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# CAN THE CFTC AND SEC WORK TOGETHER TO PREVENT ANOTHER MADOFF?

*by* CHANTAL KAZAY

On June 30, 2009, federal Judge Denny Chin of the Southern District of New York sentenced Bernard Madoff (Madoff) to 150 years in prison for operating the largest Ponzi scheme in history.<sup>1</sup> Madoff, a previously respected figure in American finance, managed his scheme under the guise of an asset management business.<sup>2</sup> Astonishingly, the Securities Exchange Commission (SEC) failed to detect Madoff's scheme for over a decade.<sup>3</sup>

As of Sept. 22, 2009, the scandal caused losses to 200,336 investors that exceeded \$13 billion dollars.<sup>4</sup> Investors and the American people alike have criticized financial regulators for not catching Madoff sooner, especially due to the scheme's length and magnitude.<sup>5</sup> As a result of the scheme, investors worry

that other scammers, similar to Madoff, remain undetected or unaddressed by regulatory agencies.<sup>6</sup>

A similar concern is whether a Madoff-like scheme could happen to the Commodity Futures Trading Commission (CFTC). On Oct. 16, 2009, the SEC and the CFTC began to address this problem by proposing changes to Congress on how the two agencies can collaborate when regulating similar securities and futures investments.<sup>7</sup>

### WHAT IS A PONZI SCHEME?

The mechanics of a Ponzi scheme are simple: a fraudster lures assets to an investment proposal with seemingly too-good-to-be-true terms, and then uses the contributions of new investors to pay returns to earlier investors.<sup>8</sup> The investment proposal appears to be profitable, but the fraudster is actually stealing money from investors.<sup>9</sup> To remain afloat, Ponzi schemes require an infinite supply of new funds.<sup>10</sup>

Ponzi schemes end when new investments are insufficient to meet existing investor redemption demands.<sup>11</sup> Allan Horwich, a senior lecturer of securities litigation at Northwestern University Law School, says Madoff was able to keep his scheme going for so long by paying promised returns.<sup>12</sup> “By meeting the demands of insistent investors, Madoff was able to deflect any suspicion on the part of investors,”<sup>13</sup> says Horwich. “This meant that only outsiders – for example, competing firms and journalists – and not his investors were complaining to the Securities Exchange Commission.”<sup>14</sup>

Figure 1.0 is a hypothetical illustration of how a professional money manager, James Smith, may use investor funds while operating a Ponzi scheme. Figure 1.0 illustrates the source, movement and use of funds in a common, non-complex Ponzi scheme.<sup>15</sup>

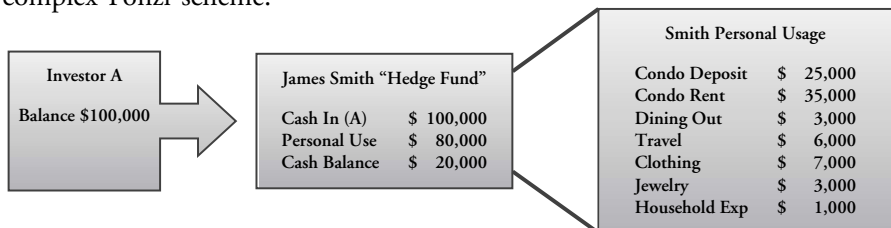


FIGURE 1.0

## THE CFTC AND THE SEC: WHAT DO THEY ACTUALLY DO?

The CFTC ensures the open and efficient operation of the futures exchange markets.<sup>16</sup> It is also responsible for protecting investors and the public from fraud, manipulation and abusive trading practices related to the sale of commodity and financial futures and options.<sup>17</sup>

The CFTC is the government agency responsible for supervising the trade of futures such as grains, precious metals, oil and currencies.<sup>18</sup> It also regulates trading in derivatives linked to stock indexes and bonds.<sup>19</sup> With the Senate's approval, the President appoints one chairperson and five futures market commissioners to the CFTC.<sup>20</sup>

Similarly, the SEC protects investors, maintains fair, orderly and efficient markets and facilitates capital formation within the securities exchange markets.<sup>21</sup> The SEC is the government agency responsible for overseeing the trading of stocks and options.<sup>22</sup> Like the CFTC, with the Senate's approval, the President appoints one chairperson and five securities market commissioners to the SEC.<sup>23</sup>

The futures and securities regulations share common ground with respect to the broad public policy objectives of protecting investors, ensuring market integrity and promoting price transparency.<sup>24</sup> CFTC Chairman Gary Gensler believes the CFTC is, in some ways, similar to the SEC. "There are areas where the CFTC and SEC regulate similar products, practices or markets, but do so differently," says Gensler.<sup>25</sup> "There are times when these differences are appropriate, but at other times, they could stifle competition, increase costs or limit investor protection."<sup>26</sup>

Because the SEC and the CFTC have overlapping and parallel jurisdiction on certain futures and options, regulation of those instruments is difficult at times.<sup>27</sup>

### COULD MADOFF HAPPEN TO THE CFTC OR THE SEC AGAIN?

CFTC Commissioner Bart Chilton believes Madoff-like Ponzi schemes are already happening within the futures exchange market. "There are hundreds of [schemes] going on all the time," says Chilton.<sup>28</sup> "There is a virtual 'Ponzi-

Palooza' out there, [and] new investor money [is] being used to pay previous investors," says Chilton.<sup>29</sup> "Consumers are being victimized all the time."<sup>30</sup>

Chilton believes that in order to combat the Ponzi schemes, the regulatory agencies need the appropriate resources and tools to address them.<sup>31</sup> One solution Chilton suggests is to give both the SEC and the CFTC criminal authority to prosecute "bottom feeders," or fraudsters.<sup>32</sup> As it currently stands, the CFTC and the SEC can only bring civil action against market manipulators.<sup>33</sup>

John Coffee, Columbia University securities law professor, also believes that the CFTC needs more of the powers the SEC has to act on cases of insider trading and market manipulation.<sup>34</sup> The CFTC "needs legislation prohibiting insider trading on commodities and transactions within its jurisdiction," says Coffee.<sup>35</sup> The CFTC should be able to impose financial penalties in cases of violations.<sup>36</sup>

The SEC "is armed with a greater enforcement club," says Coffee.<sup>37</sup> The SEC can impose penalties without going to court.<sup>38</sup> According to Coffee, "the bottom line here is that it would make sense to harmonize these penalty levels so that both agencies have equivalent powers."<sup>39</sup> This would prevent future Ponzi schemes from occurring in either the SEC or CFTC.

The CFTC and SEC have battled over regulatory turf in the past, but recently the organizations agreed on sharing regulation of the \$600 trillion over-the-counter derivatives market.<sup>40</sup> The growth of the unfettered market for derivatives, the complex financial instruments blamed for advancing the financial crisis, has made the need to fix gaps and overlaps in the two agencies' regulations especially critical.<sup>41</sup>

For example, the SEC and CFTC joint-report to Congress recommends legislation to expand the agencies' authority in certain areas and to increase its enforcement powers by establishing protections for whistle-blowers.<sup>42</sup> It also recommends new rules to improve their efficiency in working together.<sup>43</sup> "These recommendations will help to fill regulatory gaps, eliminate inconsistent oversight and promote greater collaboration," says SEC chairwoman Mary L. Schapiro.<sup>44</sup> Hopefully, new legislation will enable these agencies to harmonize their efforts and work together to detect Madoff-like schemes within the commodities and securities' markets sooner in the future.

NOTES

- 1 Diana B. Henriques, *Madoff Is Sentenced to 150 Years for Ponzi Scheme*, N.Y. TIMES, June 30, 2009, at A1, available at <http://www.nytimes.com/2009/06/30/business/30madoff.html>.
- 2 Josh Clark and Jane McGrath, *How Ponzi Schemes Work*, HowStuffWorks.com, Feb. 9, 2009, <http://money.howstuffworks.com/ponzi-scheme.htm>.
- 3 Jill E Fisch, *Top Cop or Regulatory Flop? The SEC at 75*, 95 VA. L. REV. 785, 810-11 (June 2009).
- 4 Aaron Smith, *Madoff Ponzi Prosecutors: Still Trying to Tally Loss*, CNNMoney.com, Sept. 28, 2009, [http://money.cnn.com/2009/09/24/news/economy/madoff\\_ponzi/index.htm](http://money.cnn.com/2009/09/24/news/economy/madoff_ponzi/index.htm).
- 5 Fisch, *supra* note 3 at 811.
- 6 *Id.* at 813.
- 7 *2 Market Regulators Propose Ways to Resolve Differences*, N.Y. TIMES, Oct. 17, 2009, at B3, available at <http://www.nytimes.com/2009/10/17/business/17regulate.html>.
- 8 Professor Tamar Frankel, *Assessing the Madoff Ponzi and the Need for Regulatory Reform: Hearing Before the Hearing Commission on Financial Services*, 111th Cong. at 2 (2009), available at [http://www.house.gov/apps/list/hearing/financialsvcs\\_dem/hr010509.shtml](http://www.house.gov/apps/list/hearing/financialsvcs_dem/hr010509.shtml)
- 9 *Id.*
- 10 Catherine Rampell, *A Scheme with No Off Button*, N.Y. TIMES, Dec. 21, 2008, at WK5.
- 11 Frankel, *supra* note 8.
- 12 Telephone interview with Allan Horwich, Senior Lecturer, Northwestern Law School (Oct. 9, 2009).
- 13 *Id.*
- 14 *Id.*
- 15 FIGURE 1.0: After being promised a 25 percent return on an investment of \$100,000, Investor A invests \$100,000 in James Smith's hedge fund. Smith immediately rents a fully furnished million-dollar condominium in the most exclusive building in town, using \$25,000 of the funds as a deposit and paying \$35,000 per month in rent. He also uses Investor A's funds to pay other personal expenses. Smith's total personal expenses for the period are \$80,000. Smith invites Investor A to his home and gives him a check for \$20,000 to cover the interest earned on Investor A's initial \$100,000 investment. Smith assures Investor A that he can pay a 30 percent return on an investment of \$200,000. Smith eventually convinces Investor A to keep his initial principal investment of \$100,000 and invest an additional \$100,000. Investor A relies on the seeming success of his initial investment, the check for the interest earned, the perceived personal success of Smith, and the promise of a 30 percent return on an investment when investing additional funds. Note that Smith does not invest any of the funds received from Investor A. Even if Smith had not used any of the investors' funds for personal expenses, because of the initial \$20,000 payment to Investor A, the scheme is already in debt with liabilities in excess of the invested funds.
- 16 Times Topics, *Commodity Futures Trading Commission*, N.Y. TIMES, July 7, 2009, available at [http://topics.nytimes.com/topics/reference/timestopics/organizations/c/commodity\\_futures\\_trading\\_commission/index.html](http://topics.nytimes.com/topics/reference/timestopics/organizations/c/commodity_futures_trading_commission/index.html).
- 17 *Id.*
- 18 *Id.*
- 19 *Id.*
- 20 *Id.*

- 21 *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. Securities Exchange Commission, available at <http://www.sec.gov/about/whatwedo.shtml>.
- 22 *Id.*
- 23 *Id.*
- 24 Mary L. Shapiro, *Speech by SEC Chairman: Opening Remarks before the SEC-CFTC Joint Meetings on Regulation Harmonization*, U.S. Securities Exchange Commission, Sept. 2, 2009, available at <http://www.sec.gov/news/speech/2009/spch090209mls.htm>.
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- 26 *Id.*
- 27 Mark Frederick Hoffman, *Decreasing the Costs of Jurisdictional Gridlock: Merger of the Securities and Exchange Commission and the Commodity Futures Trading*, 28 U. MICH. J.L. REFORM 681, 694-701 (Spring 1995).
- 28 Bart Chilton, *Ponzimonium*, CFTC Office of External Affairs, March 20, 2009, available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opachilton-21.pdf>.
- 29 *Id.*
- 30 *Id.*
- 31 *Id.*
- 32 *Id.*
- 33 Marc I. Steinberg and Ralph C. Ferrara, *Securities Practice: Federal and State Enforcement Database*, 25A Securities Prac. Fed. & State Enforcement §§ 7:2, 7:14 and 12:14 (Sept. 2009).
- 34 Kopecki and Gallu, *supra* note 25.
- 35 *Id.*
- 36 *Id.*
- 37 *Id.*
- 38 *Id.*
- 39 *Id.*
- 40 *2 Market Regulators*, *supra* note 7.
- 41 *Id.*
- 42 *Id.*
- 43 *Id.*
- 44 *Id.*