REPORT OF THE 2009 SPECIAL REVIEW COMMITTEE ON FINRA'S EXAMINATION PROGRAM IN LIGHT OF THE STANFORD AND MADOFF SCHEMES

SEPTEMBER 2009

SPECIAL REVIEW COMMITTEE

Charles A. Bowsher (Chairman)

____

Ellyn L. Brown

____

Harvey J. Goldschmid

____

Joel Seligman

____

INDUSTRY GOVERNOR ADVISERS
Mari Buechner
W. Dennis Ferguson
G. Donald Steel

OF COUNSEL
Paul V. Gerlach
Griffith L. Green
Dennis C. Hensley
Michael A. Nemeroff
SIDLEY AUSTIN LLP
1501 K Street, NW
Washington, DC 20005

TABLE OF CONTENTS

I. EXECUTIVE SUMMARY

On April 13, 2009, the Board of Governors ("Board") of the Financial Industry Regulatory Authority, Inc. ("FINRA") established a Special Review Committee ("Special Committee")[1] to review FINRA's examination program, with particular emphasis on the examinations of FINRA member firms associated with R. Allen Stanford and Bernard L. Madoff. The Board was particularly concerned by the significant harm to investors caused by Stanford and Madoff. Pursuant to a resolution approved by the Board, the Special Committee was asked to "recommend . . . changes in the examination program, where appropriate, to improve member oversight and FINRA's fraud detection capability," and to consider management's "monitoring [of] compliance with examination program policies."[2]

The Special Committee, acting through outside counsel, reviewed relevant examination files from 2003 to 2009 of the principal member firms associated with Stanford and Madoff. Interviews were conducted with the examiners, supervisors, and managers still employed by FINRA who were involved in the examinations. In addition, outside counsel interviewed numerous headquarters staff and senior management to enable the Special Committee to develop factual findings and recommendations.[3] In total, outside counsel conducted 60 interviews of FINRA staff. Because of ongoing civil and criminal actions involving the Stanford and Madoff schemes, counsel did not interview persons other than current FINRA employees or obtain information directly from the implicated firms or from the Securities and Exchange Commission ("SEC").

---

[1] All members of the Special Committee are public governors of FINRA.

[2] The Charter of the Special Committee is attached as Appendix A to this report. In making its recommendations regarding FINRA's examination program, the Special Committee was not asked to comment on personnel matters.

[3] The Special Committee solicited the input of FINRA senior executive staff prior to finalizing the recommendations presented in this report.

The Ponzi schemes allegedly perpetrated by Stanford and admitted to by Madoff are striking because of their size and duration.[4] Madoff's scheme spanned decades, defrauded thousands of investors, and caused an estimated $64 billion in investor losses. According to the SEC, Stanford sold numerous investors approximately $7.2 billion of fraudulent products, purported to be certificates of deposit ("CDs"), over at least a decade.

FINRA's examinations of the Madoff and Stanford firms did not uncover these frauds. The histories of the examinations of these firms present distinct lessons for improving FINRA's examination program.

A. The Stanford Case

Between 2003 and 2005, the National Association of Securities Dealers—FINRA's predecessor entity—received credible information from at least five different sources claiming that the Stanford CDs were a potential fraud. The most striking was a July 2005 five-page referral letter from the SEC's Fort Worth office that explained in detail why the purported investment strategy of the offshore bank could not have produced the consistently high returns being paid by the CDs. The letter stated that the CD program was a "possible fraudulent scheme" and that the returns were "too good to be true." According to this letter, "as of October 2004, [the Stanford firm's] customers held approximately $1.5 billion of CDs." Despite the existence of this "red flag" and others described in the body of this report, FINRA did not launch an investigation of whether the Stanford CD program was a fraud until January 2008.[5] By the time the CD program was shut down by the SEC in February 2009, the alleged amount of

[4] Bernard Madoff has confessed and pled guilty. As of the publication of this report, Allen Stanford is contesting the charges against him.

[5] As discussed in the body of the report, FINRA's 2005 cause examination did result in a charge against the Stanford firm for advertising violations relating to the CD program and a $10,000 fine.

investor funds had grown to approximately $7.2 billion. According to the court appointed receiver in the Stanford matter, the vast majority of these funds will never be recovered.

FINRA missed a number of opportunities to investigate the Stanford firm's role in the CD scheme. First, FINRA's Dallas office staff curtailed a 2005 investigation prompted by the SEC referral letter because of a concern that the offshore CDs were not "securities" regulated under federal securities laws. Facts surrounding the decision not to pursue the fraud investigation indicate that certain of FINRA's examination staff were then, and may remain, unsure of the full scope of the organization's investigative authority, are reluctant to pursue investigations where jurisdiction questions arise, and are not adequately trained to identify alternate bases of jurisdiction.

Second, although the CD program involved billions of dollars of investor funds, FINRA procedures, at the time and now, do not set forth criteria for escalation of a matter to senior management or the use of specially-trained investigators based on the gravity and substance of the fraud allegations. The Dallas staff did not provide the SEC referral letter to senior management in Washington, DC, until December 2008.

Third, FINRA's member examination program focuses the majority of member regulation resources on routine "cycle" exams. Although SEC-required cycle exams play a role in ensuring that member firms are adequately capitalized and compliant with regulatory requirements, they are not an effective means for uncovering complex frauds such as the alleged CD scheme.

Fourth, FINRA's Dallas staff did not adequately document communications with the SEC, or discussions within FINRA itself, regarding the CD program. As a result, critical decisions regarding the course of examinations were influenced by misunderstandings and incomplete exchanges of information.

Finally, FINRA did not—and still does not—have a centralized database that gives examiners direct, electronic access to all relevant complaints and referrals associated with a member firm. As a result, no single FINRA staff member was ever aware of all of the "red flags" related to the Stanford firm that are discussed in this report.

The Special Committee recommends that FINRA's examination program should be revamped to ensure that fraud detection and prevention are core elements. This is particularly critical when the potential fraud poses risk of significant harm to investors. Allegations of the magnitude and gravity of those in the Stanford case should be given the highest priority, immediately escalated to FINRA senior management, and vigorously pursued by well-trained FINRA staff with all necessary investigative tools and techniques. The Special Committee agrees with and supports the plan of FINRA senior management to create a dedicated fraud detection unit. The Special Committee believes the unit should centrally manage fraud cases involving potentially significant investor losses and ensure that cause exams involving significant allegations of fraud receive the highest priority in terms of staffing and resources.

B. The Madoff Case

The Madoff case provides a different perspective on FINRA's examination program. In contrast to the Stanford matter, the Special Committee did not find evidence that FINRA received any whistleblower complaints regarding the Madoff scheme or that the SEC shared any concerns or specific allegations about Madoff with FINRA prior to the time when Madoff admitted his fraud. Indeed, the broker-dealer records provided to FINRA contained no indication that the Madoff firm was operating an investment advisory business. Madoff maintained separate bank accounts, cordoned off the investment advisory business to a separate floor of his firm's office space, and deliberately failed to disclose his investment advisory activity in broker-dealer forms submitted to FINRA.

In 2006, the SEC caused the Madoff firm to register as an investment adviser and to submit information on its advisory business to the Investment Adviser Registration Depository ("IARD"), a system operated by FINRA pursuant to a contract with the SEC. The Madoff firm continued to represent to FINRA that it was not involved in investment advisory activity, and—more generally—that it did not maintain any customer accounts. FINRA examiners did not have direct access to the Madoff firm's IARD entries.

In the course of their cycle examinations, FINRA examiners did come across several facts worthy of inquiry associated with the Madoff scheme that, with the benefit of hindsight, should have been pursued. Most notably, in the course of examining a related firm—Cohmad Securities Corporation[6]—that brought investors into the Madoff Ponzi scheme, FINRA staff observed records of substantial, recurring payments from the Madoff firm to Cohmad. In addition, in a 2007 examination of the Madoff firm, FINRA staff uncovered commissions from a London affiliate that now appear to have served as a money laundering operation for Madoff's investment advisory business. If FINRA's examiners had fully investigated these transactions, it is possible that they would have developed suspicions and investigated further regarding Madoff's business.

In the final analysis, however, the most notable fact about the Madoff case is that FINRA's ability to effectively examine firms registered as both broker-dealers and investment advisers would be greatly enhanced if FINRA had jurisdiction to enforce the requirements of the

[6] As explained in the report, Cohmad was partially owned by Madoff and was located in the offices of the Madoff firm. On June 22, 2009, the SEC filed a lawsuit against Cohmad accusing it and its principals of "participating in Bernard L. Madoff's Ponzi scheme by raising billions of dollars from hundreds of investors under a shroud of secrecy." Complaint in *SEC v. Cohmad Securities Corp. et al.*, S.D.N.Y. 09 Civ. 5680.

Investment Advisers Act of 1940 ("Investment Advisers Act"). This additional jurisdiction would enable FINRA to be more effective in detecting fraud in both broker-dealers and investment advisers. In addition, to uncover frauds such as that perpetrated by Madoff, FINRA must amend and improve its examination process and examiner training. The Madoff case underscores the need for FINRA's examination program to develop means to verify independently the data submitted by member firms. At present, cycle exams principally rely on the representations of member firms, and, thus, are heavily dependent on the honesty and completeness of the member firm's response. The Madoff case also highlights the need to improve the exchange of information within FINRA and between the SEC and FINRA, including the sharing of information about potentially fraudulent conduct at member firms. Finally, the Madoff case demonstrates the need for FINRA to clarify the extent of its jurisdiction, and to more aggressively exercise that jurisdiction.

C. Recommendations

The issues identified above and further described in this report are the basis for the recommendations of the Special Committee. The recommendations are described in detail in this report at pages 71-76. Virtually all of these recommendations will require FINRA management and the Board to make key decisions on resource allocations. Some of these recommendations will require action by the SEC or Congress. The most important of these recommendations include:

FINRA should clarify and expand its jurisdiction to enable it to be more effective in detecting fraud and protecting investors. FINRA is fundamentally hampered by its lack of jurisdiction over investment advisory activities. FINRA should proactively seek new jurisdiction from Congress to regulate activities under the Investment Advisers Act to give it more effective means to detect future Madoff-like situations. FINRA also should clarify its current jurisdiction to regulate member firms and associated persons and more aggressively seek information, especially where there are indications of fraud. FINRA should expand its jurisdiction to enable it to obtain information from affiliates of member firms in its enforcement of the Securities Exchange Act of 1934 and FINRA rules when it believes there is evidence of fraud.

FINRA should restructure its examination program to make fraud detection a core element. The Special Committee supports FINRA management's plan to create a dedicated fraud detection unit. Examinations should be prioritized to expedite any investigation involving potential fraud, serious harm to investors, or continuing serious misconduct. This restructuring should strengthen the cause examination program and revise the cycle examination program. In taking these steps to improve its examination program, FINRA will need to make greater use of personnel with specialized skills and improve its internal exam-related procedures. In particular, FINRA should improve its documentation of legal and regulatory issues, including its internal communications and communications with other regulators.

FINRA should improve the technology available to its examination staff, enhancing systems and access so that examiners are empowered to easily locate and analyze all data and documents within FINRA regarding a member firm. Such tools could have significantly improved the staff's ability to grasp the pattern of complaints against Stanford.

FINRA should end its virtual total reliance on data provided by member firms. FINRA should adopt procedures to test and confirm certain member-provided data against third-party sources such as independent auditors and non-affiliated banks. FINRA also should cross-check data provided to FINRA in various submissions by the same firm. Third-party verification and cross-checking could have provided examiners additional means to uncover the Madoff fraud.

FINRA should work with the SEC and other regulators to expand FINRA's access to and use of available data about member firms and their associated persons. Such data sharing will assist FINRA in obtaining more complete information on those that it regulates. FINRA also should enhance its training program for the examination staff, focusing on fraud training and requiring formal continuing education and training.

The Special Committee believes the recommendations above should be implemented by means of a Plan of Action developed by FINRA management and presented for consideration by the Board. Management has agreed to present a Plan of Action for approval or ratification at the December 2009 Board meeting.

II. BACKGROUND ON FINRA EXAMINATION PROGRAM

FINRA is a non-governmental, self-regulatory organization subject to SEC oversight under Section 15A of the Securities Exchange Act of 1934 (“Exchange Act”). It was created in 2007 through the merger of the National Association of Securities Dealers (“NASD”) and the member regulation, enforcement, and arbitration functions of New York Stock Exchange Regulation, Inc. (“NYSE”). It is responsible for overseeing broker-dealers, who must register with the SEC and become members of FINRA, and registered representatives, who must pass examinations demonstrating their knowledge and expertise. As of December 31, 2008, there were 4,895 broker-dealers and 664,975 registered representatives subject to FINRA’s oversight. FINRA also engages in oversight of various securities markets and facilities. FINRA has approximately 2,800 employees and operates from Washington, DC, and New York, NY, as well as from 15 district offices around the nation.

FINRA has an active enforcement program designed to promote compliance with the Exchange Act and FINRA rules. In each year between 2004 and 2008, FINRA and its predecessors, NASD and NYSE, expelled an average of 21 firms and banned an average of 433 registered representatives from the industry. In each of these years, FINRA also suspended 396 registered representatives, collected approximately $97.4 million in fines, and obtained restitution for broker-dealer customers amounting to $105 million on average. In 2008, the settlement of its auction-rate securities cases returned $1.172 billion to investors. Each year FINRA receives about 25,000 complaints, tips, and similar items, which are processed by an organization called Central Review Group-Front End Cause. This organization handles about 20,000 of these items and refers the remaining 5,000 to district offices for processing.

FINRA's examination program is presently organized into two basic departments: Member Regulation and Market Regulation. Market Regulation, the smaller of the two departments, is not considered in this report because its responsibilities are not relevant to the Stanford and Madoff schemes.

The Member Regulation department is charged with oversight of FINRA member firms and is subdivided into Sales Practice, Risk Oversight and Operational Regulation ("Risk Oversight"), and Shared Services. Sales Practice is the largest of these three groups. It is charged with the oversight of about 4,800 member firms. It had about 560 examiners and 106 supervisors as of December 31, 2008, located in 15 district offices across the United States. The examiners are supported by enforcement lawyers also located in the district offices who report separately to the Enforcement department.

Sales Practice is responsible for conducting onsite examinations of financial operations and sales practices—called "cycle exams"—as well as "cause exams," which stem from customer complaints, anonymous tips, referrals from the SEC and other sources. Sales Practice conducts more that 2,100 cycle exams each year. Sales Practice's policy is to complete all cycle exams each year, although this goal is not always met. Firms are scheduled for cycle examinations every year, every two years, or every four years based on an annual risk assessment that incorporates numerous factors. Firms judged to be the most prone to regulatory concerns are examined each year. Sales Practice district offices also complete about 5,000 cause examinations each year.

Risk Oversight is responsible for overseeing the financial solvency of approximately 500 of the largest FINRA member firms and those with the most complex operations. For example, almost all clearing and carrying firms are examined by Risk Oversight. Risk Oversight also is assigned large proprietary trading firms with over $100 million in annual revenues. The Madoff firm was scheduled to be examined by Risk Oversight in March 2009, but this exam was obviated by Madoff’s confession. Most firms examined by Risk Oversight are located in the New York metropolitan area, and most of the subdivision’s 140-person examination staff is located in its office in New York City.

Shared Services is primarily responsible for planning the annual cycle examination program and for developing policies that control both cycle and cause examinations. This includes detailed monitoring and budgeting of examination hours. Shared Services also is responsible for the quality assurance program, Sales Practice policies, training for Sales Practice examiners and other staff, and the administration of Member Regulation.

Prior to FINRA’s formation in 2006, the member firms associated with Stanford and Madoff that are discussed in this report were members of NASD. For ease of reference, except where otherwise noted, this report generally refers to both NASD and FINRA as “FINRA.”

III. EXAMINATIONS OF MEMBER FIRMS INVOLVED IN THE STANFORD AND MADOFF SCANDALS

A. The Stanford Case

1. Background

According to civil and criminal actions brought in 2009 by the SEC and the United States Department of Justice, respectively, R. Allen Stanford ("Stanford") and his closest associates have engaged in a massive and long-running fraudulent scheme. Acting through a series of companies under their control, Stanford and his co-defendants are alleged to have sold financial products, purported to be CDs, and to have diverted investors' funds to illiquid, high-risk investments. As evidenced by sales brochures provided to FINRA and the SEC, the Stanford companies issuing and marketing the CDs represented to investors that their money was being placed in safe and liquid investments. These companies also claimed consistent double digit rates of return for the purported CDs. According to allegations in the SEC's case against Stanford, the claimed rates of return were virtually impossible under the Stanford bank's stated investment strategy, and were fabricated out of whole cloth by Stanford and his co-defendants. The defendants allegedly defrauded investors of approximately $7.2 billion.

The purported CDs, issued by Stanford International Bank, Ltd. ("the Stanford bank"),[7] were marketed by, among other entities, Stanford Group Company ("the Stanford firm"), a Houston-based company with numerous offices in the United States. The Stanford firm was established in 1995, registered with the SEC as a broker-dealer, and became a member of FINRA. As a FINRA member, the Stanford firm was subject to periodic cycle and cause exams. Because the firm's home office is located in Texas, many of these exams were conducted by

[7] The Stanford bank was founded in Montserrat and, since 1985, has been based in Antigua and Barbuda ("Antigua").

FINRA's Dallas office.[8] Between 2003 and 2008, commissions from the sales of offshore CDs constituted from 38 to 68 percent of the Stanford firm's total revenues reported to FINRA.[9]

2. Daniel Arbitration and 2003 Cycle Examination

In June 2003, a FINRA arbitration took place between the Stanford firm and Gregory Daniel, a former employee of the firm. Mr. Daniel alleged that he was wrongfully terminated, that he "was pressured to direct [his] clients['] assets to the off shore bank in Antigua," and that he was forced to sell "proprietary managed money products with no track record, cash inflows or clear investment objective." The arbitration concluded in a settlement between the parties, but the arbitrators referred the matter to FINRA's Enforcement department in August 2003 for investigation of possible rule violations by the firm or, alternately, possible abuse of the arbitration process by Daniel.

FINRA's Enforcement department, in November 2003, referred the Daniel matter to the then-Associate Director of the Dallas office, "for your review and whatever action you deem appropriate." According to email records from 2003, the Associate Director informed the examiners involved in the 2003 cycle exam of the Stanford firm about the allegations raised by Daniel. When interviewed, however, neither the Associate Director nor the Dallas Director recalled inquiring about the disposition of the Daniel arbitration referral until 2009, when news

---

[8] FINRA's Dallas office is a long-standing NASD-legacy office. From 1999 to 2003, the office was headed by Bernerd Young. In 2003, Young was replaced. The new Dallas Director implemented new procedures to increase both productivity and the diligence of examiners. Witnesses noted that Young's departure and the changes implemented by the new Director precipitated a significant change in personnel within the Dallas office—approximately half of the staff, including many examiners and exam managers, resigned their positions shortly after Young left. The office remained understaffed for some period of time. Witnesses noted that, by 2005, the staffing situation stabilized due to new hires and transfers from other FINRA offices.

After serving for a period of time as a securities industry consultant, Young was hired as the Managing Director of Compliance for the Stanford firm in June 2006, a position he held through 2009. The interviews of current FINRA employees and review of exam files identified no information to suggest that Young's presence at the firm compromised FINRA's subsequent examinations of the firm discussed in this report.

[9] These commissions are reported in FINRA's cycle exam reports of the Stanford firm under the heading "Solicitor of time deposits in a financial institution."

of the Stanford scandal broke and the Dallas Director sought to identify all files related to the firm.

The 2003 cycle exam of the Stanford firm was completed on December 15, 2003. The exam file contains no indication that Daniel was contacted by anyone on the exam team to determine what he knew about the CDs, or that FINRA took any action against the firm based on Daniel's allegations. The 2003 exam report indicated that 68 percent of the firm's revenues were generated from commissions from the sale of Stanford bank CDs. The 2003 exam file does not indicate that any of the examiners questioned the Stanford firm about the fact that it generated upwards of two thirds of its total revenue from the sale of these CDs.

3. <u>2003 Anonymous Tip Letter</u>

In September 2003, FINRA received an anonymous letter describing an ongoing fraud within Stanford's business empire. The author claimed to be an insider. In bold capital font, the letter stated that Stanford Financial Group, the parent company of the Stanford bank and firm, "**IS THE SUBJECT OF A LINGERING CORPORATE FRAUD SCANDAL PERPETUATED AS A 'MASSIVE PONZI SCHEME' THAT WILL DESTROY THE LIFE SAVINGS OF MANY, DAMAGE THE REPUTATION OF ALL ASSOCIATED PARTIES, RIDICULE SECURITIES AND BANKING AUTHORITIES, AND SHAME THE UNITED STATES OF AMERICA.**" The letter continues as follows:

> The Stanford Financial Group of Houston, Texas has been selling to the people of the United States and Latin America, offshore certificates of deposit issued by Stanford International Bank, a wholly owned unregulated subsidiary. With the mask of a regulated US Corporation and by association with Wall Street giant Bear Stearns, investors are led to believe these CD's are absolutely safe investments. Not withstanding this promise, investor proceeds are being directed into speculative investments like stocks, options, futures, currencies, real estate, and unsecured loans.

> For the past seventeen years or so, Stanford International Bank has reported to clients in perfect format and beautifully printed material of the highest quality, consistent high returns on the bank's portfolio, with never a down year, regardless of the volatile nature of the investments. By showing these unbelievable returns, Stanford has justified the expense spent on luxury, lavish styles of management, high bonuses, and generous contributions to all sorts of causes.
>
> The questionable activities of the bank have been covered up by an apparent clean operation of a US Broker-Dealer affiliate with offices in Houston, Miami, and other cities that clears through Bear Stearns Securities Corporation. Registered Representatives of the firm, as well as many unregistered representatives that office within the B-D, are unreasonably pressured into selling the CD's. Solicitation of these high risk offshore securities occurs from the United States and investors are misled about the true nature of the securities.
>
> The offshore bank has never been audited by a large reputable accounting firm, and Stanford has never shown verifiable portfolio appraisals. The bank portfolio is invested primarily in high risk securities, which is not congruent with the nature of safe CD investments promised to clients.

A copy of the Stanford bank's annual financial statement was attached to the letter, which also described Stanford's close association with Antigua, and referenced certain investigations and press articles suggesting that Stanford had engaged in bribery and money laundering. The letter concluded by urging regulators to focus on the "real market value" of the Stanford bank's investment portfolio, "*which is believed to be significantly below the bank's obligations*." (Emphasis in original.) A carbon copy notation indicated that, in addition to FINRA, copies of the letter were sent to the SEC, a U.S. Senate Committee, the Office of the Comptroller of the Currency, and various media outlets.

The anonymous letter was processed by FINRA's Central Review Group-Front End Cause department in Washington, DC.[10] An analyst in that department determined that FINRA lacked jurisdiction over the matter, and referred the letter to the SEC. When interviewed, the analyst explained that he had concluded that FINRA lacked jurisdiction because he had been

[10] At the time, the department was known simply as "Front End Cause."

instructed, as part of his training, that CDs generally were not "securities" as defined under the Exchange Act. In reaching this determination, the analyst did not focus on the offshore nature of the Stanford bank's CD program, nor did he consider alternate bases of FINRA jurisdiction. The conclusion whether an offshore CD will be considered a security is not self-evident and depends, in large part, on the specific protections provided by the regulatory system in the jurisdiction in which the product is issued.[11]

The analyst wrote a short description of his handling of the matter in FINRA's internal electronic records database (in 2003, known as "MERIT"; now known as "STAR"). The description notes that "Product listed is 'offshore CDs' and Certificates of Deposit" and that the investigation concluded with "No Juris[diction]. Referred to SEC, 10/20/2003." This comment is the only substantive description regarding the Front End Cause investigation that anyone in the Dallas office would have seen when searching for files related to the Stanford firm in the MERIT or STAR databases. The MERIT and STAR databases did not contain a copy of the anonymous insider letter, although staff would have seen a reference to the letter and could have obtained a copy from the office where the entry was made.[12]

In her interview, the Dallas Director noted that her staff typically consulted the STAR database in preparing for an upcoming exam, but that, after seeing an entry finding no

[11] For a discussion of the SEC's position that the Stanford CD are "securities," see pages 24-25 and footnote 52 below.

[12] STAR is a matter tracking system used by FINRA to track investigations, examinations, alerts, sweeps, reviews, referrals, membership applications, filings, disclosures, tips and complaints. The primary users of STAR are FINRA's Enforcement, Market Regulation and Member Regulation departments. Advertising and Corporate Finance also track matters in STAR. Departments such as Office of Disciplinary Affairs, Registration and Disclosure and Finance update matters in STAR as well with information relevant to their business practices.

Numerous matter-related data elements are tracked in STAR. These include the following: matter type, staff, source or origin, contacts (firms, individuals, registered representatives, entities), securities products, markets, comments, correspondence (including relevant dates), high level allegations, rule violations, milestone or matter dates, dispositions or resolutions, billable entities, disciplinary actions (appeals, decisions, sanctions, fines, undertakings, restitution), information requests to firms as well as responses, time and activities. Those with access to the system are able to track down related documentation by contacting the person or office that input the relevant information.

jurisdiction, they likely would not have attempted to retrieve the anonymous letter. According to email records, no one in the Dallas office saw the letter until May 2009, when it was mentioned in newspaper articles regarding Stanford. At that time, Dallas staff searched various FINRA databases and uncovered a copy of the letter.[13]

4. <u>Basagoitia Arbitration and Notice of SEC Investigation</u>

In December 2004, the Associate Director of the Dallas office received an email from a FINRA enforcement attorney. The email referenced an arbitration between the Stanford firm and Leyla Basagoitia, a former Stanford financial adviser based in Texas. The Stanford firm had terminated Basagoitia and brought the arbitration to recover a balance on an employment promissory note issued to her. Basagoitia countered by alleging that she was improperly terminated. The email also indicated that the FINRA enforcement official had received a call from an SEC attorney from Fort Worth regarding the matter. The email further indicates that the SEC attorney

> is involved in the investigation of the claimant firm (Stanford Group Company) involving, among other things, the firm's coercion of representatives to sell Antigua CD's—Respondent's claim is that she was fired because she refused to sell the CD's without documentation and due diligence. [The SEC attorney] wanted to let [FINRA] know that [the SEC Attorney—*sic*, likely Basagoitia] has provided much assistance to the SEC in their investigation and that they believe there is a problem with selling the CD's—that the instruments are and were securities, etc.

The Associate Director forwarded the FINRA enforcement attorney's email to the Dallas Director and to four exam managers in the Dallas office, stating that he "was not aware of the SEC investigation re: Sale of Antigua CDs," and that he would call the SEC unless the Dallas Director or the managers already knew something about the investigation. When interviewed,

[13] The system described in footnote 12 does not give staff direct, electronic access to all regulatory information related to a member firm.

however, the Associate Director had no recollection of the above email and did not recall calling the SEC about the matter.[14]

A March 2005 email from an attorney in the SEC's Fort Worth office indicates that the Associate Director of FINRA's Dallas office was communicating with SEC staff regarding the Stanford firm. In the email, the SEC attorney wrote: "If you have any thoughts about the suitability issue I raised in connection with Stanford, or ideas about the firm generally, I would love to hear from you." The Associate Director has no recollection of this email or the referenced communication with the SEC attorney.

5. 2005 Cycle Examination

FINRA performed its next cycle exam of the Stanford firm in 2005. The exam team consisted of a lead examiner and three junior examiners. The lead examiner had been with FINRA's Dallas office since 2000. Each of the junior examiners had less than a year of experience with FINRA.

For approximately a year leading up to the 2005 cycle exam, the lead examiner had been assigned as the Stanford firm's core examiner. At the time, a core examiner was responsible for reviewing a firm's FOCUS[15] reports and its annual audited financial statements. The core examiner was also FINRA's primary contact with the member firm.

When interviewed, the lead examiner noted that he had developed numerous concerns about the Stanford firm in his capacity as its core examiner. In particular, he noted that most of the firm's revenues were derived from the sale of CDs issued by the Stanford bank. He also indicated being troubled by the size of the commissions paid by the bank to the firm for CD

[14] Other than an occasional email reference and one reference in an internal memorandum, based on interviews and records provided, the Dallas office did not memorialize its communications with the SEC about the Stanford matter.

[15] The Financial and Operational Combined Uniform Single ("FOCUS") report is a basic financial and operational report required of broker-dealers subject to minimum net capital requirements set forth in SEC Rule 15c3-1. The report contains figures on capital, earnings, and other financial details.

referrals. In his experience, commissions typically were not paid for CD referrals, and if a commission was paid, it was generally no more than $50 per referral. By contrast, the Stanford bank paid the Stanford firm an *annual* fee equal to *three percent of the deposit sum* for every CD account referred by the firm.

The lead examiner also reported having had concerns about the Stanford firm's net capital position, and he noted that the firm had received periodic capital contributions from Stanford. He also indicated that, about every two to three months, the firm's FOCUS report generated an "exception"—an event caused by data the FOCUS system deems irregular—associated with these capital infusions. The lead examiner further expressed the opinion that the firm was "hemorrhaging" money and was being kept afloat with capital contributions. He stated that he periodically questioned the firm's Chief Financial Officer about these capital infusions. The Chief Financial Officer tried to reassure him by noting that Stanford was a prominent and wealthy individual, as evidenced by his inclusion in the Forbes 400. The lead examiner never asked the Stanford firm to provide a personal financial statement from Stanford.[16]

Finally, when reviewing FINRA's files prior to the 2005 exam, the lead examiner came across a memorandum from the Texas State Securities Board and a *Wall Street Journal* article. The Texas State Securities Board memorandum was written in the mid-1990s and expressed concern that the high return rates and commissions for CDs made it difficult for the Stanford bank to make a legitimate profit on the CDs. The *Wall Street Journal* article reported that

[16] Based on representations in the Stanford firm's filings with FINRA, R. Allen Stanford was identified to the staff as the firm's sole director. In particular, in connection with the capital contributions made to the firm by Stanford, the firm submitted to FINRA corporate resolutions approving the contributions. These resolutions were executed by Stanford and identify Stanford as the sole director of the firm, as well as the sole shareholder of a holding company that owned 100 percent of the Stanford firm. As a director of the firm, Stanford would be deemed to be an "associated person," and FINRA accordingly had jurisdiction over Stanford individually. Thus, the staff could have questioned Stanford personally about the CD program, including the composition of the bank's portfolio and the accuracy of the marketing materials distributed by the Stanford firm.

Stanford possessed immense influence in Antigua. The lead examiner indicated that the Securities Board memorandum and the *Wall Street Journal* article were not the kinds of items typically found in a FINRA case file.

The lead examiner represented that he decided to inspect virtually every area of the Stanford firm's business in the 2005 cycle exam, but to give special attention to the CD issue. He believed that prior examiners had not paid sufficient attention to the CD program. His supervisor—an exam manager in the Dallas office—agreed with this approach. According to the manager, there were substantial concerns in the Dallas office regarding the Stanford firm and the CD program in particular. According to the lead examiner, he and his manager decided that it made sense to take a broad look and "see what we reel in."[17]

While the exam team was preparing for the 2005 cycle exam, an enforcement attorney in the Dallas office joined the discussion on the CD issue. The enforcement attorney had worked for the SEC prior to joining FINRA. When interviewed, she indicated that, during her time with the SEC, she had worked on a matter involving Stanford's CD program. She also reported working on cases involving brokered CDs, which had tested the bounds of the SEC's (and FINRA's) jurisdiction under the federal securities laws. From the moment she became involved in discussions regarding the CD aspect of the 2005 Stanford cycle exam, the enforcement attorney reportedly expressed the view that the Stanford CDs were *not* "securities" regulated under the federal securities laws, and were therefore outside of FINRA's jurisdiction.

As part of the pre-exam process for the 2005 cycle exam, the lead examiner sent the Stanford firm a questionnaire. In response to a question about underwriting, the firm indicated that it was offering the CDs under the SEC's Regulation D ("Reg. D"), which exempts securities

[17] The manager was one of the individuals who, in late 2004, had received a copy of the email discussing the Basagoitia arbitration and the SEC's investigation of the Stanford firm. Prior to the 2005 cycle exam, the manager informed the lead examiner for the 2005 cycle exam that the SEC was looking into the CD program.

offered in private placements to specified investors from the registration requirements of the Securities Act of 1933. The examiner noted that he decided to further investigate the Reg. D claim during the onsite portion of the exam.

The onsite portion of the cycle exam took place in late April and early May 2005. The lead examiner focused his time on the CD program, and delegated other portions of the exam to the junior examiners on the team. He asked the Stanford firm to provide due diligence materials on the Stanford bank and the CDs. In response, the firm supplied only the bank's annual report. The examiner noted that he was surprised to learn that, according to the annual report, commercial loans constituted less than five percent of the bank's assets. He asked the Stanford firm about this fact and was told that the bank's profits came from trading operations and investments. Given the advertised rates of return on the CDs, he stated that he found this hard to believe. Although it might have been possible to make high returns on investments in developing markets, according to the annual report, the Stanford bank mostly invested in developed markets. In his interview, the examiner expressed the opinion that, if the Stanford firm was really making the high return rates on the CDs through investments in developed markets, then they were "smarter than Goldman Sachs."

Junior members of the exam team reviewed certain Stanford customer accounts, but did not come across any evidence of funds going directly from a customer account at the broker-dealer to a CD purchase.[18] The exam team did not, however, look for evidence that customers of the Stanford firm were liquidating securities to buy into the CD program; for instance, they did

[18] FINRA's 2001 cycle exam report on the Stanford firm indicates that, "For existing broker dealer clients, funds are wired by Bear Stearns from the client's brokerage account to [the Stanford bank]." While this is not direct evidence that customers of the firm were liquidating securities to purchase CDs, it is an issue that should have been investigated. It is unclear whether any of the examiners for the 2005 cycle exam ever reviewed the 2001 exam file. For a description of how the SEC ultimately asserted jurisdiction over the Stanford CDs based, in part, on the argument that Stanford firm customers sold securities in connection with the purchase of CDs, see footnotes 20 and 52.

not cross-check CD purchases with sales of securities by the same customers. Such checks would have identified customers who sold securities and bought CDs through an intermediary step such as depositing the proceeds of securities sales in a bank. A showing that the firm's customers were liquidating securities in order to buy into the CD program would have provided FINRA's staff with jurisdiction[19] to proceed against the firm under the antifraud provisions of the federal securities laws, regardless of whether the CDs themselves constituted "securities."[20]

The lead examiner also looked into the firm's claim that the CDs were a Reg. D private offering. As a general matter, SEC rules prohibit companies from engaging in a general solicitation for Reg. D offerings. However, the examiner noted that the website of the Stanford bank contained a significant amount of information about the CDs, including interest rates. He asked the Stanford firm about this and was told that the firm had no control over the content on the bank's website. The examiner did not believe that the firm's lack of control over the bank excused the apparent violation of the Reg. D restrictions, and requested that the firm provide a written statement explaining why the bank's website was not a general solicitation.[21]

On June 9, 2005, the Stanford firm responded to the lead examiner's concerns, asserting that "[w]e believe that the descriptions of CD Products on the website of Stanford International

---

[19] See footnote 52 below.

[20] In late 2008, FINRA's Boca Raton office obtained records during their exam of the Stanford firm's Miami office that indicated that a number of Stanford firm customers sold securities and simultaneously purchased CDs. Similarly, the SEC's motion in support of a temporary restraining order against Stanford indicates that "From August 2008 through December 2008 alone, approximately 50 [Stanford firm] clients liquidated approximately $10.7 million in stocks, bonds, and other similar securities and invested that money in [the Stanford bank's] CDs." Memorandum In Support of Motion for TRO, Prelim. Injunction and Other Emergency Relief, *SEC v. Stanford International Bank, Ltd. et al.*, N.D. Tex. 3:09-cv-0298-N.

[21] As referenced in the Stanford firm's audited financial statements dating back to at least fiscal year 2003, the firm had entered into a joint marketing arrangement with the Stanford bank. Specifically, the firm's annual audited financial statements indicate that "Pursuant to joint marketing agreements, the Company and an affiliated foreign financial institution agreed to jointly market and offer fixed income and trust products to their respective customers. In connection therewith, the Company is entitled to referral fees based upon percentages of the referred portfolio as defined in the respective agreements." It does not appear that FINRA staff confronted the Stanford firm with the existence of this joint marketing agreement.

Bank do not constitute a form of general solicitation. This is only general information on the Bank and its products and no current interest rates are posted on this site. An investor cannot purchase any CD product via the website." The letter also indicated that the firm did not believe the CDs to be securities subject to U.S. federal or state laws, and that the firm elected to treat the CDs as a Reg. D offering "because of the possibility that the CD deposits or CD certificates could be deemed to be 'securities' by US regulatory or judicial authority." The examiner was not persuaded by the firm's assertion that the CDs were not securities; however, he was uncertain as to whether FINRA could show that they were securities. This issue was not pursued further in the 2005 cycle exam.[22]

6. Meeting with SEC and the SEC Referral Letter

Shortly after the onsite portion of the 2005 cycle exam, on June 21, 2005, the Dallas Director and Associate Director attended a general meeting at the SEC's Fort Worth office. At that meeting, the SEC Assistant District Administrator informed the Dallas Director that the SEC was concerned about Stanford but was having difficulty pursuing the matter. The Assistant District Administrator then told the Dallas Director that the SEC would send FINRA a letter to see if it could help with the investigation.

When interviewed, the Dallas Director indicated that she was shocked that the SEC would refer the Stanford case to FINRA. If the SEC, with its subpoena power, was having problems bringing the case, she said she failed to understand how FINRA—which does not have

[22] There is no indication that the Dallas staff made any formal requests to identify the assets comprising the investment portfolio that allegedly supported the performance of the CDs or to interview Stanford firm employees regarding their knowledge of the CDs or the investment portfolio.

subpoena power—could be more successful. She did not, however, inform the SEC of these concerns at the time of the meeting.[23]

According to email records, in the days after the June meeting, Fort Worth SEC staff and the Dallas Director and Associate Director participated in at least one, and possibly several, telephone calls regarding the Stanford CD program. The Dallas Director could not recall whether she personally participated in the call(s), and noted that it was not unusual for the SEC to contact her staff directly. The Associate Director had no recollection of the substance of the call(s).[24]

On July 21, 2005, an attorney in the SEC's Fort Worth office sent a five-page letter to the Associate Director of FINRA's Dallas office. The letter began by referencing "our phone conversation," and provided "further information from [the SEC's] October 2004 examination of Stanford Group Company." The SEC letter also noted that, in the latter part of 2004, approximately 63 percent of the Stanford firm's revenues were derived from the sale of the CDs, and that the firm's customers held approximately $1.5 billion of the CDs as of October 2004. The SEC letter also indicated that, despite the dependence of its business on the CD sales, the Stanford firm "claims that it keeps no records regarding the portfolios into which [the Stanford bank] places investor funds and that it can not get this information from [the bank]. . . . [The Stanford firm's] admitted inability to get information from [the bank] about the investments underlying the CDs suggests that [the firm] may be violating NASD Rule 2310 (Suitability)."

The letter went on to indicate that, while the firm and the bank claimed that the investments offered were CDs, "[i]n reality, the offerings are either an investment contract or

[23] As discussed further at pages 36 and 65 of this report, FINRA Rule 2010 provides authority for FINRA to sanction member firms and registered representatives for conduct that fails to meet "just and equitable principles of trade," which can involve conduct that does not involve securities.

[24] No record of the substance of these calls was maintained by the Dallas office.

interests in an unregulated investment company." In a footnote, the letter set forth the SEC's legal argument as to why the CDs are securities subject to the federal securities laws:

> Neither [the bank] nor [the firm] are entitled to rely upon certain United States case law that holds that a certificate of deposit is not a security. First, [the bank], which is located in Antigua, does not meet the definition of a bank under Section 3 of the Securities Act of 1933 ("Securities Act"). Certainly [the bank] is not subject to regulatory oversight in the U.S. Although there are cases that have held that CDs issued by foreign banks may not be securities, (*Wolfe* [*sic*] *v. Banco Nacional de Mexico*, 739 F.2d 1458 (1984)) *these cases turn on the degree of protection offered by the bank regulatory system of the country of the issuing bank. . . . It is unlikely that Antigua's bank regulatory structure offers depositors a degree of protection from loss that corresponds to that which exists in the United States*. In contrast to bank CDs offered by banks in the United States, it appears that funds invested in [the bank's] CDs bear a significant risk of loss. Indeed, one document in [the bank's] marketing materials (as discussed below) notes that the investor's entire investment is at risk and that [the bank's] ability to continue to pay back principal and interest is dependent on [the bank] "continuing to make consistently profitable investment decisions."

(Emphasis added.)

Another section of the letter, under the heading "Possible Fraudulent Scheme," indicated that "[t]he CDs being offered appear too good to be true." The section also chronicled a variety of concerns associated with the CD program, including the highly unusual three percent annual concession paid for each CD referral, and the consistently high reported performance of the Stanford bank's investments during periods when most of the markets in which the bank claimed to invest were down substantially. The section also indicated that the Stanford firm engaged in sales practices commonly associated with fraudulent schemes, including "push[ing] its [registered representatives] to sell the CDs by engaging in aggressive sales contests," and possibly terminating representatives for refusing to sell the CDs.

In the final section of the letter, under the heading "Possible Misrepresentations/Omissions," the SEC indicated that it had requested, but was never provided with, specific information regarding how the Stanford bank's funds are invested. The SEC letter also noted that the Stanford firm provides U.S. investors with only a limited—and potentially misleading—disclosure statement regarding the bank's investment portfolio and associated risks, while foreign investors receive even less information on the risks associated with their investments.

When interviewed, every member of the Dallas office who was asked about the SEC letter agreed that it was unlike any letter they had received in the past. Ordinary SEC referrals bear a referral number, contain little factual information, and begin with the phrase "we are referring the following matter." Despite the absence of this boilerplate language, the Dallas office staff understood the SEC letter to be a referral.

The leadership of the Dallas office decided to open a cause exam to investigate the allegations in the SEC referral letter. On August 5, 2005, the Dallas Director wrote to the SEC's Forth Worth office, acknowledging receipt of the SEC's letter, and indicating that FINRA had opened an examination to look into the matter. The August 5, 2005 letter also indicated that FINRA would notify the SEC's Fort Worth office of the outcome of its investigation.

On September 12, 2005, the SEC's Fort Worth office sent a request letter to the President of the Stanford firm. The letter indicated that the SEC staff believed the "CDs sold by the firm to be securities," and outlined a number of areas related to the CD program that required corrective action by the firm.[25] The letter also demanded that the firm halt and correct these violations, and report in writing how this was to be achieved. The letter expressly instructed that

[25] These included misrepresentations and omissions in statements to investors (in violation of SEC Rule 10b-5), excessive commissions (in violation of NASD Rules 2440, 2810, and 2830), failure to establish, maintain, and enforce written supervisory procedures (NASD Rule 3010(b)(1)), failure to conduct periodic reviews of customer account activity (NASD Rule 3010(c)), failure to develop and implement an adequate anti-money-laundering program (NASD Rule 3011), failure to file Treasury form 90-22.1 (Bank Secrecy Act), and failure to meet continuing education requirements (NASD Conduct Rule 1120).

the firm's response be sent not only to the SEC's Forth Worth office, but also to FINRA's Dallas Director.

7. Conclusion of the 2005 Cycle Examination

The lead examiner for the 2005 cycle exam was not assigned to the cause exam triggered by the SEC referral letter. His manager provided him with a copy of the referral letter, but did not inform him about the conversations with the SEC that took place at the June meeting or in any subsequent phone calls. The lead examiner stated that he reviewed the letter quickly in 2005 and believed it to be an "exam report." He thought the letter signaled that the SEC had taken over the CD case, and that it had referred only an advertising case to FINRA. As a result, he stopped focusing on the CD issues he had identified. He did not discuss his interpretation of the SEC letter, or his decision to curtail the cycle exam's inquiry into the CD program, with his superiors.

In an interview, the lead examiner was shown a copy of the SEC referral letter. He indicated that this document was what he had referred to as the SEC's "exam report." He stated that his characterization of the SEC letter as an exam report was clearly inaccurate, and agreed that the letter was a straight SEC referral on the CD issue. He also indicated that he had seen the September 12, 2005, letter from the SEC to the Stanford firm, and that this letter may have contributed to forming his opinion that the SEC was pursuing the CD case. He expressed regret that he had misinterpreted the SEC referral letter to FINRA, and indicated that, in light of his misinterpretation, he did not do all he could have done on the CD issue.

In January 2006, because of the lead examiner's case overload, his exam manager reassigned responsibility for completing the 2005 cycle exam to another examiner. The lead examiner transferred his files to the new examiner, after which his involvement in the exam ended. The lead examiner never discussed his concerns about the CDs described herein with the examiner in charge of the 2005 cause exam. The 2005 cycle exam was completed in 2007. The exam resulted in a fine to the Stanford firm,[26] but did not result in any action related to the CD program.

8. 2005 Cause Examination

The Dallas office initiated a cause exam of the Stanford firm to address the CD issue in the summer of 2005. The same manager who had supervised the 2005 cycle exam, and had expressed concerns regarding the CDs, supervised the cause exam. The Dallas Director and Associate Director received periodic briefings on the progress of the exam. The cause exam was assigned to a senior examiner in the Dallas office who specialized in cause exams.

The same Dallas office enforcement attorney who had told the lead examiner for the 2005 cycle exam that the Stanford CDs were not securities was involved in the 2005 cause exam from its early stages. She was shown the SEC referral letter, likely just after the cause exam was initiated. After learning of the referral, she told the cause examiner and other FINRA staff that the SEC and other federal agencies, including the Postal Service and the FBI, had been looking at Stanford's CD program for some time. The enforcement attorney also told the cause examiner that none of these agencies were able to develop and initiate an enforcement proceeding against the Stanford firm. As chronicled below, during the cause exam, the enforcement attorney repeatedly expressed the view that the CDs were *not* securities, and that FINRA therefore lacked jurisdiction to pursue a suitability case related to the CD program.

Shortly after the Dallas office opened the 2005 cause exam, the cause examiner went to the SEC's Fort Worth office to inspect their case files on Stanford. Among those files, she found

[26] As a result of the 2005 cycle exam, the Stanford firm was fined $20,000 for improper check holding, including checks related to CD purchases.

a note, apparently from Leyla Basagoitia to an SEC attorney, chronicling a lack of transparency and due diligence within the Stanford firm regarding the CD program. The note also explained that the offshore CDs were "being primarily sold to unsophisticated investors in Latin America who have been led to believe that these investments are of a safe nature because they are being offered by a subsidiary of a regulated U.S. Corporation." The note surmises that, despite the extremely high advertised CD rates, "the value of the bank's assets are well below the value of its obligations to its clients. If this assumption proves to be true, Stanford has engaged in a very large Ponzi scheme." The cause examiner incorporated this letter into the exam file, but no further action appears to have been taken to determine what Basagoitia knew about the CD program.[27]

In October 2005, counsel for the Stanford firm sent FINRA's Dallas office a copy of a letter, which had also been sent to the SEC's Fort Worth office, disputing the SEC's assertion that the offshore CDs were securities. The letter cited case law from the Supreme Court indicating that CDs issued by banks in the United States and insured by the Federal Deposit Insurance Corporation were not "securities" for purposes of the federal securities laws.[28] The letter also emphasized two cases from the Ninth Circuit (including *Wolf v. Banco Nacional De*

---

[27] In August 2005, the NYSE received a letter from Maria Perdomo of Venezuela regarding Stanford's CD program. The Perdomo letter indicates that Stanford had been "operating in Venezuela for several years without proper supervision and with sales people that are neither registered in the U.S. nor in Venezuela." The letter also indicates that these representatives

> offer an offshore product to clients that they are told the product is a Certificate of Deposit of a bank, when in reality the product is simply a "hedge fund." The public does not know in reality what they are investing in, thus are being deceived. This product, I believe if sold in the U.S. must have "prospectus", explaining all the risks involved and thoroughly explaining the product itself. . . . This bank, obviously doesn't lend money, it just takes money in so they can invest it in many things (bonds, commodities, margin purchases of stocks, etc, etc) all this happening without the client knowing the scope of their supposed "certificate of deposit."

NYSE forwarded the letter to FINRA. Ultimately, the Perdomo letter was incorporated into the 2005 cause exam. It does not appear that anyone associated with the exam followed up on the allegations raised in the letter.

[28] *Marine Bank v. Weaver*, 455 U.S. 551 (1982).

Mexico,[29] which were discussed in the SEC referral letter). These cases held that certain CDs issued in Mexico were not securities, despite the fact that the Mexican government only provided deposit holders with priority claim status—and not actual insurance—if the issuing bank became insolvent. The Ninth Circuit cases concluded that, despite this limitation, the availability of bank regulation in Mexico and that nation's history of successful banks rendered the CD investments virtually guaranteed. The Ninth Circuit also declined to address a claim that Mexican authorities were not enforcing Mexican bank regulations, citing the traditional respect paid to foreign governments by U.S. courts.

In the letter, Stanford's counsel argued that Antigua, like Mexico, provided CD holders with priority claim status. Stanford's counsel also argued that the Stanford bank was subject to comprehensive regulation in Antigua, and that U.S. courts were bound to show respect to this regulatory system.[30]

Although the examiner assigned to the 2005 cause exam was not an attorney, she assumed responsibility at the district level to assess the strength of the SEC's claim that the CDs were securities and the Stanford firm's response to the contrary. She was assisted in this task by a paralegal. It does not appear that the cause examiner or the paralegal consulted any case law concerning offshore CDs other than the cases referenced in the SEC referral letter and the Stanford firm's response.[31] Although the question whether the CDs were "securities" was

---

[29] 739 F.2d 1458 (9th Cir. 1984). The other Ninth Circuit case cited by the Stanford firm's counsel is *West v. Multibanco Comerex, S.A.*, 807 F.2d 820 (9th Cir. 1987).

[30] The Stanford bank's CD program differed in several respects from CDs issued by federally regulated banks in the United States. First, in contrast to the insurance provided in the United States by the Federal Deposit Insurance Corporation, the Antiguan government does not guarantee any portion of the CD deposits or interest. Second, in contrast to most U.S. banks, the Stanford bank did not engage in much commercial lending, which might have brought an increased measure of stability to the CD program.

[31] The only other case consulted by the cause examiner—*Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith*, 756 F.2d 230 (2d Cir. 1985)—involved brokered CDs issued in the United States. This case does not appear to have any bearing on the question of whether offshore CDs issued by a bank in Antigua are securities, but the cause examiner found it to be significant. In general, a brokered CD refers to the practice of a broker

ultimately referred to Sales Practice Policy and the Office of General Counsel, no comprehensive legal analysis of the issue was ever conducted.[32]

The cause examiner stated that, based on her review of these materials, she was unable to conclude that the Stanford bank CDs were securities under the federal securities laws. The Dallas enforcement attorney involved in the 2005 cause exam agreed with this assessment. In her interview, the enforcement attorney explained that, earlier in her career, she had come across the "securities" issue in the context of brokered CDs. She recalled that the SEC and FINRA had only prevailed on the "securities" element in cases where brokered CDs were sold to the public through fractional interests. The CDs marketed by the Stanford firm were not fractionalized.

When interviewed, neither the enforcement attorney nor other staff involved in the 2005 cause exam could explain why the brokered CD analysis was determinative of the question whether the offshore Stanford CDs were securities. According to the enforcement attorney, the brokered CD cases showed that regulatory agencies did not always prevail in arguing that CDs were securities. The enforcement attorney explained that her job was to serve as a "gatekeeper" to prevent cases from moving forward to the enforcement stage unless they truly warranted formal action. She also indicated that, in her experience, Ponzi schemes do not last as long as ten years, and that the fact that the Stanford bank had been selling the CDs for such a long period of time gave the CD program some measure of credibility.[33]

---

purchasing CDs from banks and reselling them to the public. The SEC and FINRA were concerned with the practice because investors did not necessarily purchase the CD itself, and often bought a fractional interest in the package of CDs held by the broker.

[32] See below at pages 33-35.

[33] In her interview, the enforcement attorney claimed that she considered the offshore element as part of her analysis of the issue, and that she bore suspicions regarding the regulatory regimes in certain Caribbean nations. However, there is no indication that she ever discussed these concerns with anyone involved in the 2005 cause exam; rather, all participants in the staff discussion regarding the cause exam recall that their analysis relied on the brokered CD case law. The enforcement attorney also does not appear to have created any documentation regarding her legal analysis of the CD issue in connection with the 2005 cycle or the 2005 cause exam.

In January 2006, the cause examiner referred a portion of the exam to FINRA's advertising regulation staff. The advertising regulation staff found a number of deficiencies with the Stanford firm's sales brochures, including insufficient warnings about the principal risks to U.S. investors and the absence of FDIC insurance for the CD program.

According to email records, the cause examiner also conferred with the lead examiner on the 2005 cycle exam regarding the CDs. Specifically, in February 2006, she emailed him to ask whether he had "any information about what customers were liquidating to purchase Stanford CD's from your routine exam?" The lead cycle examiner responded that he "recall[ed] that most of the trades that we looked at involved new clients who bought the CDs using cash, and they did not cash out other products or securities positions." When interviewed, the lead cycle examiner acknowledged that his response was not entirely accurate, as he failed to note that the 2005 cycle exam team did not check to see if CD purchases were being indirectly funded with proceeds from liquidated securities.

The cause examiner and the enforcement attorney discussed the "securities" issue at several meetings with other staff in the Dallas office, including with the Dallas Director and Associate Director. The Dallas Director recalls that the discussions focused on the brokered CD analysis. The discussions culminated in the preparation of an investigative conference report on the 2005 cause exam in April 2006.[34] The cause examiner drafted the report, but failed to include the fact that, according to the SEC's July 2005 referral letter, $1.5 billion in investor funds were potentially at risk. The report's jurisdiction analysis simply excerpted portions of the SEC referral letter and the Stanford firm's response to the SEC. The conference report's

[34] The investigative conference is a required element of every potential formal disciplinary matter. According to FINRA's Member Regulation Handbook, "the primary goal of the conference is to enable Enforcement and Member Regulation to reach consensus on the key aspects of an investigation, including issues, appropriate scope, and required evidence about the appropriate treatment of each matter."

discussion of the state of banking regulation in Antigua quotes from, and is based in significant part on, the representations of Stanford's counsel. The report concluded that, "Based on past cases and the documented protections that are offered by Antigua, the staff does not believe [FINRA] can adequately prove that the CD's are securities." This conclusion is debatable. As described below at footnote 52, the SEC in its case against Stanford reiterated its argument that the Stanford CDs are "securities."

The conference report also described the advertising portion of the cause exam, noting that Antiguan law does not in fact provide true priority claim status for CD holders, and described the protections offered by Antiguan law as "limited." Specifically, the advertising section indicates that Antiguan corporate law gives the payment of wind-up costs, the payment of officers and employees for up to three months prior to the seizure of the bank; all taxes due; and the "fees and assessments owing to the appropriate officer" priority over any portion of time deposit funds. In addition, the advertising section indicates that time deposit holders are only given preference over other creditors for up to $20,000 in deposit funds.[35]

In May 2006, the Dallas Associate Director forwarded the conference report to an attorney in FINRA's Sales Practice Policy group of the Member Regulation department in Washington, DC.[36] The Sales Practice Policy attorney had only been in that position since January 2006. When interviewed, she indicated that her job was to field legal questions from district offices, but that this role overlapped with the function of FINRA's Office of General Counsel, and that only the Office of General Counsel was authorized to develop the

[35] The conference report ultimately identified three potential violations of FINRA's advertising rules: (1) the brochures failed to contain the name of the Stanford firm and failed to make clear the firm's relationship with the bank; (2) the brochures failed to present a fair and balanced treatment of the risks and potential benefits of the CD program; and (3) the brochures claimed, inconsistent with the assertions made by the firm to FINRA, that the bank was not subject to the reporting requirements of any jurisdiction and that CD holders were not entitled to depositor protection.

[36] At the time, the group was known as "Regulation Policy."

organization's position on legal issues. Sales Practice Policy did not then and does not now have an internal handbook to guide its staff in fielding inquiries from district offices.

The Sales Practice Policy attorney was asked to review the conference report's conclusion that the "staff does not believe [FINRA] can adequately prove that the CD's are securities." She called an attorney in the Office of General Counsel to discuss the issue. During this call, which reportedly lasted about five minutes, the Office of General Counsel attorney indicated that CDs are typically not considered securities. The Sales Practice Policy attorney did not provide a copy of the conference report or inform the Office of General Counsel attorney that the CDs in question were issued by an offshore bank. Because the conference report did not reference $1.5 billion in potentially at-risk investor funds, neither attorney was aware of the magnitude of the potential fraud. In an interview, the attorney from the Office of General Counsel stated that she found it hard to believe that neither the Dallas office nor Sales Practice Policy perceived the foreign element of the CDs as the key issue in determining whether the CDs were securities. When presented with the conference report and the SEC referral letter for the first time in her interview, the Office of General Counsel attorney indicated that, had she known the facts outlined therein, she would have focused the securities inquiry on the degree of protection offered by the Antiguan regulatory system, and that her conversation with the Sales Practice Policy attorney would surely have lasted more that five minutes.[37]

After the phone call described above, the Sales Practice Policy attorney recalls that she contacted the Dallas office and indicated that she and the Office of General Counsel attorney were unable to confirm that the Stanford bank CDs were securities. In June 2006, the Dallas Associate Director sent an email to the Dallas Director and other office staff indicating that Sales

[37] Neither attorney documented their communications with each other, nor did they create any written record memorializing what, if any, legal analysis they conducted.

Practice Policy and the Office of General Counsel agreed with the staff's assessment of the securities issue.

Meanwhile, in June 2006, Bernerd Young—the former head of FINRA's Dallas office who had left in 2003—joined the Stanford firm as Managing Director of Compliance. The Dallas staff did not consider Young's presence to have compromised the 2005 cause exam.

In 2006 and 2007, while the cause exam was still ongoing, the manager overseeing the exam attended several general meetings with the SEC's Fort Worth office.[38] At one of these meetings, he informed the SEC that FINRA's enforcement staff could not endorse the proposition that the CDs were securities. According to the manager, the SEC staff questioned whether FINRA could bring anything more than an advertising charge.[39]

During interviews, the Dallas staff were questioned repeatedly regarding the conclusion that the CDs were not securities. The Director, the Associate Director, and the manager who oversaw the cause exam expressed reliance on the opinion of the enforcement attorney, as well as the confirmation by Sales Practice Policy and the Office of General Counsel. The enforcement attorney expressed the view that, even in 2009, she is not sure that the Stanford bank's CDs are securities.

[38] Minutes maintained by the SEC's Fort Worth office of a February 17, 2006 meeting attended by staff from the SEC, FINRA and the Texas State Securities Board note that, "[FINRA] is pursuing concerns regarding Stanford Group's advertising. The brochure used to sell its affiliates supposed CDs is unbalanced regarding the risks and benefits. Whether or not the CDs are securities is irrelevant in terms of the advertising rules because it covers all communications." This occurred approximately three months before the Dallas office contacted the Sales Practice Policy attorney to get input on the Dallas staff's assessment that they could not pursue a suitability case against the Stanford firm.

Minutes maintained by the SEC's Fort Worth office of a March 16, 2007 meeting attended by the SEC, FINRA and various state regulators notes in reference to FINRA and the Stanford firm that "This matter was referred by the SEC. The firm's sales materials were run through the [FINRA] advertising department and serious disclosure and advertising deficiencies were noted. [FINRA] expects that their case will be strictly a 2210 Communications with the Public case. The SEC is looking at the issues related to whether the firm's products, which are sold as CDs, are securities."

[39] The Stanford firm ultimately settled the advertising charge for $10,000.

Dallas staff were also asked whether they ever considered bringing an enforcement action under FINRA Rule 2010—formerly NASD Rule 2110—which allows the organization to enforce "just and equitable principles of trade" at member firms. This Rule is not limited to fraud in connection with the sale or purchase of securities, and has been used by FINRA in a series of cases involving a variety of fraudulent conduct at member firms not involving "securities." The cause exam manager recalled considering this rule at the start of the exam, and could not recall why it was not pursued. The Associate Director had no recollection of considering the Rule, and expressed doubt as to whether it could serve as the basis for an enforcement proceeding. The Dallas Director expressed the opinion that Rule 2010 was not a stand alone rule and that FINRA can only bring 2010 enforcement actions if the member firm has violated some other FINRA Rule. This interpretation of Rule 2010 is not substantiated by the text of the rule, or by FINRA practices in prior enforcement actions.[40]

Finally, the Dallas Director, the cause examiner, and the enforcement attorney all noted their views that, as of 2005 and 2006, they did not have sufficient indication that the Stanford CDs were a fraudulent scheme to justify taking further action at that time. The SEC referral letter, however, contains numerous indications of fraud in connection with the CD program which were not investigated by the Dallas office.[41] The Dallas Director did not share the SEC

[40] Other FINRA employees also differed in their understanding of Rule 2010. The Regional Chief Counsel of FINRA's New Orleans office—who serves as the enforcement attorney's supervisor—indicated that FINRA takes a conservative approach to using the rule in enforcement matters. By contrast, the attorney from the Office of General Counsel indicated that Rule 2010 can be used expansively. The Office of General Counsel attorney also indicated that, when she had been employed at the SEC, SEC attorneys noted that the SEC did not have a provision like FINRA Rule 2010. For a general discussion of Rule 2010, see page 65 of this report.

[41] In particular, the letter indicates the following:

> SIB [the Stanford bank] claims it is investing in "foreign and U.S. investment grade bonds and securities, and Eurodollar and foreign currency deposits" and "securities from established, quality companies and governmental agencies from around the world." Yet, SIB's high interest rates are inconsistent with its claimed portfolio. Minimum guaranteed interest rates since 2000 have ranged from approximately 3.5% to over 6% for short-term investments. For the Index-Linked CD tied to the S&P 500, the minimum guarantee has been approximately 3.5% or a percentage of the return

referral letter or her office's decision not to investigate the CDs with senior FINRA management until December 2008.

The Dallas staff would have faced substantial hurdles in obtaining information from a non-member offshore entity such as the Stanford bank. While the Special Committee understands that the issue of whether the CDs were in fact "securities," as defined under the Exchange Act, is debatable, there were sources of information regarding the potential fraudulent scheme available from the Stanford firm—the U.S. broker-dealer—that the Dallas staff did not investigate in 2005 and 2006. In addition, the Dallas staff could have sought expert analysis of the advertised CD rates (coupled with the annual three percent concession and overhead costs) and their consistency with the claimed portfolio, as well as the claim of consistent profitability over the prior ten years.

---

of the S&P 500, whichever is higher. The brochures given to investors indicate that that percentage of participation may vary at SIB's direction, but suggest a participation rate of *125%* of the S&P 500. We are unaware of any legitimate short-term investment that not only guarantees a return significantly higher than a CD, but allows you to participate in up to 125% of equity market returns. Moreover, SIB pays an *annual* 3% trailer, which is troubling, as it adds significant, on-going costs which SIB must meet before it can generate a profit. We are unaware of any legitimate, short-term, low or no-risk investments that will pay a 3% concession every year an investor keeps his funds invested in any product.

Further, SIB's annual audit casts doubt upon its claims of consistent profitability over the last 10 years. For example, from 2000 through 2002, SIB reported earnings on investments of between 12.4% and 13.3%. This return seems remarkable when you consider that during this same time frame SIB supposedly invested at least 40% of its customer's assets into the global equity market. Ten of 12 global equity market indices were *down substantially* during the same time frame. The indices we reviewed were down by an average of 11.05% in 2000, 15.25% in 2001 and 25.87% in 2002. It is equally unlikely that the portion of the portfolio invested into debt instruments (approximately 60%) could make up the expected losses in the equity portion of the portfolio. For example, in 2002, when the global indices were down 25%, the debt portion of the portfolio would have to generate an approximately 40% return for SIB to generate the 12.4% overall return it claimed in 2002.

Finally, the Staff learned from persons formerly associated with SGC [the Stanford firm] that it also appears to be engaged in sales practices that are commonly associated with fraudulent activities. The firm pushes its RRs to sell the CDs by engaging in aggressive sales contests. Prizes offered include trips to Antigua and automobiles. One RR has stated that she was fired for her refusal to sell SIB CDs. Moreover, the SGC has refused to provide to the selling RRs any further disclosure other than the minimal information it provides to potential investors regarding the specifics of SIB's investment portfolio.

It is impossible to say whether, if the staff had taken these steps, they would have developed evidence sufficient to bring a fraud case against the Stanford firm. However, the Dallas staff may well have learned that employees of the Stanford firm were not adequately informed about the investments underlying the CD program, that material representations made in the marketing materials for the CDs were, in fact, false, and that Stanford firm customers were liquidating securities to purchase CDs based on those false representations. This information would have been relevant in building a case against the Stanford firm and its registered and associated persons, including Stanford himself, for violations of the anti-fraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5.

9. <u>2007 Cycle Examination</u>

The next cycle exam of the Stanford firm occurred in 2007, at which time approximately 43 percent of the total revenues of the firm were attributable to the CD program. Although the lead examiner assigned had worked as an examiner since 2004 and had been in the Dallas office since 2006, she had no prior experience with the Stanford firm.[42] Other staff on the cycle exam included one other relatively senior examiner and two examiner trainees.[43]

In preparing for the 2007 exam, the exam team decided not to investigate the CDs. When asked to explain this decision, the lead examiner indicated that she did not see the utility of repeating the work that was done during the 2005 cause exam. She also indicated that the exam manager who had overseen the 2007 cycle exam made the decision not to look at the CDs.

[42] Similarly, the manager who supervised the 2007 cycle exam had little prior experience with the Stanford firm, though he was aware of the 2005 cause exam because the exam had been discussed at certain management meetings of the Dallas office.

[43] No member of the 2007 cycle exam team had been with the Dallas office while Bernerd Young was in charge.

When interviewed, the manager did not recall making this decision, but agreed that a decision to exclude the CDs from the exam could not have been made without his input.[44]

When interviewed, the 2007 cycle examiner indicated that her manager had called the SEC prior to the 2007 exam and inquired about the status of the SEC's investigation. The examiner recalled that the SEC told the manager that it was currently awaiting information from the Stanford firm, and that there were no particular steps that they wanted FINRA to take regarding the CDs. The manager had no recollection of the call, and the call is not documented in the exam file. The manager indicated that the decision to exclude the CD program from the 2007 cycle exam was driven by the results of the 2005 cause exam, and not by any deference to the SEC's parallel investigation.[45] The 2007 cycle exam report contains no documentation of the decision to exclude the CD program from the exam.

10. <u>2007 Miami Branch Examination and 2009 Unannounced Branch Examinations</u>

In late 2007, a new Associate Director and the manager responsible for the 2007 cycle exam in Dallas decided to refer an examination of the Stanford firm's Miami office to FINRA's office in Boca Raton, Florida. When interviewed, they indicated that the branch exam was necessary to follow up on certain deficiencies in the firm's research reports that had been uncovered during the 2007 cycle exam. In their view, the Boca office was best positioned to conduct the exam because the office was closer to Miami, and the referral would spare Dallas staff from an extended examination outside of their home district.

---

[44] It does not appear that the focus of the 2007 exam was approved by anyone above the exam manager. At the time the exam was focused, the Associate Director had left the Dallas office, and his replacement had not yet arrived. In addition, during this period, the Dallas Director began splitting her time between managing the office and her new responsibilities as Regional Director.

[45] Numerous FINRA staff noted the organization's longstanding practice of not deferring action on issues regarding a member firm unless specifically requested by the SEC.

The Dallas office did not transmit any of the information regarding the CDs—such as the SEC referral letter—to the Boca office. In an email to the Boca office, the manager responsible for the Dallas 2007 cycle exam indicated that the firm's Miami office "was selected for two reasons: (1) large # of reps working in the branch office (I think it's over a 100) and (2) they perform market making activities in the branch. In our quest to conduct more branch exams, we decided to pick a branch of this firm during the main office field work. Other than that, *there are no red flags* or specific people to focus on during the branch." (Emphasis added.)

Although the branch exam referral from Dallas did not mention the CDs, the Director of FINRA's Boca Raton office told his exam team to look into the CD program. He had observed a number of advertisements in the Miami area press touting the financial success of the Stanford firm, and also was familiar with Young and another individual in Stanford's compliance department, which led him to conclude that the firm warranted further attention. In contrast to the approach employed by the Dallas office, the Boca office decided to focus their exam on the CDs regardless of whether they ultimately turned out to be securities.

The Boca exam team consisted of an exam manager, an examiner with two years of experience, and an examiner who had just been elevated from trainee status. The most junior examiner had participated as a trainee in the 2007 cycle exam of the Stanford firm conducted by the Dallas office and knew generally that the SEC had looked into the CD program. However, neither he, nor any member of the Boca exam team, was aware at any point during the branch exam of the existence of the SEC referral letter or of any of the key details regarding the CD program that were then known by the Dallas office. Thus, the Boca exam team was required to assemble the examination of the CD program from scratch.

In December 2007, the Boca exam team went to the Stanford firm's Miami branch office. The exam team was precluded by the firm from speaking with its employees unless a member of the firm's compliance staff was present in person or via telephone. During the exam, the team inspected documentation related to the CDs, including logs of customer files that had been "pouched" from the firm to the Stanford bank. The team also discovered that representatives of the Stanford firm were engaged in sales contests involving the CDs. Finally, the team discovered that, at the time, roughly 90 percent of the revenues of the Stanford firm's Miami office were derived from the sale of the CDs.

On January 3, 2008, the Boca exam team sent a document request under FINRA Rule 8210 to the Stanford firm.[46] The request sought information about the Stanford bank's investment portfolio. In response, the firm provided some materials regarding the CDs, but did not provide any substantive information about the investment portfolio.[47]

---

[46] Rule 8210 allows FINRA to inspect the books and records of the member firm, as well as certain owners of the member firm. The rule is a critical tool in FINRA's investigative arsenal. Because FINRA lacks subpoena power, Rule 8210 has been characterized as "one of the staff's primary tools for carrying out its regulatory responsibilities." (NASD Notice to Members 99-45 (November 1999)).

The rule itself states:

> For the purpose of an investigation, complaint, examination, or proceeding authorized by the FINRA By-Laws or rules, an Adjudicator or FINRA staff shall have the right to: (1) require a member, person associated with a member, or person subject to FINRA's jurisdiction to provide information orally, in writing, or electronically (if the requested information is, or is required to be, maintained in electronic form) and to testify at a location specified by FINRA staff, under oath or affirmation administered by a court reporter or a notary public if requested, with respect to any matter involved in the investigation, complaint, examination, or proceeding; and (2) inspect and copy the books, records, and accounts of such member or person with respect to any matter involved in the investigation, complaint, examination, or proceeding.

FINRA's By-Laws define the phrase "person associated with a member" to include "(1) a natural person who is registered or has applied for registration under the Rules of the Corporation; (2) a sole proprietor, partner, officer, director, or branch manager of a member, or other natural person occupying a similar status or performing similar functions, or a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member, whether or not any such person is registered or exempt from registration with the Corporation under these By-Laws or the Rules of the Corporation; and (3) for purposes of Rule 8210, any other person listed in Schedule A of Form BD of a member." In general, Schedule A of Form BD requires disclosure of the direct owners and executive officers of the broker-dealer.

[47] The exam team viewed the portfolio information as being critical, but did not consult with resident enforcement attorneys regarding the Stanford firm's failure to produce it.

In the summer of 2008, the Boca Director came across news stories indicating that the SEC had issued subpoenas to former Stanford firm employees Charles Rawl and D. Mark Tidwell.[48] The Boca Director immediately asked the branch exam team for an update on the status of the exam. The team informed him that the Stanford firm was resisting document requests related to the Stanford bank on the grounds that the firm and the bank were separate legal entities. The Boca Director instructed the team to send another Rule 8210 request to the firm, again asking for information regarding the bank's investment portfolio. The team sent the second 8210 request on August 27, 2008.

In December 2008, news of the Madoff investment scheme broke. Prompted in part by this news, the Boca Director again asked the exam team for a progress update. The team showed him the response to the August 27, 2008 document request. This response consisted of advertising materials for the CDs, but did not include any information concerning the Stanford bank's portfolio. The exam team indicated that Young did not appear to know what was in the bank's portfolio, even though he claimed to have done personal due diligence on the bank. In his interview, the Boca Director described Stanford's response material as mere "propaganda."

The refusal of the Stanford firm to provide information on the bank's investment portfolio prompted the Boca Director to research the firm's website. He found nothing of substance other than a report on the Stanford firm's charitable activities. He also inspected the bank's annual report and found it devoid of any substantive information regarding the bank's assets. In addition, the Boca Director inspected the Stanford firm's recent financial statements and was surprised to find that the firm claimed to be thriving at a time when the economy was in recession and peer firms were struggling. The Boca Director contacted a senior colleague at

---

[48] Rawl and Tidwell had been terminated by the Stanford firm, and, according to an exam team member, both had negative sales figures with respect to the CDs at the time of their termination.

FINRA's national office who had substantial experience in fraud cases, who agreed that the information regarding the Stanford firm was troubling.

The Boca Director then contacted the Dallas Director and Associate Director to relay his concerns about the Stanford firm. According to the Boca Director, the Dallas Director informed him that her office had already looked into the CDs and had determined that there was nothing for FINRA to pursue. The Boca Director then contacted the SEC's Miami office. The SEC's Miami office, in turn, put him in contact with the SEC's Fort Worth office. In mid to late December, the Boca Director spoke to the Regional Director of the SEC's Fort Worth office and was told that the SEC was looking into the Stanford firm.

At this point, the Boca Director decided that significant action was necessary. He conferred with the Dallas Director about the possibility of conducting unannounced onsite exams of various branch offices of the Stanford firm, and obtained permission to devote additional resources to the branch exam, including a forensic computer consultant. The Boca office also began interviewing former employees of the Stanford firm, including those who had been subpoenaed by the SEC.

Concurrently, the Boca exam team was furthering their inquiry into the CD program. As part of this effort, the exam team searched the SEC's EDGAR database for companies in which the Stanford bank might have invested. They uncovered only 13 such companies, which suggested to the team that the bank was not investing primarily in stocks, but rather in illiquid assets. The Boca examiners also reviewed FINRA's Central Registration Depository ("CRD")[49] to determine if any registered representatives were employed at the Stanford firm in addition to the Stanford bank or other Stanford companies. The examiners noted that a search for dually

[49] CRD is an electronic database that functions as the central licensing and registration system for the U.S. securities industry and its regulators. It contains the registration records of more than 4,800 registered broker-dealers and the qualification, employment, and disclosure histories of more than 660,000 active registered individuals.

employed representatives was a way of trying to get around the firm's claims that it had no access to information regarding the bank's portfolio.[50]

On December 30, 2008, the Boca examiners, together with two employees from the Dallas office, interviewed Rawl and Tidwell (the former Stanford firm employees who were the subject of SEC subpoenas). Rawl and Tidwell addressed the CD program, and indicated their belief that the Stanford bank was merely a dumping ground for Allen Stanford's failed investments. They also noted that the bank's portfolio was managed by an individual based in the Stanford firm's office in Tupelo, Mississippi. This information provided the exam team with another possible avenue for seeking information about the portfolio.

On January 9, 2009, the Boca office spearheaded six simultaneous, unannounced exams of Stanford firm branch offices.[51] Staff from the Dallas office assisted in some of these exams. Interviews conducted during these exams disclosed that the investment portfolio underlying the CDs was comprised of three tranches. Tier 1, which totaled approximately $200 million, were cash equivalent assets; Tier 2, which totaled approximately $300 million, were monitored by Stanford Financial Group analysts. No one but Stanford and one colleague had information about Tier 3 investments, which represented the vast bulk of the bank's $7.2 billion of claimed assets. After the unannounced exams, FINRA turned over the materials it had uncovered in the branch offices to the SEC. On February 16, 2009, the SEC filed a civil complaint alleging securities fraud against Stanford and his associates. The complaint named the Stanford firm and

[50] Certain marketing materials obtained by the Boca examiners from the Stanford firm's Miami office indicated that Stanford Financial Group ("SFG") provided management services in connection with the investment portfolio for the CDs. The examiners identified a number of U.S. based employees that were Stanford firm employees with series 7 registrations and that were also employed as analysts for SFG. As registered employees of the Stanford firm, FINRA had authority to question such employees about their outside business activities, even if such activities were not "securities" related. This investigative step was not taken during the prior Stanford exams.

[51] The Boca Director intended to conduct an examination of the Stanford firm's main office in Houston as well, but the Director of SEC's Forth Worth requested that FINRA refrain from doing so because the SEC wished to enter that office.

the Stanford bank as defendants. On the same day, the SEC obtained a temporary restraining order freezing Stanford's assets.[52]

In an interview, the Dallas Director was asked what had changed by 2009 to warrant FINRA's shift in attitude toward the Stanford firm. She indicated that she realized since 2005 that there was something wrong with the Stanford firm and that it was not the "cleanest" firm. She maintained, however, that FINRA did not have enough evidence of fraud in 2005. She acknowledged that the Stanford bank's claimed rates of return were a "red flag," but questioned how FINRA could have proven the fraud without access to the bank's records. She could not explain why the Boca office was able to pursue the investigation of the CDs in 2008 in ways that the Dallas office had not in 2005 and 2006.

---

[52] In the civil case against Stanford and his associates, the SEC has set forth detailed argument as to the manner in which the Stanford CD program implicates the anti-fraud provisions of the Securities Exchange Act of 1934. First, the SEC alleges that customers of the Stanford firm sold millions of dollars of stocks and bonds in order to invest in the CDs. Based on this allegation, the SEC argues that the Stanford case involves fraud in connection with the sale of securities. See *SEC v. Zandford*, 535 U.S. 813, 825 (2002) (holding that the "in connection with" element of section 10(b) of the Securities Exchange Act of 1934 is satisfied by "a fraudulent scheme in which the securities transactions and breaches of fiduciary duty coincide.").

In the alternative, the SEC maintains that the Stanford bank CDs themselves constitute "securities" subject to the anti-fraud rules of the 1934 Act. The SEC's argument is based principally on *Reves v. Ernst & Young*, 494 U.S. 56 (1990). Although *Reves* did not involve CDs or foreign-based instruments, the case sets forth the analysis as to whether instruments denominated as "notes" are "securities." As in prior "securities" cases, the *Reves* opinion emphasized the need to "examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary." *Id.* at 67. The *Reves* opinion, however, focuses specifically on availability of federal regulation. *Id.* at 69 (observing that "the notes here would escape federal regulation entirely if the Acts were held not to apply."). According to the SEC, CDs issued by foreign banks necessarily fail to meet this element. The SEC acknowledges in a footnote that pre-*Reves* lower court cases—including the pair of Ninth Circuit cases discussed above at pages 25 and 29-30—had excluded certain foreign CDs from the securities laws, but argues that those cases are inconsistent with *Reves*. See Memorandum In Support of Motion for TRO, Prelim. Injunction and Other Emergency Relief, *SEC v. Stanford International Bank, Ltd. et al.*, N.D. Tex. 3:09-cv-0298-N.

It also should be noted that, although the Stanford bank was nominally subject to regulation and inspection by the Financial Services Regulatory Commission of Antigua, according to the indictment in one of the pending criminal cases, Stanford bribed the Commission's Chief Executive Officer not to audit the bank. In addition, Stanford and the Commission's Chief Executive Officer allegedly conspired to thwart inquiries by U.S. enforcement authorities into the bank's portfolio and operations.

B. The Madoff Case

1. Background

In 1960, Bernard L. Madoff ("Madoff") founded Bernard L. Madoff Investment Securities, LLC ("the Madoff firm") and registered it with the SEC as a broker-dealer. Madoff was at all times the chairman and sole owner of the Madoff firm. The firm was a pioneer in the electronic trading of equities and was one of the first firms to join the NASDAQ. The firm became a prominent and well-respected market maker—a firm that facilitates trading in a particular security by simultaneously offering both to buy and sell the security from other broker-dealers, with the goal of making a profit from the spread between its purchases and sales. Indeed, the firm, which was never a member of the NYSE, is often credited with helping to invent the "third market"—*i.e.*, the trading of NYSE-listed stocks over-the-counter rather exclusively than on the NYSE. The firm also engaged in substantial proprietary trading for its own account. The firm's market making and proprietary trading operations constituted a successful broker-dealer business for many years. According to the firm's broker-dealer filings, neither the market making nor proprietary trading activities involved the maintenance of customer accounts.[53]

In addition to his broker-dealer businesses, Madoff also operated an investment advisory business through the same firm. The investment advisory business was, in actuality, a gigantic Ponzi scheme. According to his March 2009 plea allocution in federal court, Madoff solicited money from investors, representing to most of them that the money would be invested in stocks

[53] Madoff and some members of his family became well-known members of the financial community. Madoff served as Chairman of NASDAQ in the early 1990s. His brother, Peter Madoff, served on the NASD Board, including as Vice Chair, as well as various committees. Madoff's son, Mark Madoff, served on the NASD's National Adjudicatory Council. In 2008, his niece, Shana Madoff, served on FINRA's Compliance Advisory Committee. Interviews of FINRA staff and review of exam files identified no information to suggest that the Madoff firm received preferential or lenient treatment because of Madoff's prominence or his family's history of service to NASD and FINRA.

and options using a "split strike conversion strategy" which, he promised, would yield consistent, above-market rates of return.[54] Instead, Madoff deposited the money into bank accounts and used the principal contributed by later investors to pay returns to earlier investors. According to the SEC, the Madoff firm never executed a single securities trade in the course of the investment advisory business, nor did it engage other brokers to execute such trades. The client account statements, order tickets, trade confirmations, and other documentation relating to the investment advisory business were wholly fabricated and completely fictitious.

Madoff went to considerable lengths to conceal his investment advisory scheme and keep it separate from the broker-dealer business of the firm. For example, the market making and proprietary trading side of the Madoff firm used bank accounts held at the Bank of New York. These accounts were reflected in the firm's books and records, the FOCUS reports that it filed with FINRA, and the audited financial statements that it filed with both FINRA and the SEC.[55] The investment advisory business, on the other hand, used accounts at JP Morgan Chase, which were not reflected in regulatory filings made by the Madoff firm in connection with its broker-dealer operations. Similarly, the fictitious trading activity and securities positions that Madoff reported to his investment advisory clients did not appear in the records of the firm's broker-dealer business.

Although FINRA's New York-based staff examined the Madoff firm on a regular basis, FINRA did not learn of the Ponzi scheme—or see the firm's records of its purported investment activities—until after Madoff confessed to his sons and was arrested by the FBI on December 11,

[54] As explained by Madoff to his investment advisory clients, the "split strike conversion strategy" consisted of buying a subset ("basket") of common stocks in the Standard & Poor's 100 Index ("S&P 100") before an expected run-up in the S&P 100 and selling the basket after the index had risen. The downside risks of this effort to time the market were purportedly hedged—and the consistent returns achieved—by purchasing put options on the S&P 100 funded by sales of call options on that index.

[55] According to filings in a recent action by the SEC, the auditor of the Madoff firm produced and signed these audit reports, but did not actually perform any audits of the Madoff firm.

2008. The next day, a team of FINRA examiners joined staff from the SEC and FBI at the Madoff firm offices where, for the first time, they reviewed records related to the Ponzi scheme, much of it gathered from Madoff's personal desk and the firm's secret office space on the 17th floor of the Lipstick Building in New York.

In the 1980's, Madoff established a United Kingdom corporation, Madoff Securities International Ltd. ("MSI"), that operated as an affiliate of the Madoff firm. MSI was registered with the U.K. Financial Services Authority and engaged principally in proprietary trading. Bernard Madoff owned 30 percent of MSI, served as Chairman of its Board of Directors, and, according to public reports, exercised control over its operations. MSI was identified as an affiliate in the Madoff firm's Form BD.[56]

A third broker-dealer—Cohmad Securities Corporation ("Cohmad")—is also relevant to FINRA's oversight of Madoff. Cohmad was founded in 1985 by Madoff and Maurice Cohn. Madoff and his brother, Peter, together owned 24 percent of the firm.[57] Cohmad operated out of the 18th floor of the Madoff firm's offices, reportedly renting both space and equipment from the Madoff firm. It did not have a separate reception desk or signs; a visitor to the Madoff firm would have been unaware that Cohmad was there.

During the period relevant to this report, Cohmad was registered as a broker-dealer and reported having approximately 750 to 850 customer accounts, which were held by and cleared through Bear Stearns Securities Corporation. These accounts usually generated roughly 300 transactions per month, mostly in equities and, to a lesser extent, municipal bonds.

---

[56] Form BD is the Uniform Application for Broker-Dealer Registration. Broker-dealers use Form BD to register with the SEC, FINRA, and other self-regulatory organizations through the CRD system. A broker-dealer is required to update its Form BD by submitting amendments whenever the information on file becomes inaccurate or incomplete for any reason.

[57] The Madoff ownership interests were disclosed in Cohmad's Form BD.

Cohmad derived the vast majority of its revenues from the Madoff firm. For example, its audited financial statements for the year ended June 30, 2005, showed that more than 90 percent of its revenue ($7.1 million out of $7.8 million) was derived from the Madoff firm. By the end of 2005, its revenue from the Madoff firm had grown to 95 percent of its total revenues. Cohmad characterized these revenues as "fees for account supervision" in its internal accounting records and as "brokerage service fees" in its audited financial statements.[58] According to FINRA's 2004 examination report, Cohmad represented to FINRA that

> [A]pproximately 85 percent of the firm's revenue is generated from the execution services it provides to Bernard Madoff, a non-affiliated broker dealer. . . . Cohmad through its clearing firm, has access to the DOT [Designated Order Turnaround] system whereby it can route its listed securities for execution to the floor of the New York Stock Exchange ("NYSE"). Madoff utilizes this service through Cohmad because it is not a member of the NYSE. Cohmad earns fees from Madoff for this service, however, there are no written contracts between Madoff and Cohmad.

The Madoff firm apparently paid these fees by writing a single check each month for a specific amount, calculated down to the penny. These "brokerage service fees" —which would have been expected to vary depending on the volume of the trades routed to the NYSE—were frequently the same from month to month. For example, these payments, as reflected in Cohmad's internal financial records, were as follows during 2005:

Jan.	$548,092.82	May	$581,150.17	Sept.	$581,150.17
Feb.	$548,092.82	June	$581,150.17	Oct.	$581,150.17
Mar.	$889,676.83	July	$604,914.24	Nov.	$581,150.17
April	$581,150.17	Aug.	$581,150.17	Dec.	$581,150.17

After the Madoff scandal broke in December 2008, Cohmad admitted to FINRA staff that these fees were, in fact, compensation for bringing clients into Madoff's investment advisory business. The Cohmad representatives stated that this compensation was originally tied to NYSE

[58] In its FOCUS filings, Cohmad recorded these revenues on the line identified as "Fees for account supervision, investment advisory and administrative services."

trades that the Madoff firm routed though Cohmad, but eventually just became a "number" selected by Madoff based on the number of clients referred and the amount of new funds invested.[59] Cohmad further stated that this change from one type of compensation to another had come about due to the decimalization of trading on the NYSE. Between 2000 and 2008, these payments totaled over $67 million.

2. Registration of the Madoff Firm as an Investment Adviser

According to public reports, from 2003 to 2005, SEC staff examined the Madoff firm in response to complaints that the firm was running an unregistered, multi-billion dollar investment advisory business that operated as a Ponzi scheme.[60] In January 2006, the SEC's Enforcement Division opened an investigation of the matter. The investigation was closed without formal action after the Madoff firm agreed to register as an investment adviser. FINRA was never informed of the complaints, the SEC's investigation, or its resolution.[61]

In September 2006, the Madoff firm registered with the SEC under the Investment Advisers Act by filing Form ADV through IARD, an electronic database system which FINRA has contractually agreed to operate and maintain on behalf of the SEC. The Madoff firm's Form ADV represented, among other things, that it had approximately $17 billion under management for 23 clients, and was compensated through commissions. The Madoff firm also

---

[59] According to lawsuits filed by the SEC and the Massachusetts Securities Division, these fees were calculated as a percentage of the total cumulative amount of principal that Cohmad had brought into Madoff's Ponzi scheme, less any amounts withdrawn by clients.

[60] Based on a review of the available evidence, it appears that FINRA never received any similar complaints about the Madoff firm.

[61] In May 2006, SEC staff contacted FINRA to request data on over-the-counter options positions held by the Madoff firm and also spoke to the Vice President and Deputy Director of the FINRA Amex Regulation Division to gather background information on various options trading strategies. The SEC staff informed the Vice President that they were preparing for a deposition of Madoff (implying that an investigation was under way), but did not disclose what they were investigating or why.

represented that it (rather than a related person or third party) had custody of its advisory clients' funds and securities.

The Madoff firm did not update its registration as a broker-dealer to reflect this investment advisory business. Its Form BD, maintained in FINRA's CRD database, continued to disclose its types of business *only* as "Broker or dealer making inter-dealer markets in corporation securities over-the-counter" and "Trading securities for own account." In fact, even though it had registered as an investment adviser, the Madoff firm never disclosed to FINRA that it was engaged in any business other than market making and proprietary trading.[62]

3. 2007 Cycle Examination

As a registered broker-dealer and FINRA member, the Madoff firm was subject to periodic cycle exams by FINRA's Member Regulation department. As discussed above, the frequency of cycle examinations is generally based on an assessment of the risk of violations posed by a particular firm. At all times relevant to this report, the Madoff firm held itself out to FINRA as a market-making and proprietary trading firm that did not have any customers or maintain any customer accounts. Over the years, examinations of the firm had found only a few, relatively minor, regulatory violations even though the firm usually processed more than two million transactions per month. As one FINRA staff member explained, the Madoff firm was viewed as a "clean" firm with an excellent examination history. In light of this, the firm was designated as Category 2 and was examined every other year. The most recent—and most relevant, in light of the investment adviser registration and certain financial information in its broker-dealer records—examination is discussed in detail below.

[62] The Madoff firm filed its form ADV with the IARD system. Although FINRA operates both the CRD system (as a self-regulatory organization) and the IARD system (as a vendor), the systems are separate and data in the two systems are not reconciled. There are, for example, no automated checks to ensure that information in a firm's Form BD is consistent with its Form ADV.

FINRA conducted its most recent cycle examination of the Madoff firm in January and February 2007. The examination was performed by a single examiner from FINRA's New York district office. The examiner had several years of experience and was considered by his superiors to be highly-skilled and thorough.

In accordance with FINRA's normal practices, the 2007 cycle examination began with a standard pre-examination phase in which the examiner gathered information about the firm from FINRA's internal sources. This phase included reviews of the prior (2005) cycle examination report, the firm's FOCUS filings and audited financial statements, its examination history as reflected in the STAR system, and records of its corporate bond trading as reflected in the TRACE system.[63]

As part of the normal pre-examination process, the examiner accessed FINRA's CRD system and printed out a paper version of the Madoff firm's Form BD. Because the Madoff firm had not updated this form to reflect its investment advisory business, the printout contained no indication that the firm had registered as an investment adviser. The only hint that the examiner might have seen in FINRA's internal records that the firm was an investment adviser would have been a link, "View IA Record," that would have been displayed in some, but not all, of the screens in the CRD system. This link appeared only on CRD screens for firms that had a record in the IARD database. The 2007 cycle examiner (like the vast majority of FINRA examiners) did not have direct access to the IARD system and, accordingly, could not have viewed the firm's record in IARD even if he had clicked the link. The examiner did not notice the link and,

[63] According to the cycle examiner and other personnel from the New York district office, as of 2007, except for confirming the internet address of a firm's website, FINRA did not routinely run internet searches prior to conducting a examination. The cycle examiner ran a Google search prior to the exam to find out more about Madoff, whom he understood to be an innovator in electronic trading and a prominent member of the financial community. His Google search did not reveal that Madoff was managing money or acting as an investment adviser. The use of pre-examination internet searches has increased since the Madoff scandal broke, but FINRA has not issued any guidelines on how such searches should be conducted or the kinds of information they should target.

in any event, reviewing a firm's Form ADV was not required or even recommended under FINRA's pre-examination procedures at the time.[64]

In early January 2007, the examiner contacted the Madoff firm to inform it that FINRA would be conducting an onsite examination and sent an email to Shana Madoff, the firm's Compliance Counsel (and Madoff's niece) requesting that the firm provide information about the types of business in which it engaged by answering a web-based information request ("WebIR"). The firm completed the form the next day, indicating that it engaged only in market making (10 percent of revenues) and proprietary trading (90 percent of revenues). It did not check the box on the form for "Investment advisory services" or indicate that it had any revenues from any type of "retail" business—*i.e.*, from transactions with persons other than broker-dealers or institutional investors. In response to an email following-up on its WebIR response, the firm stated that its transactions were all "RVP/DVP [receive versus payment/deliver versus payment]," meaning it did not regularly hold customers' cash or securities as part of its trading activities.

FINRA's examination staff planned the 2007 cycle examination believing that the Madoff firm was, as it claimed, strictly a market maker and proprietary trader. Accordingly, the examination covered only the mandatory elements for such a firm—*e.g.*, verification of its net capital, review of its written procedures and supervisory controls, and examination of its trade reporting (corporate bonds were selected). The entire examination required 78.5 hours of work, the bulk of which was devoted to verifying the firm's net capital computation and reviewing its corporate bond trades.

[64] Although very few examiners had access to the IARD system, the public versions of the Forms ADV of registered investment advisers were available through the SEC's website.

The onsite portion of the 2007 cycle examination started on January 24, 2007 with a background interview of Bernard and Shana Madoff. During this interview, the FINRA examiner was (again) informed that the firm engaged only in market making and proprietary trading, did not receive customer funds, and did not receive customer securities. Although the firm disclosed its London affiliate, it did not mention Cohmad during this interview.

The Madoff firm also gave the examiner a tour of its offices on the 18th and 19th floors of the Lipstick Building, which were connected by an internal staircase and appeared to house the entirety of the firm's operations. The examiner was not shown the firm's offices on the 17th floor, on which its investment advisory business was located. Those offices were not connected to the internal staircase and—according to press reports—were not marked by a sign. The examiner never had any indication that the offices on the 17th floor existed.

The examiner spent an entire week at the Madoff firm performing the field work for the examination. He recalled that the firm promptly answered his questions, was responsive to his requests for documents, and gave him no reason to be suspicious. Madoff stopped by to speak to the examiner every day, but did not hover or attempt to steer the examiner toward or away from any areas of inquiry.

Throughout the examination, the Madoff firm provided the examiner with documents and records *only* from the market making and proprietary trading side of its business, not from its investment advisory operation. For example, in advance of his field work, the examiner had sent a written records request for "Bank Statements and Cancelled Checks" for the third quarter of 2006. The examiner was given statements only from the Bank of New York accounts (used by the broker-dealer business), not from JP Morgan Chase (used by the investment advisory business). The records request also asked for information about customers who had opened new accounts since the last cycle examination (in 2005). The Madoff firm indicated that it had no customers and no customer accounts.[65] And, although the examiner reviewed the firm's trading records, those documents did not reflect the fictitious trades that Madoff represented to his advisory clients he had made on their behalf.

Audited annual financial statements prepared by the auditor of the Madoff firm—Friehling & Horowitz CPA'S P.C.—did not disclose the existence of any of the investment advisory accounts. In a pending case against Friehling & Horwitz, the SEC has alleged that the auditor was financially dependent on Madoff, that it knowingly or recklessly made false statements related to its audits of the firm, and that it failed to perform any meaningful evaluation of the firm's customer accounts and internal controls. FINRA's procedures for confirming auditor independence were limited to confirming that the auditing firm was licensed and was a different legal entity from the broker dealer being audited.

The records provided by the Madoff firm to the examiner during his field work contained no indication that the firm was engaged in an investment advisory business or had advisory clients. To the contrary, they were entirely consistent with the normal records of a broker-dealer engaged solely in market making and proprietary trading, as the firm claimed to be. Based on the firm's representations and the absence of evidence contradicting those representations, the examination report noted that many of the mandatory examination elements related to customer protection were simply inapplicable because "[t]he firm . . . does not have any customers."

The examiner completed his field work on February 1, 2007, and the examination report on February 8, 2007. The examination report found that two violations of applicable regulations had occurred. First, the Madoff firm had understated its net capital (of more than $543 million)

[65] The Madoff firm appears to have disclosed that it had accounts for seven of its employees, but that these accounts had been completely inactive during the examination period.

by $7,201.68 (a 0.001 percent error) because it had omitted dividends earned in September 2006 on a money market account held at another broker-dealer. (The firm's minimum required net capital was $1 million, so even with the error, its excess net capital was $542 million.) Second, the examination found certain delays and errors in the firm's reporting of corporate bond trades, which were a small part of its proprietary trading operations. The examiner communicated these findings to Madoff during an exit conference on February 8, 2007.

The examiner then submitted the examination report—which recommended that FINRA issue a letter of caution to the Madoff firm for the bond trading violations—to the exam manager. After requesting minor revisions, the manager approved the report and submitted it to the Associate Director, who approved it on May 9, 2007. The Associate Director signed the recommended letter of caution on May 15, 2007, ending the examination.

4. <u>2003 and 2005 Cycle Examinations</u>

FINRA also conducted routine, cycle examinations of the Madoff firm in 2003 and 2005. These examinations—which took place before the firm had registered as an investment adviser—were very similar to the 2007 cycle examination: they were each conducted by a single examiner, covered only FINRA's mandatory examination elements, and found only minor regulatory violations (if any at all). During these examinations, the firm represented to FINRA examiners that it was engaged solely in market making and proprietary trading and, accordingly, did not have any customers or customer accounts, did not hold customer securities, and did not receive customer funds. The firm also concealed its investment advisory activities from the examiners by, for example, not providing them with bank account statements from JP Morgan Chase where the investment advisory funds were maintained.

5. Assessment of the Madoff Firm Examinations

The 2003, 2005, and 2007 cycle examinations of Madoff did not find any evidence that the firm was operating an investment advisory business, much less a Ponzi scheme. As noted above, the firm concealed its investment advisory operations from FINRA and took elaborate steps to keep that business separate from its broker-dealer business. Its investment advisory business consisted, at bottom, of a bank account and fictitious customer accounts that were not reflected on the broker-dealer's books. FINRA's examination program during the relevant period was not designed to detect the type of fraudulent activities in which the Madoff firm engaged.[66]

Nonetheless, FINRA's examinations of the Madoff firm—particularly the 2007 examination—presented several opportunities to have gathered more information about the firm's investment advisory business. During the 2007 cycle examination, FINRA staff did not obtain or review the Madoff firm's Form ADV.[67] When interviewed, FINRA staff involved in the Madoff firm examinations stated that they would have asked more questions if they had known the firm was an investment adviser. A comparison of the firm's Form ADV would have shown inconsistencies with the representations it made to FINRA. For example, the Form ADV stated that the firm had 23 customers (it actually had thousands more), even though it told FINRA it had none. The Form ADV stated that the firm (rather than a related person or third

[66] To take one example, FINRA's verification of a firm's net capital—a mandatory element of every cycle examination—is principally aimed at confirming the existence of the assets reflected on the firm's books, not at detecting undisclosed assets such as the accounts of the Madoff firm at JP Morgan Chase.

[67] Under existing law, FINRA does not have jurisdiction to regulate activities under the Investment Advisers Act. FINRA's examination program did not focus on identifying and reviewing the investment advisory activities of its members for possible violations of the Exchange Act and FINRA's own rules. Until recently, FINRA's pre-examination procedures did not require examiners to determine whether a firm was registered as an investment adviser, and its computer systems did not permit most examiners to access the IARD. Even where a broker-dealer disclosed that it was also an investment adviser, FINRA's examination program did not contain any specific guidance as to which elements should be added to an examination in that situation.

party) had custody of $17 billion of assets belonging to those customers, even though it represented to FINRA that it did not hold any customer assets. Finally, the Form ADV stated that the Madoff firm executed trades for its customers—trades that were not reflected in the firm's broker-dealer records because they had not, in fact, taken place. A careful review of the Form ADV would have led to questions about where advisory clients' assets were being kept and how transactions for those clients were being executed. Such questions would not necessarily have uncovered the fraud, but would have provided the 2007 examiner with highly relevant lines of inquiry.

FINRA's review of the financial records of the Madoff firm presented additional opportunities. An important part of FINRA's regulatory mission is ensuring that member firms have adequate capital and are not at risk of financial collapse. During each cycle examination, examiners devote a substantial amount of time to verifying a firm's net capital computations by, among other things, tracing all of the firm's assets to third-party documents such as bank statements and account records. As several FINRA staff members explained, because of the importance of the net capital requirement, cycle examinations tend to focus intensively on analyzing and testing a firm's balance sheet (its assets and liabilities), but devote little attention to the firm's income statement (its revenues and expenses). For Category 2 firms, at least, FINRA's examination program did not require that revenues or expenses—even very large ones—be specifically analyzed, much less traced to supporting documents. As one examiner explained, FINRA examiners are expected to ask questions if they notice unusual revenues or expenses, but such inquiries are incidental to the net capital review and need not be pursued beyond receiving facially reasonable answers. A more comprehensive approach to examining revenues and expenses might have provided two opportunities to have uncovered information regarding the firm's undisclosed investment advisory business.

First, although it had never done so before, the Madoff firm began to report "commission" revenue in its monthly FOCUS reports starting in September 2006—the same month in which it filed a Form ADV stating that it was compensated for its investment advisory services through commissions.[68] As alleged in the various criminal cases arising from the Madoff scandal, these "commissions" were actually the result of round-trip transactions in which Madoff transferred money from one of the Madoff firm's off-the-books accounts at JP Morgan Chase to the London affiliate, and then transferred it to one of the Madoff firm's on-the-books accounts at Bank of New York. These "commissions" totaled approximately $8 million, $108 million, and $90 million in the years ended September 30, 2006, 2007, and 2008 respectively. During 2007, they constituted more than 60 percent of the Madoff firm's reported revenue.

Commissions are a somewhat unusual source of revenue for a firm engaged solely in market making and proprietary trading, which normally would generate revenues from buying and selling securities for its own account, not from charging commissions to execute trades. FINRA's computer systems screen firms' FOCUS filings using certain algorithms to identify unusual or potentially problematic activity and generate exception reports which are reviewed and investigated by FINRA staff. The Madoff firm's FOCUS filings underwent this screening, but the system did not flag these commission revenues as a potential problem. For example, the legacy NASD FOCUS system, whose algorithms had not been updated since the mid-1990's,

[68] The Madoff firm reported "commission" revenue of nearly $8 million (out of total revenues of more than $34 million) in its September 2006 FOCUS report.

screened for new (*i.e.*, previously unreported) types of revenue, but created an exception report only if the new revenue was greater than 25 percent of a firm's total revenue in the period.[69]

During the 2007 cycle examination, the examiner reviewed the Madoff firm's financial records and its consolidated FOCUS report for the period from July through September 2006. The examiner noticed the new "commission" revenue of approximately $8 million—amounting to 23 percent of the Madoff firm's total revenue during the period—and asked about it. When interviewed, he recalled that someone, probably Shana Madoff, explained that the commissions had been paid by the firm's London affiliate on trades that the firm had executed for it. Although this might have signaled a shift in the firm's business, the answer seemed reasonable to the examiner, did not relate to any of the examination elements he was performing, and did not raise any "red flags." The examiner did not further pursue the matter and did not, for example, request supporting documentation for the commissions or proof of the underlying trades.

Second, as part of the 2007 cycle examination, the examiner made a standard request for the Madoff firm's bank statements (along with copies of its cancelled checks) that were needed to verify the firm's net capital computations.[70] Most of the cancelled checks were unremarkable and were for only a few hundred or few thousand dollars. However, one of the cancelled checks, to "Cohmad Securities," was for a much larger amount, $524,611.03. The examiner had never heard of Cohmad, had not seen any indication that it was operating out of the same office space as the Madoff firm, and was unaware that Madoff was an owner of Cohmad.[71] He did not recall

---

[69] FINRA is currently in the process of transitioning legacy-NASD firms from NASD's Centralized FOCUS ("cFOCUS") system to the NYSE's Electronic FOCUS ("eFOCUS") system, which includes more sophisticated screening algorithms.

[70] As noted above, the firm provided the requested information only for its accounts at Bank of New York and not for its accounts at JP Morgan Chase.

[71] In FINRA's New York district office, firms are assigned to groups of examiners (each headed by an examination manager) alphabetically. The Madoff firm was assigned to the group handling the "B's" while Cohmad was assigned to a different group handling the "C's."

noticing this check or asking about it, but also stated that he did not believe he would have thought that a check in this amount from one broker-dealer to another was significant or relevant to the examination he was performing. Although this was the single largest check provided to the examiner, FINRA's procedures—which did not emphasize review of a firm's expenditures—would not have required him to inquire about it or request backup documentation.

6. Examinations of Cohmad Securities

Cohmad was a small broker-dealer. For most of the period relevant to this report, it was designated as a Category 2 firm and examined by staff from FINRA's New York office every other year—*e.g.*, 2002, 2004, and 2006. These examinations found only relatively minor regulatory violations and either were closed with a letter of caution or simply filed without action. At some time after the 2006 cycle examination, Cohmad was moved to Category 3, whose firms are examined every fourth year. FINRA, accordingly, did not perform a cycle examination of Cohmad in 2008.[72]

FINRA's 2006 cycle examination of Cohmad took place during February through April 2006. It was performed by two relatively junior examiners, one of whom led the examination while the other focused principally on Cohmad's municipal securities business.

The 2006 Cohmad cycle examination began with a pre-examination phase in which the lead examiner gathered information about the firm. During this process, he reviewed Cohmad's FOCUS filings and its audited financial statements, which disclosed that Cohmad's principal source of revenue came from the Madoff firm. The notes to Cohmad's audited financial statements for the year ended June 30, 2005, discussed these revenues under the heading "related party transactions and revenues" and specifically disclosed that they had been earned by

[72] FINRA did conduct an Alternative Municipal Examination ("AME") of Cohmad's municipal securities business in 2008, as required by the Municipal Securities Rulemaking Board. The AME did not include any field work and focused solely on Cohmad's (then-inactive) municipal securities business.

"provid[ing] brokerage services to an entity owned by a minority shareholder of [Cohmad]." Cohmad's response to the WebIR indicated that 95 percent of its revenue came from "brokerage fees." The lead examiner recalled that, during the background interview at the start of the examination field work, Cohmad representatives explained these revenues by stating that they related to trades Cohmad performed on the NYSE for the Madoff firm.

The "brokerage services" rendered to the Madoff firm were the single most important part of Cohmad's business. As noted above, the payments for these services also followed an unusual pattern. The 2006 cycle examination's review of these "brokerage fees" was limited to asking about them during the background interview. The lead examiner recalled that his manager had instructed him not to review them because the Regulatory Coordinator for the section—who was responsible for reviewing Cohmad's FOCUS filings and audited financial statements—was already aware of them. The manager had little recollection of the 2006 examination and could neither confirm nor deny that such instructions had been given. It is possible that the manager based this decision on the results of prior examinations, including the 2004 cycle examination which had obtained the detailed explanation for these revenues (quoted above at page 49).

For whatever reason, the 2006 cycle examination did not review the "brokerage fees" paid from the Madoff firm to Cohmad by, for example, requesting documentation of how the fees had been calculated or of the underlying trades in NYSE-listed stocks. Although the examination did review Cohmad's trading records—a mandatory examination element—that review was limited to transactions in municipal securities, an area for which Cohmad had received letters of caution in the past. Cohmad's equities transactions were removed from the examination's focus and were not reviewed during the 2006 cycle examination, apparently because prior examinations had not found problems in this area. This normally mandatory element was also omitted from the 2004 cycle examination.[73]

FINRA's review of the areas that were included in the examination plan appears to have been thorough and complete. The 2006 cycle examination found a variety of minor regulatory violations, mostly related to Cohmad's written supervisory procedures and its handling of municipal securities transactions. The examination was concluded with a letter of caution to the firm.

FINRA's failure to examine the "brokerage fees" paid to Cohmad by the Madoff firm was a missed opportunity. Unlike the Madoff firm examiners, the Cohmad examiners were aware that Cohmad and the Madoff firm were related parties. The pattern of payments between these parties—often for identical amounts each month—was facially inconsistent with their being based on actual equities transactions. Moreover, because of their size, for these revenues to have been actual "brokerage fees," Cohmad would had to have handled a very significant volume of transactions on behalf of the Madoff firm. A request for documentation underlying these purported "brokerage fees" might have uncovered the fact that the fees were for referring clients to Madoff's undisclosed investment advisory business. This discovery alone may not have uncovered the Ponzi scheme, but it would have undermined the Madoff firm's longstanding representations to FINRA that it did not maintain any customer accounts.

In conclusion, the examinations of both the Madoff and Cohmad firms provided FINRA examiners with opportunities which, in hindsight, might have led to the discovery of Madoff's

[73] The report of the 2004 cycle examination explained:

> Staff reviewed the results of the firm's 2002 examination and noted no evidence or concerns regarding the firm's equity transactions. Considering that there has been no major changes to the firm's business and/or procedures, that there were no previous issues regarding the reporting of the firm's equity securities, and that all of the firm's equity transactions are reported by its clearing firm, Bear Stearns, no further review was warranted.

Ponzi scheme if they had been pursued. However, FINRA's examination program did not focus on the areas in which these opportunities arose. Because of its lack of jurisdiction over investment advisory activities, FINRA's examination program did not require its examiners to obtain or review the Madoff firm's Form ADV. Because of the program's focus on verifying net capital and completing specific exam elements, the examiners did not review significant revenues claimed by the Madoff and Cohmad firms beyond seeking oral explanations of what the revenues were. FINRA's procedures did not require the examiners to go further by, for example, requesting supporting documentation or testing the firms' representations against third-party information. Although FINRA's examinations did present the opportunities discussed above, its examination program did not exploit them because it was not designed to ferret out a sophisticated fraud, like Madoff's Ponzi scheme, that was kept almost entirely "off the books" of a member firm.

IV. OVERVIEW OF FINRA'S JURISDICTION

FINRA lacks jurisdiction to regulate a significant percentage of the financial institutions, products and transactions in our country. Of particular relevance for purposes of this review, FINRA lacks the authority to inspect for or enforce compliance with the Investment Advisers Act. In addition, FINRA lacks jurisdiction to directly obtain information from or regulate banks, insurance companies, savings and loan institutions, mutual funds or hedge funds.

FINRA's jurisdiction generally extends to any securities activity by a FINRA member firm or associated person that is governed by the Exchange Act or FINRA's rules.[74] This includes jurisdiction to enforce the anti-fraud provisions of the Exchange Act and SEC rules, such as Rule 10b-5.[75]

Under FINRA Rule 2010, FINRA has the authority to enforce "just and equitable principles of trade" with respect to member firms and associated persons. The SEC has held that this authority permits FINRA to sanction member firms and associated persons for a broad range of unlawful or unethical activities, including those that do not implicate "securities." For example, the SEC has approved FINRA disciplinary actions involving conduct related to insurance applications[76] and premiums,[77] tax shelters,[78] the general entrepreneurial activity of member firms,[79] and even to a member firm employee's improper use of a co-worker's credit card.[80]

---

[74] See Exchange Act § 15A(b). FINRA also has jurisdiction to enforce compliance with the rules of the Municipal Securities Rulemaking Board.

[75] Rule 10b-5 is limited to implicating the sale or purchase of "securities" as defined by the Exchange Act.

[76] *In the Matter of Thomas E. Jackson*, 45 SEC 771 (June 16, 1975).

[77] *In the Matter of Ernest A. Cipriani, Jr.*, 51 SEC 1004 (February 24, 1994).

[78] *In the matter of Daniel C. Adams*, 47 SEC 919 (June 27, 1983).

[79] *In the matter of DWS Securities*, 51 SEC 814 (November 12, 1993).

[80] *In the matter of Daniel D. Manoff*, SEC Release No. 34-46708 (October 23, 2002).

FINRA's jurisdiction is limited to activities subject to the Exchange Act and FINRA rules occurring anywhere in the legal entity, regardless of whether the activity is carried out by the nominal broker-dealer unit or by some other unit within the member firm. For example, to enforce compliance with the Exchange Act or FINRA rules, FINRA has jurisdiction to obtain information about securities transactions executed as part of an investment advisory business that is conducted within the legal entity registered as the broker-dealer.[81] FINRA, however, has not utilized the full extent of its jurisdiction.

The Exchange Act and SEC rules require FINRA to regulate the conduct of certain persons associated with a member firm. Specifically, the Exchange Act and SEC rules require FINRA to regulate the conduct of "securities persons"—that is, partners, officers, or certain employees of the member firm. The Exchange Act and SEC rules also require FINRA to regulate the conduct of "control persons"—that is, those who have the power to direct or cause the direction of the management or policies of the member firm. These definitions can encompass legal as well as natural persons—*i.e.*, both companies and human beings—and are not limited to domestic entities or individuals.[82]

Certain of FINRA's own rules and bylaws, however, limit its jurisdiction—other than for purposes of inspections and review of books and records—to natural persons associated with the member firm.[83] By contrast, NYSE's old rules—which FINRA has only implemented for firms who are members of NYSE—assert broader jurisdiction over certain associated entities. In

[81] See Exchange Act §§ 15A & 19(g); SEC Rule 19g2-1, and Adopting Release No. 34-12994 (November 18, 1976); see also FINRA Rule 2010, NASD Rule 2210, and FINRA Regulatory Notice 08-66 (October 2008) (stating that "[FINRA Rule 2010] applies to all of the business of a broker-dealer, not only to its securities and investment banking business," and that "[NASD] Rule 2210 is not limited to a broker-dealer's securities and investment banking business.").

[82] See Exchange Act § 19(g)(2); SEC Rule 19g2-1.

[83] See FINRA Rule 0140; FINRA's By-Laws at Article I(rr); see also FINRA Regulation, Inc.'s By-Laws at Article I(gg).

particular, NYSE Rule 304 asserts jurisdiction over any legal or natural person who either controls a member firm, or engages in a securities business and is controlled by or under common control with a member firm. The Exchange Act would not preclude FINRA from applying this type of authority to all FINRA member firms, and not just NYSE members.

FINRA is required to enforce compliance with the Exchange Act, Exchange Act rules and FINRA's own rules by each member, its "securities persons" (partners, officers, or certain employees of the member firm), and any person who controls the member. SEC rules relieve FINRA from the obligation to conduct examinations of control persons or other associated persons who are not "securities persons."[84] FINRA is, however, not relieved of the duty to enforce compliance by control persons. SEC rules do not prohibit FINRA from conducting examinations of a member firm's control persons and other associated persons if FINRA carefully considers the related burdens on its resources and on the examined entities.

To date, FINRA has not asserted broad authority to examine entities associated with a member firm. Rule 8210 only permits it to inspect the books and records of certain direct owners of a member firm. This review has not found any cases or SEC proceedings addressing this right to inspection, suggesting that FINRA has been reluctant to push the boundaries of Rule 8210. This review also has not found any reported case in which FINRA has attempted to assert inspection authority over indirect owners or affiliates of member firms.

FINRA has broad authority to adopt rules governing the natural persons who carry out member firms' broker-dealer business, imposing qualification standards on those individuals and regulating the substantive conduct of that business. FINRA's ability to regulate individuals' non-broker-dealer activities is more circumscribed. The SEC and the courts have upheld the

[84] See SEC Rule 19g2-1.

application of certain FINRA rules to the non-broker-dealer portions of firms' businesses. Examples include FINRA rules that (a) require individuals to provide their employer with advance notice of outside securities and non-securities activities;[85] (b) prohibit individuals from engaging in certain outside securities activities without their employer's approval;[86] and (c) require that certain outside securities activities be supervised and recorded on the employer's books and records as if the activity were being performed on behalf of the employer firm itself.[87]

[85] NASD Rules 3030 and 3040(b).

[86] NASD Rule 3040(c)(3).

[87] NASD Rule 3040(c)(2).

V. FINRA ACTIONS SINCE THE STANFORD AND MADOFF SCHEMES

The Special Committee has been informed by FINRA staff that, prior to the completion of this review and subsequent to the Madoff and Stanford schemes coming to light, FINRA has made changes to its regulatory programs to strengthen its efforts in a number of areas. These include the following: enhancing fraud training for examiners; developing more detailed procedures which will better support examiners' efforts to detect potential fraud during examinations; enhancing use of publicly available information during the pre-examination process; reviewing a sub-set of closed cases to evaluate whether they were the product of sound analysis and appropriately documented in the files; and expanding its review of arbitrations to include employer-employee disputes in the event of whistleblower allegations.

In addition, in March 2009, FINRA created the Office of the Whistleblower. The purpose of this initiative was to offer an improved way for those providing complaints or tips to reach senior staff who can quickly assess the level of risk involved and make sure each complaint or tip is properly evaluated. Those complaints warranting additional review and investigation are subject to an expedited regulatory response and are reviewed by experienced senior staff upon receipt. The Office of the Whistleblower can be reached through a toll-free number and through an internet address. This initiative has resulted in twelve referrals to the SEC, three referrals to other self-regulatory organizations and five referrals to other FINRA departments.

Finally, the staff has indicated its plan to develop a financial fraud unit. The purpose of this unit, which will combine the Office of the Whistleblower, Central Review Group, enforcement resources and industry experience, is to heighten FINRA's review of incoming allegations of serious frauds; provide a centralized point of contact internally and externally on fraud issues; have a real-time platform for discussion of potential fraud within the organization; develop internal expertise in expedited fraud detection and investigation; and better consolidate regulatory information.

VI. RECOMMENDATIONS

The recommendations below are intended to enhance the effectiveness of FINRA's examination program by increasing its ability to detect fraud and improve its investor protection functions. In analyzing these recommendations for implementation, FINRA management should seek to achieve the following strategic objectives: (i) greater emphasis should be placed on the detection of fraud; (ii) potential fraud situations and other situations presenting serious potential risk to investors should be escalated promptly and properly; (iii) examination staff should be diligent in pursuing potentially serious issues, exercising an appropriate degree of skepticism; (iv) all FINRA operating units should closely coordinate and communicate in carrying out the examination program; and (v) FINRA should provide additional resources to strengthen its cause examination program.

While a number of these recommendations can be effected by FINRA alone, others will require the concurrence of the SEC and a critical recommendation as to the expansion of FINRA's jurisdiction will require Congressional action. Virtually all of these recommendations will require FINRA management and the Board to make decisions about resource allocation and adequacy. FINRA should continue to move quickly to implement those recommendations that it can undertake unilaterally.

1. <u>Jurisdiction</u>

A. Seek Jurisdiction to Regulate Activities Under the Investment Advisers Act. FINRA's examination program is fundamentally hampered by its lack of jurisdiction over investment advisory activities. A large number of firms and a significant percentage of registered persons are also registered under the Investment Advisers Act.[88] In providing these

[88] As of August 2009, there were 925 firms registered both as broker-dealers and investment advisers.

services and managing investors' assets, therefore, these firms and individuals are largely beyond the reach of FINRA and under a less robust regulatory scheme. FINRA should proactively seek jurisdiction to regulate activities under the Investment Advisers Act. This additional jurisdiction would enable FINRA to be more effective in detecting fraud in both broker-dealers and investment advisers. If FINRA had an investment adviser examination program, it might well have identified the Madoff fraud at the time of his registration as an investment adviser. If Congress grants FINRA the authority to implement an examination program under the Investment Advisers Act, it will be able to conduct a joint exam and analyze and compare data on both broker-dealer and investment adviser activities to confirm the accuracy of data and identify problematic patterns and potential frauds. This recommendation requires action by Congress.

B. Clarify FINRA's Current Jurisdiction; Expand Jurisdiction to Affiliates of Member Firms. FINRA should clarify the extent of its jurisdiction to examine member firms and bring actions to enforce the Exchange Act and FINRA rules and it should utilize that jurisdiction fully in appropriate circumstances. FINRA should determine those situations warranting the exercise of jurisdiction beyond broker-dealer activities, such as situations in which there are indications of fraud involving potential serious harm to investors. FINRA should more aggressively exercise its authority to investigate member firms and associated persons and to gather evidence as a basis for enforcement action. In the Stanford case, for example, by more aggressively using its authority, FINRA could have obtained evidence of wrongdoing much earlier than it did. FINRA should also amend its by-laws or rules to enable it to obtain information from or investigate affiliates of member firms to enforce such firms' compliance with the Exchange Act and FINRA rules. This authority is particularly important to enable

FINRA to pursue enforcement actions against member firms or registered persons when it believes there is evidence of fraud or potential serious harm to investors. This recommendation will require SEC approval to expand FINRA's jurisdiction.

2. Examination Process and Personnel

A. Focus the Examination Program on Fraud; Establish a Fraud Detection Unit. A core element of FINRA's examination program should be the detection and prevention of fraud. The Special Committee agrees with and supports the plan of FINRA senior management to create a dedicated fraud detection unit. That unit should include highly trained fraud examiners.

B. Prioritize Examinations and Resources According to the Seriousness of Misconduct. FINRA should revise the examination program to assure that examinations are properly prioritized and resources allocated accordingly. In particular, the program should expedite any examination that identifies possible fraud involving potential serious harm to investors or continuing serious misconduct.

C. Strengthen the Cause Examination Program; Revise the Cycle Examination Program. FINRA should strengthen the cause examination program and revise the cycle examination program, shifting resources from low-risk cycle examinations to higher risk cause examinations. If FINRA is to be more effective at protecting investors from fraud and Ponzi schemes, it will need to significantly expand the resources devoted to cause examinations. This will also require strengthening the procedures for evaluating complaints, tips and other information and improving coordination among various FINRA departments responsible for such evaluation. This recommendation requires SEC concurrence to revise the cycle program.

D. Assess Structure and Management of District Offices. FINRA should assess the structure and performance of its district offices to assure that each office is carrying out the examination program efficiently and effectively. Our review of the Stanford and Madoff cases suggested significant inconsistencies in levels of performance and operational standards in the district offices that we reviewed. In particular, evaluation of the program should emphasize quality of examinations and not focus primarily on the quantity of examinations.

E. Improve Documentation and Tracking of Enforcement Referrals to and from the SEC and Other Authorities. FINRA should improve its process to record and track enforcement referrals to other agencies and those received by FINRA from the SEC or any other regulatory authority.

F. Improve Procedures to Assure Legal and Regulatory Issues Are Properly Escalated, Addressed and Documented. FINRA should revise its procedures for addressing and documenting important legal and regulatory issues that arise in connection with an examination. These include legal issues involving a large amount of funds or having an impact on many members. Such issues, which require legal research and analysis, should be addressed by attorneys, not by examiners or paralegals, and the legal analysis for any significant issue should be documented, reviewed, and approved by a supervising attorney.

G. Increase Use of Examination Staff with Specialized Qualifications. FINRA should make greater use of employees with specialized training (*e.g.*, certified public accountants with public accounting and auditing experience in the securities industry; experienced internal auditors and fraud examiners; traders and trading assistants with extensive experience in and understanding of, among other things, trading markets, derivative products, complex financial instruments and financial statement analysis).

H. Enhance FINRA's Information Technology and Systems. Technological improvements should be made to the principal information technology systems utilized by the examination staff. The goal should be to make more member firm data readily available to the examination staff, including all significant changes in member firms, regulatory actions, and significant documents. FINRA should also improve examiners' capability to analyze firms' financial data electronically.

I. Confirm Member-Provided Information with Independent Third Parties; Cross-check Data Provided by Member Firms. FINRA should require its examination program to include procedures to test member-provided information against information from independent sources, rather than relying almost exclusively on data from member firms. FINRA also should confirm the consistency of data provided to it by each firm by cross-checking data in various submissions by a firm. FINRA should work with the SEC, and other appropriate regulatory agencies such as the Public Company Accounting Oversight Board, to secure consent from third parties (*e.g.,* independent auditors) to provide means for FINRA to validate data provided by its member firms.

3. Coordination with the SEC and Other Regulatory Agencies

A. Expand Access to and Use of Information from the SEC and Other Agencies. To improve the effectiveness and efficiency of the examination program, and for investor protection reasons, FINRA should have more complete information on other authorities' actions against FINRA member firms and registered persons. FINRA should be provided with greater access to such information that is available from the SEC and other regulatory and law enforcement agencies. FINRA should continue to provide information to other regulatory agencies as appropriate. This recommendation requires concurrence by the SEC and other agencies.

B. Clarify Policies Regarding Concurrent SEC and FINRA Examinations. FINRA should revise and standardize its policies to clarify the effect of a concurrent SEC examination or investigation on the scope of a FINRA examination of the same member firm.

4. Training of FINRA Personnel

A. Enhance FINRA's Current Training Program. FINRA should implement new continuing education standards, requiring the examination staff to complete a defined number of training programs or hours over a specified period. FINRA should also expand training initiatives focused on fraud detection and investigation techniques.

5. Plan of Action

The Special Committee believes the recommendations above should be implemented by a Plan of Action developed by management and presented for consideration by the Board. Management has agreed to present a Plan of Action for approval or ratification at the December 2009 Board meeting. Execution of the Plan of Action should be monitored by a designated committee of the FINRA Board.

APPENDIX A

2009 FINRA Special Review Committee Charter

Composition
The 2009 FINRA Special Review Committee (Committee) will be composed of four FINRA Board members.

Purpose
The purpose of the Committee will be to review FINRA's examination program, in particular with respect to Ponzi schemes operated by the unregistered affiliates of Madoff Investments and Stanford Financial.

Duties and Responsibilities
The Committee shall have the following duties and responsibilities:

(i) Review and discuss with management the operation of the FINRA examination program, in particular with respect to the Ponzi scheme activities of Madoff Investments and Stanford Financial.

(ii) Recommend to the Board and to management changes in the examination program, where appropriate, to improve FINRA's member oversight and fraud detection capability.

(iii) Review and discuss with management its policies and procedures relating to monitoring compliance with examination program policies.

The Committee shall have the authority to obtain advice and assistance from internal or external legal or other consultants and advisors, and to incur such expenses as the Committee in its discretion determines necessary and appropriate in carrying out the Committee's work.

Approved April 3, 2009; amended April 13, 2009

FINRA Special Review Committee Roster

Committee Members:

- Charles A. Bowsher, Chair
- Ellyn L. Brown
- Harvey J. Goldschmid
- Joel Seligman

..
Board Advisors to the Committee
.
- Mari Buechner
- W. Dennis Ferguson
- G. Donald Steel