mr. HARBECK. In that particular instance, that didn't come to our attention. I know that for example, in the Bayou Securities Ponzi Scheme, when you read the description of the investment strategy and you see the incredible returns that were theoretically made, those were red flags that a layman could see. The reason this scheme went on as long as it did, at least at first blush is that Mr. Madoff did not try to hit a home run. He tried to be a doubles hitter. He kept—he kept himself looking like a steady hand rather than a spectacular winner.

Mr. PERLMUTTER. But here is where the SEC—we are all saying the same thing, is falling down on the job terribly. This return went on, this 8 to 19 to 12 percent went on forever, which is unlikely in good times and bad and the SEC didn't pick up on it. And where I believe where Mr. Paul is just dead wrong is that my firefighter in Colorado or his retiree along the Gold Coast, they don't know because they are sort of investing through other people or whatever. That is where the SEC comes in. And I am just curious why nobody brought this to anybody's attention. That is what you are going to find out, Mr. Kotz?

Mr. KOTZ. Yes.

Mr. PERLMUTTER. Should the Bear Stearns incident have brought this Madoff kind of thing to anybody's attention or are they just so different that the SEC problems are that different and then I would yield back, Mr. Chairman.

Mr. KANJORSKI. Thank you very much, Mr. Perlmutter.

Mr. KOTZ. Yes, I think they are different. Although we did find in the Bear Stearns case that there were red flags that were not followed up on, albeit different red flags. If we were to determine that there were red flags that weren't followed up on, then I think that would represent some sort of pattern, although it would be different types of issues.

Mr. PERLMUTTER. Okay. Thank you.

Mr. KANJORSKI. Thank you. Next we will have the gentleman from Indiana, Mr. Donnelly.

Mr. DONNELLY. Thank you, Mr. Chairman. Mr. Kotz, as the Inspector General for the SEC, you keep an eye on their operations, make sure they are doing things by the book. Do they, when they go into a firm, the enforcement arm, is there a checklist that they use where they say check, accounting situation makes sense, check, custodial relations makes sense. Is there any set form they use when they go in? Obviously, they are going to look at a number of things, but is there any list of, hey, here are the things we are at least going to make sure we check these 10 things?

Mr. KOTZ. That would be that particular office. But as part of our investigation and audit, we would look at exactly that. I do believe there are policies in place, there are procedures. I don't know if it is a check list per se, but certainly procedures as to what should be reviewed for different types of situations. What we plan to do is analyze what they were, determine whether they were triggered in this case; if they were triggered, why wasn't the resulting action taken? And if there was nothing that was triggered, then why weren't those triggered mechanisms put on the policies?

Mr. DONNELLY. I guess that is where I am leading to. We heard talk that the custodial relations didn't make sense here, that the accounting relations did not make sense, that there was no registration. At what point if there—if these are being checked, do they look up and say five of these are completely out of whack. We have to go much deeper into this?

Mr. KOTZ. In my view, it would be any one of those.

Mr. PERLMUTTER. Right. And here we see one after another, after another and this goes on for year after year and is not found by the SEC, but by the fact that there is no money left.

Mr. KOTZ. So if that is the case, either there are problems in terms of how the forms are being used or the forms are problematic. But there is a significant issue.

Mr. DONNELLY. And as Inspector General, how would we find out as Congress, what forms there are, and we would love to get copies of those.

Mr. KOTZ. We will certainly, as we produce our reports, incorporate the forms, cite them and analyze them to see what were the potential issues that one would look at and provide all of that information in our reports.

Mr. DONNELLY. I guess part 2 of this question is what other organizations that the SEC audits, enforces also may not have had these different checkmarks ticked off? Who else has an accounting situation in and as the Inspector General, I hope that is—and I am sure it is, one of the things you are looking into now is where else are there red flags? So that no other person, in my home State of Indiana or any other State who works so hard to put a few bucks away that they are not going to put it in next week and get burned by another organization?

Mr. KOTZ. No. We need to look at the forms that are problematic such that they need to be revised or whether the way the forms are reviewed is problematic such as we need to deal with that issue. So, yes, we are planning to look at way beyond just the Madoff situation because as you say, if the form was not appropriately used in that case, then it would be not appropriately used in many other cases, and in that way, we can actually see things that are coming in the future rather than what is often the case with an Inspector General office which your only ability is to see things after it was brought to your attention.

Mr. DONNELLY. Right. It would seem that we almost have to go right back to ground zero with every organization that the SEC works with.

Mr. KOTZ. I certainly think we need to look at how the SEC deals with those organizations, what is their process for examining or auditing or reviewing those organizations and figure out whether that process works. If this information is correct, it seems it didn't work at all in this case. If it didn't work in this case, then it likely doesn't work in any case. So we need to look at that and suggest, recommend reforms to make sure that it does work.

Mr. DONNELLY. I think—I know on my—personally for me, I would love to get a copy of what the SEC does for each of the inspections that they do, what steps are followed, what do they look into so that we can get an in-depth idea of that and Mr. Chairman, thank you for your time.

Mr. ACKERMAN. Mr. Chairman?

Mr. KANJORSKI. Yes.

Mr. ACKERMAN. Could I just share some information before this panel leaves? I know Mr. Foster is yet to have his turn.

Mr. KANJORSKI. Yes.

Mr. ACKERMAN. Something that I think that is of critical importance at this junction based on our colleagues' questions, if I could have 1 minute, you are talking about red flags. Up until now, nobody has seen any of the monthly statements that Mr. Madoff sent out. And I think these will be made available by the law firm that is representing the witness that we will hear from. But for the sake of Mr. Kotz and the committee, people got these detailed statements at the end of the month. Mr. Madoff turned everything into treasuries, and we believe he did this with every account or almost every account.

At the end of the reporting period with everything in treasuries, he did not have to report to the SEC. He escaped the scrutiny of your agency and perhaps nobody was watching him and the question that should be asked of all of the members of SIPC, all of the brokerages, how many of them at the end of the month show that they have turned every account into treasuries and aren't reporting? There may be many other people who have come across this brilliant way of flying under the radar and basically reporting forms to no one owner we are holding treasuries and not securities. Thank you, Mr. Chairman.

Mr. KANJORSKI. The gentleman from Illinois, Mr. Foster.

Mr. FOSTER. Thank you. Inspector General Kotz, I was interested in a related question, but it has to do with whether the SEC has systematic written procedures for just dealing with complaints like Mr. Markopolos generated, that when one of these is received, are there written procedures for cataloging these, for assigning responsibility for follow up, for tracking them and eventually dispensing with these type of complaints?

Mr. KOTZ. Yes. I believe the Enforcement Division does have procedures in place and what I am going to look at is whether those procedures are working, whether these procedures need to be revised or whether those procedures are simply not being utilized appropriately.

Mr. FOSTER. And you will be getting us copies or references of just how you handle complaints so we can see where it got dropped in this?

Mr. KOTZ. Absolutely.

Mr. FOSTER. In Mr. Markopolos's November 7, 2005, complaint or tip to you guys, they had the sentence here that says "due to the sensitive nature of the case I detail below, its dissemination within the SEC must be limited to those with a need to know," which must be a very common situation because of the obvious effect on markets and so on. Do you have any idea of the order or magnitude of the number of people inside the SEC that were actually privy to the details of this?

Mr. KOTZ. I don't know that right now, although I would say it certainly seems as though there were sufficient people who knew about it, who were in a position to do something about it. So I don't think it was a question about not enough people became aware of

it. It seems as though it was brought to the right place and that was the place that has the responsibility follow up. I don't know exactly how many people. We will obviously talk to every person who became aware of it and find that out. But it certainly seems as though it was brought to enough people that action could have been taken.

Mr. FOSTER. So this was more than 10 people and less than 100 as a guess?

Mr. KOTZ. Yes. I don't know for sure. But I would think that would be the case.

Mr. FOSTER. Okay. I guess—oh, one other question. What is the scope of your e-mails that you are looking into here? Are these limited to official SEC e-mails by current and former employees or do they include the private e-mails of current and former employees and so on?

Mr. KOTZ. Initially, we requested all the public e-mails, the SEC computer e-mails. And you would be surprised how much information is on a government e-mail. Now, as we further gain information, we can try to take steps to get personal e-mails as well. And that may be something we need to do in a couple of cases here.

Mr. FOSTER. All right. And you have the authority to do that?

Mr. KOTZ. We can. We have in the past dealt with different Internet providers and gotten the information that we have needed, yes.

Mr. FOSTER. Thank you. I yield back.

Mr. KANJORSKI. Thank you very much, Mr. Foster, and now this panel is concluded finally. Thank you, gentlemen, very much. We are holding up a panel of three more and they have been kind enough to remain here and be available. May I ask the question, is there any travel difficulties with the next three panelists? The three witnesses, do you have any travel difficulties at all?

Mr. METZGER. I have a 7:00 train.

Ms. FRANKEL. I missed this plane, but the question is whether I could go to another one.

Mr. KANJORSKI. Both to New York, the two trains?

Mr. METZGER. Boston.

Mr. KANJORSKI. Boston? Oh, my. Okay. We will try to get this completed as soon as we can. Let me get right on and welcome you to the committee.

And let us get to the testimony first of Mr. Allan Goldstein, who is an investor with Bernard L. Madoff Investment Securities. Mr. Goldstein.

## STATEMENT OF ALLAN GOLDSTEIN, RETIREE AND INVESTOR, BERNARD L. MADOFF INVESTMENT SECURITIES

Mr. GOLDSTEIN. Good afternoon, and thank you for the opportunity to testify today on my experiences with Bernard L. Madoff Securities, the impact that Mr. Madoff's actions have had upon my family and myself. My name is Allan Goldstein and I am a human face of this tragedy. I speak not only for myself, but for the many people who have lost everything because of this Ponzi scheme. I held an IRA retirement account with Mr. Madoff's firm for approximately 21 years. I am 76 years old and until my retirement, I worked in the textile trade buying and selling fabrics for use in

women's apparel. My wife Ruth and I have been married for 52 years. For the past 16 years, we lived quietly in the Taconic Mountain region of New York State. At this stage of our life, I could never have envisioned the financial devastation we are now suffering following the arrest of Mr. Madoff last month. In the blink of an eye, savings that I struggled my entire life to earn have vanished. Like many of Mr. Madoff's victims, we are hardly super rich. I was born and raised in the Flatbush section of Brooklyn in a one-bedroom apartment with my parents and sisters.

I worked my way through New York University with two jobs to pay tuition. After school, I spent 2 years in the Army, including 16 months in Korea. Ruth and I married in 1956. Our first home was a furnished basement apartment. My first job selling drapery fabrics paid $200 a month. With my scant savings accumulated over several years, I co-founded a textile company that became fairly successful through the 1970's and 1980's. Throughout that time, I always remained very conservative with my money, investing it prudently and keeping a good deal of it in money market funds. By the late 1980's, I managed to accumulate approximately $1.8 million in my IRA.

My accountant took note of the slow returns from the money market fund and recommended me to Madoff securities. He told me that Madoff generally achieved an 8 to 12 percent return per year and he employed a conservative proprietary hedging strategy that moderated market risk. In the late 1980's, I transferred $1 million from my IRA to Madoff. I received account statements every month, showing gains of 8 to 12 percent annually. As this conservative strategy offered me peace of mind, I was willing to forego outside gains in boom years in favor of greater security. In the mid-1990's, I moved the rest of my IRA savings to Mr. Madoff, approximately another million and a half dollars.

Since retiring in 2001 at the age of 69, we have used our savings at Madoff to pay our mortgage, taxes, and general living expense.

By November 2008, our Madoff account had reached approximately $4.2 million in stated value. Ruth and I thought we were living the American dream. Our dream, as well as so many others, has turned into a nightmare. We had considered Madoff securities not a get rich scheme, but a buffer against risk. We entrusted Mr. Madoff with all we had and now everything I worked for over a 50-year career is gone. I have been forced to cash in my life insurance policies to pay my mortgage. We are forced to sell our home and with the real estate market the way it is, we probably will not find a buyer and be forced into foreclosure. I sit before you a broken man.

Throughout my life, I always believed the American system of capitalism was the best regulator in the world and could safely be relied upon by investors like myself. But the Madoff scandal and the SEC's inability to detect it despite repeated written and other warnings tells me that is not the case. I believe my government has failed us and we have suffered tragically as a result. As with many other Madoff investors, the past several weeks have been a difficult waiting period for my family and myself. The media has covered the scandal zealously but there are no real details on how

and when investors will see any recovery. For me, even 5 or 6 months would be too late.

We simply do not have years to wait. Our current reality has nothing to do with profligate spending or undue market risks. We conducted our affairs in good faith in the belief that the SEC would never allow this sort of scheme to be conducted. I pray that Congress will come to understand our plight and enact some emergency legislation to allow SIPC to loosen its standards and distribute funds as soon as possible, as well as establishing a restitution fund for the Madoff victims.

We are not trust funds, hedge funds or banks. We are ordinary people who are victims of an incomprehensible crime who have had their lives turned upside down. We are turning to our government, our only help for relief and help that we desperately need. Thank you.

[The prepared statement of Mr. Goldstein can be found on page 96 of the appendix.]

Mr. KANJORSKI. Thank you very much, Mr. Goldstein. It is certainly a horrible situation.

Professor Frankel.

**STATEMENT OF TAMAR FRANKEL, PROFESSOR OF LAW, AND MICHAELS FACULTY RESEARCH SCHOLAR, BOSTON UNIVERSITY SCHOOL OF LAW**

Ms. FRANKEL. Thank you. Mr. Chairman, and committee members, thank you for the opportunity to speak about Ponzi schemes, trusting the securities market, and the need for regulatory reform. I want to emphasize that Ponzi schemes are common and they are common in the United States as well. In 2002, court cases, just court cases covered $9.6 billion of these schemes. So we have them. What is amazing in this case is the amount.

Mr. BACHUS. I am sorry. Mr. Chairman—

Mr. KANJORSKI. Yes. Could you pull your microphone just a little—

Mr. BACHUS. Pull the microphone—

Ms. FRANKEL. I am sorry.

Mr. BACHUS. It's not you. Just if you can pull the microphone towards you, it might be—

Ms. FRANKEL. Okay. Can you hear me now?

Mr. KANJORSKI. Yes.

Ms. FRANKEL. It is the amount that was so enormous and this really raises concerns. How did Mr. Madoff gain the trust of sophisticated people who knew how to read and write or knew how to ask questions? I would say first it is his personality, second he paid relatively higher returns, just as was described here. Third, he targeted trusting groups, affinity groups and that is the way it done. That is the kind of fraud this is. Fourth, he conducted a business similar to legitimate businesses. It looked like a brokerage after all. He looked like that.

And fifth, he drowned the truth in details. And that made the discovery tremendously costly and this is what happened, and I went through about 700 of these cases just in the United States—by the way, there are other places too—and found this kind of pattern. So the difficulty is verification. The difficulty is finding out,

out of all of these details, what is missing. And that is how he created undeserved trust.

Let me say two words about trust. Trust is not gullibility. Trust must be reasonable. Trust is a reasonable belief that the other person is telling the truth, that the other person will abide by his promise and reasonable belief requires some verification. But this is what the investors in the Madoff situation failed to do and others are likely also not to succeed because of the costs of verification and therefore let me add one more thing. During the last 30 years, we have really dismantled the financial structure that we used to have. So we have regulation here about financial structure that doesn't exist, that is very different. And he could combine a variety of structures together, which made the regulation also very, very difficult.

So what kind of regulatory reform would help restore investors' trust in the market which we must have. We must have this. We need deterrents and we need verification. I want to focus on verification. We heard a lot about deterrents. So first, we do not necessarily need more rules, especially not now. Rules deter, but they don't really verify. And I was very happy to hear the questions here were about verification, not about rules, additional rules. And besides—and this is one of the problems, what would be the future, fraudulent activities, we don't know. And preventive rules may prevent innovations, may prevent necessary flexibility.

So I would not focus on rules now. The second one, do we need more prosecution? Sure. We need to prosecute. But prosecution doesn't enhance trust, especially when it gives the impression that everybody in the financial business is a crook, which isn't true. It isn't true. So I would suggest that we need prosecution, but we should focus on verification. So first of all, we should verify. The investors cannot verify. The private sector gatekeepers do not verify. We have seen that time and again. The lawyers, the accountants, the rating agencies not now, they don't verify. So we are left with the government. The government must verify. So let me ask who should be examined and how. And here I reach the point that I have said before. I believe that all financial actors that can affect the financial market regardless of what you call them and whether they are registered or not registered, all of them must be examined. The main test should be the amount that they hold, not necessarily whether they are broker-dealers or this or that or the other because we don't have any more of the structure that we used to have.

Annual examinations, I think, should be mandatory, but also flexible, subject to exemptions and changes. Examiners should be highly qualified, they should be well paid, they should be sheltered from influence by the regulated entities which will be large. And they should be interdisciplined or in collaborated groups of experts. They should find out how these large institutions work and how they profit. I would not necessarily suggest that they should become the FDIC and decide whether they profit rightly or wrongly, but just how. Government verification can be effective to support investors' trust.

If you look at the FDIC, it is effective. If you look at the Internet, the verification by banks, by e-trust, by good housekeeping works.

It is effective. So the very existence of examiners like the police on the beat may also enhance trust. The emblem that the person—that these institutions may have examined by the SEC might also be desirable by them and therefore given the resource, the SEC can contribute to bringing trust back into the markets. Not necessarily people into the prison, but also back into the markets.

There are other benefits of examinations. They do not require restructuring the government. They are less expensive than verification through the courts. The problem is, I don't think the SEC has today the amounts that are necessary to examine and maybe also the talent that is needed. We need people who really know the ins and outs of the market. And most importantly, we don't have much time. I think mistrust, like trust, can become part of the culture and it is very hard to change. So congressional support of examinations can be introduced in a relatively short period of time and we need hands-on government policing fairly soon. And this is what we can achieve now. Thank you.

[The prepared statement of Professor Frankel can be found on page 86 of the appendix.]

Mr. KANJORSKI. Thank you very much, Professor.

Mr. Metzger is an adjunct faculty member at Columbia University, Cornell University, New York University and Yale University. Mr. Metzger.

**STATEMENT OF LEON M. METZGER, ADJUNCT FACULTY MEMBER, COLUMBIA UNIVERSITY, CORNELL UNIVERSITY, NEW YORK UNIVERSITY, AND YALE UNIVERSITY**

Mr. METZGER. Mr. Chairman, Mr. Ranking Member, and distinguished members, thank you for inviting me to speak. I commend you for conducting a meeting on regulatory reform of the financial services industry. In these remarks, I wish to stress two things: first, the need for top-notch internal controls; and second, that operational risk is the great unspoken-about danger. With the chairman's permission, I would like to submit my written statement for the record and summarize my principal observations and oral remarks.

Mr. KANJORSKI. Without objection, it is so ordered.

Mr. METZGER. My written statement includes the following 10 specific recommendations for new legislation or regulation:

One, there should be separate market-stability and market-integrity regulators.

Two, certain financial institutions should provide complete and timely disclosure of positional information to a market-stability regulator.

Three, the government should develop a model due-diligence questionnaire for investors.

Four, advisers should be required to remind their clients that the volatility of returns or the absence thereof is not necessarily the sole or even appropriate measure of risk.

Five, Members of Congress should mute the criticism of FAS 157.

Six, all financial intermediaries should be required to disclose how they diversify both financial and operational risks.

Seven, advisers should offer greater transparency to investors.

Eight, an independent third-party custodian should be used by all investment advisers.

Nine, accounting firms that audit broker-dealers should be peer reviewed.

And ten, the government should review whether investors benefit from soft-dollar arrangements.

Studies of hedge fund failures have concluded that the majority of them folded because of a failure to manage operational risk, not because of a failed investment strategy.

If investors could be given the tools for evaluating non-financial aspects of investments and could be convinced to use those tools, I am certain that vastly fewer of them would fall prey to investment fraud.

Unfortunately, for many investors, due diligence begins and ends with reviewing the performance record. There is a tendency for investors to "chase returns" and to assume that past performance guarantees future results.

The payoff for many hedge-fund strategies is a high probability of a small profit, and a low probability of a huge loss. Investment advisers use financial leverage to amplify returns. A manager with an impressive performance record may have achieved that success, not because of his investing skills, but because of his tolerance for risk taking.

Increased transparency allows for better due diligence and monitoring. It can help the investor identify excessive contributions in her portfolio when she aggregates her investment, and any style drift by the investment adviser.

One of the arguments made by the investment advisers who oppose transparency is that it could allow competitors to reverse engineer proprietary trading algorithms. I do not have much sympathy for those who assert this concern. Too many managers generate "fake alpha" by delivering early above-average returns when the expected return over a longer period is much lower.

Investors should be given enough information so that they can accurately asses the risk to their portfolio.

Eliminating risk is impractical, because without risk there cannot be any reward. The aim should be to achieve an appropriate balance between risk and return.

Diversification of assets and strategies, which reduces the risk of excessive concentration, is a necessary part of risk management, which must also address low-probability events.

While we may not be able to undo the damage of the past, we should resolve: first, to contribute to the development of legislation and regulation that will protect investors from Ponzi schemes and other fraud.

Second, to inform and educate investors regarding the dangers of making investment decisions solely on the basis of past performance, ignoring the importance, understanding the investment strategy, disregarding best internal control practices and piggy backing on smart money;

And third, to inform and educate investors regarding the benefits deriving from diversifying both investment and operational risks and conducting proper due diligence.

Consider the extent of our contribution if, because of today's meeting, investors will walk away from the next multi-billion-dollar fraud, avoiding the embarrassment and financial pain that inevitably follows.

Regulatory reform of the financial services industry should be a high priority. Thank you for your leadership in this important matter and for inviting me to speak. I stand ready to assist you, and welcome any questions you may have.

Mr. KANJORSKI. Thank you very much, Mr. Metzger.

[The prepared statement of Mr. Metzger can be found on page 114 of the appendix.]

Ms. FRANKEL. I join my friend. I also would like to assist.

Mr. KANJORSKI. Thank you, Professor. Professor Frankel, I didn't get to introduce you. You are a faculty member of the Boston University School of Law and have been a witness before this committee on several past occasions. We welcome you back and sought your expertise on this particular issue. Maybe we could take Mr. Goldstein's experience here and then look at your evaluation and opinion as it affects him. Why can we assume—first of all, let me say, in a capitalist system, there has to be risk. Do we all concede there is going to be risk?

Ms. FRANKEL. That is right.

Mr. KANJORSKI. Then the question of due diligence. Where does it lie, does it lie with the investor or does it lie with someone else? And I come to the conclusion it really is with the investor. Now, on the other hand, listening to Mr. Goldstein's story, I am absolutely shocked in terms of an experienced businessman, successful, hesitant when you took some of your money from your IRA and gave to the Madoff investment but you retained half of it for a decade or so. What was the compelling reason? Was it the advice of your accountants that made you select the Madoff outfit or did you individually check them out in some way? How did you get to them? I am curious.

Mr. GOLDSTEIN. It was on the advice of my accountant.

Mr. KANJORSKI. The advice of your accountant? Is there any relationship? Was he a finder, your accountant, for Mr. Madoff?

Mr. GOLDSTEIN. No.

Mr. KANJORSKI. He just heard from other people who—

Mr. GOLDSTEIN. I think he invested money with Mr. Madoff also. I was prepared for risk. I wasn't prepared for fraud.

Mr. KANJORSKI. Isn't fraud a potential risk factor, though, to be considered?

Mr. GOLDSTEIN. To my mind, no, because the securities industry is regulated by the Securities and Exchange Commission to prevent that kind of thing, in my mind.

Mr. KANJORSKI. So you believe when someone—there is a Good Housekeeping seal of approval, if securities are issued and people say the Securities and Exchange Commission approved the issuance, you don't have to go any further, you don't have to look at the character, the personality of the people involved or their track record?

Mr. GOLDSTEIN. These weren't securities. These were—my statements showed only Dow Jones components every month. There weren't any auditables—

Mr. KANJORSKI. And part of your testimony was a looking forward to some sort of relief, potentially from the government?

Mr. GOLDSTEIN. Yes.

Mr. KANJORSKI. If you had purchased General Motors stock 3 years ago and it fell from $80 to $2, do you believe that the United States Government should compensate you for that?

Mr. GOLDSTEIN. Absolutely not.

Mr. KANJORSKI. Why not?

Mr. GOLDSTEIN. Because it is a risk that I took.

Mr. KANJORSKI. What kind of risk did you take, stupidity over fraud, is it?

Mr. GOLDSTEIN. I am really having difficulty answering that question. If I bought a stock, let us say General Motors with the expectation that it was going to burn money and continue to go up and it didn't, then possibly I didn't, do my due diligence, or possibly the market was adverse to me and I would understand that and accept that readily. But this was a fraud. These people took my money.

Mr. KANJORSKI. Okay. How about you are walking down 5th Avenue and I sort of like the cut of your clothes, so I pull my little gun out and I say Mr. Goldstein, give me your wallet, do you want the government to recompensate you?

Mr. GOLDSTEIN. No.

Mr. KANJORSKI. Aren't you entitled to believe that you should live in a safe place and it wouldn't have happened except that a thief is allowed to carry on in the streets of New York?

Mr. GOLDSTEIN. I also would expect that the police force or the law would protect me to the best of their ability.

Mr. KANJORSKI. And they obviously didn't because you were robbed.

Mr. GOLDSTEIN. That is right.

Mr. KANJORSKI. So should the State of New York or the government pay you for whatever you were robbed of?

Mr. GOLDSTEIN. Possibly not, but possibly my insurance company would.

Mr. KANJORSKI. You can insure against that I see. Couldn't you have insured against dealing with fraudulent people? Isn't there some insurance? I am not aware of what the insurance—

Mr. GOLDSTEIN. I don't have anything like that, but I always thought that SIPC would do that.

Mr. KANJORSKI. What I am curious about, though, is that, having listened to some of the testimony today and having read the press reports of this, I am astounded not by you, Mr. Goldstein, I think you fall within the range of really less sophisticated than some of the people who were taken. We are talking about banks that got taken for billions of dollars and they have the responsibility of investing other people's money and due diligence and they have regulators that come in and look at their accounts. That is the thing that shocks me. Do you see where my trend of examination, Professor, is going? Can we afford to represent that the United States Government or any government can stand behind people who are defrauded?

Ms. FRANKEL. First, I want to say a word. Banks, there were eight banks that were caught in a Ponzi scheme, not very long ago,

a few years ago. So even banks can fall within such a scheme. But the question was whether we can afford to be protected. What exactly—I am sorry. Maybe I didn't follow. What was the question?

Mr. KANJORSKI. Is it reasonable to rely that the government will stand behind all fraud situations in a loss or is that concomitant with the risks of investment?

Ms. FRANKEL. Not all. But fraud I agree. And the question is the cost. How costly is it to really find out the fraud. The government does have resources that investors don't. It has the ability to force people to tell the—

Mr. KANJORSKI. Let me stop you right there, Professor. Some of the people who had the fraud, some of these banks had billions of dollars and the SEC only has $900 billion to carry out all of its functions as a regulatory agency. So really some of these people who were defrauded have far more money than the government agency.

Ms. FRANKEL. The banks, those people who were—had the money and also were regulated, they should not expect, I think, payment by the government. Taxpayers shouldn't support them. But the person like this gentleman, who did his best, but—let me say one thing. We are a specialized community. We must depend on each other. If each of us has to become an expert in law, in medicine and so on, we won't have the society we are having today. So we must rely on others. And if the cost of supervising and the cost of finding out frauds are too high, we won't be able to have a financial system. That is what people are doing now. They are taking their money and running away. That is because they can't supervise that much so it is a question of measure.

Let me add one more thing: There are three building blocks to the financial system. One of them is morality and that is self-regulation, self-limitation of the people who hold other people's money. The other one is forced morality and that is the law. The third one is protection. What we have done in the last 30 years is we have moved everything to self-protection and that is what we get.

Mr. KANJORSKI. I would love to go on, but I am taking too much of my allotted time. The gentlelady from West Virginia.

Mrs. CAPITO. I want to thank the witnesses. I want to particularly thank Mr. Goldstein for coming before the committee today. I know it is a particularly difficult time for you and you have put a human face on this. And I have just a couple of specific questions, and then just generally a couple of questions. Did you actually interact personally with Mr. Madoff at all during any of these transactions?

Mr. GOLDSTEIN. Never met him.

Mrs. CAPITO. Never met him. Were you in a circle of friends or anything who other folks were investing with him and so you were aware of other larger profits that were being made and that type of thing?

Mr. GOLDSTEIN. I knew of no one in Madoff when I first put my money in except my accountant who had money there. But over the course of years, I have come across a lot of people who are friends of mine who had money there also.

Mrs. CAPITO. And during the course of the 10 years, your money was in this—

Mr. GOLDSTEIN. 21 years.

Mrs. CAPITO. Excuse me. 21 years. Did you draw out and receive dividends and benefits all those kinds things in a regular manner that you would have expected from another investment account?

Mr. GOLDSTEIN. Yes. Since I have retired, I took out living expenses. I didn't take out any huge sums of money.

Mrs. CAPITO. Okay. Thank you. I would like to ask—I am kind of getting a conflicting message from the other two panelists, because Ms. Frankel says no more rules and Mr. Metzger is saying more regulation. Are you agreeing or disagreeing or is a regulation different than a rule? And how is that, in your minds, divergent or together?

Ms. FRANKEL. May I say something? I don't suggest that we don't need regulation or rules. They are the same as law. I think they should be the second or third in line, which would be done now should be examinations rather than rules. I am concerned about rules that would limit the ability to develop. So now the rules that Mr. Metzger suggested are different.

Mr. METZGER. Yes, I am talking about rules of disclosure. I don't think those are heavy-handed rules. I think also the way our society has developed, the lines of separation between certain types of financial products at one point were quite clear but now they are blurred. The approach toward regulation should change. I am not saying we have to have additional regulation, but I think that there ought to be a market-integrity regulator and there ought to be a market-stability regulator. Right now, information that the market stability regulator ought to have, that regulator doesn't receive. So, I don't think that this is a major change in regulations. These are just slight modifications that I think will improve things.

Mrs. CAPITO. And I will agree with that in I think the sophistication of the financial instruments that are at work here are well beyond somebody who is reading their monthly statement can begin to imagine, much less how to regulate or keep track of what is actually going on. So I think that we need something that can move quickly and can adjust from time to time probably more quickly than we have been able to adjust at this point. Would that be an accurate statement—

Mr. METZGER. Yes, it is. And I would also say that some of my legislative suggestions relate to education of investors as opposed to regulation of investors.

Mrs. CAPITO. I think that is an excellent suggestion as well. Going back to Mr. Goldstein as an individual investor, he was basing his very intelligent decisions on the fact that things that were before him were true, that the standards that Mr. Madoff had and the certifications that he had and the bond—or the ratings that he had, that all of these things in fact represented a true and honest portrayal of an honest professional. And I am sure the law is going to figure out how dishonest or whatever, but it is so difficult I think from an advised's point of view when the SEC and other regulators have come in and said, okay, okay, okay, you trust in that and then when you find out that is all a fraud, you really, I think—I think you just have to throw your hands up and be so frustrated by that because as an individual, it would be very difficult to unwind that on your own. And so—

Mr. METZGER. May I respond?

Mrs. CAPITO. Yes.

Mr. METZGER. In my written testimony, I referred to a due diligence questionnaire that the Alternative Investment Management Association has produced. I think if investors were to look at this DDQ and then question prospective investment advisers and have them respond to the survey, they would learn so much more, and it is likely that there would be far fewer frauds of this type.

Mrs. CAPITO. But the fact of the matter is a crook is a crook, and if somebody is going to lie, they are going to lie.

Mr. METZGER. No. There is a question of who is your custodian and the adviser says, "I am the custodian," there you go.

Ms. FRANKEL. And if the adviser says the custodian is in the Cayman Islands and in the Virgin Islands, what would you do then, go—

Mr. METZGER. That is a red flag.

Ms. FRANKEL. That is a red flag and what do you do next?

Mrs. CAPITO. There were a lot of red flags in this case unfortunately, and I yield back.

Mr. KANJORSKI. The gentleman from North Carolina, Mr. Watt.

Mr. WATT. Mr. Chairman, I think I am going to yield my time to Mr. Ackerman since he has a constituent who has been directly impacted by this.

Mr. KANJORSKI. Mr. Ackerman, go to it.

Mr. ACKERMAN. Thank you very much. Mr. Watt. Thank you very much, Mr. Chairman. Actually let me state for the record that Mr. Goldstein is not a constituent, he is not one of those very wealthy people to whom I refer. He does not live in my district. But of the many, many cases that I heard of, many of whom are constituents, a number of whom have lost over half a billion dollars and some of whom can keep their life together and move on after that kind of thing, even though the public has no great sympathy for somebody who has lost at least a million dollars, I want to tell you that Mr. Goldstein is the typical American dream to whom everybody aspires to be. And that is where the problem lies and that is why I suggested him as a witness, Mr. Chairman.

Mr. Goldstein's statement—and people have asked and a colleague of ours mentioned if it seems to good to be true, it is probably not true. And other people have said people should do due diligence and they should look into these things and they should be smart and these people have so much money, why aren't they that smart and we should have no sympathy for them. If one looks at Mr. Goldstein's statement—and I am sure now a lot of people will now that it is part of the record—you will see a conservative prudent person.

The first generation Americans grew up in one bedroom with sisters and parents all in one bedroom and scrimped and saved in what we used to call the into the day he could help his children and help his grandchildren and now find that he might lose his house because he is going to be underwater pretty soon if he doesn't find a buyer and then can put the house on the market. If no help comes—because he has already taken—Mr. Goldstein, how much do you have left in cash value in your life insurance?

Mr. GOLDSTEIN. None. I have taken it all out.

Mr. ACKERMAN. You took it all out for what purpose?

Mr. GOLDSTEIN. To pay my mortgage, to pay my living expenses.

Mr. ACKERMAN. Closer with the microphone.

Mr. GOLDSTEIN. I have none left. I took it all—

Mr. ACKERMAN. A little closer, please. Turn it on.

Mr. GOLDSTEIN. I took out all the money from my life insurance policy since it was only my only liquid asset. I use it to pay my mortgage, to buy food—

Mr. ACKERMAN. What month are you paid up to on your mortgage?

Mr. GOLDSTEIN. My mortgage is paid through January.

Mr. ACKERMAN. What is your mortgage payment a month?

Mr. GOLDSTEIN. About $5,900 a month.

Mr. ACKERMAN. Can you pay it next month, can you pay it the following month, can you pay it for the next 3 months?

Mr. GOLDSTEIN. I think that I can pay my mortgage for the next 2 months, February and March.

Mr. ACKERMAN. Then what happens to your April payment?

Mr. GOLDSTEIN. I just can't make it. I don't have any money.

Mr. ACKERMAN. And if you sell your house, where does that money go?

Mr. GOLDSTEIN. If I sell my house, it will pay the mortgage. But I don't know I will be able to sell. There is no market right now for homes where I live. I live in upstate New York.

Mr. ACKERMAN. And then you pay the mortgage company if it covers the mortgage. And then where do you live? You just sold your house.

Mr. GOLDSTEIN. My daughter in California has told me that she would put my wife and myself up in her house.

Mr. ACKERMAN. How does that make you feel?

Mr. GOLDSTEIN. At this stage of my life, the thought of living in my children's home is not humiliating but it is very sad. It is terrible. Terrible. So I have to end up my life living off the benefits of my children.

Mr. ACKERMAN. When your statement from Mr. Madoff that you have scrutinized every month—and I have only spoken—I have just met you today, spoke to you for a few minutes before the hearing. But looking at your statement, thank you for allowing us to make this public. And I appreciate your wife's willingness, although she could not be strong enough to be with us today, that she has allowed—

Mr. GOLDSTEIN. My wife is going through severe emotional problems because of this.

Mr. ACKERMAN. I am sure. And we appreciate her and the fact that you are willing to do this so that we can bring public light to this. But your statement shows a prudent investor. This is the face of somebody who has invested everything over 50 years starting from zero in things like Fidelity Spartan, Wal-Mart, Exxon, Intel, Johnson & Johnson. This is this month. JPMorgan, Coca-Cola, McDonald's, Merck, Microsoft, Oracle, PepsiCo, Apple, Pfizer, Abbott Laboratories, Procter & Gamble, AmGen, Philip Morris, Bank of America, Qualcomm, Citigroup, Slumberjay, Comcourse, AT&T, Conoco Phillips, United Parcel, Cisco Systems, on and on and on, for ages.

Mr. KANJORSKI. May I ask a question? Is that Mr. Madoff's statement?

Mr. ACKERMAN. No.

Mr. GOLDSTEIN. This is Mr. Madoff's statement, my monthly statement from Madoff.

Mr. KANJORSKI. Telling you what you are investing in?

Mr. ACKERMAN. This is Madoff's statement to Goldstein, to Mr. Goldstein. This is his IRA, this is his nest egg, this is his grandchildren's tuition to college that he is going to get closer to than he ever thought he would be, fortunate or unfortunate and tragic although that may be. But this shows a prudent investment. Mr. Madoff, the thief that he is, was brilliant at what he did, people should understand. He showed you what he gambled on and what you won after the fact because he sent you a statement after the trading day was over. If he bought Exxon and you were flying high on the 14th, he knew the price that you bought it at, put it down and sold it at the 15th, knew the profit you made. If Mr. Goldstein checked out or anybody else checked out their statements, to the penny this checked out. At the end of the month, swept all of this money all—whatever it adds up to, $4 million or somewhat less, swept it into treasuries. How does a man—I will ask the other witnesses. They are the sophisticated professionals. Is there any way that the Mr. Goldsteins of this world, and there are numbers of them. They are more than the high profile—and I won't name the people. You can read them in the paper who they are—that any of these people, sophisticated or average people, could have checked. The Inspector General is at a loss. He is just starting an investigation and he is scratching his head in front of us. He is talking about the Enforcement Division investigating this of the SEC. The SEC is supposed to—who was watching? If none of them could find this, how could Mr. Goldstein?

Mr. GOLDSTEIN. I must add to this that on more than one occasion, I took my statement, and I sat down with the stocks index of The New York Times, and it checked out.

Mr. ACKERMAN. Of course it did. He told you you were betting on a horse race after the race was over.

Mr. KANJORSKI. Let me ask the next question. He converted to treasuries every month?

Mr. ACKERMAN. He did nothing. He took Mr. Goldstein's money, the $4 million that Mr. Goldstein thought he had saved with all his dividends, interest, etc., and he then paid everybody their 8 percent or 10 percent a year, and then he went to Mr. Jones and said, have I got a deal for you. Look, I got this guy and that guy and all these names of all these show business people and everybody—

Mr. KANJORSKI. But you said to avoid some sort of inspection that would have been triggered by the SEC?

Mr. ACKERMAN. Yes. What he did, at the end of the month—

Mr. KANJORSKI. At the end of the month he converts everything—

Mr. ACKERMAN. He took all these stocks that he never bought.

Mr. KANJORSKI. Right.

Mr. ACKERMAN. These stocks don't exist. You can't check it out. They are in nobody's name. They are not in the street name, in Madoff's name. Maybe Madoff had some stocks in his street name.

We don't know that. But for the most part we think what is going on here, he just paid you off in new money that he took in. That is the Ponzi scheme. He got 10 million investors. He wouldn't touch you. And every once in a while, he took one of these wealthy people who are all in the same country clubs in Palm Beach and the Gold Coast of Long Island. This guy is making 10 percent for 20 years. You would be stupid not to invest. That is the track record that you checked out with everybody who is brilliant, with everybody who is making money.

And I have spoken to constituents of mine who had millions, who aren't blinking an eye. They lost it and so what. This one guy says, I called up to check it out one day and I said Bernie, I need $500,000. He said, I will wire it in your account. He said the next morning, there was $500,000. He says, the next morning, I ran to the bank so quick to put it back in. Why should I lose 10 percent? I checked it out. The money is there. This guy was brilliant. And at the end of the month all of this stock that you thought you had, he then shows you at the end is in treasuries. Sold everything, put it in treasuries. You can't check out treasuries. How many people say they should have checked? I said, where is your money? They said, I am in treasuries. I said, how do you know it is in treasuries? Because I told them to buy treasuries. I said, what if you sent it to X, Y, Z, name the 10 biggest brokerage houses you know and they are all crooks. They are not, but let's say they are. And you sent them $10 million and said, put in treasuries. Did you ever see a treasury bill? You get a statement that says he has a treasury bill. All of the Mr. Goldsteins of the world got statements. They got all of this paper that said they have treasury bills. At the end of the month, he figures I can take out $4 million. I have it in treasuries, or whatever it is.

Mr. KANJORSKI. So let me just interrupt you for a second. This is like reporting the race after it is run. If you ran through all this stock and took the day he claims that it was sold when in fact it really wasn't, it would add up to the amount he purchased through treasuries and it would show the profit.

Mr. ACKERMAN. To the penny. But thousands of people. We don't know the number. Maybe 3,000 or so people. That Mr. Madoff could do this scheme himself, he had to be a lot smarter than the genius that some people think he was. The mad genius, the evil genius. That is part of what the Inspector General and the other law enforcers are going to find out. But it is not Mr. Goldstein's fault. This is not a case where you can blame the victim for not doing due diligence. There is nothing anybody could have done.

Mr. METZGER. This was a sophisticated fraud. Most sophisticated investors would not have been able to detect that.

Mr. ACKERMAN. The SEC couldn't detect it, the watchdog, the watchdog of watchdogs, couldn't figure out what the crime was.

Mr. METZGER. This was not a garden-variety case of alleged fraud.

Mr. ACKERMAN. No. But we don't know how many mini-Madoffs there are out there. We don't know how many people sweep all of their money into treasuries. And hopefully Mr. Kotz is going to ask that question because they don't have to report to his agency. They say, I am holding those securities or I am holding very few securi-

ties. I don't have to report it to you because it is all in treasuries. This is the dilemma of Mr. Goldstein. Mr. Goldstein, who is not a cop, he is not an investigator, he is not a very sophisticated investor but he is a smart man who saved and did the prudent thing. And this is the face of the investors that we are talking about.

But he did think that he had one thing. He had the confidence, as he has told us, in his government, that his government made sure that this has a seal of approval to at least $500,000. At my college, you know what we did and we insisted that Mr. Paulson do when people we wanted them to have confidence and not have runs on the bank because they had more than that? We raised it to $250,000. So we insured those accounts for $250,000 so people with that kind of money thought that they at least had that kind of protection and they should move the money into different accounts. Right? With brokerage accounts, some people said why am I in a bank with $250,000 if I have $300,000? I will put it in a brokerage account instead of my banker's account and I am insured for $500,000. Mr. Goldstein is one of the thousands of people who were told that seal of approval, as it was called, that is given by our government, that is backed up presumably by people who are watching, the real cops, the real enforcers, or so we thought—and I did mean Inspector Clouseau instead of Jacques Cousteau. Forgive me, Jacques. So I thought it was guaranteed that if Mr. Goldstein can get his $500,000 worth of insurance and so many other people, at least they would have a temporary lifeline plus the rest of the assets that might be there.

Mr. KANJORSKI. Thank you very much, Mr. Ackerman. I will now recognize the gentleman from Alabama for 5 minutes.

Mr. BACHUS. Thank you, Mr. Chairman. Mr. Goldstein, your wife is obviously emotionally torn up by this. I am sure it has affected your health and hers. When you watch TV and you realize that Mr. Madoff is still going home every night to his luxury apartment, how does that make you feel?

Mr. GOLDSTEIN. I have to answer that. The first 2 or 3 days after the disclosure, I was very, very angry, very angry. And I decided to myself that the only way that I could survive this as best I could was to get rid of the anger. So I don't care if Mr. Madoff goes to jail. I don't care if he sits in his apartment. It doesn't—it won't affect my life one way or the other.

Mr. BACHUS. That is a good—I get a good lesson in forgiveness, although I am not sure that he should be spending the night in his luxury apartment. I am not sure what message that sends to other folks who would do this type of thing.

Mr. Ackerman called him an evil genius. Basically what he did, he made this stuff up every month.

Mr. GOLDSTEIN. I don't think one man made all this up, however.

Mr. BACHUS. Oh, I agree. I agree. I think if he were in jail, he may be more likely to cooperate. But maybe that is not true.

Mr. Metzger, you said it is not a garden variety type of fraud. A lot of people who have committed much less of a crime than this are in jail today, and went straight to jail. Does it bother you that Mr. Madoff is free on bond?

Mr. METZGER. I don't know why the government reached that decision. I cannot defend the government's—the way the government negotiated with him.

Mr. BACHUS. How about you, Ms. Frankel? Or Professor.

Ms. FRANKEL. I don't think it makes that much of a difference. I would like to see him in jail. On the other hand, I don't want to pay for his food and keep. What I would like is to make him live the way the other people—I would like his money rather than his discomfort. And then the discomfort will come.

Mr. BACHUS. You know we don't seem to apply that standard to other people who steal much less than that. We don't just ask for the money back.

Ms. FRANKEL. Then maybe we should start. We should start if we take other people's money—the point is this, he took other people's money and then they are—he should be trustworthy.

Mr. BACHUS. They are suffering worse tonight than he is. I guess that is my point. I am not—

Ms. FRANKEL. He is ruining or he has helped continuously to ruin a very important part of this country.

Mr. BACHUS. Including charities and schools.

Ms. FRANKEL. The whole financial system.

Mr. BACHUS. I for one am outraged that this man continues to walk the street and go home at night, and I consider myself a pretty forgiving person. But I think that the message it sends about law enforcement and the even-handedness and equal protection of laws is a dangerous message.

Ms. FRANKEL. I agree.

Mr. BACHUS. Thank you. You know we are talking about what—Mr. Goldstein what you did and whether you should have done something different. I wrote down some of the things that I would have done. One of them, I would have found a good investment adviser with a good track record, and that was Mr. Madoff. In fact he appeared to be about as good of—had a great track record, was—and then you know I, like you, I would have looked at my statements to see if he was investing it wisely and if I was getting a good return. And every month it would be—I would—I would have the opinion that I had done the right thing, and that would be reinforced by these made up statements. And you did that, too. You looked at them. And obviously he was investing in what I have heard other people say, and you, a lot of index funds which is diversification.

Ms. FRANKEL. That is right.

Mr. BACHUS. And treasuries, which is, what is safer than treasuries? So yes, I can't really—it is hard to understand that you could have this massive of a fraud for this period of time and have complaints come before the regulators and yet them not discover it. It just blows my mind.

Mr. GOLDSTEIN. I would just like to say one thing. I never thought of fraud in this. It was an investment. It looked perfectly fine. I was getting a return. But somewhere inside of me was the thought that this was a regulated industry, and the government was behind the regulation. And it wasn't. It wasn't. The red flags, the warnings, the letters were just pushed aside. So the end result was people like myself are suffering because of that.

Mr. BACHUS. I agree. Thank you very much.

Mr. GOLDSTEIN. Thank you very much.

Mr. KANJORSKI. Thank you very much now. Do you have that train to catch at 6:30? Is that correct?

Mr. METZGER. Mine is at 7:10.

Mr. BACHUS. I think you have already missed it.

Mr. KANJORSKI. The question is—

Mr. METZGER. I am willing to stay.

Mr. KANJORSKI. Professor?

Ms. FRANKEL. I am willing to stay.

Mr. KANJORSKI. And Mr. Goldstein?

Mr. GOLDSTEIN. Yes.

Mr. KANJORSKI. It would be very helpful because this does put a human face on a problem. And it is shocking. So I am very pleased we will be able to get—I will even start with Mr. Scott, give him the first 5 minutes.

Mr. SCOTT. Thank you, sir. I appreciate that. First of all, let me thank you for your patience and waiting. You have been here since 2:00 and it is good to see that you have stayed because, in fact, yours is probably the more important of the panels from my perspective.

Mr. Goldstein, let me just talk with you for a second. How much money are we talking about that you have invested with—

Mr. GOLDSTEIN. I invested with Madoff two different times. The total—this was 20-some odd years ago. But the total was approximately $2.5 million.

Mr. SCOTT. That is the total leading up after 20 years of investment of your money. So you had a 20-year relationship with Madoff?

Mr. GOLDSTEIN. Yes, sir.

Mr. SCOTT. And if I may ask, how did you get into this relationship? Were you referred? Did you know him?

Mr. GOLDSTEIN. I was referred by my accountant, who also had an account with Madoff.

Mr. SCOTT. Okay. Your accountant wasn't by any chance their auditor?

Mr. GOLDSTEIN. No, no, no, no.

Mr. SCOTT. So this $2.5 million that you had invested and lost with him over a 20-year period, now what did you see from this over this 20-year period? Did you engage in any selling and buying with him? Were you able to see—of the $2.5 million that you invested, what was a gain to you? What did you see for that?

Mr. GOLDSTEIN. I had a yearly return, which was give or take 10 percent.

Mr. SCOTT. Okay.

Mr. GOLDSTEIN. It was so steady. Over the years there was never any hint of impropriety. What I did was, I mortgaged my house, lived on that money, and let the Madoff money just increase in value and the account got bigger. From my $2.5 million, I have $4.2 million on my November statement.

Mr. SCOTT. 4.2 million in your November statement.

Mr. GOLDSTEIN. Yes. That is what he told me I had. Obviously I didn't have it.

Mr. SCOTT. You didn't have that because of the scheme. Let me ask you, Ms. Frankel, if I may, moving forward, you made a recommendation and I would like for you to just expound on it for a moment. When you said that rules, the regulations, I think the heart of your testimony was that we should verify. Can you explain what you are talking about when you say verify and how we would do that? Are you Ms. Frankel?

Ms. FRANKEL. Yes.

Mr. SCOTT. Yes, Ms. Frankel.

Ms. FRANKEL. The government has a right to demand proof. And in this case, that is the way mutual funds, for example, are regulated. They are—there is a whole slew of rules. And it is not merely that you have the money in a certain—with a certain bank. But you have all sorts—you have requirements for the—you have a requirement for the insurance of the employees. You have a lot of requirements. As a matter of fact, the Investment Company Act of 1940 and the Investment, even the Investment Advisers Act of 1940 have rules. But these—Mr. Madoff was a broker. Brokers are not subject to many of these rules. And they were not—that is—that is number one. Number two, I think we should have more examination. In other words, not merely they are saying, yes, we did put the money in the bank. But somebody should come there and examine and say, show me. Yes. I was at the SEC for just a year and a half. I was on loan. And I went to these examinations. They were for other things, yes, they were for soft dollars. We went in. We said hello, hello. And then we said, show us, yes. And we asked questions and the people there said for about 2 years.

Mr. SCOTT. Let me ask you this—

Ms. FRANKEL. Sorry.

Mr. SCOTT. What do you think a step in that direction would be if we in one part of the process, if we brought broker-dealers, regardless of their size, make sure that they are audited by auditors that come under the jurisdiction of the Public Accounting Board?

Ms. FRANKEL. Broker-dealers now even assert that they are not fiduciaries even though they hold other people's money. Yes? And I think the regulation of broker-dealers ought to change. And it is more complicated but it ought to change.

Mr. KANJORSKI. Thank you, Mr. Scott. Mr. Sherman, for 5 minutes.

Mr. SHERMAN. Thank you, Mr. Chairman. Mr. Goldstein, your investment was directly in Madoff. And so as I understand the position of SIPC, you stand to—you have a good claim for $500,000.

Mr. GOLDSTEIN. God willing.

Mr. SHERMAN. Yes. On the other hand, filings have been made on behalf of those who invested indirectly, where you know a fund manager would take the money of 20 people and put it into one Madoff account, and the old-fashioned position on that was those 20 people are all going to have to share $500,000. People in that situation have gone before the courts to say, no, we are 20 people. Treat us as 20 people and not as one account. If that happens, SIPC is way bankrupt.

Are you and the direct investors taking any position with regard to the claims of the indirect investors?

Mr. GOLDSTEIN. Not that I know of.

Mr. SHERMAN. Okay. Ms. Frankel, I will go a little bit outside the Madoff situation because sophisticated investors at least go with a guy who looks like he is a broker or an investment adviser. A lot of people in my district may invest in a variety of other flim-flams where—most people in my district don't know what a private placement memorandum is supposed to look like.

Ms. FRANKEL. Right.

Mr. SHERMAN. The SEC takes the position that they will surf the Web looking for problems. But they will never send an e-mail to someone who is offering an investment unless they say, hi, we are the SEC. We are investigating you. But they won't pose as a potential investor. So would it make sense for the SEC to pose either in person or online or both as a prospective investor and hear the pitch not from the people who are registered investment advisers, registered companies with the SEC but with the folks who are stealing from the less sophisticated?

Ms. FRANKEL. This is a criminal law question of entrapment. The question is, to what extent are these people entrapped?

Mr. SHERMAN. It is hardly entrapment to say—the problem we have is the SEC says, we don't want to be a law enforcement agency, which begs the question, who? It certainly is not entrapment if you see something online, "double your money in 6 months, e-mail me now and find out how" to say, hi, my name is Jack Smith. I would sure like to double my money in 6 months. But these hearings are going to create—I think it was Mr. Paul, whom I usually don't agree with, who said that one of the functions of the SEC—one of its effects is to create an image in the society that things are safe. Go try to find the right investment. And of course things are particularly unsafe for those who are not investment purveyors.

Ms. Frankel, what is your comment on that? Or, excuse me, Mr. Metzger.

Mr. METZGER. I wasn't following the question. Do you want me to tell you what I think about impersonation?

Mr. SHERMAN. Certainly, when it comes to enforcing our laws against prostitution, police have a certain approach of impersonation. The SEC will not impersonate an investor even though local cops in my district will impersonate either side of the oldest professional transaction.

Mr. BACHUS. Is that a concern for you, Brad?

Mr. SHERMAN. I am more likely to lose in an investment scam. But go on.

Mr. METZGER. That is a public policy decision. I am troubled by the idea of impersonation. I understand what the benefits are. It is a moral question. It is an ethical question.

Mr. SHERMAN. Moral, so it is moral—

Mr. METZGER. On the one hand, you have potential fraudsters, and you want to protect less sophisticated investors from these people who are committing fraud.

Mr. SHERMAN. I believe my time has expired.

Mr. KANJORSKI. Take the response, though.

Mr. SHERMAN. Thank you, Mr. Chairman.

Mr. METZGER. So, on the one hand, there is this idea of just—I just feel uncomfortable sanctioning impersonation. It just doesn't seem right. So you have to weigh the benefits. It is costs and bene-

fits. Standing on one leg, I can't give you an answer right now about how I feel about it.

Mr. SHERMAN. Every law enforcement agency does it. The SEC refuses to be a law enforcement agency. And I yield back once again.

Mr. KANJORSKI. Thank you, Mr. Sherman. We now have Mr. Green of Texas.

Mr. GREEN. Thank you, Mr. Chairman. Mr. Goldstein, my heart goes out to you. And I wish you and your wife the very best. My suspicion is that you are not here today because you lost money as a result of the stock market going down. You are here because you lost your money by way of a fraud. If you had invested the same amount of money and the stock market just didn't serve you well, my suspicion is you would not be here today. Is that a fair statement?

Mr. GOLDSTEIN. 100 percent correct.

Mr. GREEN. So I beg that you tell those who would say you could have been a better watchdog, it is your responsibility to protect yourself. We here on the committee have our opinions about it, and we have expressed them. I think my colleague Mr. Ackerman expressed himself quite well. And he made a great case. But I think it is important for you to have a message for those who say that you could have protected yourself and that we leave it to you to investigate and to ascertain whether or not you are being defrauded.

Mr. GOLDSTEIN. Is that a question?

Mr. GREEN. Yes, sir. Would you give—what would you say to them?

Mr. GOLDSTEIN. I will say exactly what I said before. I invested my money. The market goes up, the market goes down. I understand that. But I also invested my money, knowing somehow that the government, the SEC, whatever laws were involved, were protecting me from fraud, not from market volatility. Market volatility is my own problem. Fraud, on the scale that it was perpetrated, I think the government has some complicity. There were warning signs. There were letters. There were audits that weren't made. There was an accountant who didn't fit into the picture. There were so many things that happened and nobody did a thing about it. So we were all victims.

Mr. GREEN. And as a victim, you made the statement that you think that your government has failed you.

Mr. GOLDSTEIN. Yes, sir.

Mr. GREEN. And I truly understand the import of the statement that your government has failed you. What by way of restitution do you seek today as a result of this experience?

Mr. GOLDSTEIN. I don't expect to get $4.2 million back. I don't. If I get the SIPC money, that would help me to survive until I could sell my house. If there was some kind of restitution from the assets of Madoff or even a little more than that, that would be a miracle for me. That is what I am looking for. I just want to continue my life. I am not going to be driving a Mercedes-Benz. I am not going to Europe on vacation. I just want to have a normal life being in my own home, spending—I am not going to be around forever. I am 76 years old. Giving my wife some peace of mind every

night so she can go to sleep without a pill. That is all I want out of life.

Mr. GREEN. Let me thank you for having the courage to be here today. And let me add this, that you were—as you were perusing these monthly or quarterly statements—

Mr. GOLDSTEIN. Monthly.

Mr. GREEN. Monthly statements. I can easily see that you were a person assuming that you were investing not only in those corporations but in the country because all of the businesses that were called to our attention, they do business in this country. They make products that benefit the consumers. They are engaged in discovery-type efforts such that we have a better quality of life in this country. You were doing what clearly can be considered American. It was an American thing to do to invest in your country, though it was indirectly done through Mr. Madoff, who made off with a lot of money. But you were doing what was clearly an American thing to do. And I just hope that people who are reviewing this will understand that you are not some guy with deep pockets who just had millions of dollars to throw away, that you inherited money and you have had a silver spoon in your mouth all of your life. You earned every penny of what you invested. And you invested it in quality companies as perceived by you based upon what was presented to you for your perusal. And I want to let you know that I have great sympathy. And I want to make sure that we can do whatever we can to help you.

Thank you.

Mr. GOLDSTEIN. Thank you very, very much, for myself and all the other people who are in the same position I am, thank you.

Mr. GREEN. You are welcome. Thank you, sir.

Mr. KANJORSKI. The gentleman from Missouri, Mr. Cleaver.

Mr. CLEAVER. Thank you, Mr. Chairman. I have no questions. I appreciate you being here, Mr. Goldstein. There are no answers you could give me that would cause my stomach to churn less. Thank you.

Mr. GOLDSTEIN. Thank you.

Mr. KANJORSKI. Thank you, Mr. Cleaver. The gentleman from Illinois, Mr. Foster.

Mr. FOSTER. Thank you, Mr. Chairman.

Professor Metzger, my first question is relating to your Recommendation VII, which has to do with transparency. For instance, do you have a more detailed set of recommendations for exactly what sort of disclosures you would recommend?

Mr. METZGER. Yes. It is in the written testimony.

Mr. FOSTER. Okay. All right. That is I think a very interesting thing, interesting set of things to think about. You also mentioned the possible danger of reverse engineering of the trading strategies of the houses would be able to reverse engineer that if you had too much disclosure of positions and so on. And I was wondering, do you really think that would result in a less effective, less efficient market if that were, in fact, possible over time to do that? My question is, what is wrong with that if over time—

Mr. METZGER. What is wrong with people reverse engineering?

Mr. FOSTER. Yes. And being able to understand what their competitors were doing over a period of time.

Mr. METZGER. If someone has some sort of edge, some investing edge that the adviser thinks that he or she can exploit, the adviser doesn't want other people to copy what he or she is doing.

Mr. FOSTER. I understand it might interfere with the profitability of trading houses.

Mr. METZGER. Yes, in terms of society—

Mr. FOSTER. Would result in a less efficient capital allocation for our country?

Mr. METZGER. Right. So society will benefit from that type of disclosure.

Mr. FOSTER. Okay. Now the other thing has to do with the compliance and regulatory costs for the different proposals. It strikes me there is a big spread in how cost effective these are in terms of the compliance costs and how effective they would be at stopping this sort of scheme. For example, the independent custodian thing strikes me as something that would be fairly cheap and would be quite effective at eliminating the possibility of this sort of Ponzi scheme. There are other things like randomly assigning an independent auditor to all financial entities that might be very effective but very expensive to do. It might still be a good idea. I was wondering, has anyone or do you intend to actually develop estimates for the compliance costs for these different options?

Mr. METZGER. That I have suggested?

Mr. FOSTER. Yes.

Mr. METZGER. No, I haven't done that.

Mr. FOSTER. Do you think it might be feasible to do that?

Mr. METZGER. I don't think I have the data available to me, but I don't think that it should necessarily be that costly.

Mr. FOSTER. Okay. Just when you go down the whole smorgasbord of possibilities, having some estimate for what they cost not only directly to the government but for everyone that has to do with the regulations. You also had this mention that confused me of managers generating an early fake alpha, and how exactly does that work? Is there a quick way to explain that?

Mr. METZGER. I will try to use an example. Take an XYZ stock trading at $100. Assume that someone wants to sell an uncovered call option where the call would be exercised at $200, which means that the person who sells the call won't have to pay up, if you will, until the stock exceeds $200. Let's say the seller of the call receives $1 because it is very remote that the stock will rise in 1 year from $100 to $200. So, let's say this adviser does this trade 20 consecutive years; you make a dollar a year. So, the investor will say, "Wow, this person is terrific, consistent results, $1 a year, no volatility whatsoever." Then in year 21, the stock more than doubles. There is a takeover, or for whatever reason the stock more than doubles. You have lost your $20 and then some. So, that is what I mean by a fake alpha. In other words, it looks good.

Mr. FOSTER. Just because you are not sampling the whole distribution and getting the right average?

Mr. METZGER. Correct.

Mr. FOSTER. Okay. Got it.

And Professor Frankel, this is more a general question. What do you think sets the scale for the amount of effort that we should put into enforcement on this thing? If you look at what we spend to

prevent bank robberies compared to what our society loses for bank robberies, shouldn't that roughly be in the similar proportion to what we spend for security frauds compared to what we lose for security frauds? Because if that is the case, I think there is a big mismatch.

Ms. FRANKEL. Right now, our system is threatened. If it were—I wanted to say just—but if it were just the individual investors who were losing, that is one thing. But our whole system is threatened and it is dragging our economy with it. So what I am focusing on is the system. And as far as that is concerned, I would pay—I think we should pay more. Then when everything kind of balances again, then we can reduce. We don't have to commit forever. But right now, I think there is a real danger, and that—I don't know what it is.

Mr. FOSTER. It is in our straight-up self-interest to spend more on enforcement is what your basic point is?

Ms. FRANKEL. That is correct. To spend more on not enforcement, examination. I want verification. Transparency doesn't mean verified transparency. So Madoff sent him a transparency but it wasn't. I want to make sure that it is true.

Mr. FOSTER. Last question. Do you think the Madoff affair was really due in large extent to the increased complexity of modern finance? Or would this whole thing be recognizable to someone 100 years ago?

Ms. FRANKEL. No. I think we are inventive. Some of the inventions are not lending themselves to transparency at all. You have some instruments that can be understood only by those who have the algorithms and so on, yes.

Mr. FOSTER. So you think Bernard Madoff's trading strategy could not have been implemented 100 years ago?

Ms. FRANKEL. Oh, the Ponzi schemes?

Mr. FOSTER. Not the Ponzi schemes. Just his trading strategy, the split strike thing.

Ms. FRANKEL. I think it couldn't. It couldn't. I know the history of the 1920's and it was simple. It was straightforward. Yes, there were pyramids. But that was the most complicated thing.

Mr. FOSTER. Thank you. I yield back.

Mr. GOLDSTEIN. Could I add something, if I may? I am a layman and you are talking in terms I probably don't understand. But any industry where people make $50 million to $100 million salaries and give out hundreds of millions of dollars in bonuses can afford to pay for their own compliance.

Mr. FOSTER. Understood. I yield back.

Mr. KANJORSKI. Thank you, Mr. Foster. I am just going to take one or two things. Are you suggesting that we should be looking at an insurance or government guarantee? I am not quite sure that I understand from the panel what—

Ms. FRANKEL. No, no, no, no, no. Not an insurance and not a government guarantee. But examinations that will—as a matter of fact, our regulators have to find out what is really going on in the financial system. It is complicated. And I don't think they really know. There are people in the industry who do. And now they are laid off so maybe this is a good time to hire them to the government. And they will really find out what is going on, how are

things being done. That is what I suggested. And then, then you know the examinations that are being done within the SEC may not be enough and may not be the right ones. We have to know what is happening in the market.

Mr. KANJORSKI. I understand the problem. Earlier, when I was examining the three of you, it sounded like I was harsh because I have this struggle between caveat emptor and an individual's duty to do their own due diligence.

Ms. FRANKEL. Goodness, no.

Mr. KANJORSKI. To do their own due diligence. But quite frankly, I don't want you to leave thinking that I am harsh that way because quite frankly how you were taken in I can see almost everybody in the world could be taken in that way. 21 years of successful dealing and a recommendation by an accountant, potentially a lawyer. Just amazing. I don't know where we come up with this. But I will say one thing, he is an evil—who called him an evil genius? Did you call him that?

Mr. BACHUS. He did, and I quoted him. I quoted Mr. Ackerman.

Mr. KANJORSKI. Mr. Ackerman is right. Where this comes from. I am just going to throw out this one thing though and this is the problem I have. The other night I watched a druggist. They displayed the story of the druggist in Kansas City who gave chemotherapy to thousands of his patients who had cancer, and he watered down the prescription and hundreds of them died. Now no one knows for certain that any of them wouldn't have died if they had gotten the correct chemotherapy. But obviously, they did die. I was thinking that as bad as Mr. Madoff is, if all the allegations are correct, it doesn't quite rise to the level of that pharmacist. And yet the FDA is not being asked to guarantee that pharmacists give out proper prescriptions. Whether it is we can't afford it, don't know how to do it, I am not certain. But I guess what I am getting at is there is a limit on just what we can guarantee or what we can protect against. And when you get up to a fraud of this size, with the number of people involved, I would be far more understanding, quite frankly, if there were ill-informed people. But man, what a clientele to take to the cleaners, absolutely unbelievable. That is what astounds me. Bankers, insurance companies, sophisticated investors, other hedge funds. Unbelievable.

Mr. METZGER. Mr. Chairman?

Mr. KANJORSKI. Yes.

Mr. METZGER. I didn't get an opportunity yet. I want to express my sympathy for Mr. Goldstein. I really feel very badly for you, and I just wish it had never happened to you. I wish you happiness and good health.

Mr. GOLDSTEIN. Thank you.

Mr. KANJORSKI. Yes. Thank you, Mr. Metzger. That is very good. Mr. Goldstein, I am sure I speak for everybody who has heard your story, and thousands of people or hundreds of thousands who have seen it on television or will, you certainly did put a human face on this and made it far more understanding. Take care of your wife and make sure she doesn't get extreme on the situation. Enough people have already lost their lives or lost their futures. So we don't want anything worse to happen. And as Mr. Cleaver indicated, I hope that ultimately we come up with a solution to help

serve—and certainly, I am going to hold Mr. Ackerman responsible to guarantee that $500,000 is at least there. Is that correct, Mr. Ackerman?

Mr. ACKERMAN. We can work on that together, Mr. Chairman.

Mr. GOLDSTEIN. Thank you very much.

Mr. KANJORSKI. Now, I will excuse the panel, and thank you all for being as kind as you have been to remain as long as you have.

The Chair notes that some members may have additional questions for this panel which they may wish to submit in writing. Without objection, the record will remain open for 30 days for members to submit written questions to today's participants and to place their responses in the record.

Before we adjourn, the following written statements will be made a part of the record of this meeting: a communication from the Institute of International Banking Law and Practice and a communication from the Investment Advisers Association. Without objection, it is so ordered.

The panel is dismissed and this meeting is adjourned.

[Whereupon, at 6:57 p.m., the meeting was adjourned.]

# A P P E N D I X

January 5, 2009

Statement
Of
Tamar Frankel
Professor of Law
Boston University School of Law

Before the

Committee on Financial Services
Of the
U.S. House of Representatives

2:00 P.M.

January 5, 2009
Room 2128
Rayburn House Office Building

Mr. Chairman and Committee members: I greatly appreciate the opportunity to appear before you and to discuss the nature of Ponzi schemes, the importance of trust in the securities markets and the need for regulatory reform in light of the revelation of the Madoff Ponzi Scheme.

I am a Professor of Law at Boston University School of Law in Boston Massachusetts. My work focuses on the regulation of the financial system, including the institutional and market intermediaries, who advise investors, and hold and manage other people's money. Among my publications are a recent teaching book Fiduciary Law (2008), a treatise on securitization (2d ed. 2006), a book entitled Trust and Honesty, America's Business Culture at a Crossroad (Oxford University Press 2006), a teaching book entitled Trust and Honesty in the Real World (2007) (with Mark Fagan), and a treatise on the regulation of mutual funds, entitled The Regulation of Money Managers (2d ed. 2003) (with Ann Taylor Schwing). I have researched and written, but did not yet publish, a manuscript entitled Con Artists and Their "Marks," which analyses Ponzi schemes, and their success, drawing on various sources including hundreds of court cases. (A more detailed resume is attached to this statement).

The first part of my testimony analyzes Ponzi schemes, reflecting on the recent allegations against Bernie Madoff. The second part of the testimony addresses three points: (1) The nature of trust in general and investors' trust in financial intermediaries and the financial system, in particular; (2) The current break-down in investors' trust: and (3) a proposal to change the way in which the regulation of financial intermediaries is currently conducted.

## Ponzi schemes[1]

**The Nature of Ponzi schemes.** Ponzi schemes are simple. A con artist offers obligations that promise very high returns at seemingly very low risk from a business that does not in fact exist or a secret idea that does not work out. The con artist helps himself to the investors' money, and pays the promised high returns to earlier investors from the money handed over by these and later investors. The scheme ends when there is no more money from new investors.

Ponzi schemes are the inverse of compounding in finance. If new investors constituted the only source of additional capital, the number of investors needed to keep the scheme going would be astronomical.[2] These schemes usually last longer than the numbers suggest because many investors are repeat players, rolling over their short-term investments and adding to them. For example, in the 1998 case of the Baptist Foundation of Arizona, 94% of the investments in short-term loans were reinvested, and remained invested until the scheme came to an end.[3]

The amounts involved in Ponzi schemes are usually very large. They catch in their net billions of dollars from very wealthy as well as less wealthy individuals and institutions. The annual losses from Ponzi schemes in the United States vary. Based on litigated court cases, the year 2002 showed the largest amount of losses -- over $9.6 billion. Each of the years 1995 and 1997 showed losses of more than $1.6 billion. Each of the years 1996,

1990 and 1976 showed losses of over $1 billion. These numbers, however, represent only those cases that were litigated in the courts, and do not show the losses outside the courts and on the international scene.

The investors in the schemes are quite sophisticated. Charitable nonprofit corporations, religious organizations and their members have invested heavily with Ponzi operators. Famous sports stars and rich individuals have not been spared either. Banks and insurance companies have been caught in the net as well. Ponzi schemes are not unique to the United States. They have been highly successful in Romania, India, Albania, Russia and England. Thus, Bernie Maddof's scheme is far from special, although it is quite large.

**How do Con artists manage to entice wealthy, educated individuals and representatives of large institutions to hand them huge sums of money?** First, the schemes offer very high returns. For example, the Romanian scheme, Caritas, offered a return of eight times the original investment within three months. Even in a country beset by inflation this was an unbelievable return.[4] Other schemes are similar.

Second, a bubble market environment leads some investors to believe that such returns are possible. They read about enormous sums made in hours or days, by trading stocks and winning in lotteries, and about the millions earned by corporate executives and investment bankers. If it is possible to make such fabulous amounts without a life-time of hard work, investors may ask themselves: "Why not I?" Why would this offer of such high returns not be the one chance I was waiting for? Therefore, Ponzi schemes are likely to flourish in market bubbles.

Third, the stories of the con artists draw attention, curiosity and admiration. Gary Reeder, who operated a Ponzi scheme, was quoted as saying: "Gold?... That's just a small part of it. You know what gold is? It's the glitter . . . It's neon. It gets people excited." And yet, the very originality of the story should signal danger. Being the first, the business or system cannot be tested. But those who are caught in the net do not pay attention.

Fourth, con artists signal trustworthiness. They act like, live as, and mingle with, the very rich. Appearing that he did not care for money, one con artist offered his services for free. Another was selective in choosing the investors. In addition, con artists always honor redemption demands, even before payment is due. Con artists pay dividends *often and on time*, until the scheme comes to an end. They also offer information although it can often drown the truth. For example, in 1992, a con artist's "business empire swelled to a network of dozens of companies and partnerships, embracing a gold mine, an oil company, a commodities brokerage and a second car dealership..."[5] It was difficult to trace receipts and expenses. It was impossible to determine net worth and find out whether the business could meet its obligations long- term. Enron Corporation hid its scheme by such an abundance of complex details.

Fifth, con artists show great generosity. They make charitable and civic donations. As one court commented, "Mr. Bennett made a large number of civic, charitable and public

service contributions and performed good works in the areas of substance abuse, children and youth, [and] juvenile justice."[6]

Sixth, con artists' investments signal safety. The forms of the con artist's obligations and name spell respectability, using words like "trust," "partnership," and "with recourse." Their promises are very specific, not vague. The business names signal high standards: "Security Exchange", for example, was Charles Ponzi's business name.

Seventh, the first investors are the salespersons.[7] Con artists establish a strong following, starting with family members, and friends. Charles Ponzi's followers were Italian immigrants for whom he brought self-esteem and pride.[8] Another con artist targeted the immigrant Polish community in New York and New Jersey (promising investments in mortgages: risk free).[9] As one court explained, "in the initial ...stages of the plan, those investors who wished to withdraw their investments were promptly paid. The effect of such prompt payment, of course, was to convert every investor into a missionary spreading the word of the enormous profits which could be speedily attained with no discernible risk of loss."[10]

Eight, Ponzi schemes thrive in affinity groups, be they religious groups[11], investment clubs, and employees of larger organizations. These groups are vulnerable because their members are in close and frequent contact with each other; among them news travels fast, they share values and tastes, and they trust each other.[12] In Australia a large group of police officers invested in such a scheme, and but for a few who happened to withdraw their money back in time, up to 200 police agents, including the wife of an Australian Federal Police Commissioner, lost their investments. Federal police agents in Sydney, Melbourne and Brisbane were believed to have invested in a Ponzi scheme, in which one couple alone lost $400,000.[13] The fact that the investors belonged to a police organization contributed to the success of the scheme, and its extended longevity.[14] Investors can become devoted to these con artists.[15] Churches can invest with them too.[16] And some con artists create their own churches.[17]

Ninth, the personality of con artists helps. Con artists are charming, captivating, and presentable; good dressers, good listeners, and great flatterers. "[T]he epitome of the natural, fast-developing, big-time con artists, those fascinating, complex, corrupt geniuses who can instill confidence in the most erudite, shrewd Hunt or Rockefeller brother and lead them as eager lambs to the slaughter." [18] Con artists are unbeatable in playing the "nice guy." "The nice guy exaggerates his caring, ability to love, and kills with kindness . . . You cannot fight a Nice Guy!"[19] Con artists can be convincing. Living in the fairyland life of the rich while being poor they can get caught in their own fantasy. In fact, they may get so used to the roles they play that their businesses and their life style, friends and connections, become real to them. "Many first time perpetrators of this crime become so accustomed to the lifestyle it generates that they themselves are in disbelief when it crumbles, convinced over time by their own lies."[20]

## Why is it difficult to identify Ponzi schemes?

First, most con artists are similar to entrepreneurs: they are creative and their offerings are usually unique. Like many entrepreneurs con artists are over-optimistic and overconfident -- in themselves and their decisions. When they fail they try again.[21] That may explain their persistent success.

Second, Ponzi schemes are similar to legitimate businesses. Most businesses borrow and pay dividends while in debt. Individual investors buy securities on margin. Ponzi schemers operate the same way. They borrow from one group of investors and pay another. Many operating enterprises "refinance" -- borrow from Peter to pay Paul, for example, when interest rates fall. But if the chances of a successful enterprise are low, and if their managers recognize this fact but continue to borrow and repay creditors, the enterprise may back into a Ponzi scheme.[22] Entrepreneurs may start a true business, but turn it into a Ponzi scheme when they realize that there is no hope of success.[23] The issue becomes one of intent, which is difficult to ascertain.

Third, some con artists are viewed with sympathy. Investments in these schemes are similar to buying a lottery tickets, gambling,[24] and speculating in the stock market, [25] The relationship between Ponzi schemers, salespersons, and entrepreneurs may explain the forgiving attitude towards con artists. Perhaps, looking at Ponzi con artists, successful entrepreneurs may say to themselves: "There, but for the grace of God, go I."

Fourth, there is mixed sympathy for the victims. The general view of sophisticated victims is that they are greedy and gullible. We sympathize with those who could not protect themselves, but not with those who became gullible. In addition, Ponzi schemes benefit some investors at the expense of others.

**Conclusion**

Con artists and their Ponzi schemes are continuous and successful because they are so close to successful legitimate business. They signal distorted pictures of honest people and true and honest schemes. But every distortion is anchored in the true and authentic. That may explain our ambivalent reaction and the schemes persistence. Both the cons and their victims demonstrate a mix of contradictions that reside in all of us: The admired charming rouge, the driven greedy person, and the gullible and vulnerable investor. The weight of these contradictory pieces shifts depending on the social judgment about human relationship. We ask: How able were the victims in protecting themselves from the fraud? How charming and skillful were the cons in their manipulations, and how much harm did they inflict on the financial system as a whole?

Most importantly, Ponzi schemes accompany market bubbles. When the fever of speculation is driving a herding phenomenon, Ponzi schemes are likely to flourish. So long as these schemes are small, society and the financial system remain untouched. The wealthy "Marks" can absorb the loss. But when the schemes are large in terms of dollars and number of investors, and when the investors represent pools of small investors or the assets of charitable organizations, the schemes can undermine the financial system, and,

as was shown in Albania, they can destroy the economic system and the entire fabric of society.

## The Need for Regulatory Reform

Americans used to trust the financial system: its banks, insurance companies, pension funds, and mutual funds; its markets, brokers, underwriters, and advisers. For the past thirty years, apart from their homes, Americans have been investing their life's savings in the securities markets. The financial system provides the mechanism by which savers who postpone consumption, transfer their money to borrowers, who produce or consume (and cause others to produce). These transfers are performed with the help of financial intermediaries:

To take advantage of the market, investors must hand over their money or rely on the advice of financial intermediaries. No financial system can exist without investors' trust in the financial intermediaries.

In this context I define trust as "a reasonable belief that the trusted person will tell the truth and abide by his promises." Trust relieves trusting persons from the burden of verification, but exposes the trusting person to abuse of trust, that is, the risk that the trusted person, who receives the investors' money, will not tell the truth and will not abide by his promises. The risk to investors can be high: that they will lose their savings, as most investors who trusted Bernie Madoff did. The extent of the necessary trust depends on the level of the risk from the trusted persons' abuse. The higher the risk from abuse of trust, the lower trust should be and the higher the demand for verification should become.

It should be emphasized that trust does not include gullibility. The buyer of the Brooklyn Bridge is not a trusting person, but a gullible one. The investor who runs with the herd in a bubble market is not a trusting person, he relies on the judgment of others and ignores the information he possesses and discards common sense.[1] However, whatever we might call their behavior, American investors have relied on the financial intermediaries, including their brokers, and advisers and did follow the herd. Ponzi schemes are a classic example of a herd behavior by sophisticated investors, many of whom are fiduciaries managing other people's money.

For many years we have heard the call for investor education, information, and simplification of disclosure documents. The theory here is that investors should NOT trust the market intermediaries. They should investigate, examine, spend the time and educate themselves in the mysteries of the markets. And yet if the Madoff affair shows us something it shows that the theory as beautiful as it is, simply does not work in practice.

Disclosure and education does not protect investors. It is also not very efficient for them to educate themselves and specialize. They should rely on trusted advisers and managers,

[1] Neither does trust include faith, which rejects the need for verification.

as much as they rely on physicians and other experts. But we have moved the focused from the intermediaries that ought to be trustworthy, to the investors who ought to protect themselves. Having lost the balance between trusting and self protection we have lost investors trust.

No one could both trust and at the same time watch with much concern and suspicion the trusted person. So investors trusted when they should have suspected, and finally when they faced a massive fraudulent abuse of trust, they stopped trusting altogether.

When the investors' risk of abuse of trust is high, and yet their cost of verification is high as well, investors might exit the financial system. This is when the law should intervene. Law aims at reducing the investors' risks from abuse of trust by regulating the trusted persons. It reduces the investors cost of verification, for example, by requiring true and full disclosure; Law helps financial intermediaries when their cost of demonstrating trustworthiness is higher than their returns from their services.

Investors will trust the institutions only if the law and other mechanisms guarantee their trustworthiness, that is -- that they will tell the truth and abide by their promises. Market regulation is less strict and relies mostly on disclosure. But it has the clout of criminal provisions as well.

There are rules that apply to con artists engaged in Ponzi schemes. They can be viewed as issuers of securities, in which case the securities acts mandating disclosure (with or without registration) would apply to them, regardless of whether their securities are traded in secondary markets or not traded. Alternatively, these schemes, which result in management of pooled investors' money, can be viewed as unregulated mutual funds, under one or more of the exceptions in the Investment Company act of 1940. Con artists can be viewed as broker dealers regulated under the Securities Act of 1934 and their self-regulating organization. In addition, con artists can be viewed as advisers, subject to the Advisers Act of 1940, unless they enjoy one of the exceptions in the regulatory scheme.

Bernie Maddof was a registered investment adviser since 2006. Having started as a broker dealer, I assume that he was registered as such. He probably offered information to his investors, under the securities acts rules. His managerial activities, however, did not include the registration of the pools of money that he managed. He probably took shelter under sections 3(c) (1) and 3(c)(7) of the Investment Company Act of 1940. Therefore, there are rules and regulations that have governed Bernie Madoff. He will probably be found liable or guilty under these rules.

In light of the nature of Ponzi schemes and the current law, I doubt whether our priority is to pass new rules. We have sufficient rules to punish con artists that have perpetrated fraud and were caught. Besides, new regulation based on speculation about future wrongdoings, might limit innovations and creativity. New regulations based on recent past transgressions might aim at violations that are not likely to occur in the near future. After all, the horse is out of the barn. Something else might come.

What regulators lack is information about what is going on in the markets. Private sector gate-keepers -- the lawyers, accountants, rating agencies, and appraisers -- have left the gates open. They even gained by exploring and pointing to the cracks in the gates. Besides, most gate keepers and financial intermediaries believe that "everyone is doing it." A "little deception," a use of the unclear and unspecific way to move around the rule has become acceptable.[26]

We have accepted the idea that market competition, disclosure, investors' education, and the threat of punishment will prevent fraud and maintain investors trust. This is both incorrect and wrong. When trusted persons are relieved of the requirement of honest behavior and those who are vulnerable are left to protect themselves there is a good chance that they will leave the market. The idea that doing well for oneself is doing well for society, without any emphasis and balance on limitations is corrupting. The idea that investors should trust those to whom they entrust their money, and yet protect themselves from those to whom they entrust their money benefits the trusted persons is untenable. These ideas led to relieving intermediaries from accountability, giving them freedom to speculate with other people's money. We have the laws to prohibit their behavior. But we have no one to stop them in time.

Today, more than ever we need government gate-keeping examiners. We need to change the way the government regulates. Government regulators should conduct thorough and frequent examinations of broker dealers, advisors and money managers, whether they are registered or exempt from registration, so long as they control a significant size of investors' money in whatever form. These examiners should be top notch experts, well paid and highly valued. If we cannot fit them into the government mold they can be employed by a government-owned corporation, or follow the model of the FDIC, or other similar organizations. They should be the police on the beat, carrying the baton, not the shotgun.

All large financial institutions should be visited at least once every six months. A smaller fund or broker dealer may be visited once a year. A fund that evidences problems should be visited in three or even one month. Money pools which are too large to fail must be regulated fully under the Investment Company Act of 1940. Investment companies that receive exemptions should be visited very frequently and followed closely.

This proposal is limited to examinations to enforce existing prohibitions and legal requirements.[27] It shifts the regulatory emphasis to government examination and balances it against disclosure and against active prosecution.

We have a number of examination models, both of banks, mutual funds and broker dealers. Thus, this proposal is not drastic, nor unknown. The applicable laws need hardly be amended with this move. This shift, telling the public that government examiners will police those who keep public money is likely to strengthen the public's trust, and be less drastic to the regulators. The examiners' expertise would supplant the missing expertise of the investors. It can leave intact the private sector gate-keepers, but does not fully rely on them.

Hopefully regulation by a thorough examinations of experts might reduce the threat to the financial system at (ultimately) a lower cost to taxpayers, and to the economy. Examinations need not be a waste of resources even when the examiners find nothing amiss. The very existence of vigilant examinations offers a measure of insurance that lowers the risk of serious violations of the law. We can try this type of examination without drastic changes in our current regulatory system. Most importantly, the existence of expert examinations can help restore a more trustworthy culture on Wall Street, and greater support to the public's trust in the financial system.

Thank you.

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[1] The material and the authorities dealing with Ponzi schemes, is derived from my unpublished manuscript on this topic.

[2] *See From the 'Lectric Law Library' Stacks: How to Avoid Ponzi and Pyramid Schemes, at* http://www.lectlaw.com/files/inv01.htm (last visited July 10, 2001) (it was calculated that "at month 11 the number of new investors must exceed the U.S. population and at month 13 it must exceed the world population").

[3] Terry Greene Sterling, *The Moneychangers; A New Times Investigation; First in a Series*, PHOENIX NEW TIMES, Apr. 16, 1998, LEXIS, News Library, Arcnws File.

[4] Katherine Verdery, *'Caritas' and the Reconceptualization of Money in Romania*, ANTHROPOLOGY TODAY, Feb. 1995, at 3 (and authorities cited there).

[5] Singh, *Fool's Gold*, DALLAS OBS., Nov. 16, 2000, Features, at 1; N.R. Kleinfield, *Unraveling Puzzle of L.I. Car Dealer Reveals Layers of Personal Mystery*, N.Y. TIMES, Apr. 19, 1992, at A26..

[6] United States v. Bennett, 161 F.3d 171, 178 (3d Cir. 1998) , *cert. denied*, 528 U.S. 819 (1999).

[7] *Ponzi, at* http://www.crimes-of-persuasion.com/Crimes/InPerson/MajorPerson/ponzi.htm (last visited July 10, 2001).

Brian Trumbore, *Charles Ponzi, at* http://www.buyandhold.com/bh/en/education/history/2000/ponzi.html (last visited July 10, 2001) (citing ROBERT SOBEL, THE GREAT BULL MARKET: WALL STREET IN THE 1920S).

[9] Stockschlader & McDonald, Esqs. v. Kittay (*In* re Stockbridge Funding Co.), 145 B.R. 797 (Bankr. S.D.N.Y. 1992).

[10] New York v. Luongo, 47 N.Y.2d 418, 425 (1979).

[11] *E.g.*, Fox Butterfield, *This Way Madness Lies: A Fall from Grace to Prison*, N.Y. TIMES, Apr. 21, 1996, § 1, at 14 (Ms. Redd hosted many fundraisers for the church).

[12] Paul Whittaker, *Police 'Put Millions' into Failed Loans Plan*, ADVERTISER (South Australia), May 8, 1998, LEXIS, News Library, Arcnws File.

[13] Paul Whittaker, *Police 'Put Millions' into Failed Loans Plan*, ADVERTISER (South Australia), May 8, 1998, LEXIS, News Library, Arcnws File.

[14] *Regulators Sound Alarm on Affinity Scams*, CANADA NEWSWIRE, Jan. 29, 2002, LEXIS, News Library, Curnws File. Among the regulators' warnings to investors is the advice to refrain from investing on the recommendation of members of an affinity group.

[15] Jim Henderson, *Preacher Has Faith in Pitch*, HOUSTON CHRON., May 26, 2002, at 33.

[16] Terry Greene Sterling, *The Moneychangers; A New Times Investigation; First in a Series*, PHOENIX NEW TIMES, Apr. 16, 1998, LEXIS, News Library, Arcnws File.

[17] *E.g.*, United States v. Rasheed, 663 F.2d 843, 845 (9th Cir. 1981); Bruce C. Smith, *Congregation Prepares to Celebrate a Miracle, Faith Baptist Church Rises from Mountain of Debt*, INDIANAPOLIS STAR, Nov. 20, 2000, at A1 (pastor took investors' money to help church and instead lived lavish lifestyle leaving church indebted).

[18] DONN B PARKER, FIGHTING COMPUTER CRIME 120 (1983).

[19] EVERETT L. SHOSTROM, MAN, THE MANIPULATOR 35-39 (1967).

[20] *Ponzi*, http://www.crimes-of-persuasion.com/Crimes/InPerson/Major Person/ponzi.htm (last visited July 10, 2001).

[21] Avishalom Tor, *The Fable of Entry: Bounded Rationality and the Efficacy of Competition* (unpublished manuscript, Harvard Law School, Sept. 2001) (on file with author).
[22] The securitizers of loans started with the belief that they could collect more money than others do. Only when they realized that there was no hope of such collection did they begin "empty refinancing." *See* Amended Complaint, Am. Int'l Life Assurance Co. v. Bartmann (N.D. Okla. 1999) (No. 99-CV-0862-C) [hereinafter Am. Int'l v. Bartmann].
[23] *E.g.*, CHARLES PONZI, THE RISE OF MR. PONZI 68 (1935) (PONZI'S AUTOBIOGRAPHY) at 5-6, 32.
[24] Peter Fimrite, *Did He Have a Deal for You*, S.F. CHRON., Feb. 15, 1998, at 1/Z1.
[25] MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 689 (10th ed. 1999).
[26] TAMAR FRANKEL, TRUST AND HONESTY, AMERICA'S BUSINESS CULTURE AT A CROSSROAD, Ch.1 (Oxford University Press, 2006).
[27] As a simple example, we should know (1) the identity of the custodian, (2) the documents representing the assets, (3) the size of the asset pools, (4) the amounts borrowed or invested, (5) the private sector gatekeepers, (6) the structure of the pools of investors' money, whether they present direct ownership by investors, pools of investors' assets, or pools of pools of investors' assets, (7) who controls the investors' assets? Is it the salesperson, the manager, or others? And (9) how are the controlling persons regulated, if at all?

**United States House of Representatives**
**Committee on Financial Services**

**"Assessing the Madoff Ponzi**
**and the Need for Regulatory Reform"**

**Statement of Allan Goldstein**
**January 5, 2009**

Chairman Frank and Honorable Members of the Committee, good afternoon and thank you for the opportunity to testify today on my experience with Bernard L. Madoff Securities, and the impact that Mr. Madoff's actions have had on my family and myself.

My name is Allan Goldstein, and I am a human face on this tragedy. I speak not only for myself but for the many people who have also lost everything because of this Ponzi scheme. I have held an IRA retirement account with Mr. Madoff's firm for approximately 21 years. I am 76 years old, and until my retirement, I worked in the textile trade buying and selling fabrics for use in women's apparel. My wife, Ruth, and I have been married for 52 years. For the past 16 years, since my retirement, we have lived quietly in the Taconic Mountains region of New York. At this stage of our lives, I never could have envisioned the financial devastation that we are now suffering following the arrest of Mr. Madoff last month. In the blink of an eye, savings that I had struggled my entire lifetime to earn have vanished.

Like many of Mr. Madoff's victims, we are hardly super-rich. I was born and raised in the Flatbush section of Brooklyn in a one-bedroom apartment with my parents and sister. I worked my way through New York University with two jobs to pay tuition. After school, I spent 2 years in the Army, including 16 months in Korea.

Ruth and I married in 1956. Our first home was a furnished basement apartment. My first job selling drapery fabrics paid $200 per month. With my scant savings accumulated over

several years, I co-founded a textile company that became fairly successful during the 1970's and '80's. Throughout that time, I always remained very conservative with my money, investing it very prudently and keeping a good deal of it in money market funds.

By the late 1980's, I managed to accumulate approximately $1.8 million dollars in my IRA. My accountant took note of the small returns from the money market funds and recommended me to Madoff Securities. He told me that Madoff generally achieved 8%-12% per year return and he employed a conservative proprietary hedging strategy that moderated market risks. In the late 1980's, I transferred $1 million from my IRA to Mr. Madoff. I received account statements every month showing gains of 8%-12% annually. As this conservative strategy offered me peace of mind, I was willing to forgo outsized gains in boom years in favor of greater security. In the mid-1990's, I moved the rest of my IRA savings to Mr. Madoff, approximately $1.5 million.

Since retiring in 2001 at the age of 69, we have used our savings at Madoff to pay our mortgage, taxes and general living expenses. By November 2008, our Madoff account had reached approximately $4.2 million in stated value. Ruth and I thought we were living the American dream. Our dream as well as so many others has turned into a nightmare. We had considered Madoff Securities not as a get rich quick scheme, but as a buffer against risk. We entrusted Mr. Madoff with all we had, and now everything that I worked for over a 50-year career is gone. I have been forced to cash in my life insurance policies to pay my mortgage. We are forced to sell our home, and with the real estate market the way it is, we probably will not find a buyer and be forced into foreclosure.

I sit before you today a broken man. Throughout my life I have always believed that the American system of capitalism was the best regulated in the world and could be safely relied upon by investors like myself. But the Madoff scandal and the SEC's inability to detect it despite repeated written and other warnings have taught me that this is not the case. I believe my Government has failed us and we have suffered tragically as a result.

As with many other Madoff investors, the past several weeks have been a very difficult waiting period for my family and myself. The media has covered the scandal zealously, but there are no real details on how or when investors will see any recovery. For me, even five or six months may be too late. We simply do not have years to wait.

Our current reality has nothing to do with profligate spending or undue market risk. We conducted our affairs in good faith in the belief that the SEC would never allow this sort of scheme to be conducted. I pray that Congress will come to understand our plight and enact some emergency legislation that will allow the SIPC to loosen its standards and distribute funds as soon as possible, as well as establish a restitution fund for the Madoff victims.

We are not trust funds, hedge funds or banks. We are ordinary people who are victims of an incomprehensible crime and who have had their lives turned upside down. We are turning to you, our only hope, for relief we so desperately need.

Thank you.

**Statement**
**of**
**Stephen P. Harbeck**
**President and CEO**
**Securities Investor Protection Corporation**
**before the**
**Committee on Financial Services**
**U. S. House of Representatives**

**January 5, 2009**

Chairman Frank, Ranking Member Bachus, and Members of the Committee, thank you for the opportunity to appear before you today to discuss the work of the Securities Investor Protection Corporation, known as SIPC. My name is Stephen Harbeck and I have been the President and CEO of SIPC for the past six years. I have worked at SIPC for 33 years and was General Counsel prior to my appointment as President and CEO.

SIPC was created under the Securities Investor Protection Act of 1970 ("SIPA") to provide specific financial protection to customers of failed securities broker-dealers. Although created under a federal statute, SIPC is not a government entity. It is a membership corporation, the members of which are, with very limited exceptions, all entities registered with the Securities and Exchange Commission ("SEC") as securities broker-dealers. Membership is not voluntary; it is required by law.

As a fundamental part of its statutory mandate, SIPC administers the SIPC Fund from which advances are made to satisfy claims of customers. The Fund is supported by assessments on SIPC member firms and its assets currently total $1.6 billion. In addition, SIPC maintains a commercial line of credit with an international consortium of banks, and, by statute, has a $1 billion line of credit with the United States Treasury.

SIPC has no authority to examine or investigate member firms. Those are the functions of the SEC and the Financial Industry Regulatory Authority which is a self-regulatory organization ("SRO") of the securities industry. When either of those entities or any other SRO informs SIPC that the customers of a brokerage firm are in need of the protections of SIPA, SIPC may initiate a customer protection proceeding to return to customers the contents of their securities accounts within specified limits. The proceedings are a specialized form of bankruptcy. A trustee and counsel are designated by SIPC, and appointed by the United States District Court, subject to a hearing on disinterestedness. The case is then referred to the appropriate Bankruptcy Court for all purposes.

To the extent securities or cash is missing from customer accounts, SIPC may use its funds, within limits, to restore customer accounts to the appropriate account balances. SIPC may advance up to $500,000 per customer on account of missing securities, of which up to $100,000 may be based upon a claim for cash. SIPC does not protect customers against market loss in an account. It is also important to note that customer property is never used to pay any of the administration expenses, such as fees of accountants, lawyers or even the trustee in a SIPA proceeding.

Through 2007, SIPC liquidated 317 brokerage firms, and returned over $15.7 billion in cash or securities to customers. Of that sum, SIPC used $322 million from the SIPC Fund to restore missing cash or securities. To date, SIPC has never used any government funds or borrowed under its commercial line of credit.

This year has been very different from anything in our past history. In addition to three smaller cases, SIPC has faced in recent months two unprecedented events: the initiation of liquidation proceedings for Lehman Brothers Inc. in September 2008, and the liquidation of Bernard L. Madoff Investment Securities LLC, in December. Both of those cases present significant challenges, but the two cases are very different.

**Lehman Brothers Inc.**

The Lehman Brothers Inc. ("LBI") liquidation was preceded by the Chapter 11 filing of Lehman Brothers Holdings Inc. on September 15, 2008. The Holding Company owned the SIPC member brokerage firm, LBI, which in turn held securities customer accounts. In order to facilitate the sale of brokerage assets, SIPC initiated a customer protection proceeding on Friday, September 19. On application by SIPC to the United States District Court for the Southern District of New York, LBI was placed in SIPA liquidation, James W. Giddens was appointed as trustee, and the law firm of Hughes Hubbard & Reed LLP was appointed as his counsel. That day, upon removal of the proceeding by the District Court, the United States Bankruptcy Court for the Southern District of New York held an extended hearing and approved the sale of assets of LBI to Barclays Bank.

Over the following weekend, the trustee for LBI transferred customer account positions, which contained $142 billion in customer assets, to two broker-dealers, one of which was the brokerage arm of Barclays. As a result, many of the customers of the defunct firm were able to exercise control over their respective portfolios in a seamless way. While much remains to be done in every aspect of the LBI matter, the initial stages have proceeded very well.

**Bernard L. Madoff Investment Securities LLC**

The failure of Lehman Brothers Inc. was linked to the complex, systemic failure of the subprime mortgage situation. The failure of Bernard L. Madoff Investment Securities LLC, a registered securities broker-dealer and SIPC member, involved a very different problem: the theft of customer assets on an unprecedented scale. The firm was placed in a SIPA liquidation proceeding on December 15, 2008, after the principal of the firm, Bernard Madoff, confessed to having stolen customer property over a period of many years. Irving H. Picard was appointed as trustee, and the law firm of Baker & Hostetler LLP was appointed as his counsel.

Unlike the LBI case, where customer records were accurate, it became apparent very early in the Madoff case that the customer statements Mr. Madoff had been sending to investors

bore little or no relation to reality. The records sent to customers were inaccurate when compared to the inventory of securities actually held by the brokerage firm. For that reason, it was not possible to transfer all or part of any customer's account to another, solvent brokerage firm. Instead, pursuant to SIPA, Mr. Picard sought and received authority from the Bankruptcy Court for the Southern District of New York to publish a notice to customers and creditors, and to mail claim forms to them, as required by law, no later than January 9, 2009. I am pleased to report that the notice of the initiation of the case was published on January 2, 2009, and claim forms have been mailed to more than 8,000 investors at their addresses as they appeared on the Madoff firm's records within the last twelve months.

The trustee has requested information from each customer as to the sums given to the Madoff brokerage firm, and sums withdrawn from the firm, to assist in the analysis of what each customer is owed. There are some situations, particularly where the investors have not made withdrawals, where it will be relatively easy to determine exactly how much a claimant put into the scheme. In other situations, the extended time period of the deception, coupled with numerous deposits with or withdrawal of assets from the brokerage over time, may make that reconstruction very difficult. SIPC and the trustee are committed to using all available resources to resolve these issues quickly.

Mr. Madoff apparently has stated that he stole $50 billion. Even though this sum may include the annual "profits" he reported to investors in his fraudulent scheme, this defalcation is on a different order of magnitude than seen in any SIPA liquidation that has preceded it. Until customer claims are received and processed and further accounting and related work accomplished, SIPC will not know the extent of the demand on its resources. We can predict that the demand will be in excess of any previous case. Of course, the maximum amount under SIPA that SIPC can advance to any one claimant is $500,000 (including the $100,000 cash limit), even if the valid amount of the claim is much higher. The extent of recovery by customers beyond the amounts advanced by SIPC will depend upon the amount of customer property that the trustee is able to recover. Most recently, the trustee obtained a court order authorizing the release of $29 million of debtor assets to him. In addition, the trustee has identified over $830 million in liquid assets of the defunct brokerage firm that may be subject to recovery. Finally, the trustee has in place a team of highly trained attorneys, forensic accountants, and computer specialists, to assist him in locating and recovering assets. The trustee and SIPC will be aggressive in their pursuit of such recoveries.

The failure of the Madoff firm has broad potential consequences for securities regulation, as well as possible effects on SIPC. Depending on the potential cost of customer claims, SIPC will determine whether to adjust the target balance of the SIPC Fund. The amount of SIPC's $1 billion line of credit with the Treasury has not changed since the passage of SIPA in 1970, and this may merit review as well. Other matters affecting SIPC may also be appropriate for review as a result of the Madoff case. As this case moves forward and we have a clearer picture of the facts and their implications, SIPC will maintain a dialogue with Congress about any issues that may give rise to the need for changes to SIPA.

I would be pleased to answer any questions from the Committee.

# Testimony of H. David Kotz
# Inspector General of the
# Securities and Exchange Commission

## Before the U.S. House of Representatives
## Committee on Financial Services

## Monday, January 5, 2009
## 2:00 p.m.

**Introduction**

Good afternoon. Thank you for the opportunity to testify today before this Committee on the subject of "Assessing the Madoff Ponzi Scheme" as the Inspector General of the Securities and Exchange Commission ("SEC" or "Commission"). I appreciate the interest of the Chairman, as well as the other members of the Committee, in the SEC and the Office of Inspector General. In my testimony today, I am representing the Office of Inspector General, and the views that I express are those of my Office, and do not necessarily reflect the views of the Commission or any Commissioners.

I would like to begin my brief remarks this afternoon by discussing the role of my Office and the oversight efforts that we have undertaken since I was appointed as the Inspector General of the SEC approximately one year ago, in late December 2007.

The mission of the Office of Inspector General is to promote the integrity, efficiency and effectiveness of the critical programs and operations of the Securities and Exchange Commission. I firmly believe that this mission is best achieved by having a vigorous and independent Office of Inspector General to investigate and audit Commission activities and to keep the Commission and Congress informed of significant issues and findings.

The SEC Office of Inspector General includes the positions of Inspector General, Deputy Inspector General, Counsel to the Inspector General, and has staff in two major areas: Audits and Investigations. Our audit unit conducts, coordinates and supervises independent audits and evaluations related to the Commission's internal programs and operations. The primary purpose of conducting an audit is to review past events with a

view toward ensuring compliance with applicable laws, rules and regulations and improving future performance. Upon completion of an audit or evaluation, the OIG issues an independent report that identifies any deficiencies in Commission operations, programs, activities, or functions and makes recommendations for improvements in existing controls and procedures.

The Office's investigations unit responds to allegations of violations of statutes, rules and regulations, and other misconduct by Commission staff and contractors. We carefully review and analyze the complaints we receive and, if warranted, conduct a preliminary inquiry or full investigation into a matter. The misconduct investigated ranges from fraud and other types of criminal conduct to violations of Commission rules and policies and the Government-wide conduct standards. The investigations unit conducts thorough and independent investigations into allegations received in accordance with National Investigative Quality Standards. Where allegations of criminal conduct are involved, we notify and work with the Department of Justice and the Federal Bureau of Investigation as appropriate.

**Audit Reports**

I am proud to report that notwithstanding a small staff, the Office of Inspector General at the SEC has issued numerous audit and investigative reports over the past year involving issues critical to SEC operations and the investing public.

In September 2008, our audit unit issued a comprehensive report analyzing the Commission's oversight of the SEC's Consolidated Supervised Entity (CSE) program, which included Bear Stearns, Goldman Sachs, Morgan Stanley, Merrill Lynch and Lehman Brothers. The report provided a detailed examination of the adequacy of the

Commission's monitoring of Bear Stearns, including the factors that led to its collapse. The audit identified deficiencies in the CSE program that warranted improvement and identified 26 recommendations that, if implemented, would have significantly improved the Commission's oversight of the CSE firms. The Office of Inspector General audit unit also issued a second report during the same time period, analyzing the Commission's Broker-Dealer Risk Assessment program. This program operates pursuant to SEC rules which require broker-dealers that are part of a holding company structure with at least $20 million in capital to register with the Commission and provide information on the broker-dealer, the holding company, and other entities within the holding company system. The audit found that the SEC was not fulfilling all of its obligations in connection with the Broker-Dealer Risk Assessment Program and made several recommendations to improve the program.

The Office of Inspector General's audit unit has also issued numerous other reports over the past year relating to issues such as the Self-Regulatory Organization (SRO) rule filing process, the Commission's Personnel Security/Suitability program, the Division of Enforcement's oversight of receivers and distribution agents and its case-management system, the SEC government purchase card program, the Office of Financial Management's controls over premium travel, the Commission's student loan repayment program, and numerous Office of Information Technology issues such as information security, enterprise architecture, and appropriate controls over laptop computers. These audits are described in our semiannual reports to Congress and the individual audit reports are available on our website.

**Investigative Reports**

We also have a vibrant and vigorous investigative unit that is conducting or has completed over 50 comprehensive investigations of allegations of violations of statutes, rules and regulations, and other misconduct by Commission staff members and contractors. Several of these investigations involved senior-level Commission employees and represent matters of great concern to the Commission, Congressional officials and the general public. Where appropriate, we have reported evidence of improper conduct and made recommendations for disciplinary actions, including terminations. Specifically, over the past year, we have issued investigative reports regarding claims of improper preferential treatment given to prominent persons, retaliatory termination, the failure by the Division of Enforcement to vigorously pursue an Enforcement investigation, conflicts of interest involving an Enforcement investigation and concerning the solicitation of services by an outside contractor, perjury by supervisory Commission attorneys, misrepresentation of professional credentials, falsification of personnel forms and the misuse of official positions and government resources. Where appropriate, we have also referred our investigative findings to the Department of Justice for possible criminal prosecution. We are continuing to follow up with the Department and the Federal Bureau of Investigations on several ongoing criminal matters.

**The Madoff Investigation**

It is with this background in mind that I wish to discuss our planned efforts to investigate matters related to Bernard Madoff and affiliated entities. On the late evening of December 16, 2008, SEC Chairman Christopher Cox contacted me and asked my

office to undertake an investigation into allegations made to the SEC regarding Mr. Madoff, going back to at least 1999, and the reasons that these allegations were found to be not credible. The Chairman also asked that we investigate the SEC's internal policies that govern when allegations of fraudulent activity should be brought to the Commission, whether those policies were followed, and whether improvements to those policies are necessary. In addition, he requested that the 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.

Early on December 17, 2008, we opened an official investigation into the Madoff matter. Since then, we have been working at a rapid pace to begin this important work. On December 18, 2008, we issued a document preservation notice to the entire Commission informing them that the Office of Inspector General has initiated an investigation regarding all Commission examinations, investigations or inquiries involving Bernard L. Madoff Investment Securities, LLC, and any related individuals or entities. We formally requested that each employee and contractor in the Commission preserve all electronically-stored information and paper records related to Bernard L. Madoff Investment Securities, LLC in their original format.

Over the next few days, we met with senior officials from the Commission's Division of Enforcement and the Office of Compliance Inspections and Examinations, known as "OCIE," to ensure their cooperation in our investigation and our ability to gain access to their files and records. We also met with the Chairman's office to seek information and documentation relevant to the investigation.

On December 24, 2008, we sent comprehensive document requests to both the Division of Enforcement and OCIE specifying the documents and records we required to be produced for the investigation. We requested that all responsive documents be provided to our Office by January 16, 2009. In addition, we made several formal expedited requests to the SEC's Office of Information Technology for searches of the e-mails of former and current employees and contractors for information relevant to the investigation, both at headquarters and the New York and Boston Regional Offices, and have already received and are in the process of reviewing these e-mails.

We have also already begun efforts to obtain additional resources to assist the Office in undertaking this investigation. We are securing additional office space and administrative assistance and hope to add four new investigators to our Office's current investigative team.

We have also begun identifying the particular issues that need to be investigated and are reviewing and updating daily the list of witnesses that we plan to interview. We intend to begin conducting these interviews immediately and, for example, have already scheduled a meeting with Harry Markopoulos for later this month for an in-depth interview on the record. We have also already met and spoken with numerous individuals informally as part of our initial investigative efforts.

It is our opinion that the matters that must be analyzed regarding the SEC and Bernard Madoff may go beyond the specific issues that SEC Chairman Cox has asked us to investigate. We believe that in addition to conducting a thorough and comprehensive investigation of the specific complaints that were allegedly brought to the SEC's attention regarding Mr. Madoff and the reasons for the SEC's apparent failure to act upon these

complaints, as well as the staff's contact and relationships with the Madoff family and firm and their impact on Commission decisions regarding Mr. Madoff, our oversight efforts must include an evaluation of broader issues regarding the overall operations of the Division of Enforcement and OCIE that would bear on the specific questions we are examining, and provide overarching and comprehensive recommendations to ensure that the Commission fulfills its mission of protecting investors, facilitating capital formation and maintaining fair, orderly and efficient markets.

At this early stage, I thought it would be useful to identify the specific issues related to Bernard Madoff that, as a preliminary matter, we intend to investigate or review. Obviously, as the investigative efforts are just beginning, I am not in a position to provide any conclusions or findings with regard to the allegations that have been raised and do not wish to make any preliminary judgments before we have had a chance to analyze all the information. In addition, as underlying evidence relevant to the work of the Office of Inspector General could also be relevant to the pending criminal or SEC investigations into possible violations of the securities laws, I am being mindful not to comment on anything that may affect or interfere with those investigations.

The following are specific issues that we currently intend to investigate:

(a) The SEC's response to complaints it received regarding the activities of Bernard Madoff, including any complaints sent to the Division of Enforcement, OCIE, the Office of Risk Assessment and/or the Office of Investor Education and Advocacy. We plan to trace the path of these complaints through the Commission from inception, reviewing what, if any, investigative or other work was conducted with respect to these allegations, and analyze whether the complaints were handled in accordance with

Commission policies and procedures and whether further work should have been conducted;

(b) Allegations of conflicts of interest regarding relationships between any SEC officials or staff and members of the Madoff family, including examining the role a former SEC official who allegedly had a personal relationship with a Madoff family member may have played in the examination or other work conducted by the SEC with respect to Bernard Madoff or related entities, and whether such role or such relationship in any way affected the manner in which the SEC conducted its regulatory oversight of Bernard Madoff and any related entities;

(c) The conduct of examinations and/or inspections of Bernard Madoff Investment Securities LLC by the SEC and an analysis of whether there were "red flags" that were overlooked by SEC examiners and inspectors (which may have been identified by other entities conducting due diligence), that could have led to a more comprehensive examination and inspection, including a review of whether the SEC violated its own policies and procedures by not conducting timely reviews or examinations of Bernard Madoff's activities and filings; and

(d) The extent to which the reputation and status of Bernard Madoff and the fact that he served on SEC Advisory Committees, participated on securities industry boards and panels, and had social and professional relationships with SEC officials, may have affected Commission decisions regarding investigations, examinations and inspections of his firm.

In addition to these specific issues and depending upon the information that we learn during the course of our investigation, we plan to consider analyzing the following broader issues, as appropriate:

(a) The complaint handling procedures of the Division of Enforcement, including a review of how complaints are processed, internal incentives that may affect the decision whether to take action with respect to a complaint, an analysis of which complaints are brought to the Commissioners' and Chairman's attention, and whether tangible and specific complaints are being reviewed and followed-up on appropriately;

(b) The OCIE examination and inspection procedures, including an analysis of what policies and procedures were then and are currently in place, whether these policies and procedures are being followed and/or whether there are gaps in these policies and procedures relating to operations involving voluntary private investment pools, such as hedge funds, because they are subject to limited oversight by the SEC, and whether any such gaps may lead to fraudulent activities not being detected; and

(c) The relationships between different divisions and offices within the Commission and whether there is sufficient intra-agency collaboration and communication between the Agency components to ensure comprehensive oversight of regulated entities.

Obviously, this is an ambitious investigative agenda, but I firmly believe that the circumstances surrounding the Bernard Madoff matter may very well dictate a more expansive analysis of Commission operations. Moreover, it is my view that at the end of these investigative efforts, there needs to be more than just the potential identification of individuals who may have engaged in inappropriate behavior or potentially failed to

follow-up appropriately on complaints, but rather an attempt to provide the Commission with concrete and specific recommendations as appropriate to ensure that the SEC has sufficient systems and resources to enable it to respond appropriately and effectively to complaints and detect fraud through its examinations and inspections.

Of course, even with a limited staff and with many of our auditors and investigators already engaged in ongoing matters, some of which should simply not be halted even in the face of a significant priority such as this one, I understand that it is critical that our investigative efforts be conducted expeditiously. I fully understand that it is crucial for the Commission, the Congress and the investing public that answers be given to the very serious questions regarding the SEC's earlier efforts relating to Mr. Madoff in a prompt and swift manner. For this reason, as I mentioned, I am mobilizing additional resources to ensure that our Office makes every possible effort to conclude our investigations and reviews as soon as possible. We are considering preparing reports on a "rolling basis" – assuming that we can identify discrete issues that may be resolved separately and expeditiously – so that some conclusions may be provided very shortly.

Finally, I can assure you that our investigation and review will be independent and as hard-hitting as necessary. While we approach these efforts with an open mind and at this stage of the investigation we have not reached any conclusions or made any findings, the matters that have been brought to our attention require careful scrutiny and review. We will conduct our work in a comprehensive and thorough manner and, if we find that criticism of the SEC is warranted and supported by the facts, we will not hesitate to report the facts and conclusions as we find them. I think that if you review the reports issued by our office over the past year, you will see that where we have found that

criticism of the SEC or SEC officials to be warranted, we have reported our findings and concerns in a frank, yet constructive manner.

**Concluding Remarks**

In conclusion, we appreciate the Chairman's and the Committee's interest in the SEC and our Office. I believe that the Committee's and Congress's involvement with the SEC is helpful to strengthen the accountability and effectiveness of the Commission. I believe very strongly that a dynamic and effective Office of Inspector General is critical to achieving the aims of all federal agencies, including the SEC, and take very seriously our Office's responsibility to promote efficiency and effectiveness within the Commission and to detect and report waste, fraud and abuse. We intend to conduct our investigative efforts promptly and thoroughly. Thank you.

**STATEMENT BY LEON M. METZGER[1]**

**BEFORE THE**

**COMMITTEE ON FINANCIAL SERVICES**

**UNITED STATES HOUSE OF REPRESENTATIVES**

**JANUARY 5, 2009**

Mr. Chairman, Mr. Ranking Member, and Distinguished Members:

Thank you for inviting me to speak. I commend you for conducting a meeting on regulatory reform of the financial services industry, and hope that my remarks will contribute to that reform. In these remarks, I wish to stress two things: first, the need for top-notch internal controls, and second, that operational risk is the great unspoken-about danger. In this statement, I offer ten recommendations, none of which is mutually exclusive, for you to consider.

With the Chairman's permission, I would like to submit my written statement for the record and summarize my principal observations in oral remarks.

## Introduction

A trader, who ran both the front and back offices of a financial services entity, was thought to be exploiting price differences in the same security on different exchanges. Although the investors did not really understand the trades, they were pleased with the reported risk-adjusted results. In truth, they should have been concerned that the trader was either taking unreasonable risks or committing fraud.

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[1] By way of background, for the last three years, I have taught hedge-fund management courses at Columbia University School of Engineering, Cornell University Financial Engineering, New York University Stern School of Business, and Yale University School of Management. In these courses I have focused on operational controls rather than on moneymaking skills. An expert witness, arbitrator, and consultant on financial-services matters, I was associated with a hedge fund management company for 18 years, most recently as its vice chairman and chief administrative officer. My opinions do not necessarily represent those of any institution with which I have been or currently am affiliated. Nothing herein shall be construed as investment advice.

Although someone examining the trader's high risk-adjusted profits identified a potential conflict of interest and lack of segregation of duties, many were comforted because the trader's institution was audited and regulated, and had a longstanding status as a large and reputable entity. Ultimately, however, the trader's activity led to a full writedown of the portfolios he traded. While fingers were pointed at just the trader, anyone who studied the lack of segregation of duties should have been worried about this risk.

Does this story sound familiar? Indeed, it should, because allegedly it took place about 15 years ago, when a trader's purported activities led to the collapse of a 233-year-old merchant bank.[2]

Nearly one year ago, allegedly, a rogue trader at a financial services entity accumulated, because of a dramatic failure of internal controls, a position of about $73 billion, which, when unwound upon its discovery, led to a $7.2 billion loss.[3]

The common lessons we can learn from these stories is that there should be a separation between the front and back offices, management must understand fully the trades for which it directly or indirectly receives compensation, segregation of duties is critical, and everyone should be subject to oversight.

**Regulatory Structure**

Conceptually, we need two types of regulators: one to maintain market and financial-system stability, and one to maintain market integrity and protect market participants and investors from fraud.

Currently, the Federal Reserve (the "Fed") is the regulator best equipped to evaluate the systemic risk to our financial system and maintain market stability. Every financial firm, whether regulated by a federal agency or a state government—or not at all—including any hedge fund whose gross asset value exceeds $1 billion, should provide periodic and timely full transparency of all its financial assets, liabilities, notional value of derivative financial instruments, and borrowings to the Fed. The central bank should not disclose that

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[2] http://www.erisk.com/Learning/CaseStudies/Barings.asp, accessed December 30, 2008.
[3] http://www.socgen.com/sg/upload/comm24012008/en/fraudnote.pdf, accessed January 1, 2009.

information unless it is to another regulator that agrees to be bound by the same restriction of confidentiality. To minimize systemic risk, systems need to be developed to allow real-time processing of the data submitted by the financial firms.

The economic lines separating securities, commodities, and derivative financial instruments continue to blur. The U.S. Securities and Exchange Commission (the "SEC") and U.S. Commodity Futures Trading Commission should merge into one agency, creating a regulator that focuses its efforts on maintaining market integrity and protecting market participants and investors from fraud.

Given the recent growth of hedge fund capital during the last ten years, it is possible that the SEC has not been given enough financial resources to hire the staff needed to keep pace with the industry.

**Recommendation I**

There should be separate market-stability and market-integrity regulators.

**Recommendation II**

Financial institutions, as defined above, should provide full, complete, and timely disclosure of positional information to a market-stability regulator.

**Internal Control**

Three ingredients are essential to the success of hedge funds: trading strategies; capital; and infrastructure and internal controls. While the first two seem obvious, the third is equally important.

A 2003 study of 100 hedge fund failures over a 20-year period concluded that 50 percent of hedge funds had failed because of operational risk, while 38 percent folded because of investment risk alone. Of the operational failures studied, 85 percent of them came from misrepresentation (reports and valuations with false or

misleading information), misappropriation of funds (fraud), and unauthorized trading.[4]

Similarly, a 2007 study of 109 hedge fund failures over a twelve-year period concluded that 54 percent of hedge funds had failed because of fraud, 13 percent because of other operational issues, and only 33 percent because of the investment strategy.[5]

When I was interviewed in August 2004 about teaching a hedge funds course at the Yale School of Management, I said that I wanted to emphasize good operational controls, which investors tend to overlook, and are essential to the success of an investment. I was offered the job, and the importance of those controls is what I stress whenever and wherever I teach.

If investors could be given the tools for evaluating non-financial aspects of investments and would be convinced to use those tools, I am certain that vastly fewer of them would fall prey to investment fraud.

Institutional investors worry about operational business enterprise risk,[6] but cannot diversify such risk unless they invest in a large number of funds.[7]

According to one prominent industry professional, institutional-quality hedge-fund management must include checks and balances with independence and separation of duties in risk management, risk

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[4] Kundro and Feffer, Capco, http://www.edge-fund.com/Capco03.pdf, accessed December 31, 2008.

[5] Christory, Daul and Giraud, Edhec, http://www.edhec-risk.com/features/RISKArticle.2007-01-24.1044/attachments/EDHEC%20Position%20Paper%20Quantification%20HF%20Default%20Risk.pdf, accessed December 31, 2008.

[6] In a poll conducted at an Institutional Investor Conference in February 2007, 40 percent of those surveyed said their biggest concern was operational business enterprise risks; 30 percent declared investment risks like concentrated portfolios; and 30 percent asserted lack of sufficient transparency or transparency standards. Survey results, as recorded in my notes from that conference.

[7] In another study, by Christory, Daul and Giraud, they concluded that hedge fund operational risk cannot be diversified without including more than 40 funds, resulting in possible financial over-diversification. Therefore, due diligence is required before investing. 40 funds means less time to investigate each individual one and inclusion of funds with lower standards of operations, which increases likelihood of default of individual funds. See http://www.commodities-now.com/content/market-news/archive-2007/market-news-2007011763134.php, accessed January 1, 2009.

oversight, capital allocation across strategies, valuation, cash, collateral, settlements, custody, and compliance.[8]

If I were conducting a due diligence examination of a proposed investment, some of the items I might study, to understand better its operational controls, include:[9]

- the experience, expertise and professional standing of the trading adviser or fund manager;
- the adequacy of the systems, controls, governance, accounting, administration, business continuity, safekeeping, risk management, and trading and execution arrangements;
- the investment strategy and trading philosophy;
- the methodology used to calculate the fund value;
- the degree of leverage embedded in notional principal contracts;
- the level of liquidity offered and whether it is sufficient for the feeder fund to be able to meet its obligation to redeem its investors on request;
- whether there is a risk that a feeder fund may not be able to withdraw from the underlying funds in which it has invested when the investor in the feeder fund wants to withdraw capital;
- after an investor has notified that it wants to redeem its investment, what is the maximum number of days it can take to receive the redemption proceeds, including all possible restrictions;
- whether there is an independent annual audit conducted in accordance with GAAP, and if so, what are the qualifications of such auditor and has such auditor been peer reviewed;
- does the adviser trade for more than one account, i.e., "split tickets," and is there a written allocation policy;
- does the adviser use "soft dollars";[10]
- what is the alignment of interests between manager and investors;
- what is the personal securities trading policy;
- what is the use of side pockets;[11] and

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[8] Presentation to students, by Tanya Beder, Chairman SBCC Group, at Columbia University, Spring 2006.

[9] Many of these items come from draft due diligence guidance issued in March 2007 by the U.K.'s Financial Services Authority for funds of alternative investment funds open to retail investors. See http://www.fsa.gov.uk/pubs/cp/cp07_06.pdf, accessed January 1, 2009.

[10] The term, "soft dollars," is explained later in this Statement.

- what is the use of side letters[12]

In addition, the Alternative Investment Management Association has published a number of standardized due diligence questionnaires ("DDQ") for hedge fund and fund of funds managers and commodity trading advisers, the use of which I endorse.

Those who do not feel experienced enough to perform due diligence or analyze the DDQ responses should hire third-party resources for these important tasks.

**Recommendation III**

The SEC, working with a team of investors and investment managers, should organize a task force to develop a model DDQ.

**Risk is Commensurate with Reward**

Unfortunately, for many investors, due diligence begins and ends with reviewing the prospective manager's performance record. There is a tendency for investors to "chase returns" and to assume that past performance guarantees future results.

It is a maxim in investing that risk is commensurate with reward. The payoff from many hedge-fund strategies resembles that of insurance—a high probability of a small profit and a low probability of a large loss. Because it is hard to collect the typical 2-percent-of-the-capital-under-management-and-20-percent-of-the-net-profits compensation arrangement on single-digit percentage performance, investment advisers use financial leverage[13] to amplify the returns.[14] Therefore, a

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[11] A "side pocket," is the term used to describe the status of an investment from which, because it is either hard to value or illiquid, an investor cannot withdraw her *pro rata* share until the investment becomes easy to value or is sold.

[12] Certain fund managers may grant "side letters" to certain investors, which confer upon them special privileges such as reduced fees, capacity guarantees, better redemption rights, e.g., shorter notice periods, gate waivers, and greater portfolio transparency. The types of investors who receive those letters are early-stage, prestigious, and large ones, as well as those that attract others.

[13] Employing financial leverage includes both borrowing to amplify the results of the investment and embedded exposure to an asset whose value is greater than the up-front payment. Derivative financial instruments with such embedded exposure

manager with an impressive performance record may have achieved that record because of his or her tolerance for risk-taking—not because he or she is a better or smarter investment adviser than someone whose performance record is lower.

Although volatility of investment returns measured by the standard deviation is the metric the financial industry commonly uses to quantify risk, typical hedge fund payoffs do not follow a bell-shaped symmetrical distribution of returns. In fact, the frequency curve of the aforementioned payoff follows that of a right-skewed distribution.

Investors are lulled into a false sense of security as they receive reports of consistent results. Because of the low volatility, they believe that on a risk-adjusted basis, they have appropriate investments. And, then they brag to their friends about how they have discovered an "absolute return" manager, who makes money in all markets, whether they are rising, declining, or moving sideways. Their friends, who envy that performance and whose own due diligence is limited to staring at the manager's track record, pursue the same or similar low-volatility opportunities. But, then comes the unexpected low-probability-large-loss event, the high risk-adjusted-return fund is no more, and the clarion calls for regulation of hedge funds become deafening.

Here is how one media outlet described the performance of two "feeder funds":[15]

> "Investor documents seen by Financial News showed that the $2.8bn [fund] displayed **average annual returns of 11.6%** since beginning in 1995, on annualised **volatility of 2.6%**. Its largest fall in value was 0.6% in the three months from December 2002... [Another fund] has aggregate exposure to the New York trader of about $7.3bn (€5.1bn). A document seen by Financial News from an investor in hedge funds showed [the fund] documented an **average annual return of 11.3%** since its inception in 1990, on **volatility of just 2.5%** [emphasis added]."[16]

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include options, futures, forwards, and swaps. Because the term, "leverage," has a variety of meanings, anyone can choose his or her own way to calculate it.

[14] Many low-volatility strategies would find it very difficult to attract investors if they did not used leverage to boost returns.

[15] For purposes of this statement, the term, "feeder fund," refers to collective pools of capital from investors for which an independent trader is an investment adviser to the fund, in contrast to the adviser trading for each investor separately.

[16] http://blogs.wsj.com/deals/2008/12/31/funds-of-funds-restructure-to-cope-with-madoff-exposure/, accessed December 31, 2008.

Reportedly, these funds were invested in an alleged Ponzi scheme.[17]

**Recommendation IV**

One of the benefits of your conducting this meeting is that you can use your influence to teach American investors that risk is commensurate with reward, and that investors should be skeptical of low-volatility returns. I recommend that you instruct the SEC to develop regulations that will require all investment advisers, registered or not, to remind their clients conspicuously that volatility of returns or the absence thereof is not necessarily the sole or even appropriate measure of risk for the investment it is offering.

**Independent Valuations**

I would be remiss if I did not mention that, when it comes to internal control, I do not see any fundamental distinctions between hedge funds and the proprietary trading desks of investment banks, commercial banks, brokerages, dealers, insurance companies, and other financial services firms.

Valuations rank among the top internal-control concerns of institutional investors.

The U.K.'s Financial Services Authority considers the following good practices for valuations, which I endorse:[18]

- Separation of duties between portfolio manager and back office (If the firm is too small, an independent third party shall provide periodic oversight)
- Reconciliations of positions between back office and prime broker[19]

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[17] http://sec.gov/litigation/complaints/2008/comp-madoff121108.pdf, accessed January 3, 2009 and http://online.wsj.com/documents/madoffcomplaint.pdf, accessed, January 3, 2009.
[18] http://www.fsa.gov.uk/pubs/international/iosco_letter_271106.pdf, accessed December 31, 2008.
[19] A prime broker provides certain services to hedge funds such as clearing and settlement of security transactions, financing of trades, and custody of securities.

- Separate stand-alone pricing-policy document approved by senior management
- Procedures for day-to-day operation of pricing process

A few years ago, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements ("FAS 157"). Some, including members of Congress, have asserted that FAS 157 has contributed to the decline of US stocks and to the recent financial turmoil. I reject that assertion. FAS 157 makes financial statements more consistent and comparable.

On the other hand, it is not clear to me that the authors of FAS 157 envisioned circumstances when markets lock up as they did this fall. Nevertheless, the authors disallowed the use of a blockage discount when computing the value of large blocks of securities. I have been told that because managers of certain hedge funds truly believe that if they sold the large blocks on their books they would receive a discounted price, for purposes of redemptions, they pay out the withdrawing investor at the lower value. This is true notwithstanding the fact that they ignore blockage discounts for financial reporting purposes. I find this aspect of FAS 157 disconnected from reality.

Last week, the SEC submitted a report to Congress on FAS 157.[20] Although, as of the time of this writing, I have read only a small portion of the report, its eight recommendations appear to be very constructive and merit strong consideration.

**Recommendation V**

Members of Congress should mute their criticism of FAS 157 but encourage the SEC to endorse the prudent use of blockage discounts.

**Diversification**

Diversification, which reduces the risks of excessive concentration, is a necessary part of risk management. A 2007 London Business School report says that the cost of downside protection erodes returns by more than the risk reduced. "Long-term investors should control risk

[20] http://sec.gov/news/studies/2008/marktomarket123008.pdf, accessed January 1, 2009.

by investing in a portfolio that is diversified across securities, assets and markets."[21]

While the government could not require financial diversification for individuals, it ought to review whether guidance to pension plan trustees is appropriate.

For example, assume that a pension plan invests in one fund, which, in turn, invests in 40 underlying hedge funds, each employing a different strategy. Is that diversification? With regard to strategies, yes. But, what if the top-tier fund manager is an unscrupulous individual, who distributes doctored audited financial statements to his investors because he has snatched the capital to be invested and with it bought personal luxury items instead? In such an instance, the lack of operational diversification will punish the investor.

What about the investor in a multi-strategy fund that only uses one prime broker, which files under Chapter XI of the Bankruptcy Code? Again, there is strategy diversification but not operational diversification.

Is an investment in a mutual fund that tries to replicate the S&P 500 diversified? On the one hand, it may have 500 holdings. On the other hand, however, it is exposed to large-cap stocks but without any exposure to mid- and small-cap securities. It has no direct exposure to fixed income, real estate, or to international stocks. The investor has not diversified its operational risk exposure. Of course, at some point it becomes impractical to create a portfolio that addresses all investment and operational risks and, therefore, investors make tradeoffs.

**Recommendation VI**

Require all financial intermediaries, including pension plans, to disclose how they diversify their financial **and** operational risks.

**Transparency**

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21 http://www.london.edu/assets/documents/PDF/Global_Investment_Returns_Yearbook_2007_(Synopsis).pdf, accessed December 31, 2008.

I recently read the following information about an investment:

> "The split-strike conversion strategy was allegedly implemented 6-8 times per year and the investment cycle can range from 2-8 weeks. Between investment cycles, the funds' assets are invested in US Treasuries."[22]

In such an investment, full positional transparency is inadequate because it does not tell the investor how money is being made or lost—it only describes how the capital is parked when the strategy is hibernating.

Increased transparency allows for better due diligence and monitoring. It can help the investor identify excessive concentrations in his portfolio when he aggregates his investments, and any style drift by the investment adviser. On the other hand, the purpose of transparency is not for the investor to ask the manager, "Why did you buy 100 shares of XYZ?," because if an investor thinks she knows more than the adviser does, she should find another manager with which to invest.

On Opening Day of the semester, I ask the students, "Imagine that the only information you have about a fund I am offering to you is its 20-year track record and that the investment has been audited by a Big Four accounting firm since its inception. How many of you would invest in it if, over the last twenty years, its annualized return, net of fees, is 40 percent?" With this example, I aim is to illustrate that investment risk is commensurate with reward—investment fraud is not even a consideration. Typically, almost everyone in the class raises his or her hand. My objective as a teacher is to chip away at that outcome so that when I repeat that question at the last class, there is no hand in the air. For example, on December 12, one of my students at Yale, referring to the news of an alleged Ponzi scheme, emailed to me, "I am definitely a convert. Day one I would have invested but now I know better."

The term, "alpha," refers to the talent of the manager to deliver returns that exceed market risk. One of the arguments made by investment advisers who oppose transparency is that it could allow competitors to reverse engineer proprietary trading algorithms. I do not have much sympathy for those who assert this concern. Too many

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[22] http://dealbreaker.com/images/thumbs/UBP%20Madoff%2017-12-2008.pdf, accessed December 31, 2008.

managers generate "fake alpha," by delivering early above-average returns when the expected return is much lower.[23] A cynic might say the purpose of the claim simply is to mask the fake alpha.[24] In the recent alleged Ponzi scheme, investors who asked for details about the split-strike conversion strategy, reportedly were told that the methods were proprietary.[25]

Arguably, David Swensen is one of the greatest investors of our time. Once upon a time, when he considered investing in a fund, its manager would not meet his demand for transparency. Mr. Swensen told the *New York Times*, "If you are sitting in my position, how can you responsibly give money to a fund that won't tell you what they are invested in? If I went to my investment committee and told them we are invested in this fund but we don't know what the positions are, they should fire me."[26]

**Recommendation VII**

My solution to the transparency dilemma is:

- Full transparency regarding valuation policies, practices, and procedures;
- Partial transparency of performance attributes, portfolio exposures and risk metrics; and
- Limited disclosure of positions

**Independent Third-Party Administrators and Custodians**

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[23] http://knowledge.wharton.upenn.edu/papers/1352.pdf, accessed December 31, 2008.

[24] Assume that XYZ stock is trading at $100 per share today, and that one-year call options on XYZ, which are exercisable at $200, are valued at $1. If the fund manager's strategy is to sell "short" such uncovered calls every year, in most years, her clients should earn consistent low-volatile returns. When that stock unexpectedly doubles in value, however, the losses on the call will more than erase the previous years' gains. Imagine if the adviser doesn't tell her client what is the fund's strategy. The investor will believe that he has discovered an alpha-generating manager, while if he really understood the strategy, he might not ever invest in that fund.

[25] New Dog, Old Tricks, *Forbes*, by William P. Barrett, January 12, 2009, page 35.

[26] http://www.nytimes.com/2007/02/18/business/yourmoney/18swensen.html?_r=1&oref=slogin&pagewanted=all, accessed January 4, 2009.

A large investor in hedge funds recently announced that it intends to withdraw from any fund that does not use an independent third-party administrator and custodian.[27] An administrator offers services such as fund accounting, communicating with investors, and calculating the fund's net asset value. The custodian, often the prime broker of the hedge fund, is charged with the safekeeping or holding of the fund's securities.

I cannot support mandatory use of independent administrators until they agree to be legally accountable for the valuation process. Short of that, there will always be a shadow of a doubt that the processes used to determine the values were not sufficiently robust. Even if valuations are done in-house, a fund can still use independent sources, including third-party models, to value its portfolio.

While it sounds great to add an extra set of eyes, once again, investors may be lulled into relying upon a Good-Housekeeping-Seal-of-Approval-type of endorsement rather than practicing good due diligence. For example, in 1998, many thought that Value at Risk ("VaR"), a risk metric employed by investment and commercial banks, was the panacea to the risk-management issue. Fast forward ten years to the amount of money investment and commercial banks lost in 2008.

In 2004, the majority of the SEC Commissioners thought that mandatory hedge-fund manager registration would be a solution to systemic risk and fraud. Yet the firm recently in the news because of an alleged Ponzi scheme was an investment adviser registered with the SEC. Someone provided detailed questions to and raised significant concerns with the SEC in 2006, but the adviser was allowed to continue its business.[28]

Would have an independent administrator prevented the alleged Ponzi scheme recently discovered?

I support the use of an independent custodian. In my experience, best practices calls for the trader, whether an employee at a hedge fund or an investment adviser directing a managed account, to have authority only to initiate securities trades. She should not be authorized to open

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[27] http://www.ft.com/cms/s/0/3e0a619c-d131-11dd-8cc3-000077b07658.html, accessed December 31, 2008.
[28] http://online.wsj.com/documents/Madoff_SECdocs_20081217.pdf, accessed Dec 18, 2008.

brokerage accounts, execute or settle trades, or access cash, whether by withdrawal or by electronic transfer. The securities should be held with an independent custodian.

**Recommendation VIII**

I support legislation that would mandate an independent third-party custodian be used by all investment advisers, whether or not they are registered with the SEC or any state regulator. I oppose the mandatory use of an independent third-party administrator until such time as the administrators accept legal responsibility for valuations.

**Sophisticated Investors**

The SEC has promulgated minimum net-worth and annual income suitability standards that are designed to protect unsophisticated investors. Wealth serves as a proxy to measure sophistication because no one has developed a better test. Yet many of the victims of the alleged Ponzi scheme reportedly had losses that exceeded those amounts by more than one hundredfold. Unfortunately, I do not currently have a recommendation for dealing with the issue of investor sophistication.

**Regulation of Hedge Funds**

On March 3, 1999, I appeared before the Subcommittee on Capital Markets, Securities and Government-Sponsored Enterprises of the House Committee on Banking and Financial Services and made three recommendations in response to proposals that some had suggested in the aftermath of the collapse of a large hedge fund:

- first, that government not undertake any additional regulation of hedge funds;
- second, that no arbitrary limits be placed on leverage; and
- third, that, although market self-discipline is the best regulator, government should continue its practice of providing guidance to business.

I believed then, and continue to believe, that operational risk is the great unspoken-about danger. Nearly ten years later, I have re-

visited my testimony, and want to inform you that my thinking has evolved, as has the industry. Hedge Fund Research estimated the size of the industry in 1998 at $387 billion.[29] At its peak earlier this year, many estimated the size at $1.9 trillion,[30] quintuple the size at the time I testified in 1999. By comparison, the size of the US economy measured by nominal GDP has grown from $9 to $14.4 trillion, or by 60 percent.[31] The Investment Company Institute estimated the size of the mutual-fund industry at $5.530 trillion in 1998[32] and at $9.355 trillion in 2008,[33] a growth of 69 percent. To put that in perspective, the ratio of mutual fund assets to hedge fund assets has declined from about 14:1 to 5:1 in the last ten years. In 2008, shareholder wealth declined by about $7 trillion.[34] Clearly, the hedge fund industry is a much bigger player in the financial arena and therefore has a higher likelihood of contributing to systemic risk.

It is time to reorganize the regulatory structure of the financial services industry. Now is the moment to regulate substance rather than form. For example, hedge funds that extend loans to companies in distress are performing traditional banking functions, banks that issue credit default swaps are standing in for insurers, and insurers with large proprietary trading desks may economically—albeit not legally—be functioning as market makers.

2008 was the year of de-leveraging. The US government is desperately encouraging credit providers to lend. Businesses, small and large, are finding it difficult to tap credit markets, which has led to job layoffs and decline in GDP growth. While one occasionally hears of the over-leveraged hedge fund that is forced to close because gearing amplified its losses, these happenings remain relatively rare. It is ironic that the credit providers, who after 1998 improved their lending practices to hedge funds, fell down on the job with regard to other

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[29] http://www.cboe.com/Institutional/pdf/hedgefundwhitepaper_11-2001.pdf, accessed January 2, 2009.
[30] http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aCwo3Dc8DVM0, accessed January 2, 2009.
[31] http://www.data360.org/dsg.aspx?Data_Set_Group_Id=230, accessed December 31, 2008.
[32] http://www.ici.org/stats/mf/arctrends/trends_12_98.html#TopOfPage, accessed December 31, 2008.
[33] http://www.ici.org/stats/mf/trends_11_08.html#TopOfPage, accessed December 31, 2008.
[34] http://www.nytimes.com/2009/01/01/business/economy/01markets.html?ref=business, accessed January 1, 2009.

types of lenders. For example, the collapse in 2006 of a prominent hedge fund did not require the Fed-type intervention that another well-known fund needed in 1998 because the former fund was less leveraged, and counterparties were better prepared resulting from the superior transparency that they had demanded.

Based upon the information available to me, with regard to arbitrary limits placed on leverage on hedge funds, I have not changed my mind. If regulators limited the leverage that credit providers, i.e., banks, themselves could employ, market discipline would ration the leverage available to hedge funds. U.S. Treasury Secretary Henry M. Paulson stated on February 10, 2007, "Market discipline, focusing on the risk management of regulated counterparties, is the most effective way to address potential systemic risk concerns."[35] With regard to the use of leverage by hedge funds, I agree with that statement.

**Risk Management**

Risk has been defined as "the possibility of loss to capital, revenue, resources or reputation resulting from either the loss of business, the poor execution of business strategy, changes in creditworthiness of clients or counterparties, variability or volatility in financial markets, or mistakes or inefficiencies in the regular conduct of business."[36]

Eliminating risk taking is impractical because without risk there cannot be any reward. As UBS puts it: "Taking, managing and controlling risk is core to [its] business. The aim is not, therefore, to eliminate all risks but to achieve an appropriate balance between risk and return."[37]

Risk management must address low probability events. In-house investment risk-management tools and analysis could include calculation of exposures, scenarios, stress tests, VaR, and other risk measures. In a hedge fund, the risk manager may be a consultant and a traffic cop, providing perspective on risk and performance to the trading adviser as well as enforcing limits. Risk management helps in capital allocation and performance measurement. Besides investment

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[35] http://www.ustreas.gov/press/releases/hp255.htm, accessed January 1, 2009.
[36] Private communication from Douglas E. Harris, Managing Director, Promontory Financial Group, L.L.C.
[37] http://www.ubs.com/1/ShowMedia/investors/annualreporting?contentId=137532&name=AR07_RTCM_EN.pdf, accessed January 1, 2009.

risk, the risk manager may be responsible for setting and monitoring operational and counterparty risks.

Investors should be given enough information so that they can assess the risk to their portfolio.

**Peer Review of CPA Firms**

Not all CPA firms undergo a peer review of their accounting and auditing practices.[38] Potentially, a client may hire an accounting firm that lacks the appropriate industry experience.

**Recommendation IX**

The SEC should require accounting firms that audit broker-dealers go through peer review by firms that have experience auditing similar financial services entities, and that the peer reviewer look at a sample of broker-dealer assignments of the firm.

**Soft dollars**

Soft dollar practices are arrangements under which products or services other than execution of securities transactions ("soft dollar services") are obtained by an adviser from or through a broker in exchange for the direction by the adviser of client brokerage transactions to the broker.[39] By bundling soft dollar services such as research (whose definition may be aggressively interpreted at times by advisers) with costs of execution, soft dollar services could have the effect of hiding fees to investors.

**Recommendation X**

Congress should commission the Government Accountability Office to study whether investors benefit from the soft dollar arrangements that Congress allowed in 1975.

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[38] http://www.aicpa.org/audcommctr/toolkitsnpo/Peer_Review_of_CPA_Firms.htm, accessed January 4, 2009.
[39] http://sec.gov/rules/proposed/soft.txt, accessed January 1, 2009.

**Conclusion**

While we may not be able to undo the damage of the past, you, I, the media covering this meeting, and anyone who joins our efforts should resolve:

- one, to contribute to the development of legislation and regulations that will protect investors from Ponzi schemes and other fraud;
- two, to inform and educate investors regarding the dangers of making investment decisions solely on the basis of past performance, ignoring the importance of understanding the investment strategy, disregarding best internal-control practices, and piggybacking the "smart money"; and
- three, to inform and educate investors regarding the benefits deriving from diversifying both investment and operational risks, and conducting proper due diligence.

Consider the extent of our contribution if, as a result of this meeting, whether through your action or the witnesses' statements, investors will walk away from the next multi-billion-dollar fraud, avoiding the embarrassment and financial pain that inevitably follows.

Regulatory reform of the financial services industry should be a high priority. Thank you again for your leadership in these important matters and for inviting me to testify. I stand ready to assist you, and welcome any questions you may have.

INVESTMENT ADVISER
ASSOCIATION

**Statement of the Investment Adviser Association**

House Committee on Financial Services Hearing

"Assessing the Madoff Ponzi and the Need for Regulatory Reform"

January 5, 2009

Chairman Kanjorski and members of the House Financial Services Committee, the Investment Adviser Association (IAA)[1] appreciates this opportunity to present its views on Bernard Madoff and the need for regulatory reform.

For more than two decades, Bernard Madoff and his brokerage firm, Bernard Madoff Investment Securities LLC, were many things, including securities broker, off-floor trader, market maker, proprietary trader, hedge fund subadviser, investment manager, and perpetrator of the largest Ponzi scheme in history.

As part of this scheme, Madoff executed trades and "managed" client funds with a callous disregard for any semblance of the fiduciary duty owed by investment advisers. As described below, Madoff became subject to this fiduciary duty and other investment adviser legal obligations in September 2006 when his brokerage firm dually-registered with the SEC as an investment adviser. The strict fiduciary responsibility under the Investment Advisers Act of 1940 (Advisers Act) distinguishes investment advisers from others in the financial services industry and protects investors by mandating a culture within the advisory profession of placing clients' interests first and eliminating or mitigating conflicts of interest.

Upon becoming a registered investment adviser in 2006, Madoff was required to comply with numerous other legal and regulatory requirements. SEC-registered advisers are required to maintain written, comprehensive compliance programs. They must also adopt codes of ethics setting out standards of conduct expected of advisory personnel and addressing conflicts that arise from personal trading. These rules, coupled with the SEC's broad anti-fraud authority to regulate, inspect and enforce the Advisers Act, are intended to complement the fiduciary standard owed by investment advisers.

[1] The IAA is a not-for-profit association that exclusively represents the interests of investment adviser firms registered with the SEC. Founded in 1937, the Association's membership consists of more than 500 firms that (as of April 2008) collectively manage in excess of $9 trillion in assets for a wide variety of institutional and individual clients, including pension plans, trusts, investment companies, endowments, foundations, and corporations. More information is available at our website: www.investmentadviser.org

1050 17th Street N.W. · Suite 725 · Washington, DC 20036-5503 · (202) 293-4222 ph · (202) 293-4223 fx · www.investmentadviser.org

Madoff appears to have disregarded these laws and regulations, and his business "model" was rife with conflicts and the potential for abuse. Unlike the typical investment adviser, Madoff's firm reportedly executed all of its clients' securities trades, held client funds itself (without a third-party custodian), and received all of its compensation as commissions. Further, Madoff failed to employ a bona fide accounting firm to audit financial reports and allegedly fabricated false account statements for his clients.

This is in sharp contrast to the practices of typical investment advisers. According to April 2008 data from the SEC's Investment Advisory Registration Depository (IARD) system, only 5.8% of the more than 11,000 SEC-registered investment advisers are dually registered as broker-dealers and only 11 investment advisers – *less than one-tenth of one percent* – were like Madoff and received all their compensation as commissions. More than 95% of advisers charge asset-based fees while only 9.3% of investment advisers charge commissions at all, much less exclusively. Unlike Madoff, the vast majority of investment advisers neither execute trades (themselves or through an affiliate) nor hold clients' funds. Most investment advisers employ third-party custodians and brokers, and clients receive separate statements from the custodian as well as from their investment adviser.

According to widely circulated news reports on the scandal, the SEC and FINRA examined Madoff on a routine basis, and the SEC completed an investigation of Madoff in 2007. However, despite being tipped to the Ponzi scheme, the SEC apparently found no cause for any enforcement action. Instead, the SEC appears to have directed Madoff to address certain minor deficiencies and to register with the SEC as an investment adviser.

Until September 2006, Madoff was registered only as a broker-dealer. Because his firm received no separate fees for his advisory services, Madoff apparently availed himself of the broad exemption under the Advisers Act for broker-dealers whose advisory services are "solely incidental" to their brokerage activities and who do not charge "special compensation" for advice. However, on January 31, 2006, full compliance with the new SEC "Broker-Dealer Rule" was required. Among other things, the new Rule (vacated by court decision on March 30, 2007) clarified that discretionary management of clients' accounts – as provided by Madoff – could not be considered "solely incidental" to brokerage activities. Accordingly, Madoff could no longer claim an exemption from the Advisers Act on this basis.

The Form ADV disclosure document that Madoff filed with the SEC as a newly-registered investment adviser (approved September 12, 2006) revealed that Madoff's broker-dealer firm had between 51 and 250 registered representatives, only 1 to 5 of whom performed investment advisory functions. Madoff's Form ADV also confirmed that the firm received no asset-based fees and was compensated entirely by commissions.

Given the numerous "red flags" that regulators should have seen, it appears that the Madoff scandal was a failure of regulatory enforcement and not a failure of the regulations themselves. For this reason, it must be determined why the numerous inspections that were performed over the last two decades failed to reveal Madoff's unlawful activity. This inquiry should be part of a broader review of the SEC's inspection and enforcement efforts, including an examination of the adequacy of its resources.

As long-supported by the IAA, there must be full funding for the SEC's enforcement efforts. To more effectively deploy SEC resources, we also recommend that consideration be given to adjusting the minimum assets under management (AUM) for SEC investment adviser registration upwards as Congress expressly contemplated in 1996 when it set the still-current $25 million threshold in NSMIA. This change would reduce the number of federally registered advisers (and increase the number of state registered advisers) thereby permitting the SEC to better focus on larger investment advisory firms.

We recommend further that Congress and the SEC consider certain other measures to address the current market environment. As outlined in IAA's "Principles and Recommendations for Regulatory Reform" (attached), these measures include requiring registration of hedge fund managers. The IAA also recommends that the SEC consider the circumstances, if any, under which dually-registered broker-dealers like Madoff should be permitted to self-custody client funds managed on a discretionary basis.

We applaud the efforts of the House Financial Services Committee and its leadership in examining the Madoff scandal and its implications for needed regulatory reform. The IAA looks forward to the results of this inquiry and to assisting the Committee in its deliberations about possible changes in SEC enforcement or in the regulation of securities, hedge funds, brokers, or investment advisers.

Attachment

INVESTMENT ADVISER
ASSOCIATION

**IAA Principles and Recommendations for Regulatory Reform**

The Investment Adviser Association (IAA) is a not-for-profit organization representing the interests of SEC-registered investment advisory firms. The IAA's more than 500 members provide investment advice to a wide variety of high net worth individuals and institutional clients, including endowments, foundations, pensions, and mutual funds.

The Association played a major role in the enactment of the Investment Advisers Act of 1940, under which investment advisers that manage more than $25 million in assets are registered and regulated by the Securities and Exchange Commission. The law vests the SEC with broad anti-fraud authority and subjects investment advisers to a fiduciary duty. As fiduciaries, investment advisers have an affirmative duty to act in the best interests of their clients and to make full and fair disclosure to clients regarding conflicts of interest.

The IAA is persuaded that the recent financial crisis requires policy makers to consider a broad range of issues and actions. We believe the following broad principles and recommendations will be helpful in addressing regulatory reform:

- The root causes of the financial crisis – including subprime loans, securitization of mortgage instruments, and over-leverage – must be examined and addressed by Congress, the Administration, regulators, and other policy makers.

- Congress and regulators should focus on unregulated services and products that contributed to the financial crisis:

  - The IAA continues to support centralized registration and regulation of hedge fund managers by the SEC.

  - The IAA supports far stronger oversight and transparency of credit default swaps and other complex financial derivatives.

- Congress should determine whether the laws and regulations governing banks and securities firms that contributed to the financial crisis are appropriate and effective.

- Congress should consider consolidating certain government agencies, including merging the CFTC into the SEC, in order to ensure more effective regulation, efficiency, and accountability.

- Congress should consider the key elements of the Investment Advisers Act of 1940 in the regulatory framework for other financial service functions – a fiduciary duty (which includes the duty to place the interests of your client above your own interests at all times), coupled with broad anti-fraud authority and full and fair disclosure obligations overseen by a single direct regulator (SEC).

Finally, in effecting regulatory reform of the financial services industry, policy makers should be mindful of two maxims. First, managerial reorganization (*i.e.*, creating new regulatory authorities or shuffling, merging or eliminating existing regulators) does not itself constitute regulatory reform. Second, policy makers should "do no harm" in revising existing laws and regulations. Where investors' interests are protected and the industry effectively regulated, policy makers should not create new and additional regulatory requirements.

In addition to these principles and recommendations for broader reform, the IAA recommends that the SEC and other regulators continue to study specific measures to address the current market environment, including whether reinstatement of the so-called uptick rule would be beneficial.

BARNEY FRANK, MA, CHAIRMAN

U.S. House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

SPENCER BACHUS, AL, RANKING MEMBER

December 17, 2008

The Honorable Barney Frank
Chairman
Committee on Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Frank:

Last week's startling revelations about the alleged $50 billion "giant Ponzi scheme" orchestrated by Bernard Madoff, a prominent member of the securities industry for more than 45 years, exposes serious shortcomings in securities regulation and oversight that require the Committee's immediate attention.

The Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA) were reportedly unaware of Mr. Madoff's deceptions, which only came to light after Mr. Madoff revealed the scheme to two of his senior employees last week. This episode raises serious questions about the SEC's ability to fulfill its mission to protect investors and abide by its motto to be the "investor's advocate," and prompts concerns about the capabilities of self-regulatory organizations to supplement government oversight. Every day brings more news of the devastating impact of this alleged fraud on charities, private foundations, banks, broker-dealers and government entities as well as individual and corporate investors.

Accordingly, I am writing to request that the Committee hold hearings, as soon as practicable in the 111th Congress, to thoroughly investigate Mr. Madoff's conduct and the broader implications for securities market oversight and enforcement. These hearings should specifically examine the adequacy of the SEC's and FINRA's examination programs, as well as the compliance program at Mr. Madoff's firm, and should include testimony from Mr. Madoff, the SEC, FINRA, the Securities Investor Protection Corporation, Mr. Madoff's accounting firm and his victims.

Thank you for the consideration of my request.

Sincerely,

Spencer Bachus
Ranking Member

08 MAG 2735 COPY

Approved: _____
MARC LITT
Assistant United States Attorney

Before: HONORABLE DOUGLAS F. EATON
United States Magistrate Judge
Southern District of New York

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| | | |
|---|---|---|
| UNITED STATES OF AMERICA | : | COMPLAINT |
| - v. - | : | Violation of 15 U.S.C. §§ 78j(b), 78ff; 17 C.F.R. § 240.10b-5 |
| BERNARD L. MADOFF, | : | |
| Defendant. | : | |
| | : | COUNTY OF OFFENSE: NEW YORK |

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SOUTHERN DISTRICT OF NEW YORK, ss.:

THEODORE CACIOPPI, being duly sworn, deposes and says that he is a Special Agent with the Federal Bureau of Investigation, and charges as follows:

COUNT ONE
(Securities Fraud)

1. From at least in or about December 2008 through the present, in the Southern District of New York and elsewhere, BERNARD L. MADOFF, the defendant, unlawfully, wilfully and knowingly, by the use of the means and instrumentalities of interstate commerce and of the mails, directly and indirectly, in connection with the purchase and sale of securities, would and did use and employ manipulative and deceptive devices and contrivances in violation of Title 17, Code of Federal Regulations, Section 240.10b-5, by (a) employing devices, schemes, and artifices to defraud; (b) making untrue statements of material facts and omitting to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, and (c) engaging in acts, practices, and courses of business which operated and would operate as a fraud and deceit upon persons, to wit, MADOFF deceived investors by operating a securities business in which he traded and lost investor money, and then paid certain

investors purported returns on investment with the principal received from other, different investors, which resulted in losses of approximately billions of dollars.

(Title 15, United States Code, Sections 78j(b) & 78ff; Title 17, Code of Federal Regulations, Section 240.10b-5; and Title 18, United States Code, Section 2.)

The bases for my knowledge and the foregoing charges are, in part, as follows:

2. I have been a Special Agent with the Federal Bureau of Investigation ("FBI") for approximately six and one-half years, and I have been personally involved in the investigation of this matter. The information contained in this Complaint is based upon my personal knowledge, as well as information obtained from other sources, including: a) statements made or reported by various witnesses with knowledge of relevant facts; and b) my review of publicly available information relating to BERNARD L. MADOFF, the defendant. Because this Complaint is being submitted for the limited purpose of establishing probable cause, it does not include every fact that I have learned during the course of the investigation. Where the contents of documents and the actions, statements and conversations of others are reported herein, they are reported in substance and in part, except where otherwise indicated.

3. I have reviewed the publicly available web site of a securities broker dealer named Bernard L. Madoff Investment Securities LLC, from which I have learned the following: (a) BERNARD L. MADOFF, the defendant, is the founder of Bernard L. Madoff Investment Securities LLC; (b) Bernard L. Madoff Investment Securities LLC is a securities broker dealer with its principal office in New York, New York; (c) Bernard L. Madoff Investment Securities LLC "is a leading international market maker. The firm has been providing quality executions for broker-dealers, banks and financial institutions since its inception in 1960;" (d) "[w]ith more than $700 million in firm capital, Madoff currently ranks among the top 1% of US Securities firms; (e) BERNARD L. MADOFF, the defendant, is a former Chairman of the board of directors of the NASDAQ stock market; and (f) "Clients know that Bernard Madoff has a personal interest in maintaining an unblemished record of value, fair-dealing, and high ethical standards that has always been the firm's hallmark."

4. I have interviewed two senior employees of Bernard L. Madoff Investment Securities LLC ("Senior Employee No. 1", and "Senior Employee No. 2", collectively the "Senior Employees").

The Senior Employees informed me, in substance, of the following:

a. The Senior Employees are employed by Bernard L. Madoff Investment Securities LLC, in a proprietary trading, and market making capacity. According to the Senior Employees, BERNARD L. MADOFF, the defendant, conducts certain investment advisory business for clients that is separate from the firm's proprietary trading and market making activities. According to the Senior Employees, MADOFF ran his investment adviser business from a separate floor in the New York offices of Bernard L. Madoff Investment Securities LLC. According to Senior Employee No. 1, MADOFF kept the financial statements for the firm under lock and key, and stated that MADOFF was "cryptic" about the firm's investment advisory business.

b. In or about the first week of December, BERNARD L. MADOFF, the defendant, told Senior Employee No. 2 that there had been requests from clients for approximately $7 billion in redemptions, that he was struggling to obtain the liquidity necessary to meet those obligations, but that he thought that he would be able to do so. According to the Senior Employees, they had previously understood that the investment advisory business had assets under management on the order of between approximately $8-15 billion. According to a Form ADV filed by MADOFF on behalf of Bernard L. Madoff Investment Securities LLC with the SEC on or about January 7, 2008, MADOFF's investment advisory business served between 11 and 25 clients and had a total of approximately $17.1 billion in assets under management.

c. On or about December 9, 2008, MADOFF informed Senior Employee No. 1 that he wanted to pay bonuses to employees of the firm in December, which was earlier than employee bonuses are usually paid. Accordingly to the Senior Employees, bonuses traditionally have been paid in February of each year. On or about December 10, 2008, the Senior Employees visited MADOFF at the offices of Bernard L. Madoff Investment Securities LLC to discuss the situation further, particularly because it MADOFF had appeared to the Senior Employees to have been under great stress in the prior weeks. At that time, MADOFF informed the Senior Employees that he had recently made profits through business operations, and that now was a good time to distribute it. When the Senior Employees challenged his explanation, MADOFF said that he did not want to talk to them at the office, and arranged a meeting at MADOFF's apartment in Manhattan. According to Senior Employee No. 2, MADOFF stated, in substance, that he "wasn't sure he would be able to hold it together" if they continued to discuss the issue at the office.

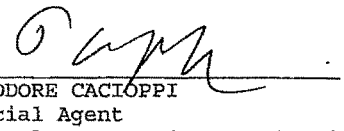
d. At MADOFF's Manhattan apartment, MADOFF informed the Senior Employees, in substance, that his investment advisory business was a fraud. MADOFF stated that he was "finished," that he had "absolutely nothing," that "it's all just one big lie," and that it was "basically, a giant Ponzi scheme." The Senior Employees understood MADOFF to be saying, in substance, that he had for years been paying returns to certain investors out of the principal received from other, different, investors. MADOFF stated that the business was insolvent, and that it had been for years. MADOFF also stated that he estimated the losses from this fraud to be at least approximately $50 billion. One of the Senior Employees has a personal account at Bernard L. Madoff Investment Securities LLC in which several million had been invested under the management of MADOFF.

e. At MADOFF's Manhattan apartment, MADOFF further informed the Senior Employees that, in approximately one week, he planned to surrender to authorities, but before he did that, he had approximately $200-300 million left, and he planned to use that money to make payments to certain selected employees, family, and friends.

f. At MADOFF's Manhattan apartment, MADOFF further informed the Senior Employees that he had also recently informed a third senior employee ("Senior Employee No. 3"), of the facts that MADOFF had just told the Senior Employees.

5. On December 11, 2008, I spoke to BERNARD L. MADOFF, the defendant. After identifying myself, MADOFF invited me, and the FBI agent who accompanied me, into his apartment. He acknowledged knowing why we were there. After I stated, "we're here to find out if there's an innocent explanation." MADOFF stated, "There is no innocent explanation." MADOFF stated, in substance, that he had personally traded and lost money for institutional clients, and that it was all his fault. MADOFF further stated, in substance, that he "paid investors with money that wasn't there." MADOFF also said that he was "broke" and "insolvent" and that he had decided that "it could not go on," and that he expected to go to jail. MADOFF also stated that he had recently admitted what he had done to Senior Employee Nos. 1, 2, and 3.

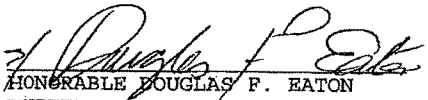
WHEREFORE, deponent prays that BERNARD L. MADOFF, the defendant, be imprisoned, or bailed, as the case may be.



DEC 11 2008

THEODORE CACIOPPI
Special Agent
Federal Bureau of Investigation

Sworn to before me this
_____ day of December, 2008



HONORABLE DOUGLAS F. EATON
UNITED STATES MAGISTRATE JUDGE
SOUTHERN DISTRICT OF NEW YORK

2. How the SEC Can Prevent More Madoffs
By Arthur Levitt Jr.
897 words

5 January 2009

The Wall Street Journal

The Bernard Madoff affair is a scandal of epic proportions.

It not only has devastated the prominent individuals and institutions who invested in his funds, but it has also further undermined whatever trust investors may have had after this year of bank failures, credit crises, and market meltdowns.

The regulatory structure that has been in place for the past eight decades to keep our markets free and fair may no longer be appropriate.

There is a lot we still don't know about the Madoff scandal.

In my eight years as chairman of the Securities and Exchange Commission (SEC), I never saw an instance where credible information about misconduct was not followed up by the agency. I knew Bernie Madoff and had no reason to believe he was not a legitimate market maker, nor did anyone at that time know he was acting as an adviser to outside investors.

Current SEC Chairman Christopher Cox, who recently said that "credible and specific allegations . . . were repeatedly brought to the attention of SEC staff," is right to investigate whether the commission failed in some way to protect investor interests.

Any potential conflicts of interest, including the fact that Mr. Madoff's niece married an SEC official last year, will likely be high on Mr. Cox's list of priorities.

Yet contrary to what some commentators have said, the Madoff affair doesn't prove that the SEC is a failed institution that must be shuttered. Nor does it show that all it needs is more money to do its job. Rather, this scandal underscores the need for a 21st century regulatory approach.

The complexity of today's products, markets and investment strategies calls for a laser-like focus on risk assessment. A regulatory agency is not omniscient. Its leadership must identify the biggest possible risks to investors and to the entire system and focus resources on these areas.

Recognizing this, Bill Donaldson, one of my successors in the SEC chairmanship, established the Office of Risk Assessment. This effort started off small. Unfortunately, after Mr. Donaldson left the SEC, it was diminished to only one staff member by last February.

Instead of being a sideshow, risk assessment must be central to the SEC's efforts. The agency needs an office that will collect information from all of the agency's divisions and propose inspection and examination priorities. It should identify problems such as excessive leverage and risks posed by new structured financial products. The office should answer directly to the SEC chairman and report monthly to the entire commission.

Once problem areas or firms are identified, the SEC must have a robust oversight and inspection capability as well as, when needed, an enforcement agency that is empowered and enabled to pursue leads.

Over the past few years, the SEC has not kept pace with inflation or innovation. Since 2002, the number of investment advisers -- such as Madoff Securities -- has increased by 50%. Yet enforcement resources have been flat or even reduced. The number of SEC enforcement division personnel was cut by 146, to 1,192 in 2007 from 1,338 in 2005.

As a result, only about 10% of investment advisers can expect to be examined every three years, and the goal of inspecting every adviser once every five years -- laughably light oversight in its own right -- has been abandoned.

More funds will help, but there must be an immediate emphasis on much better training for the enforcement and inspection staffs that deal with today's markets, their complex instruments, and most of all, trading techniques.

Enforcement is not just an exercise in overwhelming force; it's about using scarce resources to address the most significant and current market misconduct in a way that has the greatest impact. It entails drawing on a new risk-assessment approach to judge where enforcement actions will be most effective as a deterrent to bad behavior; being able to move quickly after violations of law occur; and when appropriate, exploring creative ways to craft industry-wide solutions to industry-wide problems.

Investors cannot have an accurate picture of the markets if corners of it are left free from reasonable oversight.

The Madoff scandal should be a wake-up call for more consistent, uniform and rigorous regulation of investment advising.

All investment advisers as well as hedge funds should be subject to SEC registration and oversight. (In June 2006, the U.S. Court of Appeals for the District of Columbia Circuit overturned the SEC rule requiring hedge-fund managers to register as investment advisers.)

In addition, we can no longer allow broker-dealers, regardless of their size, to be audited by any CPA.

Broker-dealers of a certain size can't rely on a mom-and-pop auditor (as apparently Mr. Madoff did); they need to use regulated auditors overseen by the Public Company Accounting Oversight Board. With more transparency, investors will be better able to judge with whom to invest their money.

Let's hope that the Madoff swindle is not a spur to haphazard regulatory responses, which often have unintended consequences, but instead the final prod for a fundamental reform of the financial regulatory structure that protects investors and keeps our markets free and fair.

Bloomberg News
By David Scheer and Ian Katz

Jan. 5 (Bloomberg) -- The U.S. Securities and Exchange Commission may come under fire from lawmakers today for failing to quash Bernard Madoff's alleged $50 billion Ponzi scheme after an investor alerted the agency to the suspected fraud.

The House Financial Services Committee is scheduled to hear from one of Madoff's alleged victims, securities law experts and the SEC's inspector general, David Kotz, who's probing the agency's handling of the matter. Harry Markopolos, the former money manager who says regulators didn't act on his tips about Madoff, canceled his appearance.

"The SEC will have to defend its existence," said Donald Langevoort, a former agency attorney who teaches securities law at Georgetown University in Washington. The meeting is "a way of sending a message to the SEC of Congress's anger and dismay that this happened, especially given all the things that have happened in the last six to eight months," such as the collapse of investment bank Lehman Brothers Holdings Inc., he said.

Markopolos, 52, a former chief investment officer at Rampart Investment Management in Boston, is now a financial fraud investigator for institutional investors. Other witnesses include Stephen Harbeck, president of Securities Investor Protection Corp.; Allan Goldstein, a retiree who invested with Madoff; Leon Metzger, a former executive with hedge-fund firm Paloma Partners LLC; and Boston University law professor Tamar Frankel.

Kotz is the only SEC employee set to testify. Markopolos withdrew, citing an illness, according to the office of Representative Barney Frank, the committee's chairman. SEC spokesman John Nester declined to comment on the pending hearing.

'Substantial Rewrite'

Madoff's firm was examined at least eight times in 16 years by regulators following up on e-mailed tips that described his business practices as "highly unusual," the Wall Street Journal reported earlier today. Madoff himself was interviewed at least twice by SEC officials, the newspaper said.

The hearing, scheduled for 2 p.m. in Washington, will help guide Congressional leaders as they weigh a "substantial rewrite of the laws governing the U.S. financial markets," Representative Paul Kanjorski, a Pennsylvania Democrat who leads a subcommittee overseeing capital markets, said in a Dec. 31 statement. In a speech last month, President-elect Barack Obama said the Madoff scandal shows "how badly reform is needed."

Whether the agency should be beefed up or dismantled will be a likely topic at meetings this year about the SEC's future. "It would be a big mistake for the hearing to start focusing on throwing more money at the SEC, until the question has been answered about whether the agency is using the resources that it has adequately," said Jacob Frenkel, a former SEC attorney now at Shulman Rogers Gandal Pordy & Ecker in Rockville, Maryland.

Free on Bail

Madoff, 70, was arrested Dec. 11 and charged at federal court in Manhattan with securities fraud after allegedly telling his sons his investment advisory business was a Ponzi scheme, in which early investors are paid with money from subsequent participants. Madoff is free on bail and hasn't formally responded to the charges or entered a plea.

Madoff's clients included banks, hedge funds, charities, universities and wealthy individuals. They had about $37 billion with Bernard L. Madoff Investment Securities LLC, according to a Bloomberg News tally of disclosures and press reports.

SEC Chairman Christopher Cox said Dec. 16 that he asked Kotz to review how the agency responded to tips about Madoff and to find ways to improve internal policies. The staff failed to act for almost a decade on "credible and specific" allegations and never recommended commissioners take action, Cox said. The SEC closed a Madoff probe in 2007 that Markopolos helped trigger.

Florida Accountants

The SEC's investigators had a brush with Madoff in 1992 while suing two Florida accountants for allegedly selling $441 million in unregistered securities. The regulator, then headed by Republican Richard Breeden, said the accountants began raising money in 1962 and placing it with Madoff while promising investors returns of 13.5 percent to 20 percent, according to court documents obtained by Bloomberg.

Auditors hired to unravel the case asked Madoff for copies of account statements, which he provided, the records show. He wasn't accused of wrongdoing.

Markopolos raised his concerns with an examiner in the SEC's Boston office in 2000, saying that Madoff's returns were too good to be true, and pressed the agency to scrutinize Madoff's business until last year, the Wall Street Journal reported Dec. 18. In a 17-page memo from November 2005, three months after Cox became chairman, Markopolos laid out a list of "red flags," and claimed Madoff must either be trading ahead of client orders, a practice known as front-running, or, more likely, running the world's largest Ponzi scheme.

Front Running

SEC investigators in New York, where Madoff's firm is based, focused on front-running, and after encountering obstacles didn't finish verifying trades Madoff said were for advisory clients, a person with knowledge of the agency's efforts said last month.

His company's trades were cleared through a single account at Depository Trust & Clearing Corp., making it difficult to distinguish transactions specifically for Madoff's advisory business, the person said.

Some transactions were completed through foreign brokerages, which meant the agency would have had to persuade other regulators to collect the data. Instead, SEC investigators closed the case in 2007 after Madoff agreed to register his investment advisory business.

The SEC was facing criticism before Madoff's arrest. Last year's collapse of investment banks Bear Stearns Cos. and Lehman Brothers tarnished the agency's reputation as a market watchdog, and senators such as Connecticut Democrat Christopher Dodd and Iowa Republican Charles Grassley have questioned its vigilance in enforcing securities laws.

Cox, a Republican appointed by President George W. Bush, has said he will leave office at the end of the Bush administration. Obama on Dec. 18 announced his choice of brokerage regulator Mary Schapiro to succeed Cox.

Madoff Chasers Dug for Years, to No Avail --- Regulators Probed at Least 8 Times Over 16 Years; Congress Starts Review of SEC Today
By Kara Scannell
1546 words
5 January 2009
The Wall Street Journal

Bernard L. Madoff Investment Securities LLC was examined at least eight times in 16 years by the Securities and Exchange Commission and other regulators, who often came armed with suspicions.

SEC officials followed up on emails from a New York hedge fund that described Bernard Madoff's business practices as "highly unusual." The Financial Industry Regulatory Authority, the industry-run watchdog for brokerage firms, reported in 2007 that parts of the firm appeared to have no customers.

Mr. Madoff was interviewed at least twice by the SEC. But regulators never came close to uncovering the alleged $50 billion Ponzi scheme that investigators now believe began in the 1970s.

The serial regulatory failures will be on display Monday when Congress holds a hearing to probe why the alleged fraud went undetected. Among the key witnesses is SEC Inspector General David Kotz, who was asked last month by the agency's chairman, Christopher Cox, to investigate the mess.

The situation is even more awkward because SEC examiners seemed to be looking in the right places, yet still were unable to unmask the alleged scheme. For example, investigators were led astray by concerns that Mr. Madoff, now under house arrest, was placing orders for favored clients ahead of others to get a better price, a practice known as "front running." Front running isn't thought to have played a role in the firm's collapse.

Concern that the SEC lacks the expertise to keep up with fraudsters is the latest criticism of the agency, which saw the Wall Street investment banks it oversees get pummeled or vanish altogether in 2008. With Congress likely to take a hard look at how to structure oversight of financial markets, the SEC is struggling to maintain its clout.

The failure to stop Mr. Madoff also is an embarrassment for Mary Schapiro, the Finra chief who has been nominated by President-elect Barack Obama as the next SEC chairman. Finra was involved in several investigations of Mr. Madoff's firm, concluding in 2007 that it violated technical rules and failed to report certain transactions in a timely way.

Ms. Schapiro declined to comment. Mr. Cox has previously acknowledged mistakes by the SEC. The agency declined to comment.

Regulatory gaps abound in the paper trail generated by the SEC's scrutiny of Bernard L. Madoff Investment Securities, according to a review of the documents. Many of the details haven't been reported previously.

For years, Mr. Madoff told regulators he wasn't running an investment-advisory business. By saying he instead managed accounts for hedge funds, Mr. Madoff was able to avoid regular reviews of his advisory business.

In 1992, Mr. Madoff had a brush with the SEC's enforcement division, which had sued two Florida accountants for selling unregistered securities that paid returns of 13.5% to 20%. The SEC believed at the time it had uncovered a $440 million fraud.

"We went into this thinking it could be a major catastrophe," Richard Walker, then-chief of the SEC's New York office, told The Wall Street Journal at the time.

The SEC probe turned up money that had been managed by Mr. Madoff. He said he didn't know the money had been raised illegally.

With no investors found to be harmed, the SEC concluded there was no fraud. But the scheme indicated Mr. Madoff was managing money on behalf of other people.

In 1999 and 2000, the SEC sent examiners into Mr. Madoff's firm to review its trading practices. SEC officials worried the firm wasn't properly displaying orders to others in the market, violating a trading rule. In response, Mr. Madoff outlined new procedures to address the findings.

Some outsiders were becoming suspicious. Harry Markopolos, an executive then working at a rival company, met with an official at the SEC's Boston

office in 2001 to lay out his concerns about Mr. Madoff's steady returns. The same month, Barron's, a Dow Jones & Co. publication, and hedge-fund trade publication MarHedge suggested Mr. Madoff was front running for favored clients.

In 2004, the SEC's examination staff in Washington opened a limited inspection into whether the firm was front running. After finding no evidence of that, officials transferred the exam to the SEC's New York office.

In 2005, the New York staff began a broader examination, interviewing Mr. Madoff, his brother, two sons and a niece, all of whom worked at the firm. The SEC found that his investment-advisory business had 16 clients and managed $8 billion. Any firm that offers advice to more than 14 clients is required to register with the agency and undergo reviews.

Mr. Madoff "would not acknowledge" that these accounts were an investment-advisory business, the 2005 report by the New York staff said, because he received commissions from trades, not a percentage of the profits, the typical arrangement for hedge funds.

Mr. Madoff said the firm's trades were executed in foreign markets outside of U.S. trading hours. For Jan. 20, 2005, "All orders and executions took place between 2:49 a.m. and 8:57 a.m. This report supports BMadoff's assertion," the SEC concluded.

After examining customer statements made over four days in January 2005, the SEC concluded that they matched the investment strategy Mr. Madoff described. The findings "somewhat alleviated" their concerns of front running, an agency report said.

The report doesn't say whether the SEC looked at bank statements or other records that would have determined whether or not the trades took place. The examination uncovered some technical trading violations that resulted in a letter from the SEC. A predecessor to Finra conducted its own review in 2005 and found no violations.

In November 2005, SEC investigators in New York met with Mr. Markopolos, who prepared a 21-page report outlining his concerns. His conclusion was that Mr. Madoff's firm "is the world's largest Ponzi scheme."

The 2005 review and Mr. Markopolos's report prompted the SEC to open an enforcement case, a notch more serious in the SEC's world than the previous examination. "The staff is trying to ascertain whether" the allegation that Mr. Madoff "is operating a Ponzi scheme has any factual basis," according to the SEC case memo.

After sifting through documents and interviewing Mr. Madoff, the SEC concluded that neither he nor Fairfield Greenwich Group, a New York firm that funneled investors' money into the firm, told investors Mr. Madoff was making investment decisions. Fairfield revised its disclosures to investors.

The SEC also found that Mr. Madoff misled the agency in 2005 about the strategy he used for customer accounts, withheld information about the accounts and violated SEC rules by operating as an unregistered investment adviser. "The staff found no evidence of fraud," according to the SEC case memo. Mr. Madoff agreed to register his business that September, and the SEC didn't make its findings public.

Finra's full-scale examination in 2007 indicated that parts of Mr. Madoff's firm had no customers. It didn't provide an explanation of this finding. "At this point in time we are uncertain of the basis for Finra's conclusion in this regard," SEC staff wrote last month, after Mr. Madoff was arrested.

"We don't have access to that document, nor have we received any feedback from the SEC on our examinations of the Madoff broker-dealer," said Nancy Condon, a spokeswoman for Finra.

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PERIOD ENDING: 11/30/08
PAGE: 1
YOUR ACCOUNT NUMBER: 1-CM450-4-0
YOUR TAX PAYER IDENTIFICATION NUMBER: ******6253

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| 91 | | 46208 | S & P 100 INDEX NOVEMBER 450 PUT | 17.800 | 162,071.00 | |
| | 91 | 32313 | S & P 100 INDEX DECEMBER 430 CALL | 26 | | 236 |
| 91 | | 36638 | S & P 100 INDEX DECEMBER 420 PUT | 30 | 273,091.00 | |
| 91 | | 40963 | S & P 100 INDEX NOVEMBER 460 CALL | 3 | 27,391.00 | |
| | 91 | 45288 | S & P 100 INDEX NOVEMBER 450 PUT | 37 | | 336 |
| | | | NEW BALANCE | | | 516 |
| | | | SECURITY POSITIONS | MKT PRICE | | |
| | 91 | | S & P 100 INDEX DECEMBER 430 CALL | 23.300 | | |
| 91 | | | S & P 100 INDEX DECEMBER 420 PUT | 16.500 | | |
| | | | MARKET VALUE OF SECURITIES LONG 150,150.00 SHORT 212,030.00- | | | |

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| 05 | | | | CHECK | CW | 10,000.00 | |
| 05 | | | | FIDELITY SPARTAN<br>U S TREASURY MONEY MARKET<br>DIV 11/05/08 | DIV | | |
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| 05 | 1,324 | | 35758 | FIDELITY SPARTAN<br>U S TREASURY MONEY MARKET | 1 | 1,324.00 | |
| 12 | 2,366 | | 2447 | WAL-MART STORES INC | 55.830 | 132,187.78 | |
| 12 | 1,547 | | 2949 | INTERNATIONAL BUSINESS MACHS | 87.270 | 135,067.69 | |
| 12 | 5,733 | | 6773 | EXXON MOBIL CORP | 72.880 | 418,050.04 | |
| 12 | 6,279 | | 7275 | INTEL CORP | 14.510 | 91,359.29 | |
| 12 | 3,003 | | 11601 | JOHNSON & JOHNSON | 59.580 | 179,038.74 | |
| 12 | 4,095 | | 15927 | J.P. MORGAN CHASE & CO | 38.530 | 157,943.35 | |
| 12 | 2,184 | | 20252 | COCA COLA CO | 44.660 | 97,624.44 | |
| 12 | 1,274 | | 24578 | MCDONALDS CORP | 55.370 | 70,591.38 | |
| 12 | 2,366 | | 28904 | MERCK & CO | 28.550 | 67,643.30 | |
| 12 | 8,645 | | 33230 | MICROSOFT CORP | 21.810 | 188,892.45 | |
| 12 | 4,368 | | 37556 | ORACLE CORPORATION | 17.300 | 75,740.40 | |
| 12 | 1,729 | | 50534 | PEPSICO INC | 56.410 | 97,601.89 | |
| 12 | 1,001 | | 51036 | APPLE INC | 100.780 | 100,920.78 | |
| 12 | 7,371 | | 54860 | PFIZER INC | 16.940 | 125,158.74 | |
| 12 | 1,729 | | 55362 | ABBOTT LABORATORIES | 54.610 | 94,489.69 | |

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PERIOD ENDING: 11/30/08
PAGE: 2
YOUR ACCOUNT NUMBER: 1-CM450-3-0
YOUR TAX PAYER IDENTIFICATION NUMBER: ******6253

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| 12 | 1,183 | | 59688 | AMGEN INC | 59.160 | 70,033.28 | |
| 12 | 2,275 | | 63512 | PHILLIP MORRIS INTERNATIONAL | 43.600 | 99,281.00 | |
| 12 | 5,460 | | 64014 | BANK OF AMERICA | 21.590 | 118,099.40 | |
| 12 | 1,820 | | 67838 | QUALCOMM INC | 33.770 | 61,533.40 | |
| 12 | 5,915 | | 68340 | CITI GROUP INC | 12.510 | 74,232.65 | |
| 12 | 1,365 | | 72164 | SCHLUMBERGER LTD | 49.480 | 67,594.20 | |
| 12 | 3,276 | | 72666 | COMCAST CORP<br>CL A | 16.510 | 54,217.76 | |
| 12 | 6,461 | | 76490 | AT&T INC | 27 | 174,705.00 | |
| 12 | 1,638 | | 76992 | CONOCOPHILIPS | 52.510 | 86,076.38 | |
| 12 | 1,092 | | 80816 | UNITED PARCEL SVC INC<br>CLASS B | 52.040 | 56,870.68 | |
| 12 | 6,643 | | 81318 | CISCO SYSTEMS INC | 16.730 | 111,402.39 | |
| 12 | 1,911 | | 85142 | U S BANCORP | 29.530 | 56,507.83 | |
| 12 | 2,275 | | 85644 | CHEVRON CORP | 73.430 | 167,144.25 | |
| 12 | 1,092 | | 89468 | UNITED TECHNOLOGIES CORP | 53.160 | 58,093.72 | |
| 12 | 11,557 | | 89970 | GENERAL ELECTRIC CO | 19.630 | 227,325.91 | |
| 12 | 3,094 | | 93794 | VERIZON COMMUNICATIONS | 30.410 | 94,211.54 | |
| 12 | 273 | | 94296 | GOOGLE | 337.400 | 92,120.20 | |
| 12 | 3,822 | | 98120 | WELLS FARGO & CO NEW | 29.800 | 114,047.60 | |
| 12 | 2,730 | | 98622 | HEWLETT PACKARD CO | 34.900 | 95,386.00 | |
| 12 | | 4,150,000 | 20733 | U S TREASURY BILL<br>DUE 2/12/2009<br>2/12/2009 | 99.936 | | 4,1 |

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PERIOD ENDING 11/30/08

PAGE 3

YOUR ACCOUNT NUMBER 1-CM450-3-0

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| .2 | 9,036 | | 25200 | FIDELITY SPARTAN<br>U S TREASURY MONEY MARKET | 1 | 9,036.00 | |
| 9 | | | | FIDELITY SPARTAN<br>U S TREASURY MONEY MARKET<br>DIV 11/19/08 | DIV | | |
| .9 | | 9,036 | 50460 | FIDELITY SPARTAN<br>U S TREASURY MONEY MARKET | 1 | | |
| .9 | 275,000 | | 55094 | U S TREASURY BILL<br>DUE 03/26/2009<br>3/26/2009 | 99.926 | 274,796.50 | |
| 9 | 6,877 | | 59499 | FIDELITY SPARTAN<br>U S TREASURY MONEY MARKET | 1 | 6,877.00 | |
| 1 | | | | CHECK | CW | 40,372.00 | |
| 1 | | | | FIDELITY SPARTAN<br>U S TREASURY MONEY MARKET<br>DIV 11/21/08 | DIV | | |
| 1 | | 6,877 | 76846 | FIDELITY SPARTAN<br>U S TREASURY MONEY MARKET | 1 | | |
| 1 | | 275,000 | 76869 | U S TREASURY BILL<br>DUE 03/26/2009<br>3/26/2009 | 99.962 | | 27 |

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YOUR ACCOUNT NUMBER 1-CM450-3-0

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| BOUGHT RECEIVED | SOLD DELIVERED | TRN | DESCRIPTION | PRICE OR SYMBOL | AMOUNT DEBITED TO YOUR ACCOUNT | AMOUNT C TO YOUR A |
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| 1,183 | | | AMGEN INC | 55.540 | | |
| 1,001 | | | APPLE INC | 92.670 | | |
| 5,460 | | | BANK OF AMERICA | 16.250 | | |
| 2,275 | | | CHEVRON CORP | 79.010 | | |
| 6,643 | | | CISCO SYSTEMS INC | 16.540 | | |
| 5,915 | | | CITI GROUP INC | 8.290 | | |
| 2,184 | | | COCA COLA CO | 46.870 | | |
| 3,276 | | | COMCAST CORP<br>CL A | 17.340 | | |
| 1,638 | | | CONOCOPHILIPS | 52.520 | | |
| 5,733 | | | EXXON MOBIL CORP | 80.150 | | |
| 11,557 | | | GENERAL ELECTRIC CO | 17.170 | | |
| 273 | | | GOOGLE | 292.960 | | |
| 2,730 | | | HEWLETT PACKARD CO | 35.280 | | |
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| 6,279 | | | INTEL CORP | 13.800 | | |
| 1,547 | | | INTERNATIONAL BUSINESS MACHS | 81.600 | | |
| 4,095 | | | J.P. MORGAN CHASE & CO | 31.660 | | |
| 3,003 | | | JOHNSON & JOHNSON | 58.580 | | |
| 1,274 | | | MCDONALDS CORP | 58.750 | | |
| 2,366 | | | MERCK & CO | 26.720 | | |
| 8,645 | | | MICROSOFT CORP | 20.220 | | |
| 4,368 | | | ORACLE CORPORATION | 16.090 | | |
| 1,729 | | | PEPSICO INC | 56.700 | | |
| 7,371 | | | PFIZER INC | 16.430 | | |
| 2,275 | | | PHILLIP MORRIS INTERNATIONAL | 42.160 | | |
| 3,276 | | | PROCTER & GAMBLE CO | 64.350 | | |
| 1,820 | | | QUALCOMM INC | 33.570 | | |
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| | | | U S TREASURY MONEY MARKET | | | |
| 1,911 | | | U S BANCORP | 26.980 | | |
| 1,092 | | | UNITED PARCEL SVC INC | 57.600 | | |
| | | | CLASS B | | | |
| 225,000 | | | U S TREASURY BILL | 99.971 | | |
| | | | DUE 03/26/2009 | | | |
| | | | 3/26/2009 | | | |
| 1,092 | | | UNITED TECHNOLOGIES CORP | 48.530 | | |
| 3,094 | | | VERIZON COMMUNICATIONS | 32.650 | | |
| 2,366 | | | WAL-MART STORES INC | 55.880 | | |

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| BOUGHT RECEIVED | SOLD DELIVERED | TRN | DESCRIPTION | PRICE OR SYMBOL | AMOUNT DEBITED TO YOUR ACCOUNT | AMOUNT TO YOU |
|---|---|---|---|---|---|---|
| 6,279 | | | INTEL CORP | 13.800 | | |
| 1,547 | | | INTERNATIONAL BUSINESS MACHS | 81.600 | | |
| 4,095 | | | J.P. MORGAN CHASE & CO | 31.660 | | |
| 3,003 | | | JOHNSON & JOHNSON | 58.580 | | |
| 1,274 | | | MCDONALDS CORP | 58.750 | | |
| 2,366 | | | MERCK & CO | 26.720 | | |
| 8,645 | | | MICROSOFT CORP | 20.220 | | |
| 4,368 | | | ORACLE CORPORATION | 16.090 | | |
| 1,729 | | | PEPSICO INC | 56.700 | | |
| 7,371 | | | PFIZER INC | 16.430 | | |
| 2,275 | | | PHILLIP MORRIS INTERNATIONAL | 42.160 | | |
| 3,276 | | | PROCTER & GAMBLE CO | 64.350 | | |
| 1,820 | | | QUALCOMM INC | 33.570 | | |
| 1,365 | | | SCHLUMBERGER LTD | 50.740 | | |
| 16,486 | | | FIDELITY SPARTAN | 1 | | |
| | | | U S TREASURY MONEY MARKET | | | |
| 1,911 | | | U S BANCORP | 26.980 | | |
| 1,092 | | | UNITED PARCEL SVC INC | 57.600 | | |
| | | | CLASS B | | | |
| 225,000 | | | U S TREASURY BILL | 99.971 | | |
| | | | DUE 03/26/2009 | | | |
| | | | 3/26/2009 | | | |
| 1,092 | | | UNITED TECHNOLOGIES CORP | 48.530 | | |
| 3,094 | | | VERIZON COMMUNICATIONS | 32.550 | | |
| 2,366 | | | WAL-MART STORES INC | 55.880 | | |

CONTINUED ON PAGE 6

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Affiliated
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**DUPLICATE** FOR ACCOUNT NTC & CO.
ALLAN GOLDSTEIN

45 BEAVER DAM ROAD
PO BOX 211
SPENCERTOWN NY 12165

PERIOD ENDING 11/30/08

PAGE 6

YOUR ACCOUNT NUMBER 1-CM450-3-0

YOUR TAX PAYER IDENTIFICATION NUMBER ******6253

| BOUGHT RECEIVED | SOLD DELIVERED | TRN | DESCRIPTION | PRICE OR SYMBOL | AMOUNT DEBITED TO YOUR ACCOUNT | AMOUNT C TO YOUR A |
|---|---|---|---|---|---|---|
| 3,822 | | | WELLS FARGO & CO NEW | 28.890 | | |
| | | | MARKET VALUE OF SECURITIES<br>LONG SHORT<br>4,250,725.14 | | | |

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|---|---|---|---|---|---|---|
| | | | YEAR-TO-DATE SUMMARY | | | |
| | | | DIVIDENDS | | | 29 |
| | | | GROSS PROCEEDS FROM SALES | | | 33,613 |

SECURITIES INVESTOR PROTECTION CORPORATION
805 FIFTEENTH STREET, N.W., SUITE 800
WASHINGTON, D.C. 20005-2215
(202) 371-8300 FAX (202) 371-6728
WWW.SIPC.ORG

January 12, 2009

**BY MESSENGER**

Honorable Gary L. Ackerman
Member of Congress
United States House of Representatives
2243 Rayburn House Office Building
Washington, D. C. 20515-3205

**RE: Bernard L. Madoff Investment Securities LLC**

Dear Congressman Ackerman:

During the hearing on the Madoff matter on January 5, 2009 before the House Committee on Financial Services, you asked that the Securities Investor Protection Corporation ("SIPC") provide you with a copy of the asset and liability accounting that Bernard Madoff was required to furnish to the United States Securities and Exchange Commission ("SEC") on or before December 31, 2008, by Order of the United States District Court for the Southern District of New York. I stated at the hearing that SIPC did not have the accounting, but that it would seek to obtain a copy for you.

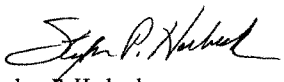
In response to your request, SIPC has consulted the SEC and the Trustee for the liquidation of the Madoff brokerage firm ("Trustee"), regarding the accounting. The SEC has declined to give SIPC a copy at this time, due to the SEC's pending investigation of Mr. Madoff and the fact that the accounting is investigatory, non-public material. The Trustee was granted access to the accounting because of his statutory duty to collect assets for the benefit of customers. That access, however, was conditioned on an agreement of strict confidentiality between the Trustee and the SEC. If SIPC were to obtain the accounting from the Trustee, it would be bound by the same promise of confidentiality.

SIPC also has consulted the Office of the United States Attorney for the Southern District of New York ("U. S. Attorney's Office") with respect to the accounting. Under the Securities Investor Protection Act ("SIPA"), a SIPA Trustee's chief responsibilities include the determination

of customer claims and the satisfaction of those claims. Claims are satisfied with funds advanced by SIPC, but more significantly in the Madoff case, with property that is collected by the Trustee. Currently, because of the ongoing related criminal and civil investigations, the Trustee's access to information necessary for him to determine claims and identify assets is restricted. The Madoff brokerage premises are considered a crime scene and before the Trustee and his staff can view any single record on the premises, access to each and every such record must be cleared through federal criminal enforcement authorities at the risk of compromising the ongoing investigations. The U. S. Attorney's Office has expressed the view to SIPC's General Counsel that a release of the accounting would impair the security of assets and the government's ability to recover assets for equitable distribution to victims of Mr. Madoff's crime.

We regret that we are unable to provide the accounting. Nevertheless, please be assured that SIPC stands ready to assist you and the Committee in any other way that it can.

Respectfully submitted,



Stephen P. Harbeck
President and Chief Executive Officer

SPH/ved

cc: Honorable Barney Frank (by messenger)
Honorable Spencer Bachus (by messenger)
Honorable Paul E. Kanjorski (by messenger)
James Clarkson, Acting Regional Director,
United States Securities and Exchange Commission
Lev Dassin, Acting United States Attorney for the
Southern District of New York
Irving H. Picard, Trustee

O