Commentary: In Madoff's Wake, Client Custody Rule to Get a Makeover

By Scott M. Dubowsky; The Nelson Law Firm, LLC

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My wife and I recently had dinner with friends who lost money in the Madoff scandal. Since I generally like to stir up trouble, I asked whether they would ever invest in a hedge fund again. I was fishing for an "Are you kidding me?" sort of heated response to add some life to our dinner conversation. But that didn't happen.

Instead, our friends said nonchalantly that they were sticking with their hedge funds and considering some new funds. Their financial adviser told them that in the wake of Madoff and other high profile investigations, hedge funds were now safer than ever. This adviser was evidently some sort of a financial Svengali. He had used the trite but seemingly popular "flying on a plane is safer after a crash" analogy to convince our friends to stay the course. Well, to each his own.

I suspect that my friends are not alone in thinking that all of this Ponzi scheme hooplah now makes it difficult for the fraudsters to go undetected. Surely no criminal would be brazen enough to steal from the investing public while the harsh light of justice is focused squarely on our financial markets!

I am not convinced. But to be fair to my friends, recent media coverage supports their confidence. In fact, in a speech by SEC Commissioner Mary Schapiro in mid-May, the SEC announced that it has brought nearly two dozen enforcement actions involving alleged Ponzi schemes since the beginning of the year, in many cases, "halting the fraud and seeking the return of money for investors." That sounds fairly impressive, but I don't think it tells the whole story. These enforcement actions are more a symptom of the problems that plague our financial markets than the cure for these problems.

One area of particular concern for the SEC is the substantial number of enforcement actions alleging misappropriation of client assets—simple theft. To address this concern, the SEC has proposed amending Rule 206(4)-2 of the Investment Advisers Act of 1940, which regulates the custody practices of registered investment advisers. The SEC believes that the proposed amendments will provide additional safeguards. Unfortunately, these amendments may do little more than provide false hope.

The SEC's proposed amendments would, among other things, require all registered investment advisers that have custody of client funds or securities to undergo an annual surprise examination by an independent public accountant to verify client funds and securities. In addition, unless client accounts are maintained by an independent qualified custodian (i.e., a custodian other than the adviser or a related person), the adviser or related person must obtain a written report from an independent public accountant that includes an opinion regarding the qualified custodian's controls relating to custody of client assets.

In large part, the proposed "new" rule is identical to the rule that was in place prior to 2003. In 2003, the SEC amended the custody rule to eliminate the annual surprise examination for advisers that had a reasonable belief that ''qualified custodians'' provide account statements directly to clients. At that time, the SEC believed that direct delivery of account statements by qualified custodians would provide clients confidence that any unauthorized transactions would be reflected and, as a result, would be sufficient to deter advisers from fraudulent activities.

In reinstating this rule, the SEC says that it now believes that a surprise examination by an independent public accountant would provide ''another set of eyes'' on client assets, and thus additional protection against their misuse. In addition, the independent public accountant could uncover fraud that clients have not discovered on their own, which could result in the earlier detection of fraudulent activities. So far so good, and another set of eyes can't hurt.

But it's a mistake to think that this walk down memory lane is going to be effective to prevent Madoff-style fraud. From published reports of the Madoff investigation, it is apparent that Madoff's fraud began long before 2003, and the pre-2003 rule was ineffective to prevent his theft of client funds. It was ineffective because, for most of the years he was stealing from his clients, Madoff was not a registered investment adviser and it seems that neither FINRA nor the SEC was even aware that he was managing client accounts. Similarly, the new rule, applying only to registered investment advisers, would do nothing to stop an unregistered hedge fund managed by Madoff today.

As long as billions upon billions of investor dollars are in the hands of unregistered hedge fund advisers, rules that apply only to registered advisers will be, at best, inadequate. The financial crisis has exposed not only Madoff and his ilk, but also the enormous systemic risk to the entire global economy presented by huge, unregulated pools of capital. However, the courts have tied the SEC's hands when it comes to monitoring these "dark" funds; now the only hope for truly effective investor protection is Congressional action to create broader regulatory authority over all investment advisers.

Some folks at the SEC appear to agree. Last month, SEC Commissioner Kathleen Casey, in a speech concerning the revisions to the custody rules, noted that "to the degree that flaws in custodial practices or the custody rule itself are not at the heart of the matter, we must be confident that these proposals do more than give false assurances against similar frauds . . ." Commissioner Casey went on to note that ". . . I agree with those who think that what we most need is a wholesale re-evaluation of our approach to investment advisory and broker-dealer oversight and conduct. . . . [I]t does give me pause to engage in rulemaking related to one component of the Advisers Act when there are much broader issues for us to consider."

There seems to be an endless and energetic supply of fraudsters, and as long as we continue to tolerate gigantic gaps in regulatory authority, fraud will continue to flourish. Our regulatory framework has failed to keep pace with the growth of hedge funds, the massive size of some of our financial institutions, and the ever-increasing complexity of derivative financial instruments, a situation that has brought the world economy to the brink of ruin. Looking for salvation from a custody rule that was promulgated in 1962 clearly is not the best path forward and only provides false hope to those who rely on our laws to protect them.

Scott M. Dubowsky is a principal of The Nelson Law Firm in White Plains, N.Y. He can be reached at smdubowsky@nelsonlf.com.