

MVE220 Financial Risk

The Madoff Fraud

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Abstract:

A short explanation of the Ponzi scheme carried out by Bernard Madoff, the explanation to how it could go on for such a long period of time and an investigation on how it could be prevented in the future.

The report were written jointly by the group members and the analysis was made from discussion within the group

1. Introduction

Since the ascent of money, different techniques have been developed and carried out to fool people of their assets. These methods have evolved together with advances in technology, and some have proved to be more efficient than other.

One of the largest of these schemes ever carried out occurred in modern times in the United States, it was uncovered as recently as in late 2008. The man behind it managed to keep the scheme running for over 15 years in one of most monitored economic systems in the world. The man in charge of the operation, Bernard L. Madoff, got arrested for his scheme and pled guilty to the embezzling of billions of US dollars.

It struck many as unimaginable how such a fraud could occur in an environment so carefully controlled by regulations and supervised by different institutions. The uncovering of the scheme rose questions on how this could go undetected for such a long time, and what could be done to avoid similar situations in the future. This report gives an insight on how the Madoff fraud was carried out, how it could go unnoticed for so long and if similar frauds could be prevented in the future.

2. The Madoff fraud

Bernard Lawrence Madoff founded Bernard L. Madoff Investment Securities LLC, a small Wall Street investment firm in 1960. The firm was initially a small penny stock trader but it grew fast due to its use of innovative computer technology. The firm became one of the largest market makers in the US, and by 2008, the year of B.L. Madoff's arrest, Bernard L. Madoff Investment Securities LLC was the sixth largest market maker on Wall Street [1].

One division of the company was the "advisory and investment management division", where investors could put their money in a hedge fund. Over the years this "hedge fund" continued to deliver an almost constant return to the investors on just above ten percent. This is a very high return given over a long period of time, which made people concerned. Madoff himself explained to *The Wall Street Journal* in 1992 [2] that there was nothing special with the high returns, and referred to the high

average annual returns for the US stock index. As it would turn out later, the fund was in fact the world's largest Ponzi scheme.

Method of the fraud

The method of the scam was a classic Ponzi scheme. The definition of a Ponzi scheme given by Investopedia is; *“A fraudulent investing scam promising high rates of return with little risk to investors. The Ponzi scheme generates returns for older investors by acquiring new investors”* [3]. This was basically how the advisory and investment management division of Bernard L. Madoff investment securities LLC operated. In the article *“The Madoff scam: Meet the liquidator”* by CBSNews [4] Madoff said that the division started as a perfectly legitimate business, but he confessed that the returns given since approximately 1995 were fabricated. When a customer made an investment, he simply put the money into a bank account, and when asked for a withdrawal he took the money piled up in that account. Withdrawals were simply covered by new investments.

Madoff used a variety of techniques that made it difficult to disclose the scam. At the end of each month Madoff sold all stocks and financial instruments so that the hedge fund only reported the amount of cash to the authorities. Further on, investors did not have any online access to their investments, instead they received a mail with their account information and balance each month [5]. As a result of these precautions and many more, explained in the next section, it took until late 2008 before the scam was exposed, although people had accused the so-called hedge fund for fraud as early as 2001.

Exposure and punishment

The ones who finally exposed the scam were Bernard Madoff's sons, Andrew and Mark Bernard, who after they found out that the company was based on a Ponzi scheme reported it to the authorities. This resulted in the arrest of Madoff on December 11th, 2008. He was accused of fraud and the embezzling of up to 65 billion dollars. He pled guilty to all charges, including money laundering, mail fraud and making false filings, and in June 2009, Madoff was sentenced to serve 150 years in prison [6].

3. How could this happen?

So how could Madoff pull off the biggest Ponzi scheme in the history of finance? The question should rather be why the SEC, the U.S. Securities and Exchange Commission, didn't interfere with Madoff's investment company despite receiving warning flags for almost a decade before the actual arrest.

A quick introduction to Harry Markopolos

In 1999, Harry Markopolos, a former securities industry executive, received information about a fund running \$6 billion, which would make it one of the biggest funds on Wall Street at the time. Investors claimed they had gained a steady return of about 1-2% each month, which made Markopolos suspicious since the fund manager Bernard Madoff never had been mentioned in the same context as hedge fund management before. Markopolos claimed it took him five minutes of looking at the numbers to realize that the whole operation was a fraud. He says it took him another four hours to actually reverse engineer the system and prove that the money could have only be obtained through fraud [7].

On May 20th in 1999, Markopolos reported Bernard Madoff to the Boston SEC. The SEC took no action, even though Markopolos filed a more detailed report to the SEC a year later in 2001. In 2005, he sent a 21-page memo to SEC regulators entitled "The World's Largest Hedge Fund is a Fraud", analyzing over 14 years of return numbers [8]. However, Madoff was first arrested in 2008, eight years after Markopolos filed his first report. So how did Madoff manage to continue the scheme for such a long time without it being disclosed?

Access to Washington

The Madoff family had through the years gained access to the Washington lawmakers and regulators. Madoff himself was a chairman on the board of the Securities Industry Association, later merged into SIFMA where his brother Peter Madoff sat as a member of the board [9]. Also, Madoff's niece Shana Madoff married SEC compliance official Eric Swanson, directly tying the Madoff family to the SEC [10]. Madoff's investment firm also spent more than \$400,000 to influence the federal government through SIFMA and the former Bond Market Association [11]. Although

the fraud has not been attributed to corruption in Washington, critics claim the connections helped Madoff in going undetected for such a long period of time [12].

The 5% payout rule

Mitchell Zuckoff, a professor of journalism at Boston University, says that the “5% payout rule” helped Madoff in going undetected for a long while. The federal law requires private foundations to pay out 5% of their funds every year. Because Madoff mainly managed money for charities, he could therefore avoid sudden or unexpected withdrawals. Given a \$1 billion investment, the fraud could go on for 20 years, handing out \$50 million each year, without even taking in new investors [13].

The SEC

Perhaps the biggest reason for Madoff’s ability to avoid problems for such a long time was the SEC. In 2011 it was revealed that the SEC had disciplined eight employees over their handling of the Ponzi scheme. The actions was a result of an internal investigation into the commissions operations and how it overlooked six warnings about Madoff’s trading business over 16 years. The report said that the scandal was the cause of an inexperienced staff and delayed examinations [14]. Critics say that the SEC is often understaffed and are unable to handle the amount of workload put on to them, which still may be the case, enabling additional frauds in the future [15].

4. How do we prevent future frauds?

It is hard to give a straightforward answer to the question whether this type of scheme could happen again, and what methods that could be used to prevent it. History has shown over time that new scams are being invented, often in connection with new technologies.

Revitalization and specialization of the SEC

The errors and ignorance at the SEC is still the only variable proven to enable the Madoff fraud to continue over a decade. There were probably more factors that mattered, like corruption and loopholes therein. However, the most immediate actions to prevent similar events of occurring must take place internally in the commission. As stated, critics name the understaffing and lack of competence in the organization as the main reason for not investigating Madoff.

Markopolos writes in his testimony to Congress, shortly after Madoff was sentenced, *“As is typical for the SEC, too many of the staff lawyers lack any financial industry experience or training in how to conduct investigations. In my experience, once a case is turned into the SEC, the SEC claims ownership of it and will no longer involve the investigator”* [16]. Obviously, seeing as the fraud was unnoticed for so long, the SEC or even new regulators need not only more staff, but also more specialized staff to handle future unique situations of the Madoff kind.

Since 2008, the SEC has performed a number of “post-Madoff” reforms, including new leadership in the Enforcement division to “ensure that it focuses on significant cases that will have a meaningful impact”. They have also started initiatives to encourage cooperation with “insiders” as well as recruiting staff with specialized experience [17]. All in all, the SEC has learnt its lessons from the mistakes in the Madoff case. However, four years after the sentencing of Madoff, we still don’t know if it has had an immediate effect on the financial industry. Quoting Bill Singer, a securities industry attorney, *“there are people on Wall Street, even as Madoff was sentenced, who were saying that they could have pulled off what Madoff did and not get caught”* [18].

The enhancement of the SEC and maybe the start of specialized regulators seem to be the right way to prevent future frauds, but if the risk can be fully eliminated is for the future to find out.

5. Reading guide

As the Madoff investment scandal is the biggest of its kind in financial history, there is extensive information about the incident. We recommend watching the documentary film “Chasing Madoff”, where Markopolos and his colleagues narrate and discuss the fraud. Accompanying this, Markopolos’ 21-page-memo filed to the SEC in 2005 explains the fraud mechanisms three years before Madoff’s arrest.

News articles worth reading include our references, most notably “The Madoff Case: A Timeline” ([1]), for an overview of the fraud and how it progressed and “Family filled posts at industry groups” ([9, 10, 11, 12]) for further discussion regarding Madoff ties to Washington regulators. (Note that the article can be locked behind a pay wall depending on how many times you access it).

Furthermore, for those who do not entirely grasp the concept of a Ponzi Scheme and disregarding the specific Madoff case, the popular culture show “Two and a half men” shows a simple fraud carried out by character “Alan” in the episode “That Darn Priest”. It is obviously blended in with situational comedy, however the episode does a good and humorous job of illustrating the most simple technique for a Ponzi scheme by bankrolling “returns” with new investments.

6. References

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