

LESSONS LEARNED FROM BERNARD MADOFF: Why We Should Partially Privatize the Barney Fifes at the SEC

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TABLE OF CONTENTS

I.	INTRODUCTION.....	2
II.	BACKGROUND: THE LARGEST PONZI SCHEME IN HISTORY	3
	A. <i>The Chronology of Public Revelations About Madoff</i>	3
	B. <i>The Chronology of the SEC's Internal Investigations</i>	5
III.	FINDINGS OF INCOMPETENCE IN THE MADOFF EXAMINATIONS	6
	A. <i>The 1992 Opportunity to Stop the Scam</i>	6
	B. <i>SEC Examinations and Non-Examinations from 2001 to 2008</i>	11
	C. <i>A Digression on Options and Madoff's Claimed Hedge Strategy</i>	22
IV.	THE ROLE OF AUDITORS AND MADOFF'S AUDITOR.....	27
	A. <i>The Auditing Function in Capital Markets</i>	27
	B. <i>Madoff's Auditor David Friehling</i>	33
V.	OTHER FINANCIAL SCANDALS OF THE LAST DECADE	37
VI.	SECONDARY LIABILITY TO PROMOTE A CULTURE OF INTEGRITY	42
VII.	A CALL FOR MORE FINANCIAL LITERACY IN LEGAL EDUCATION.....	47
VIII.	CONCLUSION	51

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I. INTRODUCTION

Everyone with a little knowledge of contemporary American culture is familiar with the caricature of Barney Fife, the deputy sheriff of Mayberry, North Carolina.¹ Deputy Fife is a well-meaning public servant with good intentions, but is also a bumbling fool who frequently creates problems where none exist and turns minor problems into major catastrophes that must be resolved by others.² Analysis of multiple U.S. Securities and Exchange Commission (SEC or Commission) investigations of Bernard Madoff beginning in 1992 indicates that the Barney Fife caricature aptly portrays the personnel in the SEC's Office of Compliance Inspections and Examinations. If my characterization of SEC staff as deputy Fifes seems unduly harsh, please reserve judgment until reading all of the facts of the Madoff investigations.

This alarming revelation of incompetent examinations should lead to two conclusions. First, the SEC is simply not capable of providing adequate protection for the integrity of our public financial markets without assistance from private attorneys general. In other words, securities laws must be amended to make it easier for private plaintiffs to recover from culpable parties to fraud in contrast with the increasingly constrictive approach the U.S. Supreme Court has taken.³ The second conclusion to be drawn from the record is that it is vital for law schools to provide more in the way of basic education about the functioning of financial markets because law schools provide the pool of talent from which most of the staff of financial regulatory agencies are drawn.⁴ Even if the attorneys who control the investigations at the SEC are not likely to become intimately familiar with the details of option markets, they should at least understand when they need to consult with experts and rely on expert advice rather than allow a con-artist, like Madoff, to intimidate them with non-responsive answers to questions about suspicious activity.

1. Wikipedia, Barney Fife, http://en.wikipedia.org/wiki/Barney_Fife (last visited Sept. 3, 2010).

2. *See id.* (describing Barney Fife as a comically inept character).

3. *See generally* Mark Klock, *What Will It Take to Label Participation in a Deceptive Scheme to Defraud Buyers of Securities a Violation of Section 10(b)? The Disastrous Result and Reasoning of Stoneridge*, 58 U. KAN. L. REV. 309, 339–47 (2010) [hereinafter Klock, *Participation in a Deceptive Scheme*] (explaining the need for secondary liability to promote ethical behavior in financial market transactions).

4. *See, e.g.*, José Gabilondo, *Financial Moral Panic! Sarbanes-Oxley, Financier Folk Devils, and Off-Balance-Sheet Arrangements*, 36 SETON HALL L. REV. 781, 850 (2006) (“I call on my transactional law colleagues to foster more integration of analytical financial methods into a basic legal education. Such an approach might produce more transactional lawyers capable of spotting and stemming future financial moral panics.”).

I will build the case for my thesis by first providing a brief overview of Madoff's criminal activity and then describe what is publicly known about multiple SEC investigations of Bernard L. Madoff Investment Securities, LLC (BMIS) that were all closed without action, and I will further explain why the SEC should have known Madoff's Ponzi scheme was afloat years earlier.⁵ After establishing that the SEC staff did not competently handle their investigations, I will review the argument for expanding private litigant access to the courts for redress against secondary participants in financial market fraud.⁶ I will also discuss the effects of private enforcement on market integrity in the context of Ponzi schemes. Finally, I will develop the conclusion that law schools should provide a better education about the functioning of financial markets and that government attorneys should be more open to the involvement of financial experts in making decisions and less engaged in turf protection.

II. BACKGROUND: THE LARGEST PONZI SCHEME IN HISTORY

A. *The Chronology of Public Revelations About Madoff*

Over the course of more than two decades, Bernard Madoff conducted a massive Ponzi scheme which went undetected by federal regulators notwithstanding numerous tips and facts that were irreconcilable with honest business practices.⁷ Estimates of the amount of money stolen from investors have reached sixty-five *billion* dollars.⁸ On December 10, 2008, Madoff admitted to employees of BMIS that he had been running a Ponzi scheme through his investment advisory business and that BMIS had

5. A Ponzi scheme is a fraud in which investors are promised a high rate of return. The investors are paid back with new funds deposited by an increasing number of new investors. *See* MITCHELL ZUCKOFF, *PONZI'S SCHEME: THE TRUE STORY OF A FINANCIAL LEGEND* 313 (2005) (quoting Ponzi explaining how his business worked). Charles Ponzi became infamous for running this scheme on a massive scale during 1919–1920. *See id.* at 187 (describing the scale of cash coming into Ponzi's operation). After his death, the term Ponzi scheme became a commonly used label for such investment scams. *Id.* at 314.

6. *See generally* Klock, *Participation in a Deceptive Scheme*, *supra* note 3, at 339–47 (arguing that economic theory justifies expanding secondary liability as a method of mitigating information problems that inherently damage financial markets).

7. *See* Grant McCool & Martha Graybow, *Madoff Pleads Guilty, Is Jailed for \$65 Billion Fraud*, *REUTERS NEWSWIRE*, Mar. 13, 2009, available at <http://www.reuters.com/article/idUSTRE52A5JK20090313> (stating that prosecutors said the scheme lasted over twenty years).

8. *Id.* (“[P]rosecutors have said it amounted to as much as \$65 billion over 20 years and involved more than 4,800 client accounts.”).

liabilities of about fifty billion dollars.⁹ Federal officials arrested Madoff on a single count of securities fraud on December 11, 2008.¹⁰ On March 10, 2009, Madoff was charged with eleven counts including securities fraud, investment adviser fraud, wire and mail fraud, money laundering, making false statements, perjury, filing false documents with the SEC, and theft from employee benefit funds.¹¹ Two days later, Madoff appeared in Federal District Court for the Southern District of New York and pled guilty to all counts.¹² On June 29, 2009, Madoff was sentenced to one hundred and fifty years in federal prison for his crimes.¹³

As the case against Madoff developed, questions about how such a large scam could have gone on so long without detection naturally arose.¹⁴ Then SEC Chairman Christopher Cox made a written statement on December 16, 2008 expressing concern that the agency failed to aggressively pursue credible tips about fraud by Madoff and asked the SEC's Inspector General to conduct an investigation into the SEC's handling of complaints about Madoff.¹⁵ On January 5, 2009, Congressional leaders called on the SEC to accelerate its internal investigation.¹⁶ On January 27, 2009, the Senate Banking Committee questioned top officials at the SEC about the agency's botched handling of BMIS.¹⁷ Members of Congress were quoted in the

9. *Bernard Madoff Timeline: Seven Months from Confession to Guilty Plea to Sentencing*, TELEGRAPH.CO.UK, June 29, 2009, available at <http://www.telegraph.co.uk/finance/financetopics/bernard-madoff/5650615/Bernard-Madoff-timeline-seven-months-from-confession-to-guilty-plea-to-sentencing.html>.

10. *Id.*

11. Criminal Information, United States v. Madoff, No. 09-cr-00213 (S.D.N.Y. Mar. 10, 2009), available at <http://www.justice.gov/usao/nys/madoff/20090310criminalinfo.pdf>.

12. Diana B. Henriques & Jack Healy, *Madoff Jailed After Pleading Guilty to Fraud*, N.Y. TIMES, Mar. 13, 2009, at A1.

13. Diana B. Henriques, *Madoff, Apologizing, Is Given 150 Years*, N.Y. TIMES, June 30, 2009, at A1.

14. See Binyamin Appelbaum & David S. Hilzenrath, *SEC Didn't Act on Madoff Tips: Regulator Was Warned About Possible Fraud as Early as 1999*, WASH. POST, Dec. 16, 2008, at D1 (stating that the Madoff scam "rais[es] questions about the agency's ability to police the financial marketplace").

15. Press Release, Christopher Cox, Chairman, U.S. Sec. & Exch. Comm'n, Statement Regarding Madoff Investigation (Dec. 16, 2008), available at <http://www.sec.gov/news/press/2008/2008-297.htm>.

16. See Jesse Westbrook & David Scheer, *Congress Demands SEC Speed Madoff Inquiry to Improve Oversight*, BLOOMBERG, Jan. 5, 2009, available at http://www.bloomberg.com/apps/news?pid=20601103&sid=aRUImQ8ix_IU&refer=us ("U.S. lawmakers . . . demanded the agency speed up an internal investigation of its missteps to help in their overhaul of market regulations.").

17. See Donna Block, *Regulators Grilled over Madoff*, DAILY DEAL, Jan. 28, 2009 ("The Senate Banking Committee wanted answers from regulators Tuesday, Jan. 27, as to why, for decades, no one managed to uncover Bernard Madoff's alleged \$50 billion Ponzi scheme.

press making statements to the effect that the SEC should be cut back or eliminated because it apparently could not do its job properly. One Congressman was quoted as stating, “Who is responsible for protecting the securities investor, because I want to tell that person that they suck at it This is a spike in the heart of the investment community that makes America run.”¹⁸ The agency endured fervent pressure to investigate itself and reveal the findings publicly.¹⁹

B. *The Chronology of the SEC’s Internal Investigations*

The SEC, on June 25, 2009, retained the services of FTI Consulting, Inc. to provide an external review and analysis of the SEC’s Office of Compliance Inspections and Examinations (OCIE) regarding the adequacy of their examinations of Madoff and his firm, BMIS.²⁰ On August 31, 2009, the SEC Office of the Inspector General (OIG) released its report on its own internal “Investigation of Failure of the SEC to Uncover Bernard Madoff’s Ponzi Scheme.”²¹ This report essentially concluded that there were no inappropriate relationships between Madoff and the SEC (no criminal conduct by the staff), but that in spite of ample information brought to the Commission over the years, and three examinations and two investigations of Madoff and his firm, a “thorough and competent investigation or examination was never performed.”²²

FTI Consulting, Inc. assembled a team of experts which reviewed the OIG report, supporting documentation, testimony, exhibits, and documentation of all OCIE policies and procedures, and work product from OCIE examinations of Madoff.²³ The engagement team also interviewed

Lawmakers questioned the enforcement director of the Securities and Exchange Commission and another SEC official . . .”).

18. Westbrook & Scheer, *supra* note 16 (quoting Congressman Gary Ackerman).

19. Reuters, *Regulators Defend Madoff Oversight*, N.Y.TIMES.COM, Jan. 27, 2009, available at http://www.nytimes.com/2009/01/28/business/28madoff.html?_r=1 (“The banking committee pressed top enforcement officials on how and why they failed to uncover Mr. Madoff’s alleged \$50 billion fraud.”).

20. FTI CONSULTING, REVIEW AND ANALYSIS OF OCIE EXAMINATIONS OF BERNARD L. MADOFF INVESTMENT SECURITIES, LLC, Report No. 468, at 1 (U.S. Sec. & Exch. Comm’n, Office of Inspector Gen., Sept. 29, 2009), available at <http://www.sec-oig.gov/Reports/AuditsInspections/2009/468.pdf> [hereinafter FTI, REVIEW OF OCIE EXAMINATIONS].

21. U.S. SEC. & EXCH. COMM’N, OFFICE OF INVESTIGATIONS, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF’S PONZI SCHEME, Report No. 509, at 1 (Aug. 31, 2009), available at www.sec.gov/news/studies/2009/oig-509.pdf [hereinafter OIG, INVESTIGATION OF MADOFF].

22. *Id.* at 20–21.

23. FTI, REVIEW OF OCIE EXAMINATIONS, *supra* note 20, at ii.

more than a dozen key OCIE managers and staff.²⁴ From this information, FTI Consulting, Inc. produced Report No. 468 on September 29, 2009, which summarized its findings and provided seventeen specific detailed findings and thirty-seven recommendations for changes in the conduct of OCIE examinations.²⁵ The OIG then gave the recommendations to OCIE management and OCIE management was given an opportunity to respond.²⁶ The OCIE management response concurred with all thirty-seven of the recommendations, but expressed concern that two of the recommendations would require additional resources.²⁷ The OIG expressed satisfaction that OCIE management concurred with the recommendations and wrote:

We believe that these recommendations would simply ensure a basic level of competence in OCIE examinations and can be fully implemented in short order. While we understand that OCIE believes that two of the 37 recommendations may require additional resources, we expect OCIE to immediately implement a substantial portion of the two recommendations and seek additional resources to assist in full compliance.²⁸

The next section will describe the most significant failures in examination policies the FTI engagement team and the OIG documented.

III. FINDINGS OF INCOMPETENCE IN THE MADOFF EXAMINATIONS

A. *The 1992 Opportunity to Stop the Scam*

The first SEC investigation that should have triggered immediate action against Madoff occurred in 1992.²⁹ Over more than a decade during the 1980s and into 1992, two Florida accountants, Frank J. Avellino and Michael S. Bienes of Fort Lauderdale, sold \$440 million in unregistered securities to public investors in violation of the Securities Act.³⁰ The

24. *Id.*

25. *See id.* at vi–viii.

26. *Id.* at 51.

27. *Id.* at 64.

28. *Id.*

29. *See* OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 61 (“[A]ssuming that Bernard Madoff was running his Ponzi scheme in 1992, the SEC missed an excellent opportunity to uncover this scheme by not undertaking a more thorough and comprehensive investigation.” (internal footnote omitted containing facts suggesting that Madoff’s Ponzi scheme was running in 1992)).

30. *See* Randall Smith, *Wall Street Mystery Features a Big Board Rival*, WALL ST. J., Dec. 16, 1992, at C1 (“The Securities and Exchange Commission recently cracked down on one of

accountants had promised the investors, in writing, guaranteed riskless returns between 13.5% and 20%.³¹ The accountants were vague about how the funds were used, telling customers that their money was turned over to be managed by an unnamed broker that eventually turned out to be Madoff.³²

Anyone who has taken a course in finance understands that the first and most basic principle of financial markets is that average returns can only be increased by taking on risk.³³ If this were not true, then arbitrage opportunities would exist.³⁴ Arbitrage is accomplished by borrowing money at a low rate and making a riskless investment at a higher rate.³⁵ The proceeds from the investment are then used to repay the loan with the surplus pocketed by the arbitrageur. The arbitrageur essentially is collecting money without using any of his own capital, thus creating his or her own free money tree.³⁶ Economic theory and common sense suggest that such a money tree would be quickly stripped of all cash and that any arbitrage opportunities that might exist temporarily will be quickly eliminated by investors happy to harvest the free cash.³⁷ The idea that such arbitrage could continuously persist for more than a decade is complete nonsense.³⁸

Tipsters reported Avellino & Bienes to the SEC which took action against them in 1992.³⁹ The SEC shut down the operation and fined the two

the largest-ever sales of unregistered securities. Investors had poured \$440 million into investment pools raised by two Florida accountants, who for more than a decade took in money without telling the SEC . . .”).

31. *Id.*

32. *Id.*

33. See BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* 220–21 (1999) (“As every reader should know by now, risk has its rewards Thus, to get a higher average long-run rate of return in a portfolio, you need to increase the risk level of the portfolio . . .”).

34. See IVO WELCH, *CORPORATE FINANCE: AN INTRODUCTION* 362 (2009) (comparing the lack of arbitrage opportunities with the idea that money does not grow on trees).

35. See generally *id.* at 360–63 (defining and explaining arbitrage).

36. Cf. Michael S. Knoll, *The Ancient Roots of Modern Financial Innovation: The Early History of Regulatory Arbitrage*, 87 OR. L. REV. 93, 99 n.25 (2008) (giving a numerical example of a hypothetical arbitrage in which an investor pockets money without making an investment).

37. See WELCH, *supra* note 34, at 362 (“True arbitrage opportunities are difficult or outright impossible to find in the real world, especially in very competitive financial markets.”).

38. See Burton G. Malkiel, *Searching for Rational Investors: Explaining the Lowenstein Paradox*, 30 J. CORP. L. 567, 570 (2005) (“[A]n analysis of the returns earned by professional investors provides the most convincing evidence that unexploited *ex ante* opportunities to earn excess returns do not exist and that markets are generally quite efficient.”). Earlier in the paper Professor Malkiel defines an efficient market as one without any “discernible arbitrage opportunities.” *Id.* at 568.

39. OIG, *INVESTIGATION OF MADOFF*, *supra* note 21, at 42.

men and their company.⁴⁰ The fines were a paltry fifty thousand dollars per man and two hundred and fifty thousand for the business.⁴¹ On investigation, Avellino and Bienes told the SEC that the secret to their success was that they turned their money over to Madoff to invest for them.⁴² At the time, Madoff was known for his brokerage business and innovations in executing orders at lower costs than other brokerage businesses.⁴³ However, Madoff was not known as a money manager.⁴⁴ It is important to understand the distinction between a money manager and a broker and the conventional methods for compensation because Madoff's claims about his fee structure were very suspicious.⁴⁵

Brokers execute trades for customers by taking a buy order and finding a willing seller, or taking a sell order and finding a willing buyer.⁴⁶ In performing this function the broker earns a commission fee.⁴⁷ In acting as a broker, the broker never takes ownership of the security.⁴⁸ This can be confusing because a broker can also be a dealer.⁴⁹ A dealer maintains an inventory of cash and securities and provides publicly displayed firm quotes at which he is willing to buy or sell up to a given quantity.⁵⁰ Dealers make profits on the spread—the difference in the prices they quote for buying and selling.⁵¹ The bid price is what the dealer will pay, which is always less than

40. *Id.* at 58–59.

41. *Id.* at 59.

42. *Id.* at 46.

43. *See id.* at 50 (describing Madoff as a pioneer and innovator in developing automated third market trading and taking market share away from the exchanges).

44. *See* Smith, *supra* note 30 (“Bernard L. Madoff . . . until now not known as an ace money manager.”).

45. *See* OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 28 (“Madoff’s fee structure was suspicious because Madoff was foregoing the significant management and performance fees typically charged by asset managers.”).

46. *Cf.* GORDON J. ALEXANDER ET AL., FUNDAMENTALS OF INVESTMENTS 17 (James C. Boyd et al. eds., 3d ed. 2001) (“A broker acts as an agent for an investor . . .”).

47. *Id.*

48. *See* ZVI BODIE ET AL., ESSENTIALS OF INVESTMENTS 74 (Stephen M. Patterson ed., McGraw-Hill/Irwin 5th ed. 2004) (explaining that the role of a broker is simply to execute orders).

49. *See* Mark Klock, *The SEC’s New Regulation ATS: Placing the Myth of Market Fragmentation Ahead of Economic Theory and Evidence*, 51 FLA. L. REV. 753, 757 (1999) [hereinafter Klock, *Regulation ATS*] (giving the example of New York Stock Exchange specialists who sometimes act as brokers and sometimes act as dealers).

50. *See* John L. Watson, III, *Market Makers: The Hallmark of the Nasdaq Market*, in THE NASDAQ HANDBOOK 223, 224 (Douglas F. Parillo et al. eds., 1992).

51. *See* WILLIAM F. SHARPE ET AL., INVESTMENTS 72 (Paul Donnelly et al. eds., 6th ed. 1999) (“[T]he [bid-ask] spread is the dealer’s compensation for providing investors with liquidity.”).

the ask price that the dealer is willing to sell at.⁵² A broker can take an order from a customer and fill it from his own inventory, essentially acting as both a broker and a dealer, earning both a commission fee for brokering and additional compensation on the spread as the dealer.⁵³ The broker has a legal obligation to obtain the best available price for his customer.⁵⁴ Courts have interpreted this duty as fulfilled if the broker executes the order at the best publicly displayed quote.⁵⁵ For a broker-dealer to fill a customer's order from his own inventory without violating his duties to the customer, he must match the best publicly displayed quote.⁵⁶

By contrast, money managers charge customers an annual fee based on a percentage of the value of the assets under management.⁵⁷ A typical management fee might be two percent. This percentage, however, is variable and customers should always check this figure.⁵⁸ The money manager is also entitled to recover costs in addition to the fee, but the costs are typically capped.⁵⁹ These might also be capped at a maximum of two percent, although this figure also varies.⁶⁰ A passively managed index fund will have lower costs.⁶¹ One of the suspicious facts surrounding the Avellino, Bienes, and Madoff story is that Madoff claimed not to be

52. See *id.* (“The stock will be purchased typically at the dealers’ asked price and sold at the bid price, which is lower.”).

53. See Klock, *Regulation ATS*, *supra* note 49, at 766–67 (describing industry practice of large brokers crossing customer orders internally at different prices to increase profits).

54. Jonathan R. Macey & Maureen O’Hara, *The Law and Economics of Best Execution*, 6 J. FIN. INTERMEDIATION 188, 191 (1997).

55. See *In re Merrill Lynch Sec. Litig.*, 911 F. Supp. 754, 773–74 (D.N.J. 1995). While the summary judgment granted in this case was reversed on appeal, the appellate court simply stated that there was a material dispute of facts as to whether the additional costs and delay from searching for a better quote would offset any potential gain. See *id.*; see also *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 272 (3d Cir. 1998).

56. See *Merrill Lynch*, 911 F. Supp. at 773–74.

57. See FREDERIC S. MISHKIN & STANLEY G. EAKINS, *FINANCIAL MARKETS & INSTITUTIONS* 549 (6th ed. 2009) (describing the fees applied by managed funds).

58. See generally MALKIEL, *supra* note 33, at 398–401 (providing a primer on mutual fund costs).

59. See MISHKIN & EAKINS, *supra* note 57, at 550 (“Investors should very carefully evaluate a mutual fund’s fee structure before investing, since these fees can range from 0.25% to as much as 8% per year. No research supports the argument that investors get better returns by investing in funds that charge higher fees.”).

60. See MALKIEL, *supra* note 33, at 399 (describing the range of operating expense charges by funds).

61. See MISHKIN & EAKINS, *supra* note 57, at 549 (“Index funds do not require managers to choose securities. As a result, these funds tend to have far lower fees than other actively managed funds.”).

charging any fees for asset management.⁶² Madoff claimed to be earning compensation solely off of commissions.⁶³

The SEC approached Madoff about returning the money Avellino & Bienes had given him on behalf of their investors.⁶⁴ Normally the conversion of a large position to cash will be carried out over a few days to avoid an adverse price impact, but that did not happen in the case of Avellino & Bienes' golden broker. The very next day Madoff came up with \$440 million.⁶⁵ Perhaps the second most important principle in finance is that more liquid investments yield lower returns on average.⁶⁶ The liquidity of an asset is based on the speed and cost of converting the asset to cash.⁶⁷ Assets that can be converted to cash more quickly at lower cost than other assets are more liquid.⁶⁸ Treasury bills are extremely liquid because there is a deep secondary market that enables one to convert them to cash at low cost in a matter of minutes.⁶⁹ Houses are an example of an illiquid asset because the time and costs associated with finding a buyer for a specific house is high.⁷⁰ Other things equal, investors prefer liquid assets to illiquid assets.⁷¹ Therefore, in the financial markets, investments that are more liquid will necessarily provide a lower average yield.⁷² In other words, investments that yielded high returns with no risk and perfect liquidity (conversion to cash, within a day, at zero execution costs) are doubly suspicious.

In response to Madoff's action, the SEC puffed its chest out like a proud peacock and issued press releases congratulating themselves on getting back

62. See Smith, *supra* note 30 ("Mr. Madoff says he charged the investment pools only what he described as standard brokerage commissions.").

63. *Id.*

64. See OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 53 (reporting New York Enforcement Staff attorney's recollection about approaching Madoff for the return of investors' funds).

65. *Cf. id.* ("[Madoff] was able indeed to liquidate the investments and get the cash available within a very short period of time . . .").

66. See ZVI BODIE ET AL., INVESTMENTS 267 (Michael W. Junior et al. eds., 4th ed. 1999) ("Investors prefer more liquid assets with lower transaction costs, so it should not surprise us to find that all else equal, relatively illiquid assets trade at lower prices or, equivalently, that the expected return on illiquid assets must be higher.").

67. *Id.*

68. *Id.*

69. MISHKIN & EAKINS, *supra* note 57, at 218.

70. See STEPHEN A. ROSS ET AL., CORPORATE FINANCE 335 (7th ed. 2005) (describing single family suburban homes as illiquid assets).

71. See BODIE ET AL., *supra* note 66, at 267.

72. See ROSS ET AL., *supra* note 70, at 335 (explaining that investors require higher returns when investing in assets with low liquidity).

all of the investors' money in the largest disgorgement in history.⁷³ The incredibly unbelievable part of the story is that no one at the SEC asked Madoff where he got the \$440 million.⁷⁴ Apparently, Barney Fife is not the kind of public servant who would realize that if Madoff had taken \$440 million from these two accountants, there might have been other clients who had also given Madoff money. Madoff simply was not asked about it. "[T]he SEC never considered the possibility that Madoff could have taken the money that was used to pay back Avellino & Bienes' customers from other clients as part of a larger Ponzi scheme."⁷⁵

According to the OIG report of its internal investigation:

The SEC actually conducted an examination of Madoff that was triggered by the investigation of Avellino & Bienes, but assembled an inexperienced examination team. The examination team conducted a brief and very limited examination of Madoff, but made no effort to trace where the money that was used to repay . . . investors came from. In addition, although the SEC examiners did review records from DTC [Depository Trust Clearinghouse], they obtained those DTC records from Madoff rather than going to DTC itself to verify if trading occurred. According to the lead SEC examiner, someone should have been aware of the fact that the money used to pay back Avellino & Bienes' customers could have come from other investors, but there was no examination of where the money that was used to pay back the investors came from. Another examiner said such a basic examination of the source of the funds would have been "common sense."⁷⁶

The SEC missed a golden opportunity here in the style of Barney Fife.

B. SEC Examinations and Non-Examinations from 2001 to 2008

In 2001, two articles were published in prominent sources (*Barron's* and *MAR/Hedge*) that provided sufficient detail and raised a number of issues "including Madoff's highly unusual market-timing; his unusually

73. Cf. OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 59 ("Because the Trustee arranged for Avellino & Bienes' customers to be refunded the funds they invested and penalties were assessed against the defendants, the SEC considered the result of the litigation to be a satisfactory one.").

74. See *id.* at 61 ("[N]o investigative actions were taken to determine if the funds that Avellino & Bienes arranged to have repaid were taken from other customers as part of a larger Ponzi scheme engineered by Bernard Madoff.").

75. *Id.* at 26.

76. *Id.*

consistent, non-volatile returns; and his ability to buy and sell securities without affecting the market.”⁷⁷ OCIE should have monitored these publications and initiated a cause investigation in response, but they did not pursue any of the issues raised in the news articles until 2004 after receiving additional complaints.⁷⁸ In response to these findings in 2009, the external examination of OCIE recommended that the SEC provide all examiners with access to relevant industry publications; establishment of protocols “for searching and screening news articles and information from relevant industry sources that may indicate securities law violations at broker-dealers and investment-advisers”; and identification of red flags for initiating cause examinations.⁷⁹

In 2003, the OCIE received a detailed complaint from a highly credible hedge fund manager that should have initiated an immediate cause investigation.⁸⁰ The OCIE, however, did not commence an investigation until more than six months later, and upon commencing the investigation they only examined the issue of front-running.⁸¹ Other red flags in the tip were not investigated, and in fact, it should be noted that the complaint did not raise front-running as an issue.⁸² Examples of issues that were raised, but not considered, were allegations that Madoff’s auditor was a related party, lack of an independent custodian, whether Madoff’s returns were feasible given his purported strategy, Madoff’s fee structure, whether Madoff’s returns should have shown some correlation with the overall market performance, whether there was actually enough market volume taking place to be consistent with Madoff’s claimed trading activity, and why Madoff’s account statements at the end of each month showed only cash holdings.⁸³ This last red flag is a particularly strong signal of suspicious activity. Apparently, Madoff told investigators that he was not required to report investment holdings because he liquidated his

77. FTI, REVIEW OF OCIE EXAMINATIONS, *supra* note 20, at 3.

78. *See id.* at 4 (“[W]e found that OCIE did not conduct sufficient review and follow-up of the two articles raising concerns about Madoff’s operations.”).

79. *Id.* at 4–5.

80. *Id.* at 5.

81. *Id.* at 6. “Front running is an illegal attempt by a broker to insert one trade for the broker’s benefit in front of a large trade order received from the broker’s customer.” *Id.* at 6 n.4.

82. *See* OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 97 (“[T]his [complaint] more or less doesn’t say front-running in it. This . . . says that trades are done, but apparently information in the market didn’t support the fact that those trades were being done. And so that doesn’t necessarily mean front-running at all. . . . It means something else.” (quoting testimony of OCIE Associate Director Gohlke)).

83. FTI, REVIEW OF OCIE EXAMINATIONS, *supra* note 20, at 6 n.5.

investments at the end of each month and held them in cash.⁸⁴ The investigators accepted this explanation without question. Anyone with a rudimentary knowledge of investing would find such a claim to be preposterous beyond belief. The transaction costs and tax consequences of such a strategy would be unacceptable and inconsistent with the purported high returns and low volatility.⁸⁵

The importance of a timely investigation should be obvious as delays in investigating credible evidence of a massive fraud can exacerbate the magnitude of the fraud.⁸⁶ “Delays in starting a cause examination may prolong the effects of any illegal conduct, which may increase the potential harm to investors and capital markets.”⁸⁷ FTI Consulting, Inc. found that OCIE delayed commencement of a cause examination for an unacceptable period of time, thus leading to a FTI recommendation that OCIE establish protocols for determining when to initiate cause examinations, including a reasonable time frame for investigation, as well as a monitoring procedure indicating when the time has expired for OCIE management.⁸⁸

The SEC received another similar tip in 2004 that resulted in a cause investigation in 2005, but again there was an unacceptably long delay of eight months and the investigation again focused on a much narrower scope than the allegations in the tip.⁸⁹ This time the tip suggested that Madoff’s secrecy should be investigated and his claim that he was obtaining his high returns with low risk by using options was inconsistent with lack of volume and price movement in the options exchange.⁹⁰ However, the investigation again focused on front-running as well as cherry-picking.⁹¹ Cherry-picking is the illegal practice of allocating less profitable trades to certain accounts

84. See OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 80 (“[A]ccounts are typically in cash at month end.”).

85. See, e.g., Allison L. Evans, *Portfolio Manager Ownership and Mutual Fund Performance*, 37 FIN. MGMT. 513, 521 (2008). Professor Evans explains:

Low turnover helps minimize selling expenses (brokerage and transaction costs) and potentially a fund’s tax burden, since fewer sales may decrease the capital gains or losses a fund would trigger. In fact, after avoiding net taxable gains altogether . . . [a major investment research firm] lists low turnover as the next-best way for managers to minimize the potential tax burden on mutual fund distributions.

Id.

86. See FTI, REVIEW OF OCIE EXAMINATIONS, *supra* note 20, at 5.

87. *Id.*

88. *Id.*

89. *Id.* at 7–8.

90. See *id.* at 8 (“The 2004 Complaint also raised additional concerns about Madoff’s representations concerning his options trading and his secrecy.”).

91. *Id.*

and more profitable trades to favored accounts.⁹² The investigators did not come up with evidence of front-running or cherry-picking, but they did not examine other issues raised in a responsible manner.⁹³ According to one independent analyst, SEC staff were told by Madoff that the option volume did not show his activity because he did all of his option trading off exchange and offshore.⁹⁴ Again, it is incredible and beyond belief that such an answer would be accepted and close off further investigation.

Another embarrassment for the Commission was revealed when it was discovered that two different offices of the SEC were investigating Madoff for the same allegations.⁹⁵ The 2004 OCIE cause examination was duplicated by a 2005 NERO (Northeast Regional Office) cause examination because the OCIE did not enter their investigation of Madoff into an SEC database.⁹⁶ The NERO investigation learned of the duplication directly from Madoff, creating an embarrassment.⁹⁷ Even more embarrassing is the fact that once the two teams became aware of the common effort their exchange of information and documents was entirely inadequate.⁹⁸ The exchange of information did not communicate open and unresolved issues or conclusions that would have led to further investigation.⁹⁹

An additional problem with the investigation was the lack of experience and expertise among the investigation team for conducting examinations to verify account balances and purported returns.¹⁰⁰ Furthermore, according to the external review and analysis of the Madoff examinations:

92. *Id.* at 8 n.6.

93. See OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 32–33 (“To the extent that the . . . examiners did examine issues outside of front-running, they conducted their examination by simply asking Madoff about their concerns and accepting his answers. . . . [E]xaminers explained it was not their practice to seek information from third parties when they conducted examinations.”).

94. See *id.* at 192 (“Madoff told examiners that he executed his trades in London after hours.”); *id.* at 285 (“[T]he Enforcement staff was not suspicious of Madoff’s claim to have had billions of dollars invested in undocumented . . . options contracts.”); *id.* at 295 (“Madoff’s response listed twelve overseas entities through which BMIS purportedly executed options trades . . .”).

95. See FTI, REVIEW OF OCIE EXAMINATIONS, *supra* note 20, at 14 (“The failure of one office to realize a duplicative examination was being conducted by another office resulted in embarrassment and a waste of Commission resources.”).

96. *Id.*

97. *Id.* The NERO is simply the New York based office of OCIE’s Washington headquarters. OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 145 n.88.

98. See FTI, REVIEW OF OCIE EXAMINATIONS, *supra* note 20, at 14 (“Once the two teams became aware of their common objective, the exchange of documents and information was inadequate.”).

99. *Id.* at 15.

100. *Id.* at 16.

The examination teams also lacked expertise related to effectively identifying signs of fraud. The inconsistent and contradictory explanations of trading strategies that Madoff provided to both examination teams and Madoff's suspicious behavior, which included, agitation, secrecy and anger when certain documents or information was sought during the 2005 NERO Cause Examination, should have been interpreted as indications that he was deliberately misleading staff in order to mask illegal activity.¹⁰¹

The inexperience of the investigation teams and their willingness to accept Madoff's answers without verification challenge the concept of a Commission that protects the integrity of the market.¹⁰² This is even more demonstrable when the answers given by Madoff appear implausible. In the words of the Inspector General:

During the course of both these examinations, the examination teams discovered suspicious information and evidence and caught Madoff in contradictions and inconsistencies. However, they either disregarded these concerns or simply asked Madoff about them. Even when Madoff's answers were seemingly implausible, the SEC examiners accepted them at face value.¹⁰³

One of the very suspicious features of Madoff's operation was the fact that he claimed to be generating high returns with low volatility, but did not charge any management fees.¹⁰⁴ He claimed that his only compensation came solely from brokerage commissions.¹⁰⁵ The advantage to Madoff in making this claim is that if true, he would not need to be registered as an investment adviser.¹⁰⁶ This issue was considered by two SEC investigation

101. *Id.* at 17.

102. *See, e.g.,* Zachary A. Goldfarb, *Staffer at SEC Had Warned of Madoff*, WASH. POST, July 2, 2009, at A1, available at <http://www.washingtonpost.com/wp-dyn/content/article/2009/07/01/AR2009070104223.html> ("The SEC's inability to detect Madoff's fraud was a high-profile embarrassment for the agency, which was already under scrutiny for the collapse of investment banks under its watch, helping fuel the financial crisis.").

103. OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 23.

104. The suspicion about this is exemplified by a passage from an article about Madoff: "[E]xperts ask . . . why Madoff Securities is willing to earn commissions off the trades but not set up a separate asset management division to offer hedge funds directly to investors and keep all the incentive fees for itself . . ." Michael Ocrant, *Madoff Tops Charts; Skeptics Ask How*, MAR/HEDGE, May 2001, at 3.

105. OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 173.

106. Generally, anyone who is doing business as an investment adviser must register with the SEC under the Investment Advisers Act, 15 U.S.C. §§ 80a-1 to -64 (1940).

teams in 2004 and 2005.¹⁰⁷ An important consideration in determining whether Madoff should have been registered as an investment adviser would have been whether Madoff exercised discretionary authority over the accounts.¹⁰⁸ An extremely simple way to reach a determination on this issue would have been for the investigation team to contact Madoff's clients.¹⁰⁹ Unfortunately and inexplicably, neither investigation team contacted any clients. According to the external review and analysis:

Had the examination team contacted BMIS' clients, those funds could have confirmed that BMIS had full discretion over their accounts as well as the implementation of the trading strategy for those accounts. The funds could have also provided additional detail with regard to the trading, clearing and settlement process and who was involved in that process. Finally, each fund contacted could have verified the number of accounts they had with BMIS in order to confirm whether Madoff was accurately reporting the number of accounts for each fund to examination staff. A number of BMIS' clients were SEC-registered investment advisers, which meant that the SEC had authority to request additional information under Section 204 of the Advisers Act.

....

Contacting clients to corroborate statements made by the registrant's representative may be critical to uncovering fraud in a cause examination.¹¹⁰

The 2005 NERO investigation was led by a recent law school graduate who had only joined the Commission nineteen months earlier, had never been the lead examiner on an investigation before, and had little knowledge about broker-dealer issues.¹¹¹ The examination was closed with many open and unsettled questions.¹¹² Only a month later, another tip was received by the SEC claiming that Madoff's hedge fund was a fraud.¹¹³ This investigation carried over into 2006.¹¹⁴ During the investigation,

107. FTI, REVIEW OF OCIE EXAMINATIONS, *supra* note 20, at 19; *see also* OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 266 (stating that the question of whether Madoff should be registered as an investment adviser was the focus of an investigation).

108. FTI, REVIEW OF OCIE EXAMINATIONS, *supra* note 20, at 19.

109. *Id.*

110. *Id.* at 20.

111. OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 36.

112. *See id.* at 35 ("Thus, the NERO cause examination of Madoff was concluded . . . with numerous open questions . . .").

113. *Id.*

114. *See id.* at 37–38 (describing the progress of this investigation from December 2005 through April 2006).

enforcement staff consulted with an expert on options who in a twenty-minute review concluded that Madoff's claimed strategy would not be expected to earn significant excess returns over the market.¹¹⁵ However, the investigators did not communicate this information to SEC management.¹¹⁶

Enforcement staff planned to take testimony from Madoff regarding his option trading in May of 2006.¹¹⁷ In preparation for this testimony, two days before the event, enforcement staff met with officials of the National Association of Securities Dealers (NASD).¹¹⁸ An official of the NASD recalled telling the SEC enforcement staff that they "needed to do a little bit more homework before they were ready to talk to [Madoff]."¹¹⁹ The official recalled thinking that the options strategies were "over their heads" with respect to the SEC enforcement staff.¹²⁰ But the staff refused to delay taking Madoff's testimony until they were better prepared to understand how options worked.¹²¹ "Because of the Enforcement staff's inexperience and lack of understanding of equity and options trading, they did not appreciate that Madoff was unable to provide a logical explanation for his incredibly consistent returns."¹²² If the staff had attempted to make a simple inquiry with a third party to verify Madoff's testimony, they would have discovered that he was not trading anything close to the volume that he claimed.¹²³ One statement claimed 2.5 billion dollars in S&P 100 equities on a particular day being held in one of his funds where Depository Trust Corporation records indicated that only 18 million dollars worth was being held, which is off by a factor of 139.¹²⁴

Madoff agreed to register as an investment adviser in August of 2006.¹²⁵ This agreement sufficiently satisfied the SEC staff so that they closed that investigation.¹²⁶ Again, the comparison with Barney Fife comes to mind as when Barney Fife accepts without verification the new story of someone he has caught fibbing. According to the SEC's Inspector General:

115. *Id.* at 38.

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.* at 39.

123. *Id.* ("A simple inquiry to one of several third parties could have immediately revealed the fact that Madoff was not trading in the volume he was claiming.")

124. *Id.*

125. *Id.* at 349.

126. *See id.* at 41 ("After Madoff was forced to register as an investment adviser, the Enforcement investigation was inactive for 18 months before being officially closed in January 2008.").

We also found that investors who may have been uncertain about whether to invest with Madoff were reassured by the fact that the SEC had investigated and/or examined Madoff, or entities that did business with Madoff, and found no evidence of fraud. Moreover, we found that Madoff proactively informed potential investors that the SEC had examined his operations. When potential investors expressed hesitation about investing with Madoff, he cited the prior SEC examinations to establish credibility and allay suspicions or investor doubts that may have arisen while due diligence was being conducted. *Thus, the fact the SEC had conducted examinations and investigations and did not detect the fraud, lent credibility to Madoff's operations and had the effect of encouraging additional individuals and entities to invest with him.*¹²⁷

In another enumerated finding of the external analysis and evaluation by FTI Consulting, it was revealed that Madoff changed his story to examiners regarding his options strategy in a manner inconsistent with published reports about Madoff activities in *MAR/Hedge* and *Barron's*, and also inconsistent with the tips received.¹²⁸ Apparently examiners were suspicious about Madoff's claims regarding his options strategies, but when Madoff responded to questions about options with a new claim that he did not do that any longer, the issues were dropped.¹²⁹ This should have been an additional piece of evidence suggesting that Madoff was misleading his clients about what his strategy was, which would have been a violation of securities laws.¹³⁰

During this examination Madoff changed other parts of his story multiple times.¹³¹ A memorandum written by OCIE examiners revealed that Madoff told them that he had zero advisory clients, then four advisory clients, then he admitted that the number was "closer to 15."¹³² None of these discrepancies, however, were resolved by the investigation team, and the investigation was closed although many open issues remained.¹³³ The Commission's policy at that time, apparently, was to form examination

127. *Id.* at 25 (emphasis added).

128. FTI, REVIEW OF OCIE EXAMINATIONS, *supra* note 20, at 21.

129. *Id.*

130. *Id.*

131. *See id.* ("In a memorandum examiners . . . described how Madoff had changed his story several times.").

132. *Id.*

133. *Id.* at 35.

teams based on who was available, and if the examiners lacked expertise in certain areas the examination team avoided those areas!¹³⁴

Another fundamental problem with Madoff's stories was that his reported trade and settlement dates were inconsistent with the industry standard practice, and the sequence of trades in the options and cash markets was inconsistent with what investigators' understanding of the strategy indicated they should be.¹³⁵ Questions about the clearing procedures led Madoff to tell the examination team that Barclays Bank PLC "clears for the brokers in London."¹³⁶ The team requested information from Barclays Bank PLC regarding any accounts affiliated with Bernard Madoff and received a response indicating that Madoff had recently opened an account, but had no trading activity.¹³⁷ Barclays' response also "noted that a prime brokerage and trading relationship with a Madoff-affiliated entity exists with our UK affiliate, Barclays Capital Securities Ltd., an FSA-regulated institution."¹³⁸ But the investigation team never followed up their information request with Barclays Capital Securities!¹³⁹ Rather than attempt to understand industry practices in the UK, the investigation team found it more convenient to accept Madoff's admittedly vague verbal explanations.

Very basic problems with the investigations continue endlessly. Several sources of clearing data are maintained on member firms including BMIS. For example, the Options Clearing Corporation maintains trade data for all cleared and settled option trades by its member firms.¹⁴⁰ The National Securities Clearing Corporation and Depository Trust Corporation maintain daily records that show a market participant's positions.¹⁴¹ Also the Financial Industry Regulatory Authority (FINRA), the successor to NASD, collects data through NASDAQ on a daily basis.¹⁴² The investigation team never attempted to collect data from any of these sources to verify trading volume purported by Madoff.¹⁴³ According to the external investigation and

134. See generally OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 89–91 (finding that examination teams consisted solely of attorneys with little experience and no training and were not selected based on expertise).

135. See *id.* at 305 ("Throughout the Enforcement staff's Madoff investigation, the Enforcement staff was confused about certain critical and fundamental aspects of Madoff's operations.").

136. FTI, REVIEW OF OCIE EXAMINATIONS, *supra* note 20, at 22.

137. *Id.*

138. *Id.*

139. *Id.* at 22–23.

140. *Id.* at 25.

141. *Id.*

142. *Id.* at 24–25.

143. See OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 39 (suggesting that "the most egregious failure" of the SEC staff was to not verify trade data).

analysis, “had the OCIE or the NERO examination team conducted a trading volume analysis based on third parties’ data, they would have uncovered a significant red flag that, with further inquiry, would likely have led to discovery of the Ponzi scheme or, at the very least, Madoff’s fictitious trades.”¹⁴⁴ Several of the tips directed the Commission to look at trading volume.¹⁴⁵ Specifically, complaints alleged that the trading volume taking place on the exchange was insufficient to support the level of trading Madoff claimed to be doing and “it was inconceivable [Madoff] could find sufficient counterparties for the quantity of trading necessary to implement the split-strike conversion strategy.”¹⁴⁶

The 2004 examination team was pulled off of the Madoff investigation to work on other priorities and never returned to complete the investigation.¹⁴⁷ One individual was responsible for keeping a spreadsheet of open investigations, but that individual denied responsibility for monitoring open investigations to see whether they were ever completed.¹⁴⁸ This essentially rendered the work done in the 2004 investigation useless. One of the recommendations of the external investigation was that all examination teams write closing reports, identifying both conclusions reached and any substantive open issues discovered.¹⁴⁹ One would think that this would be a standard practice that would not require a major scandal and outside review for it to be imposed, but sadly it was not.

The 2005 investigation was not left open and hanging. It was officially closed even though a number of important issues remained unresolved.¹⁵⁰ The main conclusion of the 2005 investigation was “that Madoff was not front-running his market-making customers in order to benefit his investment advisory clients.”¹⁵¹ However, the team was not able to understand how Madoff made his returns, how his split-strike conversion strategy worked (which was the strategy that he claimed to use to eliminate volatility in returns related to market fluctuations), or to rule out the possibility that Madoff was doing something illegal to achieve his returns.¹⁵² Many significant red flags that prompted the investigation were never resolved even though the team closed the investigation.¹⁵³

144. FTI, REVIEW OF OCIE EXAMINATIONS, *supra* note 20, at 26.

145. *See id.* at 26–27 (summarizing tips received regarding trade volume).

146. *Id.* at 27.

147. OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 125.

148. FTI, REVIEW OF OCIE EXAMINATIONS, *supra* note 20, at 32.

149. *Id.* at 34–35.

150. *Id.* at 35.

151. *Id.*

152. *Id.*

153. *Id.*

In December of 2006, the SEC received a sixth complaint about Madoff claiming that Madoff was commingling clients' funds with his own.¹⁵⁴ According to the Inspector General's report:

In investigating this complaint, the Enforcement staff simply asked Madoff's counsel about it, and accepted the response that Madoff had never managed money for this investor. This turned out to be false. When news of Madoff's Ponzi scheme broke, it became evident not only that Madoff managed this investor's money, but also that he was actually one of Madoff's largest individual investors.

Shortly after the Madoff Enforcement investigation was effectively concluded, the staff attorney on the investigation received the highest performance rating available at the SEC, in part, for her "ability to understand and analyze the complex issues of the Madoff investigation."¹⁵⁵

The SEC received yet another tip in June of 2007, which was ignored.¹⁵⁶ In January of 2008, the SEC officially closed its last open investigation of Madoff.¹⁵⁷ In March of 2008, another tip was received informing the Commission that Madoff was keeping two sets of books.¹⁵⁸ The updated complaint was sent to the enforcement staff who had worked on an earlier Madoff investigation.¹⁵⁹ The complaint was sent back with a note stating, "[W]e will not be pursuing the allegations in it."¹⁶⁰ Had the SEC acted competently on any of these earlier tips, the Ponzi scheme would have been detected before Madoff confessed in December of 2008.¹⁶¹

One of the most shocking revelations to come out in the aftermath of the scandal is the fact that Madoff's audits were bogus and that the SEC did nothing to look into the allegations that the auditor lacked independence, even though several tips for these allegations were received.¹⁶² Tipsters questioned whether it was possible for a firm with a single active

154. OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 40.

155. *Id.* at 41.

156. *Id.*

157. *Id.*

158. *Id.*

159. *Id.*

160. *Id.*

161. *See id.* ("[T]he SEC never properly examined or investigated Madoff's trading and never took the necessary, but basic, steps to determine if Madoff was operating a Ponzi scheme. Had these efforts been made with appropriate follow-up . . . the SEC could have uncovered the Ponzi scheme well before Madoff confessed.").

162. *See* FTI, REVIEW OF OCIE EXAMINATIONS, *supra* note 20, at 37 ("Examinations did not adequately look into the allegations of the auditor's lack of independence or refer such allegations to the appropriate agency.").

accountant to competently audit the large volume of Madoff accounts.¹⁶³ Eventually it was revealed that the auditing firm did not perform meaningful audits of Bernard Madoff Investment Securities, LLC.¹⁶⁴ This will be discussed in more detail in Section IV, *infra*.

C. *A Digression on Options and Madoff's Claimed Hedge Strategy*

There is one more component to the Madoff scandal that needs to be discussed. Whenever Madoff was pressed to explain how he could provide such great returns with such low variability, he would tell investors and regulators that he utilized a split-strike conversion strategy.¹⁶⁵ Understanding how this strategy is supposed to work requires a basic understanding of stock options. I give an abbreviated explanation to aid in understanding Madoff's claimed strategy below.

Options have a finite life.¹⁶⁶ They must be used by their expiration date or they are forfeited.¹⁶⁷ There are two types of options: calls and puts.¹⁶⁸ Call options give the buyer of the option the right to purchase stock at a contracted price called the strike price.¹⁶⁹ Put options give the buyer of the option the right to sell stock at a contracted price also called the strike price.¹⁷⁰ If the market price of a stock is below the strike price of a call option, that option is said to be out-of-the-money because it would not be reasonable to use the option to purchase stock at a higher contracted price than the stock could be purchased for at market.¹⁷¹ In that case, the buyer of

163. See OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 419 (noting that the investment community was concerned about the auditor being small and unknown while Madoff was reportedly managing billions of dollars).

164. See Press Release No. 2009-60, U.S. Sec. & Exch. Comm'n, SEC Charges Madoff Auditors with Fraud (Mar. 18, 2009), available at <http://sec.gov/news/press/2009/2009-60.htm> ("Friedling . . . did not perform a meaningful audit of BMIS . . .").

165. See Criminal Information at 4, United States v. Madoff, No. 09-cr-00213 (S.D.N.Y. Mar. 10, 2009), available at <http://www.justice.gov/usao/nys/madoff/20090310/criminalinfo.pdf> ("MADOFF marketed to clients and prospective clients an investment strategy referred to as a 'split strike conversion' strategy.").

166. See STEPHEN A. ROSS ET AL., CORPORATE FINANCE 612 (6th ed. 2002) ("Options are special contractual arrangements giving the owner the right to buy or sell an asset at a fixed price anytime on or before a given date.").

167. See JOHN C. HULL, FUNDAMENTALS OF FUTURES AND OPTIONS MARKETS 166 (4th ed. 2002) (describing the precise minute of expiration for a stock option).

168. ROBERT A. JARROW & STUART M. TURNBULL, DERIVATIVE SECURITIES 15 (2d ed. 2000).

169. *Id.*

170. *Id.*

171. Mark Klock, *Is It "The Will of the People" or a Broken Arrow? Collective Preferences, Out-of-the-Money Options, Bush v. Gore, and Arguments for Quashing Post-*

the option would simply let the option expire worthless, and the seller of the option would keep the premium that the buyer paid him for writing the option.

If the call option is in-the-money at the time the option expires, then the option is worth exactly the difference in the market price of the stock and the strike price of the option.¹⁷² So, for example, if a call option has a strike price of \$50 and the stock is selling for \$54 on the day the option expires, the option will be worth \$4 at that point in time. In this case, the option plus \$50 in cash can be converted into a share worth \$54; the total value of the two packages must be the same.¹⁷³ So at expiration, the value of a call option is equal to the greater of zero or the stock's market price less the strike price.¹⁷⁴

Put options at expiration have the opposite relationships of calls.¹⁷⁵ That is, a put option expires worthless if the market price of the stock is below the strike price because it would be more lucrative for the buyer of the put to sell the stock at market than to exercise the put to sell the stock at a lower contracted price.¹⁷⁶ Buying a put option on stock that an investor owns is a form of insuring the value of the stock.¹⁷⁷ Suppose an investor owns a stock worth \$50 and buys a put option with a strike price of \$50. If the price of the stock rises the put will expire worthless, but the investor will still have the appreciated stock and thus enjoys the upside of the market. If the price of the stock falls then the investor suffers a loss on the stock, but the investor has an equal size offsetting gain on the option. In this example, if the stock falls in value to \$45, the put would be worth \$5 and the investor would still have a total value of \$50. Therefore, at expiration the value of the put is the greater of zero or the strike price less the stock's market price.¹⁷⁸

Prior to expiration, an option will be even more valuable because losses are truncated and gains are not.¹⁷⁹ So purchasing an out-of-the-money

Balloting Litigation Absent Specific Allegations of Fraud, 57 U. MIAMI L. REV. 1, 5 (2002) [hereinafter Klock, *Out-of-the-Money Options*].

172. *Id.*

173. See WELCH, *supra* note 34, at 987 (explaining the no arbitrage argument for pricing stock options).

174. JARROW & TURNBULL, *supra* note 168, at 16.

175. See WELCH, *supra* note 34, at 981 (“[A] put option is the flip side of a call option.”).

176. See SHARPE ET AL., *supra* note 51, at 610 (explaining that a put option will expire worthless if the stock price is more than the strike price).

177. WELCH, *supra* note 34, at 982.

178. JARROW & TURNBULL, *supra* note 168, at 18.

179. See Klock, *Out-of-the-Money Options*, *supra* note 171, at 5–6 (explaining how truncated losses balanced against unlimited possible gains creates positive value for options).

option before expiration will cost more than zero.¹⁸⁰ Similarly, purchasing an in-the-money option before expiration will cost more than the difference between the strike price and the stock's current market price.¹⁸¹

It should be mentioned that the financial markets have worked out the problems associated with the obvious possibility that the seller of an option could renege on his or her obligation to buy or sell stocks at prices that are above or below market. The Options Clearing Corporation acts as the buyer to the seller and the seller to the buyer so that no one has to worry about the trustworthiness and credit worthiness of his or her counter party.¹⁸² The Options Clearing Corporation does not have to worry about it either. No one is permitted to write an option unless they have an account with sufficient collateral to cover potential losses, and contractually agree to terms that authorize the Options Clearing Corporation to use the collateral to cover losses.¹⁸³

Of course, there is a shortcoming to the insurance strategy. The insurance is costly.¹⁸⁴ To insure the value of the stock the investor must pay a premium for the put option, and as the option expires the investor will need to pay another premium for a new put. The split-strike conversion strategy, also known as a collar, is an attempt to get around the cost of the insurance.¹⁸⁵ In this strategy, an investor with stock buys a put option with a lower strike price and sells a call option with a higher strike price.¹⁸⁶

To give another simple example, suppose the investor owns a stock worth \$50. The investor buys a put option with a strike price of \$45 and sells a call option with a strike price of \$55. The money received for selling a call slightly out-of-the-money will approximately equal the cost of buying a put option slightly out-of-the-money.¹⁸⁷ If the stock falls in value, the downside is limited to \$45 by the protective put option. At the same time, if the stock price rises the investor can enjoy some upside, but the gains are

180. *See id.* at 6 (“[A]n . . . out-of-the-money option . . . with time remaining before expiration still has significant value due to the truncation of losses.”).

181. *See id.* (explaining why the in-the-money option is worth more before expiration).

182. SHARPE ET AL., *supra* note 51, at 603.

183. *See HULL, supra* note 167, at 174–75 (explaining how the Options Clearing Corporation functions).

184. *See JARROW & TURNBULL, supra* note 168, at 15 (“The premium is the price paid for an option. Because each option can be viewed as a type of insurance contract for hedging risks, the terminology is analogous to that used for the price paid to purchase (life) insurance contracts.”).

185. *See GEORGE M. JABBOUR & PHILIP H. BUDWICK, THE OPTION TRADER HANDBOOK* 94 (2004) (explaining that the collar strategy provides insurance at little or no cost).

186. *Id.*

187. *Id.*

capped.¹⁸⁸ This is essentially the strategy that Madoff claimed to use on a basket of S&P 100 companies.¹⁸⁹

The split-strike conversion strategy will reduce the volatility of returns,¹⁹⁰ but it will not generate better than riskless returns at zero risk.¹⁹¹ Empirical research done by two Canadian economists demonstrates this as an empirical fact.¹⁹² Common sense and the intuition underlying the work done by many Nobel Prize winning economists, however, suggests that if anyone could generate greater than riskless returns and no risk there would be an arbitrage opportunity that would necessarily be competed away.¹⁹³ According to one former Madoff investor, “[a]nybody who’s a seasoned hedge-fund investor knows the split-strike conversion is not the whole story. To take it at face value is a bit naïve.”¹⁹⁴ I believe that even less experienced investors and certainly financial regulators should understand this. The examination teams for the SEC should have understood this point well enough to be suspicious of Madoff and investigate more thoroughly. What happened instead was that they did not understand the strategy, did not make the effort to learn about the strategy so that they could understand it, and allowed themselves to be intimidated by a con-artist using terminology they did not comprehend.¹⁹⁵ This is unacceptable.

The SEC’s major blunders surrounding BMIS are summarized as follows:

188. *Id.*

189. See Erin E. Arvedlund, *Don’t Ask, Don’t Tell*, BARRON’S, May 7, 2001, at 26 (quoting from Madoff hedge-fund offering memorandums).

190. *Id.*

191. See OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 38 (quoting an expert as stating that the split-strike conversion strategy “was not a strategy that would be expected to earn significant returns in excess of the market”).

192. Carole Bernard & Phelim Boyle, *Mr. Madoff’s Amazing Returns: An Analysis of the Split-Strike Conversion Strategy*, 17 J. DERIVATIVES 1, 1 (2009), available at <http://ssrn.com/abstract=1371320>.

193. Cf. Stephen A. Ross, *The Interrelations of Finance and Economics: Theoretical Perspectives*, 77 AM. ECON. REV. 29, 32 (1987) (“The intuition underlying the efficient market theories is the intuition of the lack of arbitrage [in a competitive equilibrium].”).

194. Arvedlund, *supra* note 189, at 26 (quoting a former Madoff investor).

195. See David Stout, *Report Details How Madoff’s Web Ensnared S.E.C.*, N.Y. TIMES, Sept. 2, 2009, at B1 (“Unseasoned investigators from the Securities and Exchange Commission were alternately intimidated and enthralled by a name-dropping, yarn-spinning Bernard L. Madoff as he dodged questions about his financial house of cards, according to a scathing new report on the agency’s repeated failure to uncover the huge investment fraud.”). See generally OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 180–82 (describing Madoff’s efforts to intimidate and impress examiners).

- 1) failure to ask Madoff how he could come up with \$440 million of investor funds collected by Avellino & Bienes so quickly when they were invested in riskless high-yield investments;¹⁹⁶
- 2) failure to ask Madoff whether any other clients had turned funds over to him;¹⁹⁷
- 3) failure to verify the registration, independence, and capabilities of the auditing firm;¹⁹⁸
- 4) failure to investigate whether sufficient volume in stock and options markets existed;¹⁹⁹
- 5) failure to investigate Madoff's claim that he converted the positions to cash each month;²⁰⁰ and
- 6) failure to investigate the feasibility of earning the claimed returns with the split-strike conversion strategy.²⁰¹

Many more blunders have been found, but these are the most shocking in that they should have raised suspicion on the part of anyone with a minimal understanding of financial markets. Surely it is not too much to expect that the regulators of financial markets have a minimal understanding of the markets they regulate. Lawyers have strong analytical skills and are fully capable of learning and understanding the basics of financial markets and should be expected to do so if their area of work requires it.²⁰² If they are unwilling to learn, then the investigations should be *conducted, controlled, and managed* by financial economists and accountants.

Lest one think that the incompetence underlying the Madoff investigations and examinations was merely a random set of improbable coincidences that would almost certainly not recur at the agency, it must be reported that the SEC has systematically mishandled tips on fraud received

196. See OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 49 (noting that no effort was made to determine where the money came from).

197. See *id.* (noting that a branch chief during the investigation knew that Madoff absolutely could have taken the funds from other investors).

198. FTI, REVIEW OF OCIE EXAMINATIONS, *supra* note 20, at 37.

199. See OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 39 (suggesting that failure to verify trading was the most egregious failure of the investigators).

200. See FTI, REVIEW OF OCIE EXAMINATIONS, *supra* note 20, at 6 n.5 (noting concern that Madoff's accounts were purportedly held in cash only at the end of the month).

201. See OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 420 (noting that private entities conducting due diligence on Madoff determined that his strategy was not credible).

202. See Mark Klock, *Contrasting the Art of Economic Science with Pseudo-Economic Nonsense: The Distinction Between Reasonable Assumptions and Ridiculous Assumptions*, 37 PEPP. L. REV. 153, 161 (2010) ("Lawyers are trained to hone their critical reasoning."); Mark Klock, *Are Wastefulness and Flamboyance Really Virtues? Use and Abuse of Economic Analysis*, 71 U. CIN. L. REV. 181, 236 (2002) ("As lawyers we are trained . . . to persuasively argue . . . with the available evidence and law.").

from the outside.²⁰³ An executive at Moody's went to the SEC with information that the company "was blessing mortgage-backed investments that it knew were dangerous" and was ignored.²⁰⁴ Allen Stanford's large Ponzi scheme was reported to the SEC by a former vice president of the company and was ignored.²⁰⁵ There is no escape from the conclusion that "the SEC has a haphazard, decentralized system for analyzing outsider information."²⁰⁶

IV. THE ROLE OF AUDITORS AND MADOFF'S AUDITOR

A. *The Auditing Function in Capital Markets*

The BMIS Ponzi scheme highlights the importance of accounting information and auditors in our financial markets. It also underscores the need for at least minimal regulation of auditors. Yet, in this case, all of the rules regulating auditors were broken and went undetected for years.²⁰⁷ Thus, this financial catastrophe also illustrates the ineffectiveness of regulation in the presence of incompetent watchdogs.²⁰⁸ In order to understand the importance of the watchdog function, it is helpful to first review the role of accounting and auditing in complex organizations:

Both financial reporting and auditing . . . predate the federal securities laws. [These practices exist in the absence of government mandate.] The explanation is based on the standard firm model, which treats the firm as a collection of contracts[,] with a salient feature involving the separation of ownership and management. Accountants produce financial reports to create verifiable data that provides shareholders with information about management performance for purposes of compensation and

203. See generally Zachary A. Goldfarb, *At SEC, the System Can Be Deaf to Whistleblowing*, WASH. POST, Jan. 21, 2010, at A1 (describing the SEC's system for treating whistleblowing complaints).

204. *Id.*

205. *Id.* at A17.

206. *Id.*

207. See Thomas Zambito et al., *David Friehling, a CPA for Bernard Madoff, Charged with Securities Fraud, Surrenders to the FBI*, NYDAILYNEWS.COM, Mar. 18, 2009, available at http://www.nydailynews.com/money/2009/03/18/2009-03-18_david_friehling_a_cpa_for_bernard_madoff.html#ixzz0f3WH0qXL ("When mega-thief Bernard Madoff lied, accountant David Friehling swore to it—for 17 years and \$65 billion in swindled funds, authorities said . . .").

208. See, e.g., Stout, *supra* note 195 (describing inexperience, incompetence, and regulatory ineptitude by the market's watchdog).

renegotiation of contracts. The divergent interests and asymmetric information between managers and owners create real economic costs called deadweight losses. Corporate law mitigates these costs by imposing fiduciary duties on the management of the corporation[.] [B]ut economic incentives exist to reduce the costs [more if practical]. The purpose of financial reports is to lower these costs . . . thereby increas[ing] the size of the pie to be divided. The purpose of audits is to verify the honesty and quality of the reports.²⁰⁹

The standard model of the modern corporation is the nexus of contracts model.²¹⁰ In this model, accounting information performs five distinct functions: (1) it measures the input of each participant into the pool of corporate resources; (2) it calculates the contractual property rights of each participant; (3) it informs appropriate participants about the extent to which others have fulfilled their duties and received their entitlements; (4) it facilitates the maintenance of a liquid secondary market for the contracts so that the departure of a single individual does not impair the continuation of the corporation; and (5) because the contracts of participants need to be renewed or renegotiated periodically, it provides a pool of common verified knowledge which facilitates negotiation and contract formation.²¹¹ It is impossible for any system to perform these functions with absolute precision.²¹² The production of useful summary information necessarily involves some distortion which implies the use of some subjective judgment.²¹³ The intrinsic quality problem in auditing is that:

[F]inancial statements are based on estimates, and the essence of all estimates is opinion. Like all estimates and opinions, there is a quality dimension, not merely a quantity dimension, to financial

209. Mark Klock, *Two Possible Answers to the Enron Experience: Will It Be Regulation of Fortune Tellers or Rebirth of Secondary Liability?*, 28 J. CORP. L. 69, 86–87 (2002) [hereinafter Klock, *Fortune Tellers*] (footnotes omitted).

210. See STEPHEN A. ROSS ET AL., *CORPORATE FINANCE* 15 (4th ed. 1996); Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179, 179 (1985); R. H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386, 387–89 (1937); Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 *CORNELL L. REV.* 1266, 1266 (1999). *But see* Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 *TEX. L. REV.* 579, 642 (1992) (criticizing the contractarian model of the corporation); Eric W. Orts, *Shirking and Sharking: A Legal Theory of the Firm*, 16 *YALE L. & POL'Y REV.* 265, 328 (1998) (criticizing models of the firm based solely on markets without ethical considerations).

211. SHYAM SUNDER, *THEORY OF ACCOUNTING AND CONTROL* 20 (1997).

212. See Klock, *Fortune Tellers*, *supra* note 209, at 73.

213. See *id.* at 89 (“The reality is that financial statements are based on estimates, and the essence of all estimates is opinion.”) (footnote omitted).

information that renders the problem more complex. Furthermore, the quality of summarized financial information is costly to ascertain, and hard financial facts cannot be achieved even at infinite costs. The hard facts are simply unobservable.²¹⁴

The role of auditing is to verify and communicate with credibility that the accounting information is a fair characterization of the transactions underlying the contracts.²¹⁵ Fraud occurs when agents attempt to take out more than their contractual entitlement, or deceive others about their performance or input into the corporation.²¹⁶ Audits by independent third parties are used to detect fraud.²¹⁷ The public perceives detection of fraud to be the primary role of auditors.²¹⁸ Accounting information about the corporation is a public good.²¹⁹ It is necessary not only for the participants in the corporation to know that they are being treated fairly, but it is also necessary for potential participants to have the information.²²⁰ In other words, to preserve the liquid and well-functioning secondary market for financial securities, the accounting information must be public and it must be credibly verified by independent third parties.

The importance of credible auditing to the public is seen through the effect of fraud on the economy. Economies with fraud are underdeveloped.²²¹ Fraud makes it difficult to raise capital, which means that the cost of capital is high, capital investments are not made, and there are adverse consequences for employment, national income, tax revenue, and economic growth.²²² Credible auditing deters fraud and promotes confidence in markets, and this lowers the cost of capital, which increases investment, employment, income, and growth.²²³

214. *Id.* (footnotes omitted).

215. *See* SUNDER, *supra* note 211, at 124 (explaining that the primary role of auditors is to detect fraud).

216. *Id.*

217. *See id.* at 114–15 (explaining how auditors economically reduce the information asymmetry between managers and investors).

218. *Id.* at 124.

219. *Id.* at 92.

220. *See id.* at 92–93 (comparing the role of accounting in the capital markets to that of advertising in the product markets, giving away free information to attract new participants to join the firm).

221. *See* Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 783 (2001).

222. Klock, *Participation in a Deceptive Scheme*, *supra* note 3, at 352–53.

223. *Cf.* SUNDER, *supra* note 211, at 90 (“Other things being equal, investors would pay less for the stock of a firm that uses ineffective internal controls, internal audit, outside audit, and disclosure of accounting policies.”).

In a previous article, I emphasized the tenuous nature of the quality of accounting information:

Perhaps the most misunderstood fact pertaining to financial statements, and the most essential element to publicize in [advancing the] regulation of mandatory public disclosure, is that all financial statements represent guesses of varying quality. While reasonable people should understand that . . . earnings forecasts might [well] diverge from what actually happens [without fraud], most people do not understand that even “actual” earnings are a subjective distorted approximation rather than an objective fact. [We] cannot possibly know what our corporations’ business activities have earned in income because [we] cannot know what our corporations incurred in costs. Cost determination requires estimates of the future, and estimates of the future cannot be confirmed in the present.

. . . .

Much of the . . . commentary on auditing seems to adopt the rule that “correct” financial figures exist and . . . we only need to force companies to disclose them. Many prominent attorneys have publicly called for tighter controls on accountants and auditors in order to ensure that another incident like Enron “never happens again.” While obviously a laudable goal, it is an extremely dangerous proposition. Good regulation deters crime, but does not stop the most extreme cases.²²⁴

Quality assurances can be given in a credible manner if there is a minimum level of liability on the auditors.²²⁵ In the words of Professor Black:

Securities or other laws that impose on accountants enough risk of liability to investors if the accountants endorse false or misleading financial statements so that the accountants will resist their clients’ pressure for laxer audits or more favorable disclosure.

Accountants are reputational intermediaries. When they audit and approve financial statements, they also rent out their reputations for conducting a careful audit that can catch some

224. Klock, *Fortune Tellers*, *supra* note 209, at 73 (footnotes omitted).

225. *See id.* at 109 (suggesting that imposing civil liability on auditors for aiding and abetting fraud will improve financial disclosures more than tightening accounting standards).

fraud and discourage attempts at fraud, and for painting a tolerably accurate picture of a company's performance.²²⁶

Auditors must have partial responsibility for the accuracy of their opinions. If they took no responsibility, there would not be any value in hiring them.²²⁷ If they took full responsibility, however, they would be unwilling to be hired.²²⁸ Determining the right level of exposure is difficult, but it is clear that they must have some exposure to liability and some ability to pay for their audits to be valuable.²²⁹ It is too costly to replicate all of the accounting work in a large firm, so auditors conduct random samples of transactions to verify the consistency, conformity, and accuracy of their treatment.²³⁰ If a large sample of transactions detects no fraud, then the auditors can infer with a high level of statistical confidence that the accounting information is valid.²³¹ At the same time, there will be some small probability that the auditors will fail to detect fraud.²³² Risk of liability ensures that the auditors have appropriate incentives to detect fraud, which provides the public with some assurances that undetected fraud is a statistical accident and not intentional.²³³

Thus, there are strong economic reasons for effective auditing firms to be large. One is that only by being large can they have deep enough pockets to convey some credibility.²³⁴ If they have nothing to lose by participating in fraud, then they have no credibility. Another benefit to being large is that they can diversify the risk of statistical error, and liability for statistical

226. Black, *supra* note 221, at 794 (emphasis omitted).

227. See SUNDER, *supra* note 211, at 124 ("Either a complete denial or a complete acceptance of such responsibility [for fraud detection] would quickly put auditors out of business.").

228. *Id.*

229. See *id.* at 115 ("Shareholders protect themselves against manager-auditor collusion by engaging large, reputable audit firms who can provide a degree of insurance through their deep pockets.").

230. See Black, *supra* note 221, at 794 (stating that some liability is required for auditor reputations to be valuable).

231. Cf. SUNDER, *supra* note 211, at 120 (discussing the application of statistical methods in auditing).

232. See, e.g., Evelyn R. Patterson, *Strategic Sample Size Choice in Auditing*, 31 J. ACCT. RES. 272, 283 (1993) (discussing the relationship between sample size and the probability of failing to detect fraud).

233. See Black, *supra* note 221, at 794 (stating that liability risk is necessary to provide some quality assurance in auditing).

234. See SUNDER, *supra* note 211, at 115 (explaining that audit firm size increases audit quality).

anomalies can be spread across a large pool.²³⁵ Additionally, by being large the auditor does not derive a large percentage of its income from a single client and is capable of performing the audit independently.²³⁶ Furthermore, an honest corporation is willing to pay more for the auditing services of a large firm to signal to the public that its reported accounting information is accurate.²³⁷ Finally, it is easier for a large auditing firm to establish a reputation, and reputation is extremely important.²³⁸ In the words of one esteemed accounting professor: “[A]udit services have a special characteristic: their quality cannot be monitored by other agents at the time of delivery. Even after delivery, it is difficult to monitor their quality because the frequency of audit failure is low. Auditors’ reputation becomes all important.”²³⁹

This background information highlights the importance of using a large and reputable auditor to verify the audits of a large financial firm. Financial firms deal in paper, electronic securities, and legal representations of rights to future contingent cash flows.²⁴⁰ The legal ownership of uncertain future cash flows is much more susceptible to fraud than the ownership of physical assets.²⁴¹ Large financial firms especially need credibility to raise capital. The fact that Madoff was not using a large and reputable audit firm should have raised a red flag immediately and caught the scrutiny of the SEC staff.²⁴² This omission of investigation on the part of the SEC is particularly amazing given that they should have some minimal understanding of the industry they regulate.

235. *See id.* at 119 (explaining that an audit firm’s use of computer-based statistical programs across many clients can provide consistency in judgments, which is a useful defense against negligence charges).

236. *See id.* at 127 (“Larger audit firms, receiving only a small fraction of the total revenue from any single client, can be more independent of the client.”).

237. *See, e.g.,* Jagan Krishnan & Paul C. Schauer, *Differences in Quality Among Audit Firms*, 192 J. ACCT. 85, 85 (2001) (finding a positive relationship between audit firm size and audit quality); *cf.* Jere R. Francis & Michael D. Yu, *Big 4 Office Size and Audit Quality*, 84 ACCT. REV. 1521, 1549 (2009) (finding within large accounting firms that auditors working in the larger offices provide higher quality audits).

238. *See* SUNDER, *supra* note 211, at 125 (“Auditors’ reputation becomes all important.”).

239. *Id.*

240. *See* MISHKIN & EAKINS, *supra* note 57, at 4 (defining a financial instrument).

241. *See id.* at 401 (noting that the financial service sector is particularly vulnerable to conflicts of interest and ethical dilemmas).

242. *See* OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 419 (reporting that the unknown and small accounting business was a matter of concern to sophisticated investors); Reuters, *supra* note 19 (“Mr. Dodd expressed disbelief that the S.E.C. did not zero in on the fact that Mr. Madoff’s auditor was a tiny, little-known auditor. ‘Isn’t it often a preliminary question to ask, who is your auditor?’ said Mr. Dodd.”).

In the case of the multiple investigations and examinations of Madoff and his firm, the SEC staff never verified his audits.²⁴³ They asked for his audited statements, and when he produced them, they put them in the file without verification.²⁴⁴ Yet, when the scandal broke and the Office of Inspector General received paperwork to check on the auditor, it took only a few hours to determine that the auditor was not legitimate and did absolutely no auditor work.²⁴⁵ The auditor did not have sufficient resources to perform bona fide audits and provide credibility to the audit function. Indeed, the auditor was not registered with the Public Accounting Oversight Board as the original Sarbanes-Oxley law required.²⁴⁶ This clearly indicates that in any investigation or examination it is essential to verify that the underlying auditor is registered, known in the audit community, legitimate, and actually confirms the audits. The public watchdog should be able to verify at least this much.

B. Madoff's Auditor David Friehling

Madoff's operations were purportedly audited by David G. Friehling and his firm Friehling and Horowitz, CPAs, PC.²⁴⁷ Horowitz was Friehling's retired father-in-law and was eighty years old when he passed away on March 12, the day Madoff pled guilty.²⁴⁸ The firm effectively consisted of a single active accountant who told the American Institute of Certified Public Accountants that the business had not done audits for more than fifteen years.²⁴⁹ Under the Sarbanes-Oxley law of 2002, public accounting firms that intend to conduct public audits of public U.S. companies must be

243. OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 173.

244. *See id.* at 174 (reporting testimony of examiner stating that they had a copy of the annual audit in the files, "[t]hat's it").

245. *Id.* at 174 n.107.

246. *See* Floyd Norris, *Audit Rule Is Revived By S.E.C.*, N.Y. TIMES, Jan. 9, 2009, at B5, available at <http://query.nytimes.com/gst/fullpage.html?res=9A00E0DB1F3BF93AA35752C0A96F9C8B63&scp=56&sq=&st=nyt> ("[b]rokerage firms like Madoff Securities are required to be audited by firms that were registered with the Public Company Accounting Oversight Board, which was created under the Sarbanes-Oxley Act in 2002," but Friehling was not registered because the SEC issued a waiver of the requirement for privately held firms).

247. William K. Rashbaum & Diana B. Henriques, *Accountant for Madoff Is Arrested and Charged with Securities Fraud*, N.Y. TIMES, Mar. 18, 2009, at B1, available at http://www.nytimes.com/2009/03/19/business/19madoff.html?_r=2&n=Top/Reference/Times%20Topics/People/F/Friehling,%20David%20G.?ref=david_g_friehling.

248. *Id.*

249. *See* Complaint at 17, Sec. & Exch. Comm. v. Friehling, No. 09-CV-2467 (S.D.N.Y. Mar. 18, 2009), available at <http://www.sec.gov/litigation/complaints/2009/comp20959.pdf> ("[A]nnually since 1994, Friehling falsely told the AICPA that he did not conduct audits.").

registered with the Public Company Accounting Oversight Board.²⁵⁰ Friehling was not registered with them, which begs the question as to how the SEC investigation team could have overlooked his lack of registration.²⁵¹

According to the external investigation team, it took only a few hours to determine that Madoff's auditor was not involved in bona fide auditing.²⁵² The audit firm had three employees, one of which was retired and the other of which was secretarial.²⁵³ In testimony given during the OIG's investigation of the failure of the SEC to uncover Bernard Madoff's Ponzi scheme, a New York Staff Attorney said of Friehling's work papers, "I didn't see anything that resemble[d the] kind of formal work papers, auditor work papers that would comply with generally accepted audit standards. So, there was almost nothing that indicated that any audit work had been done."²⁵⁴

Reputable firms use large auditing companies because the deep pocket of the auditor automatically conveys a signal of credibility.²⁵⁵ For a financial player the size of Bernard L. Madoff Investment Securities, LLC to not use a large auditor should have generated immediate suspicion about the credibility of the audits.²⁵⁶ The SEC investigation team asked Madoff to produce his audited reports.²⁵⁷ He provided the audited reports, which were put into the file without question, along with notations to the effect that he had produced his audited reports.²⁵⁸ It is really quite remarkable that an investigation team would not look into the name of the auditor.²⁵⁹ This lack

250. See 15 U.S.C. §§ 7211(a), 7212(a) (2002).

251. Cf. OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 420–21 (noting that many of the private entities that did due diligence on Madoff and did not invest with him because of the warning signals, felt that the SEC could have detected the Ponzi scheme).

252. *Id.* at 174 n.107.

253. *Id.* at 419.

254. *Id.* at 174 n.107.

255. See SUNDER, *supra* note 211, at 115 ("Shareholders protect themselves against manager-auditor collusion by engaging large, reputable audit firms who can provide a degree of insurance [against fraud] through their deep pockets.").

256. Cf. OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 419 (noting a sophisticated investor disparagingly referring to Friehling as "some suburban little shopping mall kind of accounting firm").

257. *Id.* at 178.

258. Cf. *id.* at 174 (quoting examiner: "I know we had a copy of the annual audit of the broker-dealer, I believe, in my files. That's it."); *id.* at 422 (noting members of a research firm stating that SEC examinations are conducted by inexperienced attorneys "working off of a rote formulaic process that [they] d[o] not understand" and relying heavily on checklists).

259. See FTI, REVIEW OF OCIE EXAMINATIONS, *supra* note 20, at 37 ("Procedures must be put into place to ensure that serious questions about an auditor's independence are investigated and examined.").

of follow up is a strong indication of the lack of understanding by the SEC staff as to the nature of the auditing business.

Competent and trustworthy auditing is absolutely essential to viable deep and highly liquid capital markets.²⁶⁰ Investors do not have full access to the facts themselves, and must rely on the summarizations prepared by accountants and the assurances given by auditors.²⁶¹ Dr. Lawrence Summers, current director of President Obama's National Economic Council and former Secretary of the Treasury and President of Harvard University, said: "The single most important innovation shaping [the American capital] market was the idea of generally accepted accounting principles. The importance of an independent, private-sector, open due process system to establish financial reporting standards cannot be overemphasized."²⁶² Auditors fulfill exactly that role:

From the very beginning of federal securities regulation, accountants, auditors, and financial reporting generally were considered primary components in maintaining integrity and public confidence in the marketplace. The statutory scheme reflects this view. The Supreme Court clearly supported this role as well:

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. . . . This . . . function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

While the scope and priority of a certifying accountant's duty to the investing public is a topic of debate within the accounting profession, there is widespread recognition by the profession of its role in influencing public confidence.²⁶³

Obviously, one role of auditors is to provide verifiable data that can support an opinion that a company's financials fairly and accurately reflect

260. *Cf. id.* ("The lack of an independent auditor raises potential concerns with regard to safety of custody of assets.").

261. Edmund L. Jenkins, Chairman, Fin. Acct. Standards Bd., *The FASB's Role in Serving the Public: A Response to the Enron Collapse*, at 6, available at http://www.fasb.org/news/fasb_role.pdf (last visited Oct. 22, 2010).

262. *Id.* at 2–3.

263. Klock, *Fortune Tellers*, *supra* note 209, at 80–81 (quoting *United States v. Arthur Young & Co.*, 465 U.S. 805, 817–18 (1984)) (footnotes omitted).

the underlying transactions and have been created in accordance with generally accepted accounting principles.²⁶⁴ However, it is also the role of auditors to provide credibility to their opinions.²⁶⁵ Credibility is a difficult problem to overcome.²⁶⁶ The best method for overcoming the credibility problem is to have an auditor with high net worth willing to subject themselves to legal liability.²⁶⁷

For his role in the Ponzi scheme, Friehling was charged by the SEC with the following: violating Section 17(a) of the Securities Act; violating and aiding and abetting violations of Section 10(b) of the Exchange Act and Rule 10b-5; and, aiding and abetting violations of Sections 206(1) and 206(2) of the Advisers Act, Section 15(c) of the Exchange Act and Rule 10b-3 thereunder, and Section 17 of the Exchange Act and Rule 17a-5 thereunder.²⁶⁸ According to the Acting Director of the SEC's New York regional office, "Friehling essentially sold his license to Madoff for more than seventeen years while Madoff's Ponzi scheme went undetected. For all those years, Friehling deceived investors and regulators by declaring that Madoff's enterprise had a clean audit record."²⁶⁹ In fact, the SEC alleged:

[T]hat Friehling merely pretended to conduct minimal audit procedures of certain accounts to make it seem like he was conducting an audit, and then failed to document his purported findings and conclusions as required under GAAS [generally accepted accounting standards]. If properly stated, those financial statements, along with BMIS related disclosures regarding reserve requirements, would have shown that BMIS owed tens of billions of dollars in additional liabilities to its customers and was therefore insolvent.

. . . Friehling similarly did not conduct any audit procedures with respect to BMIS internal controls, and had no basis to represent that BMIS had no material inadequacies. Afraid that his work for BMIS would be subject to peer review, as required of accountants who conduct audits, Friehling lied to the American

264. See SUNDER, *supra* note 211, at 114 ("[A]uditors accept certain responsibilities for the veracity of financial statements and disclosures.").

265. See *id.* at 124 (noting that the public is willing to pay for audits only because they believe auditors are responsible for detecting fraud).

266. See *id.* ("Responsibility for fraud detection presents auditors with a difficult economic problem to be resolved . . .").

267. See Linda E. DeAngelo, *Auditor Size and Audit Quality*, 3 J. ACCT. & ECON. 183, 183 (1981) ("[A]uditors with a greater number of clients have 'more to lose' by failing to report a discovered breach in a particular client's records. This collateral aspect increases the audit quality supplied by larger audit firms.").

268. Press Release No. 2009-60, *supra* note 164.

269. *Id.*

Institute of Certified Public Accountants for years and denied that he conducted any audit work.²⁷⁰

Friehling pled guilty to the allegations in the complaint and entered into a plea agreement that provides protection from further prosecution and a recommendation to the Court for some consideration in sentencing in exchange for cooperation.²⁷¹ His maximum sentence could be 114 years.²⁷²

V. OTHER FINANCIAL SCANDALS OF THE LAST DECADE

The past decade has been full of other major financial scandals including the subprime mortgage crisis, the collapse of the credit derivatives markets, insider trading by Martha Stewart, spinning charges against Frank Quattrone of Credit Suisse First Boston, bogus analyst recommendations by Henry Blodgett at Merrill Lynch and Jack Grubman of Salomon Smith Barney (part of Citigroup), and the Global Legal Settlement involving the ten largest investment banks.²⁷³ More recently, the massive and infamous insurance company American International Group (AIG) concocted sham transactions to overstate their financial strength.²⁷⁴ These are just some examples of serious problems with the integrity of financial markets. Indeed, the decade began with what was then the largest financial scandal in all of history—the exposure of fraud leading to the collapse of Enron.²⁷⁵

Enron began as a bricks-and-mortar energy firm that shifted its focus towards trading in derivatives.²⁷⁶ Enron grew rapidly into an enormous corporation that was not well diversified and took major risks.²⁷⁷ Those

270. *Id.*

271. Plea Agreement, *United States v. Friehling*, at 3–4 (Nov. 3, 2009), available at <http://www.justice.gov/usao/nys/madoff/friehlingdavidpleaagreement.pdf>.

272. *Id.* at 2.

273. See generally MISHKIN & EAKINS, *supra* note 57, at 399–416 (discussing business ethics in financial institutions and describing these scandals and others).

274. See Zachary A. Goldfarb, *General Re Settles Federal Charges in AIG Case*, WASH. POST, Jan. 21, 2010, at A17, available at <http://www.washingtonpost.com/wp-dyn/content/article/2010/01/20/AR2010012004826.html> (reporting that a reinsurer owned by Warren Buffet's Berkshire Hathaway paid ninety-two million dollars to settle federal charges over fraudulent sham transactions with AIG).

275. Enron was clearly the largest U.S. business collapse in history at the time of its occurrence. See, e.g., Leslie Wayne, *Enron's Collapse*, N.Y. TIMES, Jan. 13, 2002, available at <http://www.nytimes.com/2002/01/13/business/enron-s-collapse-before-debacle-enron-insiders-cashed-in-1.1-billion-in-shares.html>.

276. Frank Partnoy, *A Revisionist View of Enron and the Sudden Death of "May"*, 48 VILL. L. REV. 1245, 1261 (2003).

277. See, e.g., Richard D. Cudahy & William D. Henderson, *From Insull to Enron: Corporate (Re)Regulation After the Rise and Fall of Two Energy Icons*, 26 ENERGY L.J. 35, 38

risks led to enormous losses that were concealed from the public by both executives at Enron and their auditors at Arthur Andersen.²⁷⁸ Enron utilized many creative accounting schemes to move liabilities off their balance sheet and create an illusion of financial strength.²⁷⁹ Additionally, large financial intermediaries such as Merrill Lynch provided assistance to Enron in continuing and extending the fraud on the market.²⁸⁰ Many investors, employees, and even large financial intermediaries suffered enormous losses when the fraud came to light.²⁸¹ Among the investors losing money was the Regents of the University of California, which had invested and lost a substantial sum.²⁸² The Regents and other Enron investors brought suit against Merrill Lynch for its participation in the fraud.²⁸³

One of the most infamous fraudulent transactions perpetrated by Enron with the assistance of Merrill Lynch was known as the Nigerian Barges Transaction.²⁸⁴ Enron owned a fleet of Nigerian barges which were unprofitable assets.²⁸⁵ Enron arranged for Merrill Lynch to purchase these barges with a promise to repurchase them in six months at a higher price.²⁸⁶ The substance of the transaction was therefore a collateralized loan and a liability to Enron.²⁸⁷ However, the transaction was treated as a onetime sale thus hiding the liability and even creating the appearance of a profit on the sale of bad assets.²⁸⁸ This transaction prolonged Enron's fraud making the corporation appear to have continued viability.²⁸⁹ Because Enron and their auditor Arthur Andersen were both insolvent, the Regents of the University of California looked to the deep pockets of Merrill Lynch and other

(2005) (observing that Enron was concentrated on energy during a time of a surge in economic activity and loaded with risk).

278. See, e.g., *Enron and Andersen Both Blackened with Soot*, HOUSTON CHRON., Jan. 23, 2002, at 24 ("There can be little doubt that senior officials at Anderson and Enron connived to falsely inflate Enron's earnings and hide its debts.").

279. See Gabilondo, *supra* note 4, at 816–19 (describing the mechanics of transactions underlying misleading accounting statements).

280. See *Regents of the Univ. of Cal. v. Credit Suisse First Boston*, 482 F.3d 372, 377 (5th Cir. 2007) (describing the "Nigerian Barges Transaction" between Enron and Merrill Lynch).

281. See Marisa Taylor, *Former S.D. Federal Judge to Consult UC Regents on Enron*, SAN DIEGO UNION-TRIB., May 2, 2002, at C1 ("UC Regents, the lead plaintiff in an effort to recover billions of dollars from current and former Enron Corp. officials.").

282. *Regents of the Univ. of Cal.*, 482 F.3d at 378–79.

283. *Id.* at 377.

284. See *id.*

285. *Id.*

286. *Id.*

287. *Id.*

288. *Id.*

289. See *id.*

involved investment banks to recover their losses based on their role in Enron's fraud.²⁹⁰

The Fifth Circuit Court of Appeals dismissed the class-action claim.²⁹¹ The Court held that even if Merrill Lynch knew that Enron's reasons for engaging in these transactions was to perpetuate fraud, the plaintiffs had no cause against Merrill Lynch for aiding the fraud.²⁹² The Court reasoned that Merrill Lynch's participation was not direct enough to be primarily liable because the conduct did not constitute a misrepresentation that investors in an efficient market could be presumed to rely upon.²⁹³ The Supreme Court denied certiorari, and the decision stands.²⁹⁴ Because of this decision, Merrill Lynch and other financial institutions know that they can avoid civil liability in private party actions and can freely assist and profit from their assistance in fraud as long as they avoid direct communications with investors.²⁹⁵

The Enron fraud was so massive and so publicly spectacular that Congress felt compelled to respond with new legislation.²⁹⁶ The result was the Sarbanes-Oxley Act (SOX). SOX was intended to provide more transparency, oversight, and accountability in matters of corporate

290. *Id.*

291. *Id.* at 393–94.

292. *See id.* at 384 (“[T]he banks were not fiduciaries and were not otherwise obligated to the plaintiffs. They did not owe plaintiffs any duty to disclose the nature of the alleged transactions.”).

293. *See id.* at 385–86 (“[A] plaintiff must not only indicate that a market is efficient, but also must allege that the defendant made public and material misrepresentations; i.e., the type of fraud on which an efficient market may be presumed to rely. These plaintiffs have not alleged such fraud.”) (footnote omitted).

294. *Regents of the Univ. of Cal. v. Merrill Lynch*, 552 U.S. 1170, 1170 (2008).

295. *See Klock, Participation in a Deceptive Scheme, supra* note 3, at 328 (“[I]f the fraudulent transactions can be classified as involving transactions for goods and services rather than transactions for financial products, private actions under the securities laws will not be available no matter how much harm was wrought on the public securities markets.”); Robert A. Prentice, Stoneridge, *Securities Fraud Litigation, and the Supreme Court*, 45 AM. BUS. L.J. 611, 683 (2008) (“The . . . holding that collateral parties who knowingly participate in fraudulent schemes are merely ‘secondary’ parties who cannot be held liable is utterly inconsistent with every relevant body of fraud law in existence in 1934.”); Stuart Sinai, Stoneridge—*Escape from Securities Liability Notwithstanding Active, Intentional, Deceptive Conduct*, 8 J. BUS. & SEC. L. 170, 187 (2008) (stating that the Supreme Court has rewritten federal securities law to make private actions inapplicable “unless the ‘act’ or ‘course of business’ committed by a defendant is also accompanied by his direct misstatement to investors or the market”).

296. *See, e.g.,* Troy A. Paredes, *Foreword to F. Hodge O’Neal Corporate & Securities Law Symposium: After the Sarbanes-Oxley Act: The Future of the Mandatory Disclosure System*, 81 WASH. U. L.Q. 229, 231 (2003) (attributing Congress’s passing of the Sarbanes-Oxley Act to the Enron scandal and the collapse of WorldCom).

governance.²⁹⁷ This Act has been very costly and highly controversial.²⁹⁸ The controversy surrounds multiple facets of the legislation from its effectiveness to its very legality.²⁹⁹

Another infamous scandal of the decade involved Charter Communications, Motorola, and Scientific-Atlanta.³⁰⁰ Charter was the fourth largest cable company in the United States, a Fortune 500 firm with annual revenue exceeding \$1.4 billion, and a stockholder equity in excess of \$3 billion at the end of 1999 according to their 10-K filing of March 30, 2000.³⁰¹ When corporate officers realized that corporate earnings were going to fall short of analyst expectations, they approached at least two of their vendors, Motorola and Scientific-Atlanta.³⁰² These vendors produced set-top boxes for Charter and sold them to Charter.³⁰³ Charter proposed that it would “pay” an extra twenty dollars per box and in exchange the vendors would return this overpayment by purchasing advertising from Charter in an amount equivalent to twenty dollars per box sold.³⁰⁴ This sham transaction was effectively a wash, but it had the effect of inflating Charter’s advertising revenues without inflating costs because Charter would treat the now more expensive set-top boxes as capital expenditures to be amortized over several years rather than expensed.³⁰⁵ In order to deceive Charter’s auditors about the transactions, officers of all companies falsified and back-dated agreements to make the advertising purchases appear to be unrelated to the set-top box sales.³⁰⁶

297. See generally Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 62–67 (2002) (providing an overview of the Sarbanes-Oxley Act).

298. See, e.g., Mae Kuykendall & Elliot A. Spoon, *Introduction to Michigan State University College of Law Sarbanes-Oxley Symposium: Enforcement, Enforcement, Enforcement . . .*, 2004 MICH. ST. L. REV. 271, 272 (2004) (“Writing about SOx has become a cottage industry.”). Further evidence of the controversy around the Sarbanes-Oxley legislation is given by the June 28, 2010 Supreme Court decision holding part of the Act unconstitutional. See *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 130 S. Ct. 3138, 3151 (2010) (“We hold that the dual for-cause limitations on the removal of Board members contravene the Constitution’s separation of powers.”).

299. See, e.g., Kuykendall & Spoon, *supra* note 298, at 272 (“Commentators have argued that SOx represented an overreaction, was not broad enough, will be too costly or did not cost much at all under the circumstances.”).

300. See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 153–55 (2008) (summarizing the parties and the facts).

301. Charter Commc’ns, Inc., Annual Report (Form 10-K), at 3, 58 (Mar. 30, 2000).

302. *Stoneridge*, 552 U.S. at 153.

303. *Id.* at 154.

304. *Id.*

305. *Id.* at 154–55.

306. *Id.* at 155.

When the fraud was detected, Charter's stock price plummeted and Stoneridge Investment Partners, which had large holdings and large losses in Charter, sought to recover from Scientific-Atlanta and Motorola for their role in the fraud.³⁰⁷ In a 5-3 decision the U.S. Supreme Court held in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, that the vendors were not primarily liable under the securities laws because their fraud took place in the product market (sale of set-top boxes) rather than the financial market (sale of stock), and Scientific-Atlanta and Motorola made no fraudulent communications directly with investors.³⁰⁸ According to the Court, the only actionable fraud under the securities laws was in the production of Charter's financial statements, which was not done by Motorola or Scientific-Atlanta.³⁰⁹

The Court's simplistic analysis is displayed in the majority's concluding paragraph:

Unconventional as the arrangement was, it took place in the marketplace for goods and services, not in the investment sphere. Charter was free to do as it chose in preparing its books, conferring with its auditor, and preparing and then issuing its financial statements. In these circumstances the investors cannot be said to have relied upon any of respondents' deceptive acts in the decision to purchase or sell securities; and as the requisite reliance cannot be shown, respondents have no liability to petitioner under the implied right of action.³¹⁰

I previously criticized this reasoning writing:

Product markets and financial markets are intertwined, and to assert that a fraud could not have met the reliance requirement in the securities market because the fraud took place in the product market is not logical. The markets are connected like a hammer's head and handle, and when one part is moved the other part necessarily follows. Transactions in the product market directly affect prices in the securities markets. This is what the prices,

307. See W. Taylor Marshall, Note, *Securities Law—The Securities Exchange Act of 1934—'Round and 'Round We Go: The Supreme Court Again Limits the Circumstances in which Federal Courts May Hold Secondary Actors Liable Under Section 10(b) and SEC Rule 10B-5*, *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008), 31 U. ARK. LITTLE ROCK L. REV. 197, 223 (2008) (“[I]nvestors of Charter's common stock sued Respondents for securities fraud under section 10(b) of the Exchange Act, seeking to recoup losses from Respondents for their role in entering into various transactions that enabled Charter to issue misleading financial statements.”).

308. See *Stoneridge*, 552 U.S. at 166–67.

309. *Id.*

310. *Id.*

which are subjective valuations about the future, are based on. Additionally, the reporting and misreporting of those transactions in the product market directly affect prices in the securities markets. The late Professor James Tobin of Yale University received a Nobel Prize in large part for his work explaining the linkage between the market for physical assets and financial markets. The *Stoneridge* majority has created a contrived distinction for the purpose of eliminating liability by the perpetrator of a but-for cause of the securities fraud. The distinction between preparing the financial statements and providing the sham transactions upon which the financial statements were based is arbitrary and whimsical.³¹¹

Furthermore, the Court also held that private plaintiffs do not have any right of action against parties that merely assist in financial fraud.³¹² The *Stoneridge* majority did recognize that the SEC could have taken action against Scientific-Atlanta and Motorola if it chose to do so.³¹³ This was little consolation to investors, however, especially in light of the fact that the U.S. Solicitor General filed an amicus curiae brief in support of Motorola and Scientific-Atlanta.³¹⁴ The Court's decision in *Stoneridge* effectively immunizes from private liability all financial institutions that profit from assisting in financial fraud as long as they avoid direct communication with shareholders.³¹⁵

VI. SECONDARY LIABILITY TO PROMOTE A CULTURE OF INTEGRITY

I explained in a paper commenting on *Stoneridge*:

There is a very good reason [as to] why a scheme of secondary liability is essential for rebuilding and maintaining the integrity of [U.S.] financial markets. If players in financial markets are always given the benefit of the doubt when they engage in questionable activities which are not clearly illegal, then financial market participants are effectively being encouraged with economic incentives to engage in shady conduct. This is effectively the well-

311. Klock, *Participation in a Deceptive Scheme*, *supra* note 3, at 327 (footnotes omitted).

312. *See Stoneridge*, 552 U.S. at 162 (“Aiding and abetting liability is authorized in actions brought by the SEC but not by private parties.”).

313. *Id.* at 162–63.

314. Brief for the United States as Amicus Curiae Supporting Affirmance, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 522 U.S. 148 (2008) (No. 06-43), 2007 WL 2329639.

315. *See Klock, Participation in a Deceptive Scheme*, *supra* note 3, at 330 (“We cannot protect the integrity of the financial markets if we provide for immunity from civil liability where the fraud is consummated in the product market.”).

known moral hazard problem that was rigorously explored by the Nobel Prize-winning economist Kenneth Arrow and is a principal topic in the insurance field. Moral hazard [is the situation in which] people are encouraged to engage in undesirable behavior because they are insulated from [the] consequences [of it]. For example, a homeowner who does not take precautions against fire and even engages in hazardous activities because he is fully insured.³¹⁶

Secondary liability for aiding and abetting fraud in securities markets was a well established doctrine in all circuits until 1994, when the Supreme Court surprised everyone by tossing out this doctrine in *Central Bank*.³¹⁷ The secondary liability concept is fairly simple. Anyone who aids or assists a liable party in violating federal securities laws is also liable, just as a joint tortfeasor would be jointly liable for giving an assailant a stick for the purpose of beating a victim.³¹⁸ This doctrine could be used to reach the pockets of an accounting firm that advised a seller of securities how to cook his or her books with the least chance of being detected in an audit.³¹⁹

In *Central Bank*, the bank dragged its feet on updating a stale appraisal in a depressed real estate market for land that was used as collateral in a

316. *Id.* at 341–42 (footnotes omitted).

317. See Douglas M. Branson, *Running the Gauntlet: A Description of the Arduous, and Now Often Fatal, Journey for Plaintiffs in Federal Securities Law Actions*, 65 U. CIN. L. REV. 3, 11 (1996) (“[In *Central Bank*] [t]he Supreme Court reversed twenty-five years of reliance on the common-law construct of aiding and abetting by lower federal courts to hold collateral participants to securities transactions secondarily liable.”); James D. Cox, *Just Deserts for Accountants and Attorneys After Bank of Denver*, 38 ARIZ. L. REV. 519, 545 (1996) (“The Supreme Court discarded a doctrine that had not only been accepted by all the circuits but had matured and become predictable, and there was no evidence the doctrine had created mischief in its wake.”); Marc I. Steinberg, *The Ramifications of Recent U.S. Supreme Court Decisions on Federal and State Securities Regulation*, 70 NOTRE DAME L. REV. 489, 489 (1995) (“In a decision that delighted ‘deep pockets,’ shocked the plaintiffs’ bar, and befuddled neutral observers, the Supreme Court . . . held that aiding and abetting liability in private actions may not be imposed under section 10(b) of the Securities Exchange Act of 1934 . . . or under rule 10b-5. The Court’s decision swept away decades of lower court precedent that nearly universally recognized the propriety of such secondary liability under the statute and rule.”) (footnotes omitted).

318. See William H. Kuehnle, *Secondary Liability under the Federal Securities Laws—Aiding and Abetting, Conspiracy, Controlling Person, and Agency: Common-Law Principles and the Statutory Scheme*, 14 J. CORP. L. 313, 321–22 (1988) (stating “courts almost universally have been willing to infer joint tortfeasor liability for aiding and abetting” under the federal securities laws).

319. See Klock, *Fortune Tellers*, *supra* note 209, at 82 (“The search for deep pockets led to liability for . . . accounting firms that might have assisted corporations or their officers and directors in securities violations. . . . [But] [a]iding and abetting liability for accountants and auditors was more than just a plaintiff’s attorney’s contrivance to reach a deep pocket. It was an important policy tool . . .”).

bond issue.³²⁰ Shortly after the bonds were issued, the issuer defaulted and it was discovered that the collateral was worth much less than what had been disclosed in the stale appraisal.³²¹ Although four Justices believed that Central Bank should be held liable for reckless conduct, it would have certainly been possible for the majority to assert that the Bank's conduct did not rise to the level of aiding and abetting fraud without tossing out the entire doctrine.³²² But toss it out the majority did.³²³

The Court's decision in *Central Bank* was met with extremely strong criticism.³²⁴ So strong that the following year when Congress amended the securities laws in the Private Securities Litigation Reform Act (PSLRA) to generally provide more procedural advantages for defendants in securities suits, it expressly deemed aiding and abetting a violation of the law, a violation itself actionable by the SEC.³²⁵ Unfortunately, Congress was silent as to whether private parties could seek redress against aiders and abettors.³²⁶

320. See *Cent. Bank of Denver v. First Interstate Bank*, 511 U.S. 164, 167–68 (1994). The Court described the scenario as follows:

Central Bank received a letter from the senior underwriter for the 1986 bonds. Noting that property values were declining in Colorado Springs and that Central Bank was operating on an appraisal over 16 months old, the underwriter expressed concern that the 160% test was not being met.

Central Bank asked its in-house appraiser to review the updated 1988 appraisal. The in-house appraiser decided that the values listed in the appraisal appeared optimistic considering the local real estate market. He suggested that Central Bank retain an outside appraiser to conduct an independent review of the 1988 appraisal. After an exchange of letters between Central Bank and AmWest in early 1988, Central Bank agreed to delay independent review of the appraisal until the end of the year, six months after the June 1988 closing on the bond issue. Before the independent review was complete, however, the Authority defaulted on the 1988 bonds.

Id.

321. See *id.*

322. Cf. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 169 (2008) (Stevens, J., dissenting) (observing that *Central Bank* merely involved assisting fraud passively through the inaction of not updating an appraisal in a timely manner rather than active participation in a scheme by backdating agreements).

323. See *Central Bank*, 511 U.S. at 194–95 (Stevens, J., dissenting) (“[I]nstead of simply addressing the questions presented by the parties, on which the law really was unsettled, the Court *sua sponte* directed the parties to address a question on which even the petitioner justifiably thought the law was settled, and reaches out to overturn a most considerable body of precedent.”).

324. See, e.g., Mark Klock, *Litigating Securities Fraud as a Breach of Fiduciary Duty in Delaware*, 28 SEC. REG. L.J. 296, 322 (2000) (citing widespread criticism by commentators).

325. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified at 15 U.S.C. § 78t(e) (2000)).

326. Klock, *Participation in a Deceptive Scheme*, *supra* note 3, at 322.

In the first possible opportunity to reach the question, the Court took the *Stoneridge* case.³²⁷ The five Justice majority seemed eager to find that the conduct of Motorola and Scientific-Atlanta in assisting Charter Communications' fraud could not be construed as direct participation in the fraud precisely so they could rule on the question of private action for aiding and abetting liability.³²⁸ In order to say that the defendants could only be liable, if at all, for merely aiding and abetting a fraud, the Court had to create the contrived distinction between fraud in the product market and fraud in the financial market.³²⁹ The Court held that the defendants' fraud took place in the product market and not in the financial markets because the defendants were not involved in the production of the financial statements, only the underlying sham transactions used to create the sham financial statements.³³⁰ This then enabled the majority to address the question of private liability for aiding and abetting the fraud and hold that the PSLRA, which expressly made aiding and abetting violations a violation itself, did not provide for a private right of action.³³¹

So we are now in a situation in which current law provides that anyone who aids or abets a violation of any section of the securities laws will be deemed to have violated the law himself or herself and subject to action by the SEC.³³² However, under *Stoneridge*, it is definitive that private parties are not entitled to relief against aiders and abettors under Section 10b.³³³ Congress should change the law and expressly allow private parties to pursue claims for aiding and abetting fraud under the securities laws. It is not sound public policy to legislate that deep pockets such as Merrill Lynch, Motorola, and Scientific-Atlanta can escape liability because the Commission, under one presidential administration and the absence of

327. See *Stoneridge*, 552 U.S. at 163 (in the first high Court interpretation of § 104 of the PSLRA the majority states, “[W]e give weight to Congress’ amendment to the Act restoring aiding and abetting liability in certain cases but not others. The amendment, in our view, supports the conclusion that there is no liability.”).

328. See Klock, *Participation in a Deceptive Scheme*, *supra* note 3, at 332–33 (“[T]he Court was eager to have an opportunity to limit the express cause of action for secondary liability that Congress inserted into the PSLRA . . .”).

329. See *id.* at 333 (“In order to have the opportunity to limit the language providing for secondary liability, it was necessary for the Court to reach the conclusion that there was insufficient causal connection between the conduct and the fraud in the financial market.”).

330. *Stoneridge*, 552 U.S. at 166–67.

331. *Id.* at 162–63.

332. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified at 15 U.S.C. § 78t(e) (2000)).

333. See Prentice, *supra* note 295, at 648 (“Congress chose to reinstate the SEC’s authority to bring action against aiders and abettors, but did not enact proposals to allow aiding and abetting lawsuits by private litigants in suits for damages. . . . *Stoneridge* . . . suggests that . . . Congress must have meant to preclude other avenues for remedy, including private litigation.”).

many high profile victims, elects to not charge the culpable participants, while David Freihling is subjected to liability by the Commission, under a different presidential administration and the presence of many high profile victims such as movie stars, athletes, wealthy, politically involved constituents, and other celebrities.³³⁴ This is not justice. This will not foster a culture of integrity in the markets.

Shortly after our financial markets collapsed, Senator Carl Levin stated:

In *Stoneridge*, the Supreme Court determined that shareholders are barred by federal law from suing third parties that help public companies commit fraud, and must instead rely on federal regulators to punish wrongdoing and recover funds. Given limited federal resources, however, that ruling means, in too many cases, banks, accounting firms, lawyers and others will be able to aid and abet corporate fraud, and shareholders will have no legal recourse. That isn't fair, and it undermines investor confidence in U.S. markets.³³⁵

Although the U.S. markets have made a partial comeback since those words were uttered, it is clear that investor confidence in the integrity of the markets remains seriously below what it used to be.³³⁶ Given the revelations that Madoff was able to pass several examinations and investigations by SEC staff while conducting his massive Ponzi scheme, even when credible information expressly directed the SEC where to look for the fraud, it is an obvious proposition that market integrity would be better protected if we supplement SEC enforcement with private enforcement.

Private liability for aiding and abetting fraud will foster a culture of integrity in our markets because financial market participants will conduct themselves in a manner designed to avoid litigation.³³⁷ Under the current law, accountants and other deep pockets can profit from fraud as long as the

334. See Michelle Singletary, *How Madoff Became an Equal Opportunity Thief*, WASH. POST, May 3, 2009, at G1, available at <http://www.washingtonpost.com/wp-dyn/content/article/2009/05/02/AR2009050200121.html?nav=emailpage> (noting some of Madoff's victims "including a senator, major financial companies, universities, Nobel laureate Elie Wiesel, movie stars, and the charity established by movie director Steven Spielberg").

335. *Where Were Watchdogs? Financial Crises and Breakdown of Financial Governance: Hearing Before Homeland Security and Governmental Affairs Committee*, 111th Cong. (Jan. 21, 2009) (statement of Sen. Carl Levin).

336. See, e.g., Maria Panaritis & Jane M. Von Bergen, *No Immediate Remedy Seen for Economic Malaise*, PHILA. INQUIRER, Jan. 27, 2010, at A1, available at <http://www.allbusiness.com/economy-economic-indicators/economic-indicators/13802062-1.html> (stating consumer confidence "remains well below the level of a healthy economy").

337. See Klock, *Fortune Tellers*, *supra* note 209, at 106-07 (arguing that express recognition of aiding and abetting liability will deter auditors from operating in a shady ethical zone).

SEC does not decide to utilize its scant resources to prosecute them.³³⁸ However, once subjected to the possibility of private law suits, we can be sure that accountants and other deep pockets will factor the possibility of liability exposure into their decisions about how to behave and will conduct their businesses with higher ethical standards.³³⁹ Casual empirical observation reveals that most people do not drive within posted speed limits when they do not see any enforcement because they know that they can only be cited by an officer and the probability of enforcement is low. But drivers also know that if their excessive speed results in an accident, they will be subject to private litigation by their victims. Thus, most people tend to stay reasonably close to the posted speeds even if they exceed them a bit. It does not seem reasonable to provide a lower level of enforcement possibilities to deter fraud in our financial markets than we provide to deter dangerous driving on our streets.

In another recent paper I suggest that:

The need for secondary liability is not solely to provide remedies for isolated investors defrauded by bankrupt parties with assistance for profit by solvent and culpable secondary actors. Secondary liability is also needed to create incentives for ethical corporate behavior and restore investor confidence in the national market for securities. The integrity of our entire market is at risk. Capital is being drained and the economy is floundering. The Court's decisions are incentivizing and encouraging further unethical behavior in the markets, and we must put a stop to it before we have many more Enrons and Madoffs.³⁴⁰

VII. A CALL FOR MORE FINANCIAL LITERACY IN LEGAL EDUCATION

Legal education is necessarily forward looking.³⁴¹ Law schools train students for careers that will take place in the future.³⁴² As economies become increasingly integrated into a single global economy, clients and lawyers both will face a more intensely competitive environment than in the

338. See Sinai, *supra* note 295, at 187 (“Under *Stoneridge*, a professional can rest easy so long as the attorney, CPA, and investment banker make no statements to the public. It appears no matter their culpability, they will escape private civil liability under § 10(b).”).

339. See Klock, *Participation in a Deceptive Scheme*, *supra* note 3, at 340 (“[I]f the liability rules governing the market are changed to punish unethical conduct, the amount of unethical conduct will decrease.”).

340. *Id.* at 318 (footnote omitted).

341. Thomas D. Morgan, *Educating Lawyers for the Future Legal Profession*, 30 OKLA. CITY U. L. REV. 537, 537 (2005).

342. See *id.* at 539.

past.³⁴³ “[C]lients are likely to expect lawyers to understand their business . . . affairs, not just apparent legal issues.”³⁴⁴ This makes a basic understanding of business finance important not just for business lawyers, but also for lawyers practicing in the areas of real estate, contracts, torts, white-collar crime, and divorce.³⁴⁵ In the words of Professor Morgan, past President of the American Association of Law Schools, “[l]awyers who do not take the time, or who lack the background knowledge, to understand what their clients do, how they do it, and the problems the clients may create, will inevitably have problems serving their clients.”³⁴⁶ Although this has always been true, the more intense competitive economic pressure of the future will require the most successful lawyers to have a stronger background in other disciplines.³⁴⁷

Another commentator offers additional justification for improving cross-discipline training and observes that the more innovative law schools are doing it:

Since law students and business students will work together throughout their careers, we waste a precious opportunity if we do not bring the two groups together frequently to learn from each other now. More than just pedagogically useful, cross-disciplinary education can also help students form valuable connections and relationships, and so further enhance the practical value of their education. These benefits are not limited to law students and business students; students from many different disciplines can gain from leaving their own worlds and working alongside students in other programs. Of course, universities have offered cross-disciplinary courses for many years. Yet, for reasons I discuss throughout this Essay, I believe that we can get much more out of cross-disciplinary education than we have gotten so far.

343. *See id.* at 539–40 (predicting globalization will increase and create intense competitive pressure).

344. *Id.* at 540.

345. *Cf.* Robert J. Rhee, *The Socratic Method and the Mathematical Heuristic of George Pólya*, 81 ST. JOHN’S L. REV. 881, 882 n.5 (2007) (“In my classes, Torts, Business Associations, Corporate Finance, and Negotiations, basic mathematical intuitions arise more frequently than students prefer. Examples include complex causation, marginal costs, capital structure, asset valuation, expected value and probabilities, and basic intuitions of law and economics.”).

346. Morgan, *supra* note 341, at 540.

347. *Id.* at 541 (“Clients of the future . . . are even more likely to want their lawyers to resemble multi-disciplinary consultants rather than narrow legal technicians.”).

Fortunately, several of our leading schools have reached this conclusion, and have started to make major changes to realize the benefits of cross-disciplinary training.³⁴⁸

Yet another commentator states that:

Lawyers need to be educated more broadly—with courses beyond the traditional law school curriculum—if they are to serve their clients and society well.

....

. . . To serve clients capably or address major social and political issues, lawyers now must work in cross-disciplinary/cross-professional teams

....

The idea is to utilize the rest of the university to create a more three-dimensional legal education. We realized that the rest of the university is training the people who will become our students' clients. Good lawyers need to understand what their clients do.³⁴⁹

Basic knowledge of finance will become an essential component of the education for many lawyers.³⁵⁰ Even knowledge of advanced finance will be useful for many. Thus, it is important for competitive leading law schools to increase the opportunities for education in this discipline. Northwestern University has adopted a plan to put more emphasis on finance in the academic program.³⁵¹ Professor Morgan recently said:

Financial issues are likely to be drivers of business success. Lawyers who can understand and intelligently address such issues will be more valuable than their less-adaptable counterparts. Clients can do only so much in terms of building more efficient machines or designing more efficient production lines. Ready and efficient access to capital from several sources will be critical to business clients, and lawyers will play a part in finding and acquiring that capital. Because access to capital markets is often

348. Seth Freeman, *Bridging the Gaps: How Cross-Disciplinary Training with MBAs Can Improve Transactional Education, Prepare Students for Private Practice, and Enhance University Life*, 13 *FORDHAM J. CORP. & FIN.* 89, 101–02 (2008).

349. Stanford Law Sch. News Ctr., A “3D” JD: *Stanford Law School Announces New Model for Legal Education*, Nov. 28, 2006, <http://www.law.stanford.edu/news/pr/47/> (internal quotations omitted).

350. See Morgan, *supra* note 341, at 557 (“[L]aw schools ultimately will have to acknowledge that learning corporate finance may be equally or more important to a student than taking another course in corporate taxation.”).

351. Judith Welch Wegner, *Reframing Legal Education’s “Wicked Problems”*, 61 *RUTGERS L. REV.* 867, 947 (2009).

highly regulated and because the costs of being wrong about the legal requirements are often of “bet-the-company” magnitude, lawyers will be heavily involved in those efforts. Yet, understanding the legal requirements will require an understanding of the financial instruments the client plans to employ. Developing financial understanding sufficient to analyze sophisticated financial instruments has not been a traditional part of the law school curriculum.³⁵²

Obviously, the government regulatory agencies that recruit regulators from the ranks of new law school graduates will benefit from more financial education in law school, but also the rest of the legal profession would be well served by producing attorneys who are more financially literate.³⁵³ Many students are not well served by the current offerings and requirements in law schools.³⁵⁴ After the current first year of law school, students frequently end up in upper level electives without having had any exposure to the basic analytical methods and important concepts in finance.³⁵⁵ Such concepts include the measurement of risk, return, liquidity, and the effects these variables have on asset pricing. To quote another commentator, “I call on my transactional law colleagues to foster more integration of analytical financial methods into a basic legal education.”³⁵⁶ If we had such preparation, we might have fewer financial catastrophes and panics.³⁵⁷

Law schools cannot prepare most lawyers to keep current with the newest and most complex models of measuring risk and pricing financial assets. Therefore, it is also important that lawyers conducting investigations requiring such knowledge both consult with experts and rely on the advice of the experts.³⁵⁸ It is clear in the record of the investigations of Madoff that

352. Morgan, *supra* note 341, at 546.

353. See Gabilondo, *supra* note 4, at 850 (“[I]t would behoove the legal profession to produce lawyers who are more financially fluent.”).

354. See Freeman, *supra* note 348, at 94 (“Law schools can do a much better job training students how to practice law.”).

355. See Robert J. Rhee, *The Madoff Scandal, Market Regulatory Failure and the Business Education of Lawyers*, 35 J. CORP. L. 363, 382–83 (2009) (explaining that students enter securities regulation without a deep understanding of finance and having only been exposed to some finance concepts that become meaningless jargon).

356. Gabilondo, *supra* note 4, at 850.

357. See *id.* (“Such an approach might produce more transactional lawyers capable of spotting and stemming future financial moral panics.”).

358. Cf. Rhee, *supra* note 355, at 377–78 (attributing the SEC failure to catch Madoff to a lack of business literacy on the part of the inexperienced lawyers who worked there).

some examiners would not consult with experts, and that some examiners would not follow the expert advice.³⁵⁹

On February 25, 2010, the University of Maryland School of Law hosted an event, “The Madoff Scandal: Why the SEC Failed to Uncover It and How It Can Identify the Next One,” by SEC Inspector General David Kotz.³⁶⁰ On March 10, 2010, the Center for Law, Economics and Finance at the George Washington University School of Law similarly hosted a conference, “Madoff: A Year Later; What Have We Learned?” with panelists including Madoff’s attorney and other experts from FTI Consulting, the media, practicing lawyers, and academics.³⁶¹ Having attended both events, I observed that the most salient points pertained to the fundamental lack of financial education among the SEC examination teams’ members.

VIII. CONCLUSION

When the collapse of Enron occurred, politicians screamed for increased regulation of accountants and auditors in order to assure that such a massive fraud “would never happen again.”³⁶² The result was Sarbanes-Oxley, a massive and costly set of regulations.³⁶³ Yet such a massive fraud occurred again. Even before the Enron scandal, some prominent legal scholars such as Robert Prentice called for governmentalizing the audit function.³⁶⁴ Such a proposal could result in an entire bureaucracy of Barney Fife auditors. We can provide more training for SEC examiners and more rules and checklists for them to follow, but at the end of the day, a government employee does not have as strong an incentive to adequately police the market as private market participants have to protect their investments.

359. See OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 41 (observing that the enforcement staff refused to take the financial experts’ professional advice during their investigation).

360. Univ. of Md. School of Law, *News and Events: SEC Inspector General to Speak About Madoff Scandal Feb. 25*, http://www.law.umaryland.edu/about/news_details.html?news=524 (last visited Oct. 22, 2010).

361. George Washington Univ., *Past Events*, http://www.law.gwu.edu/Academics/research_centers/C-LEAF/Pages/PastEvents.aspx (last visited Sept. 18, 2010).

362. See Sue Kirchhoff & Robert Schlesinger, *Subpoenas on Enron Issued; Calls to Aide Cited*, BOSTON GLOBE, Jan. 12, 2002, at A1 (quoting Ken Johnson, spokesperson for the House Energy and Commerce Committee), available at 2002 WLNR 2603336.

363. See Ribstein, *supra* note 297, at 3 (observing that Sarbanes-Oxley is the most important legal response to Enron and arguing that it is unjustified and carries significant costs).

364. See Robert A. Prentice, *The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing*, 61 OHIO ST. L.J. 1597, 1667 (2000).

Two important, clear lessons from the Madoff Ponzi scheme are: first, that increased expensive regulation passed in reaction to a crisis will not guarantee the prevention of fraud; and second, that the government cannot perform the audit function well. Indeed, government efforts can provide a false sense of security and exacerbate fraud.³⁶⁵ There are two inferences that I wish to draw from these lessons. First, the integrity of the market will be best protected if auditors face liability in private actions under all sections of the securities laws for aiding and abetting sales of unregistered securities and fraud on the market. Second, law schools need to provide more financial education for law students who expect to work in the business law arena. If the young and inexperienced staff attorneys put in charge of some of the Madoff investigations had completed a course in basic corporate finance or financial markets, they likely would not have been willing to accept Madoff's ludicrous explanations.

We cannot test the hypothesis that Merrill Lynch would not have assisted with the Nigerian Barges Transaction and Motorola would not have assisted with Charter's sham transaction if they knew that they could be liable in private actions. However, it is obvious that corporations will be more likely to assist in fraud if they know, as they definitively know now under the holdings in *Stoneridge* and *Regents of the University of California*, that they cannot be subject to private liability.³⁶⁶ Furthermore, the analysis of the SEC's handling of BMIS makes it clear that the Commission lacks the competent resources required to protect the market.³⁶⁷ Rather than give the Commission more resources to squander, the economical solution is to give assistance to the Commission in its mission by enabling private parties to pursue deep pockets that assisted in fraud. Such a regime will foster a stronger culture of integrity in the market and deter businesses from assisting in fraud and profiting on assistance with fraud.³⁶⁸

Returning to my comparison of SEC staff with Barney Fife, one can imagine an episode in which the town bank's alarm has sounded and an

365. See OIG, INVESTIGATION OF MADOFF, *supra* note 21, at 425 (observing that investor belief that the SEC had examined and cleared Madoff encouraged further investment in the Ponzi scheme).

366. See Klock, *Participation in a Deceptive Scheme*, *supra* note 3, at 336 (describing the moral hazard created by the Court's holding in *Stoneridge* which encourages unethical conduct in business).

367. See Joe Davidson, *SEC's Madoff Probe Botched by Inexperience*, WASH. POST, Sept. 9, 2009, at A17, available at <http://www.washingtonpost.com/wp-dyn/content/article/2009/09/08/AR2009090803463.html> (interpreting the SEC's self-investigation as finding systematic failure due to inexperience and incompetence of the staff).

368. See Klock, *Participation in a Deceptive Scheme*, *supra* note 3, at 341 (arguing that secondary liability is important for protecting the integrity of the market).

obvious robber with a sack of money runs past deputy Fife and says, “He went that way!” while pointing in the opposite direction. Naturally, the good deputy runs in the direction the robber pointed as the robber continues on his way to safety unimpeded. The analogy comes alarmingly close to the events that transpired between Madoff and the SEC staff.

Congress amended the securities laws to expressly make aiding and abetting a violation of the law, but then with poor judgment or wording provided that only the SEC could take action against aiders and abettors.³⁶⁹ There is no logical justification for such a limitation on private causes of action, which played a major role in protecting the integrity of our securities markets for decades.³⁷⁰ The SEC simply is not capable of policing all fraud by itself and needs the assistance of private attorneys general to foster a culture of integrity.³⁷¹ Without the private attorneys general, fraudsters know that they have a small probability of being subjected to enforcement actions by the SEC. They can hide in the vast market and take their chances on isolated enforcement actions by the Commission. If they are caught, they might have to disgorge their profits and pay a modest fine. If they are not caught and targeted, they will reap large rewards. The gamble seems like a pretty good one, especially for fraudsters who are likely to be much less risk adverse than the general population. Only with the threat of private enforcement actions will the players in the markets have sufficiently strong incentives to play honestly and conduct their business with integrity.

369. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified at 15 U.S.C. § 78t(e) (2000)).

370. *Cf.* Cent. Bank of Denver v. First Interstate Bank, 511 U.S. 164, 200 (1994) (Stevens, J., dissenting) (“Aiding and abetting liability has a long pedigree in civil proceedings brought by the SEC under § 10(b) and Rule 10b-5, and has become an important part of the SEC’s enforcement arsenal.”).

371. *Cf.* U.S. GEN. ACCOUNTING OFFICE, PROTECTING THE PUBLIC INTEREST: SELECTED GOVERNANCE, REGULATORY OVERSIGHT, AUDITING, ACCOUNTING, AND FINANCIAL REPORTING ISSUES 25 (2002) (“[L]imited resources have forced the SEC to be selective in its enforcement activities. . . .”) (testimony of David M. Walker, Comptroller General, U.S. Gen. Accounting Office); *id.* at 19 (indicating that the SEC must prioritize cases as it is not capable of prosecuting every case); JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 773 (4th ed. 2004) (stating that the SEC’s “trial staff is too small to handle more than a fraction of the cases being investigated”). Not only must SEC enforcement staff be concerned about the agency’s own resources, but they may be unable to ignore administrative and judicial resources. “Judges want us to settle, and if we don’t, they are not happy campers. They don’t have the resources to try these cases.” Rachel McTague, *High Court Ruling on Secondary Liability for Securities Fraud Tested, Lawyer Says*, 36 SEC. REG. & L. REP. 2059 (2004) (quoting private attorney Melvyn I. Weiss).