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

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.