

Calls for New Rules After Madoff

By Donna Mitchell

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There has been increasing support among investment advisors to formalize business practices governing the handling of client assets as a result of Bernard Madoff's alleged Ponzi scheme. Specifically, some are calling for client assets to be handled by outside custodians. Others say the Securities and Exchange Commission needs to step up its oversight and enforcement.

SEC-registered investment advisors who handle investor assets through third-party custodians name the custodians on documents filed with the SEC. This is a common practice among investment advisors, but making it mandatory would instill more confidence, says William L. Prickett, chair of the securities and financial litigation practice group at Seyfarth Shaw LLP, a New York City-based law firm. The firm recently launched a cross-disciplinary legal team to address the Madoff fraud crisis.

Others say that the SEC needs to bolster its efforts. "It appears that the Madoff scandal was a failure of regulatory enforcement, and not a failure of the regulations themselves," says Neil Simon, vice president of government relations for the Investment Adviser Association, a Washington-based advocacy group that represents SEC-registered investment advisors, which included Bernard L. Madoff Investment Securities LLC. "Certainly we believe that attention needs to be paid to SEC enforcement. The Madoff case suggests that there were significant deficiencies."

The issue certainly has not escaped the attention of Congress. In January, the House Committee on Financial Services convened to discuss the need for regulatory reform. Rep. Paul E. Kanjorski (D-PA) said: "The allegations that Bernard Madoff stands at the center of a \$50 billion scam simply shocks the conscience. These deeply disturbing events have raised even more troubling questions about the effectiveness of our regulatory system."

While many of Madoff's practices appeared to be within the letter of the law, they were still unusual enough that they should have raised red flags, according to the Investment Adviser Association. For example, unlike other investment advisor firms, it held client funds itself without a third-party custodian and, presumably, executed all of its clients' securities trades.

But, passing new rules governing the investment advisory business will not be a top priority for Congress when it convenes, says Simon. That's because Congress is grappling with issues that stem from the bigger economic and financial sector breakdown, such as credit default swaps and hedge fund oversight.

Meanwhile, advisors who might be facing questions from investors about their potential exposure to the Madoff firm can take several steps to ensure that they have acted reasonably to protect their portfolios, says Michael Sonnenfeldt, founder and chairman of Tiger 21, an investment club for high-net-worth individuals. He says that advisors shouldn't be afraid to put their clients through the same rigors of a Tiger 21 portfolio defense. Every year, each member meets with a subgroup of members to present a portfolio defense; complete with income statements, balance sheets and points about their investment philosophies. Although some Tiger 21 members did invest with Madoff, none of them lost more than 10% or 20% of the value of their assets, says Sonnenfeldt. In contrast, some investors outside Tiger 21 reportedly were wiped out completely.