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Back To The Future: Is Disbanding OCIE The Answer?

Law360, New York (January 05, 2010) -- On Sept. 29, 2009, the Office of Inspector General of the U.S. Securities and Exchange Commission issued a report (the "IG Report") evaluating the adequacy of examinations conducted by the Office of Compliance Inspections and Examinations ("OCIE") in response to complaints regarding the activities of Bernard L. Madoff and his investment firm, Bernard L. Madoff Investment Securities LLC ("BMIS").[1]

The IG Report was released following Madoff's conviction for defrauding his clients of billions of dollars in one of the largest Ponzi schemes exposed to date, a scheme that the SEC failed to uncover despite having received several credible tips, some dating back as far as 1999, alleging wrongdoing on the part of Madoff.

The report detailed numerous deficiencies regarding the manner in which OCIE's examinations of Madoff and BMIS were conducted and made 37 recommendations for how OCIE's operations could be improved to avoid similar missteps in the future.

The question, however, is whether these recommendations and other reforms implemented by the SEC since the Madoff scandal broke go far enough in addressing the systemic and structural issues that allowed such a massive fraud to go undetected.

Background

The SEC created the OCIE in 1995 by consolidating the inspection and examination programs authorized by the Securities Exchange Act of 1934 Act, the Investment Company Act of 1940, and the Investment Advisers Act of 1940, that had been previously housed in the Division of Markets and Trading (then Market Regulation) and the Division of Investment Management.

One of the principal reasons for creating the OCIE was to streamline and improve the examination process. It was believed that by consolidating the SEC's inspection and examination functions into a single office, the OCIE would be in a position to ensure

greater consistency among examinations, provide improved focus on examination activity, direct resources more efficiently and effectively, and respond to changes in the industry faster.[2]

It was also believed that the creation of a single office responsible for examinations and inspections would increase efficiency in training, staffing complex examinations, and dealing with firms whose operations cross jurisdictional lines.[3]

Unfortunately, the IG Report shows that many of these objectives, at least as they related to the Madoff case, were not achieved.

Inspector General's Report — OCIE Missteps

In the IG Report, the Inspector General found that mistakes were made by OCIE staff at virtually every step of its examination process, culminating in the staff's failure to uncover the massive fraud being perpetrated by Madoff.

Specifically, the IG Report noted that the OCIE's policies and procedures were lacking in several important areas.

There were no formal policies or procedures in place for handling tips and complaints received by OCIE, which resulted in its failure to properly evaluate and act upon information available to it in the form of news articles and reliable tips received from industry professionals that raised red flags.

There were also no formal policies or procedures in place requiring the preparation of planning or closing memoranda. This shortcoming led to examinations that were unfocused in scope and contributed to the inadequate sharing of information among OCIE staff.

The IG Report also found that the OCIE's examination practices were deficient.

The OCIE failed to form appropriate examination teams, often staffing teams that lacked a branch chief or examiners who possessed appropriate expertise. The teams that were formed to examine BMIS did not understand, and did not endeavor to learn, how the company functioned, resulting in their failure to uncover Madoff's Ponzi scheme.

Examiners neglected to adequately investigate contradictions and discrepancies discovered during their examinations of Madoff and BMIS and failed to verify representations made by Madoff or corroborate his purported trading volume with information requested from independent third-party sources.

Several examiners closed their investigations of Madoff and BMIS without resolving numerous issues or without fully investigating all of the claims raised against Madoff and BMIS.

Inspector General's Report — Recommendations for Improvement

In light of its findings, the Inspector General offered a total of 37 recommendations for ways in which the OCIE examination process could be improved. These recommendations included, among others:

- 1) providing examiners with access to industry publications and databases and establishing protocols for analyzing the information gathered from such sources to identify and investigate red flags and potential violations of securities laws;
- 2) the creation of a collection system for the information contained in tips and complaints that will ensure that the tips and complaints are vetted within 30 days of receipt and examinations are commenced within 60 days of receipt;
- 3) the reporting of any tips or complaints not vetted within 30 days, or examinations not commenced within 60 days, to the OCIE director;
- 4) establishing procedures clarifying the requirements for planning and closing memoranda, including requirements for discussions of the scope of an examination, review of the memoranda by unaffiliated senior-level officials, the documentation of all substantive interviews and other relevant information received by OCIE staff, the logging of all examinations into a tracking system that can be accessed by all OCIE staff members, and the conclusion of all examinations with a closing report;
- 5) the selection of examination teams based on the focus of the examination and the expertise of the team members selected, rather than on availability of team members;
- 6) increasing the training of OCIE staff, including the qualification of staff, by means of an industry certification, to conduct thorough and comprehensive examinations and the training of examiners in the mechanics of securities settlements and exchange regulations, both foreign and domestic;
- 7) requiring OCIE staff to verify statements and transactions with independent third parties;
- 8) granting OCIE staff access to self-regulatory organization databases so that the staff can verify registrant information and
- 9) making clear that OCIE management will support examiners in their pursuit of evidence during examinations.

In response to the IG Report, the OCIE was to have provided the Inspector General with a written corrective action plan addressing the agreed upon recommendations (they concurred with all 37 recommendations) by November 13.

Bolder Action — Eliminating the OCIE

While the recommendations made by the Inspector General for improving the OCIE's shortcomings are extensive, they do not go far enough to fully eradicate the inefficiencies uncovered in the OCIE's operations.

A course of action that was not raised in the IG's Report, but which should be considered, is dismantling the OCIE as an independent office within the SEC and shifting its functions back into the Divisions of Markets and Trading and Investment Management.

Under the current structure, the inspection and examination functions of the OCIE are segregated from the policymaking functions of the line divisions. As a result, the OCIE is comprised of examiners who often have little substantive experience in the areas in which they are conducting examinations as they do not deal with the subject matter on a day-to-day basis.

This separation has had a detrimental effect on the quality of inspections and examinations conducted by the OCIE, with examiners often focusing on the narrow subject matter with which they are familiar and ignoring or failing to uncover other, often larger and more important, issues they come across, as was shown to have been the case in the Madoff and BMIS investigations.

Shifting these examiners from a stand-alone inspection and examination division into the substantive, policymaking divisions would immerse them in the subject matter with which they deal during inspections and examinations. This would enable examiners to develop greater proficiency in that subject matter and allow them to more effectively conduct inspections and examinations.

In turn, this would greatly improve the chances of examiners spotting tangential issues that may expose additional violations of the federal securities laws, rather than conducting compartmentalized investigations that focus only on the specific issues with which a given examiner may be comfortable.

Additionally, such a structure may make it easier for examiners and other SEC staff to administer rules and regulations more consistently.

Moving examiners back into the line divisions would also help to more efficiently and effectively assign personnel to inspections and examinations.

For instance, if the subject of an inspection or examination was an investment adviser or investment company, examiners from the Division of Investment Management, who understand the manner in which such entities function and the laws that govern them, would be staffed on the examination.

Likewise, if the subject of an examination was a broker-dealer, transfer agent or self-regulatory organization, the examination would be staffed with examiners from the

Division of Markets and Trading who are familiar with the inner workings of those organizations and the laws under which they function.

Such a shift in staffing would be a marked improvement over the current process, which staffs examiners based largely upon availability at the time an examination commences.

Some may argue, however, that eliminating the OCIE is unnecessary in light of reforms being implemented by the SEC, including efforts to address or implement the IG Report's specific recommendations.

Additionally, some may contend that having examiners for investment companies, investment advisers and broker-dealers in a single office rather than divided between two divisions allows for greater interaction and collaboration among examiners with different industry focuses.

While current SEC reform efforts will no doubt improve the efficiency of the OCIE, the fundamental issue of separation from the division with the day-to-day substantive experience remains.

Furthermore, while, in theory, having all examiners in a single office should improve communication and collaboration among examiners of different backgrounds, as noted in the IG Report, such interaction and collaboration did not necessarily occur in practice.

What Next?

Restructuring the SEC along these lines has its supporters, including, among others, former SEC Commissioner Paul Atkins and Rep. Spencer Bachus, R-Ala., the ranking Republican member of the House Financial Services Committee, who each have, at one time or another, either suggested or called for the elimination of the OCIE and the reintegration of examiners back into the line divisions.

This view is not just a Republican position as it seems to have its Democratic supporters as well. For instance, a provision in the discussion draft of the Restoring American Financial Stability Act of 2009 (the "Senate Bill") released by Sen. Christopher Dodd, D-Conn., in November 2009 would effectively gut the OCIE by moving examiners back into the line divisions.

Section 965 of Title IX Subtitle F of the Senate Bill[4] would require that compliance inspections and examinations be performed by examiners housed in, and reporting to the directors of, the Division of Trading and Markets and the Division of Investment Management.

While this provision does not expressly eliminate the OCIE, little would remain with that office, assuming that the SEC does not maintain redundant staffs, if this provision were to become law.

While legislative mandates may make future reforms, if necessary, difficult to implement,[5] the SEC should seriously examine the possibility of reintegrating examiners into the line divisions and take action on its own accord.

Even though the implementation of the SEC's 37 recommendations as well as other announced reforms will make the OCIE better, reintegration of examiners into the line divisions would help the SEC come even closer to ensuring that the mistakes discovered during the Madoff scandal are not repeated.

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[1] Review and Analysis of OCIE Examinations of Bernard L. Madoff Investment Securities LLC, available at www.sec-oig.gov/Reports/AuditsInspections/2009/468.pdf.

[2] See Lori A. Richards and John H. Walsh, Compliance Inspections and Examinations by the Securities and Exchange Commission, 52 Bus. Law. 119 (1996-1997).

[3] See id.

[4] Restoring American Financial Stability Act of 2009, available at banking.senate.gov/public/_files/AYO09D44_xml.pdf.

[5] Regardless of whether OCIE should or should not be eliminated, this legislation, as drafted, would require an act of Congress to implement any future changes to the location of examination staff.