Center for Financial and Accounting Literacy

Madoff: Risks and Reforms
Protections for Investors from Ponzi Schemes, such as the Madoff Swindle

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In the wake of the Madoff swindle, as well as other recent Ponzi schemes and abuses involving investment advisers, the SEC has initiated a number of reforms, including a requirement for annual "surprise exams" of investment advisers by independent public accountants to better assure the safekeeping of investor assets. These reforms take effect March 12, 2010. The SEC has also provided interpretive guidance for independent accountants who conduct the surprise audits.

Surprise Audits and Other Reforms

The reforms are designed to protect investors who do business with investment advisers registered with the SEC. Investment advisers differ from banks and broker-dealers in that advisers frequently do not have physical custody of their clients' funds or securities. This opens the door to abuses, such as those described in recent SEC enforcement actions in which advisers allegedly distributed false account statements showing non-existent funds.

To help protect investors from the heightened risk of fraud or theft associated with non-custody of assets, the SEC amended its "custody rule" to include the following requirements:

- All custodians of client assets will need to send statements directly to advisory clients (investors), rather than through the investment adviser, and advisers will be required to instruct their clients to compare any account statements received from the custodian with those received from the adviser.
- In most cases where a registered investment adviser does have custody of client assets, the adviser will be required to undergo an annual surprise exam by an independent public accountant to verify that the reported assets exist. These advisers will need to disclose the identity of the public accountant that performs its surprise exam and report the reasons for any changes in auditors. Under the final rule, the independent accountant must be registered with the PCAOB and the first examination must take place by December 31, 2010. Exceptions: Exceptions to the surprise audit requirement were made for: (1) advisers who have custody of client assets solely because of the adviser's authority to deduct advisory fees from client accounts, and (2) advisers to pooled investment vehicles that are subject to an annual financial statement audit by an independent public accountant and that distribute the audited financial statements to the pool's investors.

- In cases where the adviser is reporting on assets and there is no independent report by an independent custodian, (e.g., the custodian is a related person), the investment adviser will be subject to a review that results in a SAS 70 report, i.e., a written report prepared by a PCAOB-registered and inspected accountant that describes the controls in place, tests the effectiveness of the controls and provides the results of these tests. These reports will need to meet standards set by the PCAOB. The first internal control report must be obtained by September 12, 2010 (six months from the effective date of the final rule.

To address concerns that the surprise exams are limited to annual exams, leaving the investor exposed to risks that can remain undetected for up to twelve months, the final rule provides Commission reporting requirements. Each investment adviser subject surprise audits must enter into a written agreement with an independent accountant that, among other things, requires the accountant to notify the Commission within one business day of any material discrepancy found during the course of the examination. The rule also establishes reporting requirements for dismissal or resignation of the accountant.

Additional Guidance for Independent Accountants

A companion release on "Commission Guidance Regarding Independent Public Accountant Engagements," provides interpretive guidance for the independent accountants who perform the surprise audits. The guidance modernizes and clarifies the procedures to be performed, including confirmation of client funds with the custodian and the client and examination of the securities over which an investment adviser has custody.

Will the reforms prevent future Ponzi Schemes?

Only time will tell. As the SEC acknowledged in the final rule, no set of regulatory requirements will prevent all fraudulent activities by advisers or custodians. But these newly-established reforms will provide investors with greater protection and better information about the custodial practices of registered investment advisers.

Answers to Frequently Asked Questions (FAQs)

What is a Ponzi scheme?

Ordinarily, returns to investors are paid from profits on investments. In a Ponzi scheme, the proceeds from investments made by newer investors are used to pay returns to older investors. These schemes may be exposed in times of economic slowdowns when the broker faces a lack of new investors.

How much money was involved in the Madoff swindle?

Media accounts have reported that $64 billion was involved. This is believed to be the largest Ponzi scheme in history. - and one of the longest-running. It reportedly went undetected for nearly twenty years.

Was Madoff audited?

Yes. The SEC has charged the auditors of Madoff's broker-dealer firm with committing securities fraud by falsely representing that they had conducted legitimate audits, when in fact they had not.

Were others involved?

This is a matter of ongoing investigation. The SEC has also filed civil complaints against several large "feeders" that channeled billions of dollars to Madoff's firm in exchange for millions of dollars in fees.

Helpful Links

SEC final rule on "Custody of Funds or Securities of Clients by Investment Advisers"
http://www.sec.gov/rules/final/2009/ia-2968.pdf
SEC press release 2009-269 announcing final rule and companion release for independent accountants
http://www.sec.gov/news/press/2009/2009-269.htm.
SEC interpretive guidance for independent accountants http://www.sec.gov/rules/interp/2009/ia-2969.pdf.
SEC press release 2009-116 http://www.sec.gov/news/press/2009/2009-116.htm
Proposed rule http://www.sec.gov/rules/proposed/2009/ia-2876.pdf
SEC Enforcement Release (against auditors)
http://www.sec.gov/litigation/litreleases/2009/lr20959.htm
SEC Administrative Order (against Madoff) http://www.sec.gov/litigation/admin/2009/34-60118.pdf
Testimony on issues raised by the Madoff matter http://www.sec.gov/litigation/admin/2009/34-60118.pdf
SEC Administrative Order Against large "feeder" fund
http://www.sec.gov/litigation/litreleases/2009/lr21095.htm