TESTIMONY OF LINDA CHATMAN THOMSEN

DIRECTOR, DIVISION OF ENFORCEMENT

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Before the

United States Senate Committee on Banking, Housing and Urban Affairs

Concerning Investigations and Examinations by the

Securities and Exchange Commission and

Issues Raised by the Bernard L. Madoff Investment Securities Matter

Tuesday, January 27, 2009

Good morning Chairman Dodd, Ranking Member Shelby, and members of the Committee. I appreciate the opportunity to appear here today to discuss matters relating to the Ponzi scheme allegedly perpetrated by Bernard L. Madoff and related enforcement concerns. I am Linda Thomsen and for nearly 14 years it has been my privilege to serve on the staff of the Securities and Exchange Commission.

Before I go any further I want to thank the Committee for understanding that because of our collective desire to preserve the integrity of the investigative and prosecution processes there are matters that I cannot discuss today.[1] None of us wants to

[1] As set forth below in this testimony, the SEC filed a civil enforcement action alleging securities fraud against Bernard L. Madoff and Bernard L. Madoff Investment Securities LLC on December 11, 2008, and the United States Attorney's Office filed a parallel criminal action the same day. These actions are presently being litigated before the United States District Court for the Southern District of New York. Aside from the allegations of the publicly filed complaints, I cannot comment on the pending civil and criminal litigation or the underlying investigations in order to avoid jeopardizing the ongoing legal and investigative processes. In addition, I cannot comment on any historical SEC enforcement investigations of Mr. Madoff, his firm or associated persons because the information is non-public and the SEC's Office of the Inspector General is actively investigating any such prior matters. The SEC's Inspector General recently testified before the House of Representatives Financial Services Committee regarding the scope of his investigation. See H. David Kotz, Inspector General, U.S. Securities and Exchange Commission, Testimony Before the U.S. House of Representatives Committee on Financial Services, January 5, 2009, available at http://www.sec.gov/news/testimony/2009/ts010509hdk.htm.

do anything that would jeopardize the process of holding the perpetrators accountable. That being said, I will try to address some of the overarching issues related to the Madoff situation. In that regard, my views are my own, and while they are informed by my years on the staff of the Commission, they do not necessarily reflect the views of the Commission or any other member of the staff.

Publicly Disclosed Investigations of Bernard L. Madoff, Bernard L. Madoff Investment Securities, LLC, and Associated Persons

On December 11, 2008, the SEC sued Bernard L. Madoff and his firm, Bernard Madoff Investment Securities, LLC, for securities and investment advisory fraud in connection with an alleged Ponzi scheme that allegedly resulted in substantial losses to investors in the United States and other countries. The alleged scheme is outlined in the Commission's complaint filed in the United States District Court for the Southern District of New York, captioned United States Securities and Exchange Commission v. Bernard L. Madoff and Bernard L. Madoff Investment Securities LLC, 08 Civ. 10791 (LLS) (S.D.N.Y. Dec. 11, 2008). The SEC's Enforcement Division is coordinating its ongoing investigation with that of the United States Attorney's Office for the Southern District of New York, which filed a parallel criminal action on December 11, 2008, in connection with of Mr. Madoff's alleged Ponzi scheme.

With respect to past SEC enforcement investigations related to Mr. Madoff or his firm, two enforcement actions were filed by the SEC's New York Regional Office in 1992 alleging violations of the securities registration provisions in connection with offerings in which the investors' funds were invested in discretionary brokerage accounts with an unidentified broker-dealer, who in turn invested the money in the securities

market. The unidentified broker-dealer in these cases was Bernard L. Madoff. The first matter was entitled SEC v. Avellino & Bienes et al.[2] In that case, two individuals, Frank Avellino and Michael Bienes, raised $441 million from 3200 investors through unregistered securities offerings. They formed an entity, Avellino & Bienes ("A&B"), which offered investors notes paying interest rates of between 13.5 and 20%. A&B collected the investors' monies in a pool or fund that was invested in disretionary brokerage accounts with Mr. Madoff's broker-dealer firm, and Mr. Madoff in turn invested the monies in the market. A&B received returns on the invested funds from Mr. Madoff, but kept the difference between the returns received from Mr. Madoff and the lesser amounts of interest paid on the A&B notes.

The second matter, SEC v. Telfran Associates Ltd., et al., was a spinoff from A&B and involved the creation of a feeder fund to A&B.[3] In Telfran, two individuals who had invested in A&B, Steven Mendelow and Edward Glantz, formed an entity called Telfran Associates. Telfran raised approximately $88 million from 800 investors through unregistered securities offerings over a period of three years. Telfran sold investors notes paying 15% interest, which they in turn invested in notes sold by A&B that paid between 15 and 19% interest. Since investor funds collected by A&B were invested with Mr. Madoff, the Telfran investor funds were also invested with Mr. Madoff, albeit indirectly.

Although the SEC was initially concerned that these unregistered offerings might be part of a huge fraud on the investors, the trustee appointed by the court in Avellino & Bienes found that the investor funds were all there. The returns on funds invested with Mr. Madoff appeared to be exceeding the returns the promoters had promised to pay their

[2] SEC v. Avellino & Bienes et al., Lit. Rel. No. 13443 (Nov. 27, 1992).
[3] SEC v. Telfran Associates Ltd., et al., Lit. Rel. No. 13463 (Dec. 9, 1992).

investors, so there were no apparent investor losses.[4] In both cases, the SEC sued the entities offering the securities and their principals for violations of the securities registration provisions of the federal securities laws. The SEC also sought the appointment of a trustee to redeem all outstanding notes and the appointment of an accounting firm to audit the firms' financial statements.

Both cases were settled by the promoters' consent to reimburse each investor the full amount of their investment and to submit to an audit by an accounting firm, and their further consent to be permanently enjoined from further unregistered offerings in violation of the federal securities laws. In addition, each of the companies making the unregistered offerings agreed to pay a penalty of $250,000, and each of the principals in those companies agreed to pay a civil penalty of $50,000.[5] By executing the SEC's consent orders, Avellino & Bienes, Telfran and their respective principals agreed to cease offering unregistered investment opportunities to the public. Because the court-appointed trustees in Avellino & Bienes concluded the investor funds were all there and all investor funds in both cases were ultimately reimbursed to the investors, the SEC did not pursue fraud charges in those cases. Neither Mr. Madoff nor his firm was named as a defendant in either case.

As widely reported in the press, the SEC's New York Regional Office commenced another investigation of Mr. Madoff in early 2006. Two years later, in January 2008, that investigation was closed without any recommendation of enforcement action.

[4] Randall Smith, Wall Street Mystery Features A Big Board Rival, Wall St. J, Dec. 16, 1992 at C1.
[5] SEC v. Avellino & Bienes et al., Lit. Rel. No. 13880 (Nov. 22, 1993); SEC v. Telfran Associates Ltd., et al. , Lit. Rel. No. 13881 (Nov. 22, 1993).

Securities Regulators, Criminal Authorities and Other Parties Who May Investigate The Alleged Ponzi Scheme and Related Matters

Many securities regulators, criminal authorities, and private parties have the authority to investigate, or conduct civil discovery from, Mr. Madoff, his firm, and others who might potentially be held civilly or criminally liable in connection with the alleged Ponzi scheme. Together, these regulators, criminal authorities and other parties have an extremely broad range of possible remedies and sanctions.

On December 11, 2008, the SEC filed a civil action alleging securities fraud against Mr. Madoff and his firm Bernard L. Madoff Investment Securities LLC in the United States District Court for the Southern District of New York. The Commission's complaint alleges that Mr. Madoff admitted to two senior employees of his firm that for many years he had been conducting the investment advisory business of his firm as a giant Ponzi scheme—using funds received from new investors to pay returns to previous investors—and estimated that the scheme has resulted in losses of approximately $50 billion. The complaint further alleges that Madoff also informed these senior employees of his firm that he had approximately $200-300 million left, which he planned to use to make payments to selected employees, family and friends before turning himself in to the authorities.[6] The SEC immediately sought, and obtained, a preliminary injunction and other emergency relief to prevent the dissipation of any remaining assets.[7] Among the other remedies available to the SEC in civil enforcement actions are disgorgement of ill-gotten gains, permanent injunctive relief against violations of the federal securities laws,

[6] SEC v. Bernard L. Madoff et al., 08 Civ. 10791 (S.D.N.Y. Dec. 11, 2008), Complaint at 2, 4-6.
[7] SEC v. Bernard L. Madoff et al., 08 Civ. 10791, Order on Consent Imposing Preliminary Injunction, Freezing Assets and Granting Other Relief Against Defendants (Dec. 18, 2008).

remedial undertakings, civil penalties, revocation of registration and investment advisor or industry bars, which may be either time-limited or permanent.

Also on December 11, 2008, the United States Attorney's Office for the Southern District of New York filed a criminal action against Mr. Madoff in connection with the alleged Ponzi scheme. Criminal authorities generally have authority to seek incarceration of criminal defendants, as well as to obtain criminal restitution and fines. Criminal authorities may also have the power to seek the imposition of conditions on an individual's liberty, such as probation, denial of voting rights, mandatory curfew and house arrest.

All told, the two actions filed by the SEC and United States Attorney's Office alone (depending, of course, on findings of liability and guilt), expose Mr. Madoff to billions of dollars in liability and decades of incarceration. Both the SEC and the United States Attorney's Office are continuing our investigations and fact-finding. As is our practice, we and the federal criminal prosecutors are coordinating our efforts as allowed by law.

There are numerous other parties and entities that may be able to pursue Mr. Madoff, his firm and related entities or individuals. For example, the Financial Industry Regulatory Authority, or FINRA, may pursue disciplinary action against Mr. Madoff's in connection with any activities undertaken in its capacity as a registered broker-dealer. Like the SEC, FINRA can order disgorgement, impose civil fines and bar or impose conditions on the employment of an individual by any broker-dealer firm, again either permanently or for a specified time.

The 50 states, as well as their respective securities regulators and criminal authorities, may also investigate and bring civil or criminal actions against Mr. Madoff, his firm and related entities or individuals under applicable state laws. Several states have reportedly commenced such investigations against Mr. Madoff or Madoff-related entities. State attorneys general, securities regulators and criminal authorities are authorized to seek many of the same sanctions as their federal counterparts, though the available remedies and sanctions may vary to some extent under differing state laws. Further, any period of incarceration would be served in a state, rather than federal, prison or other detention facility.

The investors who reportedly incurred losses as a result of Mr. Madoff's alleged Ponzi scheme include a large number of foreign nationals, banks and corporations. To the extent foreign citizens, corporations and instrumentalities have suffered losses as a result of Mr. Madoff's alleged misconduct, foreign governments, their respective securities regulators and criminal authorities may also have power to investigate and bring actions under foreign law. For example, the United Kingdom's Serious Fraud Officehas reportedly commenced an investigation of Mr. Madoff, particularly the activities conducted through his London office.

Private citizens and corporate entities may have standing to pursue civil actions against Madoff and associated entities or persons, either in the United States or in their home countries. Private civil actions are primarily brought to seek compensatory and possibly punitive damages. While many private actions have already been filed against Mr. Madoff and various others, the efficacy of these actions will depend in part on the existence and the amount of assets from which a judgment might be satisfied.

Finally, in the SEC's action against Madoff, the United States District Court for the Southern District of New York granted the application of the Securities Investor Protection Corporation (SIPC) for the liquidation of Bernard L. Madoff Investment Securities LLC and appointed a trustee. The SIPC trustee will marshall the assets and process the claims of customers and creditors of Madoff's firm in an equitable manner.[8]

Enforcement Division Complaints, Tips and Referrals

The Enforcement Division receives hundreds of thousands of tips each year from various sources. Some are from credible sources who provide detailed information in support of the tip, and some consist of nothing more than newspaper clippings or printed promotional material sent with no further explanation. Some come from industry competitors, some from disgruntled present or former employees, some from present or former investors, and others are totally anonymous. On the one hand, complaints, tips and referrals from the public often provide valuable information about potential securities violations; on the other hand, sources at times may be attempting to enlist the SEC's authority and resources in efforts to advance their own private interests, which may or may not be consistent with our enforcement mission.

Complaints, tips and referrals come to the Enforcement Division in every imaginable form. We get telephone calls, handwritten letters, thick bound dossiers with numbered exhibits and extensive accounting analyses, complaint forms from the Enforcement Division's Office of Internet Enforcement, newspaper articles with company names circled in red ink, formal referrals from other regulators, informal referrals from other Offices and Divisions of the SEC, notes from reformed fraudsters,

[8] Id.; see also Information for Madoff Customers, available at http://www.sec.gov/divisions/enforce/claims/madoffsipc.htm.

anonymous scribbling, seemingly random pieces of a company's financial statements, and occasional lengthy and disjointed diatribes that make no discernible securities-related claims.

While we appreciate and examine every lead we receive, we simply do not have the resources to fully investigate them all. We use our experience, skill and judgment in attempting to triage these thousands of complaints so we can devote our attention to the most promising leads and the most serious potential violations. Because the process necessarily involves incomplete information and judgment calls made in a tight timeframe, we are also continually working on ways to improve our handling of complaints, tips and referrals to make optimal use of our limited resources.

There are a number of major channels through which complaints, tips and referrals flow in to the Enforcement Division. First, there are calls and letters that are processed and screened by the Office of Investor Education as complaints, tips and referrals or "CTRs." The most promising of these are forwarded to attorney staff in the Enforcement Division. Second, on the SEC's website, there is an Electronic Complaint Center that allows members of the public to record complaints and tips on simple online forms. The online complaints are reviewed and triaged by the professional staff of the Enforcement Division's Internet Enforcement Group, which refers them to staff for further investigation based on subject matter or geography.

Yet another group of staff within the Division reviews and evaluates hundreds of "Suspicious Activity Reports" or "SARS" that are filed with federal banking regulators by banks and financial institutions nationwide. SARS that potentially involve securities

are forwarded to the SEC. After screening by experienced staff, promising referrals based on SARS are sent to enforcement staff throughout the country.

FINRA and stock exchanges (referred to as "Self-Regulatory Organizations" or "SROs") are another source of referrals. The SROs provide continual and cutting-edge computerized surveillance of trading activities in their respective markets. They regularly report suspicious activities and trading anomalies to the Enforcement Division's Office of Market Surveillance through a variety of periodic reports. They also provide referrals regarding particular suspicious trades that may show possible insider trading ahead of a publicly-announced transaction, such as a merger or acquisition. The SEC's Office of Market Surveillance automatically opens a preliminary investigation of each such referral and then forwards it to appropriate staff, generally based on geographic location of the issuer or suspected traders. The staff then becomes responsible for further inquiries that will either lead to the opening of a full investigation or the closure of the preliminary investigation.

The Enforcement Division also receives referrals of potential securities law violations from other Offices and Divisions within the Commission. These referrals are either taken up directly by the Regional Office where the complaint was discovered or arose, or are directed to staff having appropriate expertise regarding the particular type of complaint. For example, referrals involving accounting issues are directed to the Office of the Chief Accountant in the Enforcement Division for further evaluation and referral to staff as appropriate. Similarly, referrals from throughout the Commission regarding over-the-counter stocks, potential microcap fraud and securities spam are directed to the

Trading and Markets Enforcement Group, which has extensive experience in this market segment, for further evaluation and possible referral to staff.

It is important to note that many complaints, tips and referrals are made directly to staff in the Office nearest the complainant and are investigated or addressed by that office. Among the options available to staff receiving a tip or lead are further investigation of the lead, declining to pursue the lead for lack of apparent merit, transfer of a potentially viable lead to an office with a closer geographical connection to the alleged misconduct, or referral of the lead to subject matter experts for further evaluation and possible assignment to staff.

The primary consideration in determining whether to pursue any particular tip depends on whether, based on judgment and experience, the tip provides sufficient information to suggest that it might lead to an enforcement action involving a violation of the federal securities law. This determination requires the exercise of judgment regarding, among other things: the source of the tip; the nature, accuracy and plausibility of the information provided; an assessment of how closely the information relates to a possible violation of federal securities law; the validity and strength of the legal theory on which a potential violation would be based; the nature and type of evidence that would have to be gathered in the course of further investigation; the amount of resources the investigation might consume; and whether there are any obvious impediments that would prevent the information from leading to an enforcement action (for example, the conduct complained of is not securities-related).

When we determine that we have a promising tip, we investigate. We follow the evidence where it leads and will pursue and develop evidence regarding the liability of a

full array of persons and entities--from the central players to the peripheral actors--and we do so without fear or favor. In commencing an investigation, we usually do not know whether or not the law has been broken and, if so, by whom. We have to investigate, and our investigation may or may not lead to the filing of an enforcement action. We are resource constrained. The approximately 3,500 employees of the SEC (of whom approximately 1000 are in the Enforcement Division) are charged with regulating and policing an industry that, as described in Ms. Richards' testimony, includes over 11,300 investment advisers, 4,600 registered mutual funds, over 5,500 broker-dealers (with approximately 174,000 branch offices and 676,000 registered representatives), as well as approximately 12,000 public companies. Every day we are compelled to make difficult judgments about which matters to pursue, which matters to stop pursuing, and which matters to forego pursuing at all. Every investigation we pursue, or continue to pursue, entails opportunity costs with respect to our limited resources. A decision to pursue one matter means that we may be unable to pursue another. No single case or investigation can ever be considered in a vacuum, but rather must be viewed as one of thousands of investigations and cases we are or could be pursuing at any given time.

In pursuing our work, the staff of the Enforcement Division is devoted to public service and our mission of investor protection. In recent days there have been suggestions that the staff is not motivated to pursue the big case and somehow is inclined to look the other way. Nothing could be further from the truth. Based on my experience with the hard-working men and women in the Enforcement Division, our staff lives to bring cases, particularly big and difficult cases. The staff is bright, creative and professionally zealous; for most of us, nothing is more rewarding than pursuing a good

case. Athletes may score runs or kick goals, but we bring enforcement actions. The filing of an enforcement action is one of the few solid benchmarks of success in the pursuit our mission.

One need only look at the eight days surrounding the bringing of the Madoff case to see ample evidence of our commitment. During the Monday to Monday period between December 8 and December 15, 2008, the Commission also:

- sued Mark Dreier, an attorney selling bogus notes;[9]
- brought an action against Fidelity traders for taking illegal gifts and gratuities;[10]
- finalized some of the landmark auction rate securities cases, which provided billions of dollars of liquidity to thousands of investors within just months after that market froze;[11]
- sued a Russian broker-dealer for operating in our markets in violation of our rules;[12]
- settled a complex financial fraud matter involving reinsurance;[13]
- filed, in coordination with criminal authorities, an action to halt a wide-ranging market manipulation scheme;[14] and
- filed a $350 million dollar settled action against Siemens for bribery of foreign officials in violation of the Foreign Corrupt Practices Act,[15] the largest SEC settlement in the Act's 30 year history.

[9] SEC v. Marc S. Dreier, Lit. Rel. No. 20823 (Dec. 8, 2008).
[10] Former Fidelity Employees to Pay More Than $1 Million to Settle SEC Charges for Improperly Accepting Lavish Gifts Paid For By Brokers, SEC Press Rel. No. 2008-291 (Dec. 11, 2008).
[11] SEC v. Citigroup Global Markets, Inc. et al., Lit. Rel. No. 20824 (Dec. 11, 2008).
[12] In the Matter of CentreInvest, Inc., OOO CentreInvest Securities, Vladimir Chekholko, William Herlyn, Dan Rapoport, and Svyatoslav Yenin, Exch. Act. Rel. No. 59067 (Dec. 8, 2008).
[13] SEC v. Zurich Financial Services, Lit. Rel. No. 20825 (Dec. 11, 2008).
[14] SEC v. National Lampoon et al., Lit. Rel. No. 20828 (Dec. 15, 2008).
[15] SEC v. Siemens Aktiengesellschaft, Lit. Rel. No. 20829 (Dec. 15, 2008).

Everyone at the SEC wishes the alleged Madoff fraud had been discovered sooner. We are committed to finding way to make fraud less likely and fraud detection more likely. But we need to acknowledge a hard truth our forefathers recognized--if men were angels we wouldn't need government. We wouldn't need laws either. The reality is that people do break the law and when they do so, there is harm, sometimes great harm.

Looking at what we can do to deter fraud or find it sooner, the steps fall into three general categories: law enforcement; law and regulation; and resources. On the enforcement front, we are looking for ways to help identify from among the various streams of information we receive and those that our staff independently develops, the systemic risks and emerging trends we should investigate. We have pursued risk-based investigations where we identify a potential trouble spot and then develop investigative plans to test whether the problem exists at a given company and the markers for the problem that might enable us to identify it more quickly in other firms.

Just last week, we brought a case against General Motors involving pension accounting and related disclosures that was the result of that process.[16] For the last several years, the SEC has been concerned about the adequacy of the assumptions underlying public issuers' pension accounting and related reserves, as well as related disclosure issues. In an analogous context, the Enforcement Division had already confronted substantial disclosure problems related to pension obligations in our enforcement action against the City of San Diego. In that case, the SEC brought an enforcement action against the City of San Diego for issuing bonds without adequately disclosing the city's overwhelming future pension obligations to city employees.[17] We

[16] SEC v. General Motors Corporation, Lit. Rel. No. 20861 (Jan. 22, 2009).
[17] In the Matter of City of San Diego, California, Exch. Act Rel. No. 54745 (Nov. 14, 2006).

were concerned that the kind of pension-related disclosure and accounting issues we encountered in the San Diego case might be an even bigger problem in the context of corporations that are public issuers—which may have many more employees and much more complex pension obligations. Accordingly, the Enforcement Division decided to review pension accounting assumptions and related disclosures at a number of large public issuers, and the GM case announced last week was the result of that review. Our risk-based initiatives are resource-intensive and time-consuming, but they have produced results—both in terms of filed enforcement actions and the related deterrent effects in the market.

On the law and regulation front, as has been widely acknowledged, our current system includes many products and businesses that are largely unregulated (hedge funds, for example); products and businesses that are regulated only on the state level (many insurance products, for example); and balkanized regulation on the federal level (the different regulatory schemes that apply to broker-dealers and investment advisors, for example).

For example, there are products that appear to be comparable from an investor's perspective that are in fact subject to widely varying degrees of oversight and regulatory risk (and indeed, these varying products are oftentimes sold to an investor by the same person). By the same token, in the course of a single conversation with a customer, an investment professional may be acting in his capacity as a broker-dealer or in his capacity as an investment adviser, with differing disclosure and legal obligations at any given moment, but the customer is usually unaware of any difference between these roles, and would find the distinctions bewildering in any event.

Consideration should be given to harmonizing the regulatory regimes that apply to these similar products and businesses. Such harmonization could benefit not only the individual investor but also the market as a whole by contributing to restored market confidence.

On a more micro level, consideration should be given to quite specific steps that might contribute to slowing down or detecting fraud within an investment advisory business. For example, consideration could be given to requiring third party custody of customer assets, imposing requirements regarding qualifications, size and resources of accounting firms eligible to audit such businesses, or requiring additional disclosure.

As to resources, over the past few years our job has grown substantially. Just one example is noted in Lori Richards' testimony. In 2002, there were 7547 registered investment advisers; today, there are 11,300—an increase of 50%. The amount of resources available to the SEC has not kept pace with the rapid expansion in the securities market over the past few years--either in terms of the number of firms or the explosion in the types of new and increasingly complex products, including securities, hedge funds and related trading strategies, collateralized debt obligations, credit default swaps and financial derivative products, some of which were expressly designed to avoid SEC regulation and oversight. Nor have our resources expanded to address the ongoing globalization of the international financial markets.

While we always do our utmost to do more with less, if we had more resources, we could clearly do more. We could do more investigations, file more enforcement actions and achieve more deterrence. More resources would also allow us to spend more time to determine whether a particular problem may be widespread in certain market

segments--those risk based investigations I described earlier. Resources could also allow us to use more technology in our work. Technology can be quite useful in maximizing our effectiveness, but technology is often expensive, requires consistent maintenance, and must be periodically updated. We also need to be sure that enforcement personnel have access to market, trading, analytical, accounting and economic expertise when they need it and that they have the training to know when they should call upon that expertise. The agency's renewed focus on risk assessment will help to address these concerns.

Finally, we need to focus on investor education and the creation of a strong compliance tone and culture in the securities industry. All of us need to encourage investors to be their own best advocates and to practice basic safe investing principles, such as skepticism and diversification. And all of us need to do everything we can to encourage a tone and culture, especially among those who make their livings from other people's investments, that mere compliance with the law, narrowly viewed, is not the highest goal to which we aspire, but the base from which we start. We should all work toward a system where those who work in it are responsible stewards of the treasures entrusted to them.