Madoff

MVE 220 (16/17)

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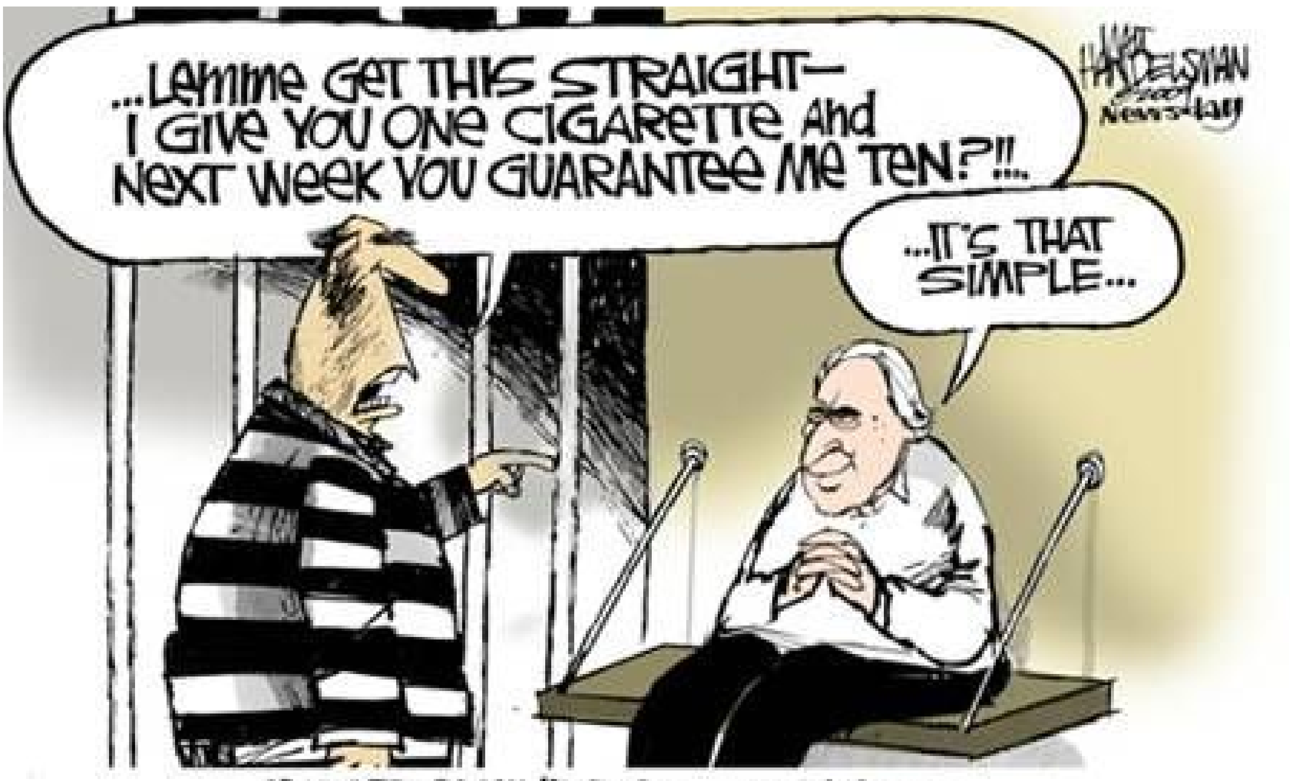

1. Aim

The aim of this report is to give the reader a summary of the fraud staged by Bernard Madoff, as well as a grasp of how it could happen and how we are trying to prevent it from ever happening again.

2. Method

We have used various sources found on the internet and on the Chalmers library. Because of the extent to which the scheme involved big losses of money for common people, a lot of feelings may have affected the various texts that we have used. Therefore we have tried to apply a critical thinking and having an open mind while gathering information. We did also use a newly released podcast, "Ponzi Supernova", which contains exclusive interviews with Mr. Madoff himself as well as investigators. This podcast contained a lot of useful information on most parts of the whole ordeal, but one have to keep in mind that it is a podcast that aims to entertain people, and therefore has to be taken with a grain of salt.

3. Introduction

Bernard Madoff, a name familiar to many, was the man behind the biggest Ponzi scheme in the history of time. A scheme that would last over 15 years and eventually led to thousands of people losing more than $50 billion. Amongst the victims were banks, universities, charities and civilians. The circumstances and events that made the scheme possible and those that made it collapse are many and complex. This assignment is an attempt to clear up some of them along with the concept of a Ponzi scheme, how this could happen and what the consequences of the scheme were.

4. Ponzi schemes

The term Ponzi scheme comes from Charles Ponzi who was the first person to ever do a Ponzi scheme. Ponzi used the idea of buying discounted postal reply coupons and redeeming them at full price. By taking advantage of this arbitrage he claimed to be able to give 50%

profit in 45 days or 100% profit in 90 days to his investors. Since there was no actual trading of coupons the scheme eventually collapsed and the investors lost their money(Business Insider, 2014).

The idea behind a Ponzi scheme is that instead of using the investors' money to generate a profit, the swindler uses the deposits of new investors to pay return to earlier investors. To attract investors the swindler offers an often unrealistically high return. This return is then paid, as stated before, by using the money that new investors deposit. Since there are no value adding activities going on and the swindler needs to pay his existing investors, there will never be enough money to pay back all of his investors, leading to an inevitable crash when investors try to withdraw their money(Business Insider, 2014).

The Ponzi scheme is hard to keep up over longer periods of time due to several reasons. One of them being that the scheme requires the swindler to continually attract more and more investors to pay return to his existing investors. The amount of money needed will also rise for every dollar invested in the fraud. Another reason being that investors will be affected by psychological factors i.e. during recessions people tend to withdraw their money which often leads to even more people withdrawing and the scheme collapses(Securities and exchange commission, 2013).

5. Bernard Madoff Investment Scandal

Bernard Madoff Investment Securities(in the text referenced to as BMIS), the company that would later go on to be the business through which Madoff performed his scheme, was founded in 1960 as an innovative stock exchange broker. It relied on computer technology and high tech to get an edge over its rivals on the New York Stock Exchange. Later Madoff took part in the creation of the NASDAQ, which helped him build his reputation in Wall Street.(The independent, 2009)

It was however, not this part of the company that ran the schemes. Instead, it ran through the disguised "investment management and advisory division", which was only accessible for a selected few, at the beginning only for his closest friends. In the beginning they made what Madoff calls "legitimate money", and lots of it. As word spread, more people wanted in and

he opened up his fund for other to partake in, with promises of a consistent 20% return. Soon, pension funds, hedge funds, major banks like Banco Santander and the Central Bank of Ireland, as well as celebrities had joined this seemingly lucrative business.
The reason for that the scheme worked so well, was that they “picked a return, and worked backwards” as Frank DiPascali, the former Chief Financial Officer of BMIC called it when questioned by the court. It means that for example, if you had invested 10 dollars in January, then by June you want 15 back. Then you would be given those money back, which was claimed to come from good investments which in turn was found in data history using computer programs (if you think about it, it’s not hard to “make money” if you are just using number from the past). The investments never actually occurred though, and the money you got back came from others who had invested in the fund. To assist with this, the only way to look at how your money in the fund was developing, was to ask for a letter to be sent to you with the information which meant that you had no online access at all. For this to work, a lot of people had to be involved. For example, Frank Dipascali, who himself was under investigation, helped getting the guys running the computers convicted. (Ponzi Supernova, 2017)

At the same time, one might think that auditors should have caught the operations of Madoff. According to Azim, M. and Azam, M. (2016) this was avoided by having a small accounting firm, staffed only by three people of which only one was a certified accountant, do the auditing. This company named Friehling & Horowitz, played a major role in the scheme by falsifying documents and ensuring investigators that the internal controls were satisfactory. While one might think that big accounting firms like KPMG and BDO Seidman should have seen some red flags, they all said that it was secure to invest in BMIS. Experts suggests that this might have been due to the firms only checking the statements made by Madoff himself. It also seems that the management of some funds that had invested in BMIS were aware of the fact that only one accountant was doing the auditing, and that they might have taken advantage of this. However, no real evidence have been presented to reach conclusions about the extent of this.(Azim, M & Azam, M. 2016)

While the above text suggests that Madoff never was close to getting caught, several investigations was onto him. Most notably of these was an investigation conducted by Harry

Markopolos which gave a tip to SEC in 2000 saying they should look into Madoff's business. Markopolos was a portfolio manager in the end of 1999, working for a management firm in Boston's financial district. He was, in the beginning of 2000, asked to reverse-engineer a strategy to make the firm's customers able to invest in Madoff's business since it was so successful. Therefore he discovered that the returns couldn't be completely legal and started to dig deeper into the business. One thing that tipped him off was that Madoff's name wasn't on the marketing materials which was something that Markopolos had never seen before. Madoff also had positive returns after the fees, which according to Markopolos calculations shouldn't be possible with his strategy. Although, in April 2008 he decided to drop his investigation of Madoff since the SEC didn't proceed with it and Markopolos had other cases that went forward. Still, Harry Markopolos played an important part in the discovery of the Madoff scheme. (Dick Carozza, 2009)

The financial crisis of 2008 was the beginning of the end for Madoff's Ponzi scheme. When the crisis hit many clients withdrew their money invested in Madoff. After several attempts at attracting new investors and getting funding from banks to be able to pay back his investors Madoff admitted defeat. After advising his two sons to pay out $170 million dollars in early bonuses he confessed his crimes to his sons(Harry Markopolos, 2010).

Madoff's sons reported him to authorities which led to his arrest shortly after. Madoff was accused of losing $50 billion of his customers' money. However this amount included the false profits that Madoff's scheme reported. The amount that was actually invested in the scheme is estimated to be around $36 billions out of which $18 billions were reimbursed to the investors (CBS news, 2009).

In 2009, Madoff confessed in court to 11 felonies and was sentenced to 150 years in prison. He claimed to have been the only one involved in the scheme but it has been questioned several times on different grounds. Firstly because pulling off this scheme alone would require incredible amounts of work for one person. Also, claims have been made that investors that profited of Madoff's scheme should have been able to tell that it was a hoax but invested anyways and made profits of it(Wall Street Journal, 2009).

6. Consequences

Direct consequences of the Madoff scheme are that Bernie Madoff was sentenced to prison for 150 years and that many people lost their savings and pensions. Also, Madoff's son, Mark Madoff, committed suicide exactly two years after his father was caught (Larry Celona, 2010).

It's difficult to determine exactly how big the losses were, but it's estimated to be between $50 billion to $65 billion (Chelsey Parrott-Sheffer, 2009), but the invested amount lost in the Ponzi scheme is estimated to be $17.5 billion (The Madoff Recovery Initiative, n.d). There is a trust fund called The Madoff Recovery Initiative that aims to reimburse the victims for their losses. Irving Picard, partner in the law firm Baker Hostetler, for example has been filing a large number of lawsuits to increase the sum for the victims (Maglich, 2013).

After the scheme, actions by the SEC were taken to prevent this for happening again and for letting cases like this to go undetected. For example, they have redone the system for how complaints and tips are handled. This was, in Madoff's case, one reason for how the scheme could continue even if tips were sent to SEC. Another move taken by the SEC is "Improving Risk Assessment Capabilities" (U.S. Securities and Exchange Commission, 2014) which means that they improve methods and strategies to better identify what risks there are for the investors in different areas. This way, it's easier to find the firms that may need an inspection and therefore also a greater chance to find the firms which isn't following the law (U.S. Securities and Exchange Commission, 2014).

7. Reducing risk of future incidents

It's difficult to say exactly how to prevent it from happening again. As stated above, changes has already been made by the SEC. One of the most important ones according to us is redoing the complaint system. By following up complaints as they arrive, the SEC will hopefully be able to detect Ponzi schemes much earlier. In the case of Madoff's scheme, the case would have been resolved much quicker if tips would have been handled better.

Another issue for the SEC is that there was a lack of knowledge in finance within the organization. This is a problem since they need to be able to detect schemes made by people with far more superior knowledge in the field.

8. Reading recommendations

We strongly recommend listening to the podcast *Ponzi Supernova* by Steve Fishman for some real insight into the mind of Bernard Madoff. It's quite enjoyable and easy to follow, with a decent narration. One does also get to see the point of view from several different parties, including, but not limited to Bernard himself, investigators and victims. Since it was only released earlier this year, it sheds some new light on what actually was going on.
The podcast is available at Audible.com, which is a subscription service for audiobooks. There is however a free 30-day trial, which also includes a trial to Amazon Prime.

Bernard Madoff's 'Ponzi Scheme': Fraudulent Behaviour and the Role of Auditors is also an interesting read that takes on the role of examining how auditors handled the situation, as well as providing a psychological point of view on what makes a man able to commit these frauds.

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