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## How the SEC Can Prevent More Madoffs

*Bolster its risk-assessment and enforcement staff.*

By [ARTHUR LEVITT JR.](#)

The Bernard Madoff affair is a scandal of epic proportions. It not only has devastated the prominent individuals and institutions who invested in his funds, but it has also further undermined whatever trust investors may have had after this year of bank failures, credit crises, and market meltdowns. The regulatory structure that has been in place for the past eight decades to keep our markets free and fair may no longer be appropriate.

There is a lot we still don't know about the Madoff scandal. In my eight years as chairman of the Securities and Exchange Commission (SEC), I never saw an instance where credible information about misconduct was not followed up by the agency. I knew Bernie Madoff and had no reason to believe he was not a legitimate market maker, nor did anyone at that time know he was acting as an adviser to outside investors.

Current SEC Chairman Christopher Cox, who recently said that "credible and specific allegations . . . were repeatedly brought to the attention of SEC staff," is right to investigate whether the commission failed in some way to protect investor interests. Any potential conflicts of interest, including the fact that Mr. Madoff's niece married an SEC official last year, will likely be high on Mr. Cox's list of priorities.

Yet contrary to what some commentators have said, the Madoff affair doesn't prove that the SEC is a failed institution that must be shuttered. Nor does it show that all it needs is more money to do its job. Rather, this scandal underscores the need for a 21st century regulatory approach.

The complexity of today's products, markets and investment strategies calls for a laser-like focus on risk assessment. A regulatory agency is not omniscient. Its leadership must identify the biggest possible risks to investors and to the entire system and focus resources on these areas.

Recognizing this, Bill Donaldson, one of my successors in the SEC chairmanship, established the Office of Risk Assessment. This effort started off small. Unfortunately, after Mr. Donaldson left the SEC, it was diminished to only one staff member by last February.

Instead of being a sideshow, risk assessment must be central to the SEC's efforts. The agency needs an office that will collect information from all of the agency's divisions and propose inspection and examination priorities. It should identify problems such as excessive leverage and risks posed by new structured financial products. The office should answer directly to the SEC chairman and report monthly to the entire commission.

Once problem areas or firms are identified, the SEC must have a robust oversight and inspection capability as well as, when needed, an enforcement agency that is empowered and enabled to pursue leads.

Over the past few years, the SEC has not kept pace with inflation or innovation. Since 2002, the number of investment advisers -- such as Madoff Securities -- has increased by 50%. Yet enforcement resources have been flat or even reduced. The number of SEC enforcement division personnel was cut by 146, to 1,192 in 2007 from 1,338 in 2005.

As a result, only about 10% of investment advisers can expect to be examined every three years, and the goal of inspecting every adviser once every five years -- laughably light oversight in its own right -- has been abandoned.

More funds will help, but there must be an immediate emphasis on much better training for the enforcement and inspection staffs that deal with today's markets, their complex instruments, and most of all, trading techniques.

Enforcement is not just an exercise in overwhelming force; it's about using scarce resources to address the most significant and current market misconduct in a way that has the greatest impact. It entails drawing on a new risk-assessment approach to judge where enforcement actions will be most effective as a deterrent to bad behavior; being able to move quickly after violations of law occur; and when appropriate, exploring creative ways to craft industry-wide solutions to industry-wide problems.

Investors cannot have an accurate picture of the markets if corners of it are left free from reasonable oversight. The Madoff scandal should be a wake-up call for more consistent, uniform and rigorous regulation of investment advising. All investment advisers as well as hedge funds should be subject to SEC registration and oversight. (In June 2006, the U.S. Court of Appeals for the District of Columbia Circuit overturned the SEC rule requiring hedge-fund managers to register as investment advisers.)

In addition, we can no longer allow broker-dealers, regardless of their size, to be audited by any CPA. Broker-dealers of a certain size can't rely on a mom-and-pop auditor (as apparently Mr. Madoff did); they need to use regulated auditors overseen by the Public Company Accounting Oversight Board. With more transparency, investors will be better able to judge with whom to invest their money.

Let's hope that the Madoff swindle is not a spur to haphazard regulatory responses, which often have unintended consequences, but instead the final prod

for a fundamental reform of the financial regulatory structure that protects investors and keeps our markets free and fair.

**Mr. Levitt was chairman of the SEC from 1993 to 2001.**

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