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"THE MADOFF INVESTMENT SECURITIES FRAUD: REGULATORY AND OVERSIGHT CONCERNS AND THE NEED FOR REFORM"

"You only find out who's swimming naked when the tide goes out."

Warren Buffett
(Annual Letter to Berkshire
Hathaway shareholders)

Chairman Dodd, Ranking Member Shelby, and Fellow Senators:

I am pleased and honored to be invited to testify here today. I have been asked to address reforms that might prevent future Ponzi schemes and the jurisdiction (or lack thereof) of the SEC and FINRA over investment advisers similar to Mr. Madoff. I will get to these points quickly without further delay.

I. The Persistence of Ponzi Schemes

The tide has gone out on Wall Street, and in Warren Buffet's words, we are now finding out "who has been swimming naked." Sadly, it has been the recurrent pattern in Ponzi schemes,[1] and similar investment frauds, that they are revealed not by regulatory detection and enforcement, but by their own collapse under the pressure of investor demands for redemption when the market sours (and investors become belatedly anxious). As a result in part of the spectacular collapse of the Madoff fraud, investors are now demanding redemption at a record level, and other Ponzi schemes are coming to light. Symptomatically, many of the recent Ponzi schemes show the same basic pattern and thereby also reveal what reforms could best prevent them at relatively low cost. In truth, the only features that are truly distinctive about the Madoff fraud are its extraordinary scale (an order of magnitude higher than any other such scheme) and its multi-decade duration. Uniquely, Mr. Madoff was able (i) to transcend traditional "affinity fraud" and move to a global scale through the use of "feeder funds" (i.e., hedge funds that seek to diversify through investing in other funds – or "fund of funds"), and

[1] According to Wikipedia.com, "A Ponzi scheme is a fraudulent investment corporation that pays returns to investors out of money paid by subsequent investors rather than from profits." The name comes from Charles Ponzi, who gained notoriety for such an investment scheme in Boston shortly after World War I. This definition may, however, overstate, as most Ponzi schemes do involve some real investments in assets or securities with only a portion of the new investors' investments being paid to the old investors.

(ii) to maintain investor confidence in his operation for several decades (which factor, of course, aggravates the problem of inadequate regulatory oversight).

Ponzi schemes occur in all societies, and there have been similar scandals in Russia, Eastern Europe (particularly in Albania where one helped cause the fall of a government), India and, very recently, the U.K. In the U.S., although Ponzi schemes are infrequent and represent only a tiny minority of alternative investments, they do produce substantial losses on a recurring basis. Other scholars have computed the losses from Ponzi schemes, as shown by litigated court cases, and concluded that the prior record year was 2002 when "over $9.6 billion" was lost.[2] But annual losses of over $1 billion are frequent, with over $1.6 billion lost in 1995 and 1997 and over $1 billion in 1996, 1990, and 1976.[3] The amount so lost varies radically from year to year largely because Ponzi schemes tend to be uncovered only in periods of market stress – "when the tide goes out on Wall Street."

Any estimate of the total losses caused by Ponzi schemes is likely to understate, because litigated cases ignore those schemes in which the collapse is so complete that there is no hope of recovery and hence no incentive for litigation. In that light, it seems more important to examine some representative case histories in order to identify common denominators. The following appear to be the leading recent cases:

1. <u>Bernard L. Madoff Investment Securities, LLC ("Madoff Securities")</u>. On the facts known so far, two basic failures in internal controls are evident in the Madoff case: First, Madoff cleared his own trades and did not use either an independent custodian or a clearing broker to execute and clear his trades. Second, Madoff was audited by a small

[2] See Statement of Tamar Frankel, Professor of Law and Michaels Faculty Research Scholar, Boston University School of Law before the House Committee on Financial Services, January 5, 2009 at p. 2.
[3] Id.

auditing firm, Friehling & Horowitz, which only had three employees. Of these three, one was a secretary; another was Jerome Horowitz, an 80 year old, semi-retired partner, living in Florida, and the third was David Friehling, who was not subject to even the peer review process mandated by New York State because he claimed not to conduct audits (ironically, this may have truer than regulators realized). The Friehling & Horowitz firm was not registered with the Public Company Accounting Oversight Board ("PCAOB"), because of an overbroad exemptive rule (discussed below) that the SEC repeatedly adopted in the wake of Sarbanes-Oxley to spare broker-dealers that were not publicly held from the oversight of a PCAOB-registered auditor.

2. Bayou Group LLC. Organized in 1996 and re-organized in 2003, the Bayou Fund and its various successor hedge funds were all managed by Bayou Management LLC, and the trading activities of the group were conducted through a single, captive broker-dealer called Bayou Securities LLC.[4] All these entities were owned and controlled by Sam Israel ("Israel"), the chief executive of Bayou Management. Thus, as in the case of Madoff, there was no independent custodian or clearing broker.

Beginning in 1999 and continuing through 2005, Israel and his chief financial officer created a non-existent and entirely fictitious auditing firm, Richmond-Fairfield Associates, to generate false performance summaries and false financial statements to mislead investors. Weekly, monthly, quarterly and annual financial reports were generated by this bogus auditing firm and distributed to investors.

The Bayou Ponzi scheme collapsed in 2005, but it had lost money from its outset, pursuing an options trading strategy not unlike that which Bernard Madoff claimed to

[4] This summary of the facts comes from In re Bayou Group LLC, 2008 Bankr. LEXIS 3261 (Bankr. Ct. SDNY October 16, 2008). Mr. Israel and others are now serving prison terms.

have been pursuing. Before its collapse, Israel caused the Bayou funds to make a bank transfer of $120 million from various accounts to a bank account at PostBank in Germany; $100 million of this amount was then transferred to a bank account controlled by Israel in the United States. This latter amount was seized by the Arizona Attorney General in May 2005 and restored to the bankrupt estate. Again, it needs to be underscored that such a $120 million transfer to a foreign bank is precisely what a reputable independent custodian would not allow. Similarly, had the auditor for the Bayou Funds been required to have been registered with the PCAOB, it would have been comparatively simple for investors to check and ascertain whether they were dealing with a legitimate auditor (instead of an entirely bogus firm). Nor would Israel have dared to invent a bogus auditor.

As of August 31, 2005, the loss that resulted from this classic Ponzi fraud exceeded $218 million.[5]

3. Arthur Nadel and Scoop Management. Currently a fugitive from justice, Mr. Nadel ran six Florida-based hedge funds with reported assets of over $350 million. In the wake of the Madoff collapse, anxious investors sought redemptions, and Mr. Nadel disappeared. At least, a $50 million shortfall in funds has been reported. Red flags again are evident with respect to the auditing of these funds. In 2005, the Hedge Co. Net Index ousted Mr. Nadel's funds from its website index because of his failure to provide current audited results.[6]

4. Martin Armstrong and Princeton Economics International. This seven year Ponzi scheme purported to trade currencies, in particular gold and silver, and raised over

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[5] Id. at *36.
[6] See "Fund Fugitive's '05 Finagling," N.Y. Post, January 20, 2009 at p. 30.

$3 billion. Investors who purchased his “Princeton Notes” appear to have lost over $700 million.[7] In January 2002, Republic Securities, the broker dealer that traded for Mr. Armstrong and handled his accounts, plead guilty to conspiracy and securities fraud charges and paid approximately $569 million in restitution. Although this represents the fairly unique case in which (i) there was a custodian, and (ii) it was complicit in the fraud, the $569 million in restitution obtained from it shows that an independent custodian can at least provide restitution to victims.

5. J. V. Huffman and Biltmore Financial Group.[8] This relatively small $25 million fraud was uncovered by the North Carolina Secretary of State’s Securities Division, and the SEC later brought suit in November 2008. Mr. Huffman assured investors that he “operated like a mutual fund.” His fraud continued for over 17 years. Like Mr. Madoff, Mr. Huffman paid a steady high return (as much as 16.54% in 2007, but never below 8%). In fact, Mr. Huffman never invested his investors’ funds in securities, mortgages, or other investments, but used them to subsidize his lavish lifestyle. In short, his modus operandi was similar to that of Madoff, but on a smaller scale, and he again did not use any custodian or clearing broker.

6. Pinnacle Development Partners LLC and Gene O’Neal.[9] Before its collapse in 2006, this real estate investment fund raised more than $69 million over 15 months by promising a 25% return on its notes in 45 days (later extended to 60 days). Some 2,000 investors (mainly in the United States) invested. According to the indictment, Mr. O’Neal

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[7] For the basic information on this case, I am relying on The Press Release issued by the U.S. Attorney’s Office for the Southern District of New York on April 10, 2007 (available on LEXIS).
[8] See “SEC Charges N.C. Resident, Biltmore Financial Group for Operating Multi-Million Dollar Ponzi Scheme,” States News Service, November 12, 2008 (available on LEXIS).
[9] See “Head of Purported Real Estate Investment Bund Indicted in $69 Million Ponzi Scheme,” March 8, 2007, U.S. Fed News (available on LEXIS).

"recycled" some $25 million in invested capital from new investors to old investors. In order to foster the illusion of actual economic activity, real estate properties were transferred between Pinnacle's three partnerships with the sale price paid by one partnership being as much as 10 times the initial acquisition price paid by another partnership. Prior to the indictment, the SEC did obtain a preliminary injunction in this case.

7. Other Noteworthy Cases. In 1997, John Bennett Jr. was sentenced to prison (and served 11 years) in connection with a $700 million Ponzi scheme that principally focused on churches, colleges, and cultural institutions.[10] Promising to return to investors double the amount of their donations to his Foundation for New Era Philanthropy, he solicited individuals and institutions with an evangelical Christian orientation (again, as with Madoff, this is an example of "affinity fraud"). In another high profile case, Martin Frankel looted around $200 million and then fled to Germany, carrying twelve passports and several million dollars worth of diamonds. J. T. Wallenbrock & Associates sold promissory notes, raising over $230 million from over 6,000 investors.[11] Reed E. Slatkin perpetrated a classic Ponzi scheme that raised over $600 million and continued for over 15 years. Using fake financial statements that referenced fake brokerage firms, he mainly solicited Hollywood entertainment figures and fellow Scientologists – again, an example of affinity fraud.[12] To the best of my knowledge, with the exception of the Martin

[10] See Infield, "Similarities in Madoff Case and a Local One," The Philadelphia Inquirer, December 17, 2008 at p. A-1.
[11] These cases are summarized in Jerry Markham, Mutual Fund Scandals – A Comparative Analysis of the Role of Corporate Governance in the Regulation of Collective Investments, 3 Hastings Bus. L. J. 67, 119 (2006).
[12] See "The 10 Nastiest Ponzi Schemes Ever," Business Pundit, December 15, 2008.

Armstrong case, there has not been a legitimate, independent custodian involved in any of these cases.

8. Summary. Although many more cases could be cited, two observations deserve emphasis: First, both the scale and frequency of Ponzi schemes seems to be increasing. Although Madoff is in a class by himself, the increase in the size of the typical Ponzi scheme appears to be the product of the growth of the hedge fund industry and the new popularity of alternative investment schemes. The SEC has also noted this correlation.[13] Second, the increased frequency of Ponzi schemes contrasts sharply with the fact that no mutual fund registered under the Investment Company Act of 1940 has ever collapsed and been exposed as a Ponzi scheme. In fairness, the relevant contrast here is not between mutual funds and hedge funds (for example, Mr. Madoff was not running a hedge fund, but was an investment adviser). Rather, it is between mutual funds, which seem immune to Ponzi schemes, and other investment vehicles, which are less regulated and seem more vulnerable to fraud.

II. Can Ponzi Schemes Be Efficiently Prevented?

As just noted, a marked disparity exists between the seeming immunity of mutual funds and the relative vulnerability of other collective investment vehicles: mutual funds have not experienced Ponzi schemes, while hedge funds, other pooled investments (real estate investment trusts), and investment advisers have. In the past, Ponzi schemes were frauds perpetrated by solo entrepreneurs or a small, tight-knit group, working within a cohesive "affinity group" that trusted them because of their shared background. More

[13] See "Registration Under the Advisers Act of Certain Hedge Fund Advisers," 69 Fed. Reg. 72054, at 72056 (Dec. 10, 2004) (noting that 51 enforcement cases had been brought in preceding five years against hedge fund advisers for losses exceeding an estimated $1.1 billion).

recently, however, larger hedge funds – Bayou and Arthur Nadel's Scoop Management are the leading examples – have engaged in similar practices.

What distinguishes mutual funds from hedge funds and investment advisers that may explain this disparity? Two differences stand out: (1) independent custodians, and (2) PCAOB-registered auditors. A third difference is the requirement of an independent board in the case of a mutual fund, but this difference is not easily generalized and would be infeasible for most investment advisers. Desirable as independent boards may be, they are unlikely to be able to stop a determined crook. The first two reforms are thus examined below:

A. The Custodian

Section 17(f) ("Custody of Securities") of the Investment Company Act of 1940 requires a registered management company to "place and maintain its securities and similar investments in the custody of" a bank or a dealer admitted to a national securities exchange, "subject to such rules and regulations as the Commission may from time to time prescribe fro the protection of investors."[14] As amplified by SEC rules, the custodian requirement largely removes the ability of an investment adviser to pay the proceeds invested by new investors to old investors. The custodian will take the adviser's instructions to buy or sell securities, but not to remit the proceeds of sales to the adviser or to others (except in return for share redemptions by investors). At a stroke, this requirement eliminates the ability of the manager to "recycle" funds from new to old investors.

[14] See 15 U.S.C. § 80a-17(f)(1). Section 17(f) also permits the management company to maintain securities with "such company, but only in accordance with such rules and regulations or orders" as the SEC may prescribe.

In the nearly seventy years since the passage of the Investment Company Act of 1940, frauds have occurred in connection with mutual funds, but not true Ponzi schemes. Admittedly, a truly predatory investment adviser might find ways to circumvent the custodian requirement, but most Ponzi schemes appear to develop as acts of desperation as investment managers that have incurred losses struggle to hide them and "borrow" some of the funds from new investors in order to pay the promised return to the original investors. Their desperate hope is that they can eventually recoup their losses (indeed, this appears to have been the Bayou experience). Section 17(f) eliminates both this opportunity and incentive.

In the case of hedge funds, because they are exempt from the Investment Company Act,[15] Section 17(f) is simply inapplicable to them. To be sure, many and probably most hedge funds do use an independent custodian as a matter of "best practices," but some do not (as the Bayou fund and the hedge funds run by Arthur Nadel appear to show). Thus, both the Bayou Funds and those run by Mr. Nadel were able to make large payments to their investment advisers at the point of collapse (for example, as discussed earlier, Bayou transferred $120 million to a German bank, of which $100 million was quickly returned by that bank to Mr. Israel). The vulnerability of hedge funds thus seems obvious.

In the case of investment advisers (and this is the category into which Madoff Securities falls), the SEC's rules are more complex. Under Rule 206(4)-2 ("Custody of Funds or Securities of Clients By Investment Advisers") under the Investment Advisers

[15] See Sections 3(c)(1) and (7) of the Investment Company Act (exempting funds held by "qualified purchasers" and by less than 100 owners where no public offering is made).

Act of 1940,[16] an investment adviser must maintain client funds or securities with a "qualified custodian." However, the term "qualified custodian" is defined by Rule 206(4)-2(c)(3) to include any broker-dealer registered under the Securities Exchange Act of 1934, at least to the extent that it is "holding the client assets in customer accounts." This means that an investment adviser who was not itself a registered broker-dealer would have to use a clearing or prime broker to hold its customers' securities and funds. But to the extent that Madoff was a registered broker-dealer, he was permitted to clear his own trades through his own broker-dealer firm. Worse yet, because Mr. Madoff claimed to be trading through his British subsidiary, even Madoff's New York brokerage employees were not necessarily aware of his trading activities (as his trades were allegedly done through a foreign affiliate).

Obviously, the simplest most direct reform that has the greatest chance of preventing Ponzi schemes is to require use of an independent custodian – by both investment advisers and hedge funds.[17]

B. <u>A PCAOB-Registered Auditor</u>

It has escaped almost no one's attention that Madoff Securities was "audited" by effectively a one-person auditing firm that was not registered with the Public Company Accounting Oversight Board ("PCAOB").

Why wasn't Friehling & Horowitz registered with PCAOB when it was auditing a broker-dealer with custody over more than $30 billion in customer accounts? Under the

[16] See 17 CFR § 275.206(4)-2.

[17] This author originally made this proposal in a December 16, 2008 Op/Ed piece for CNN.com. See Coffee, "Where Was the SEC?" www.cnn.com. Since then, others have also endorsed this proposal, as discussed later.

Sarbanes-Oxley Act, broker-dealers were required to use such a registered auditor.[18] The answer here is simple, blunt and disappointing: the SEC exempted all broker-dealers that were privately held (i.e., not a publicly held "reporting" company under the Securities Exchange Act of 1934) from the requirement that they use a PCAOB registered accountant. In Securities Exchange Act Release No. 34-54920,[19] the SEC extended earlier orders issued in 2003, 2004, and 2005 that exempted privately-held broker-dealers from the obligation to use a registered public accounting firm.

The rationale for this position seems both dubious and symptomatic. Although a privately held firm may have few shareholders who need properly audited financial statements, it may have many customers (and the SEC) who have an interest in knowing that appropriate auditing procedures have been followed.

Because the SEC did not (in the wake of the Madoff scandal) renew this exemptive order in December, 2008, the point is now moot. For the future, privately held broker-dealers will be required to use PCAOB-registered auditors.

C. The Insurer: SIPC

The Securities Investment Protection Corporation ("SIPC") is the functional analogue to the Federal Deposit Insurance Corporation ("FDIC"); the former protects customers of insolvent broker-dealers, while the latter protects depositors of insolvent banks. But the analogy between them is inexact for many reasons. A key difference is

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[18] See Section 205(c)(2) of the Sarbanes-Oxley Act (amending Section 17(e) of the Securities Exchange Act to require use by a broker-dealer of a "registered public accounting firm").
[19] See 2006 SEC LEXIS 2886 (December 12, 2006).

that SIPC is a "passive safety net," which makes no significant effort to prevent failures or to price its insurance in terms of the riskiness of the individual broker-dealer firm.[20]

Normally, private insurers price their insurance in terms of the riskiness of the insured and its activities. A chemical company that was a toxic polluter would pay more for insurance covering environmental claims than an efficiently-run chemical company that stayed well within both the law's requirements and industry "best practices." Such pricing forces the polluter to internalize the costs of its own misconduct and creates a disincentive.

In contrast, throughout its history, SIPC has either charged its broker-dealer members a flat fee (which has been as low as $150 in 1996 and 1997) or made an annual percentage of revenues assessment (which has been as low as 0.065% during the 1990s). It thus does not distinguish between its member firms, even though they represent different risk levels. SIPC also has no watchdog powers over its members; it neither proscribes unsafe or unsound practices nor conducts examinations of its members.

A private insurer would, of course, appraise the risk level of the insured's behavior. Thus, if a broker-dealer did not use an independent custodian, this failure would result in an increased premium to those of its customers who sought insurance covering the risk of insolvency and/or misappropriation of their accounts.

To the extent that SIPC today neither plays a meaningful watchdog role (as the FDIC does) nor prices its insurance on a risk-adjusted basis, it is subsidizing high risk broker-dealers. Put differently, the future Bernie Madoffs are receiving an undeserved discount on their insurance costs that increases their incentive to commit fraud.

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[20] This point is not original with this author. See Thomas W. Joo, Who Watches the Watchers? The Securities Investor Protection Act, Investor Confidence, and the Subsidization of Failure, 72 S. Calif. L. Rev. 1071 (1999).

Correspondingly, to the extent that broker-dealer customers are at least partially insured, they have less reason to fear risky or fraudulent broker-dealers – and so a "moral hazard" problem arises.

These comments are not intended as criticisms of the current management of SIPC, which has no authority to play a watchdog rule today. But it does lead to three policy conclusions: (1) SIPC insurance should be risk-adjusted; (2) "cheap" SIPC insurance can be socially costly; and (3) SIPC could be given a watchdog role with respect to unsafe and unsound financial practices by broker-dealers, because they will ultimately bear the loss.

D. Policy Conclusions

The most important reform is to require an external and independent custodian for all collective investment vehicles. The SEC has adequate authority to do this for registered investment advisers, but lacks authority over hedge funds. Although some industry opposition can be expected, it is noteworthy that, in the wake of Madoff, the Investment Advisers Association ("IAA") has already endorsed a requirement that all advisory assets be handled by external, independent custodians.[21] This position may be their preferred alternative to another, more controversial policy recommendation that FINRA be given jurisdiction over investment advisers (on which I take no position). Still, it does suggest that any political opposition to a custodian requirement can be overcome.

III. Regulatory Oversight

The most obvious question that arises in the wake of the Madoff scandal was why regulators failed to detect the fraud, or to even conduct a detailed examination of his

[21] See Sara Hansward, "Adviser Group Urges that Investor Assets Be Held By Custodians," Investment News, January 12, 2009 at p. 2.

investment advisory business, over a multi-decade period. This question is being currently investigated by the SEC's Inspector General, and I will not attempt to prejudge this issue, anticipate his conclusions, or pass judgment on the Enforcement Division's performance in this case; nor am I well positioned to evaluate the credibility of the warnings that the SEC received.

Still, two issues are more susceptible to a legal analysis from my perspective:

First, although Madoff Securities was only required to register as an investment adviser by the SEC in 2006, Madoff Securities was not thereafter examined by the SEC's Office of Compliance, Inspections and Examinations. Even given the severe cost constraints under which the SEC labors, was this omission justifiable?

Second, given that the Financial Industry Regulatory Authority ("FINRA") (and its predecessor, the NASD) had jurisdiction over Madoff Securities for several decades, was its failure to closely inspect the firm's advisory activities justifiable based on the argument that it lacked jurisdiction over investment advisers?

In both cases, as discussed below, I believe the justifications for inattention are insufficient.

A. SEC Examination

Historically, investment advisers were examined by the SEC's Office of Compliance, Inspections and Examinations in the first year after they registered with the SEC as investment advisers. Here, that would have been 2006 or 2007. Yet, because of cost constraints, no such examination was conducted, as this Office now uses risk-based criteria to determine which firms to examine.

Although hindsight has 20/20 vision which overlooks how difficult it is to discern frauds, I must conclude that if the SEC's risk-adjusted criteria did not consider Madoff Securities to be a risky case that justified an early examination, those criteria need to be revised. The critical facts were that even, as of 2006, Madoff Securities (1) had many billions of dollars in customer accounts under its management, (2) did not use an external custodian or prime broker, but cleared its own trades; (3) used an unusual options trading strategy that on closer inspection seemed incapable of implementation; and (4) used the same trading strategy for all clients, rather than provided individualized investment advice – and so arguably resembled an unregistered investment company. Opaque trading strategies have long been an identifying characteristic of Ponzi schemes. Although Madoff Securities had long paid a high return to its investors, the strange consistency in these returns over decades was puzzling, had attracted much skeptical commentary within the industry, and was arguably as much a warning signal as a re-assuring factor. Still, if one fact stands out, it was the sheer magnitude of the amount under management. This and the fact that the Madoff Securities' advisory business had not previously been vetted by the SEC called out for an early examination.

B. <u>FINRA's Jurisdiction</u>

Prior to 2006, Madoff Securities was only a broker-dealer and not a registered investment adviser. Thus, during this period, I see no reason that FINRA (or at that time the NASD) should have abstained from examining and monitoring the advisory side of Madoff Securities. This side was never formally separated in a different subsidiary; nor was it even geographically remote.

Section 202(a)(11) of the Investment Advisers Act defines the term “investment adviser” to mean “any person who, for compensation, engages in the business of advising others . . .,” but then excludes from this definition “(C) any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor. . . .”[22] Thus, if Madoff Securities was not registered as an investment adviser, it had to be taking the position (rightly or wrongly) that it was servicing these clients “solely incidental to the conduct of” its business as a broker-dealer. If so, that brokerage business was by definition within the NASD’s and FINRA’s jurisdiction.

After 2006, when Madoff Securities did register as an investment adviser, it was required (as earlier discussed) by Section 206(4) of the Investment Advisers Act and Rule 206(4)-2 thereunder to use a “qualified custodian” to hold its customers’ funds and securities. As earlier discussed, Madoff Securities, the investment adviser, could use (and did use) Madoff Securities, the broker dealer, as its “qualified custodian” (i.e., it could “self-clear”). But this conduct in holding securities and executing trades was the conduct of a broker-dealer and was fully within the NASD’s jurisdiction.

Finally, Madoff Securities had no right or privilege to resist any inspection by the NASD (or later FINRA) or to fail to provide information on the ground that its investment advisory business was exempt from NASD oversight. If it resisted on this ground, the NASD and FINRA had full power to discipline it severely. NASD Rule 8210 makes it clear beyond argument that the NASD can require a member firm to permit the NASD to inspect its books, records, and accounts and to provide other information. As the NASD further advised its members in its Notice to Members 00-18 (March 2000):

[22] See 15 U.S.C. § 80b-2(a)(11).

> "Implicit in Rule 8210 is the idea that the NASD establishes and controls the conditions under which the information is provided and the examinations are conducted."

I have previously served on an NASD disciplinary committee and found that any associated person of a member firm who resists a NASD investigation or directs others not to testify can be barred (and was so barred, in at least one instance during my term of service) from the industry for such resistance.

Let me conclude with a simple illustration: Imagine that on an examination of a broker-dealer, the NASD found that several roulette wheels were in operation in one of its offices and gambling was occurring (legally or otherwise). In my judgment, even though such activity did not involve the conduct of a brokerage business, the NASD (and later FINRA) on such a discovery could and should seek to determine the impact of these activities on the broker-dealer's financial condition and its books and records. Similarly, on learning that Madoff Securities held billions of dollars of customer funds and securities for which it was the "qualified custodian," it was incumbent on the NASD to examine the adequacy of the internal controls relating to the management, custody, and security of those accounts. Similarly, at this point, the NASD might have examined the audited financial statements of Madoff Securities and properly asked who the firm's unknown accountant was.

I express no view on whether the NASD or FINRA necessarily should have uncovered the Madoff fraud, but I reject as overbroad the claim that they had no jurisdiction or reason to inquire.

Thank you for your time and attention, and I would be happy to attempt to answer any questions that you may have.