Bernard Madoff

MVE220 financial risk

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Both of authors have discussed and agreed on all parts of the project. The following paragraphs were mainly written by:
Robert - Introduction, Madoff's journey to fraud, Key people, Consequences
David - The mechanics behind the scheme, The failure of the SEC, People affected
Together - Conclusions

Introduction

Bernard Madoff was the founder of the company Bernard L Madoff investment Securities which was responsible for one of the biggest financial scams throughout history. It has been estimated to reach roughly 65 billion dollars and Bernard Madoff was sentenced to 150 years in prison.

Madoff's journey to fraud

The company was founded in 1960 by Madoff using $5000 that he had saved up from his lifeguard job and other side gigs that he had going. As well as $50 000 that he had borrowed from his in-laws. The company grew fast with the help from Madoff's father in-law who drew in a big list of clients from being a retired certified public accountant. Madoff also manage to attract a lot of new investors with his high gain promises at 10% or more as part of his ponzi scheme.
The trick with a Ponzi scheme is to continuously keep attracting new investors whose money paid for the investors that wanted to withdraw their money from the company. As long as the input is greater than the output the scheme works. But in 2008 the financial market was unreliable and one after another of Madoff's investors wanted to withdraw their investments. According to affarsvarlden.se the sum of investors that wanted to withdraw was roughly seven billion dollars and Madoff only had 300 million dollars to distribute.
It is not hard to see that eventually a ponzi scheme would run into trouble. But what is impressive is how Madoff's firm managed to stay in business for decades before it was discovered (Cervenk, 2009).

Key people

The company did well according to the books and as they expanded Madoff started recruiting family members to work for him. His two sons Andrew and Mark both work for their father but weren't involved in the scheme of invest management. Instead they manage the trading arm of Madoff's securities. They both claimed to be unaware of the fact that it was all a big lie, until Bernard told them in 2008. Both of the sons went straight to the authorities and confessed that the whole asset management was built on a Ponzi scheme. There was no crucial evidence to show that the brothers knew about the scheme, so they faced no charges. However, Mark later committed suicide in 2010 and Andrew died in cancer 2014 (Larson, 2017).

His brother Peter Madoff was his right-hand man and they worked together for a better part of 40 years. Peter the chief compliance officer and ran the operations of the firms trading business. Peter got sentenced in 2012 to 10 years in prison for his part in the Ponzi scheme (The Telegraph, 2017).

Ezra Merkin was the fund manager and in chairman of the General motors finance arm. Merkins had 2 billion dollars of funds to manage that he lost to the fraud. In 2012 he reached a settlement at 410 million dollars with the New York attorney general's office (The Telegraph, 2017).

Robert Jaffe was the son-in-law of Madoff and he was the middle man towards the clients, as Madoff rarely spoke to them directly. Jaffe worked on recruiting new potential clients for the Ponzi scheme but denied being aware that Madoff had been running a decades-long fraud. In 2010 Jaffe also made a settlement for dealing with Madoff (The Telegraph, 2017).

Frank DiPascali was one of the longest working employees at Madoff's firm and could be referred to as a chief financial officer. He was prosecuted and faced a possible sentence for 100 years. He also played a key role as a witness as he testified against five former employees accusing them of knowingly aiding Madoff. DiPascali died three months before his sentencing ni may 2015 (The Telegraph, 2017).

The mechanics behind the scheme

The way Madoff claimed to be generating revenue was with a split-strike conversion strategy, which involves buying stock and hedging the investments with both long and short positions on options. As it turns out however, these transactions were only ever done on paper. When an investor made a deposit the money was transferred to Madoff's personal business account where it later could be used to pay those who wanted to withdraw money. To hide this they used a computer program to falsify account statements as well as trading reports. This way Madoff could determine the return for his customers by picking out stocks which had performed well during some time period and then backdating trading reports (Hays, 2010).

He managed to keep all this hidden by being very secretive about his dealing and he also had some unconventional tricks to prevent anyone from noticing the lack of real transactions. Everytime the firm were to report its holdings he claimed to sell all assets and thus only reported how much cash there was in the fund. This should probably have raised some suspicion since there is no apparent tactical reason for an investor to do this other than to conceal their holdings. Also, his client were not given any sort of electronic access to their accounts, the only way they got any information on the development of their investments were via the faked account statements sent out by the firm (Appelbaum,Hilzenrath & Paley, 2008).

The failure of the SEC

The whole thing could have been uncovered several years earlier though, if only the right people had been willing to pay a little more attention. When Madoff finally confessed it was not all that surprising to everyone, none of the major firms on Wall Street dealt with him because they suspected that his numbers were too good to be true. While this was mostly theoretical speculation however, a man named Harry Markopolos had some pretty

substantial evidence that Madoff was a fraudster. He worked as a financial analyst and wanted to figure out Madoff's strategy, thus he tried to reverse engineer it but quickly realised that something was off. In an interview with CBS News he says that the most obvious tell at first was how even the performance was, as the market went up and down, Madoff's fund only went up. Markopolos also says that he with some simple calculations proved that for Madoff to execute his strategy he would have had to buy more options than actually existed on the Chicago Board Options Exchange (Court & Sharman, 2009).

The United States Securities and Exchange Commission (SEC) is the agency responsible for enforcing the laws regarding stock and options exchange, to keep the market fair and protect its investors. Markopolos first reported Madoff to the SEC as early as year 2000 and then four more times during the years leading up to Madoff's arrest in 2008. He claims that by 2005 he had 29 "red flags" and that if the SEC had conducted a proper investigation it would have been impossible to miss that it was a scam (Court & Sharman, 2009).

The SEC has on several occasions been accused of not being proactive enough as well as being afraid to take action against well respected people in high-ranking positions. This is very well highlighted by the Madoff case; in 2006 they actually started to look into Markopolos allegations, but a formal investigation were never started and the case was closed within a year with the conclusion "no evidence of fraud". Mainly two reasons have been brought up when trying to explain this shortcoming, one of which being that the regulators were not competent enough on the subject matter. Markopolos states that many of the regulators working for the SEC are very badly suited for the job, referring to them being lawyers without any special knowledge of finance, thus not having the ability to see that something clearly was wrong. The other reason some people suspect may have influenced the investigation is the fact that Madoff had ties with people at the agency at a personal level and that they therefore gave him some extra leeway. On the subject of him being investigated Madoff said: "I'm very close with the regulators so I'm not trying to say that what they do is bad. As a matter of fact, my niece just married one". He also talked about how the job the SEC did made it impossible to break any rules without being detected (Court & Sharman, 2009).

Consequences

Because of Madoff's actions a new reform was proposed at the SEC which was criticized as mentioned earlier for not discovering Madoff's scheme. This reform included greater transparency and coordination between regional offices and improved fraud detection procedures. In 2013 the SEC added new requirements that brokers holding investor assets file quarterly reports explaining how they handle their customers assets. This was the problem as Madoff pointed out himself in an interview that his fraud wasn't detected because auditors did not manage to verify BLMIS assets at depository trusts.
These new requirements have been successful with the SEC which has filed a record number of enforcement actions against investment companies. These efforts have resulted in 6 billion dollar penalties and disgorgement (Maglich, 2013).

People affected

With these huge sums of money there were obviously a lot of people whose investments were somehow handled Bernard Madoff. The money invested in Madoff's fund came from two different sources; those who invested directly in the fund and also so called feeder funds. Madoff attracted most of the direct investments from the jewish community in New York and Palm Beach, where he was a well liked and much respected businessman. There were individuals investing there personal money as well as different charity organizations etcetera. Many of these investors had some sort of personal connection to Madoff or had at least heard enough about him to feel that they could trust him. He used this reputation to attract a lot of money over the years and with the result he was getting no one really thought to question him (Appelbaum,Hilzenrath & Paley, 2008).

When the word started to go around on the results he was getting other funds started investing in him as well. These feeder funds took in money from investors which they then simply invested in Madoff's fund. This took the scheme to a whole new level, both in terms of the money involved and the geographical distribution of it (Appelbaum,Hilzenrath & Paley, 2008). Many of these funds were based in countries throughout Europe and Asia and they contributed to quite a large part of the money in Madoff's fund. An example is the Spanish bank Banco Santander who lost roughly $2.3 billion of their customers money (The Wall Street Journal, 2009).

Altogether investors lost approximately $20 billion of the money they invested, that is not taking into account the profit Madoff claimed to have generated. There has been done a lot of work to try and recover this money for the investors and it is still going on 10 years after the scheme was uncovered. According to The Madoff Recovery Initiative the total recovered amount as of April 20, 2018 is $12.978 billion, and the aim is to keep that number growing in the future (The Madoff Recovery Initiative, 2018)

Conclusions

As long as there is money to be made from it, people will always find new creative ways to cheat and these schemes can be hard to find when you do not know what you are looking for. In this particular case however, it is pretty obvious that the whole thing should have been discovered earlier. A big part of the blame falls on the SEC, as it should, but in retrospect it is clear that the investors themselves probably should have been somewhat more suspicious as well, given that there were some strong warning signs. This mostly applies to the feeder funds, who definitely should have the knowledge required to stay away from a scheme like this.

The regulatory changes that have been made goes a long way towards the same thing happening again, but as previously mentioned, people will find other ways to cheat. For investors though, there are ways to reduce the risk of losing money to some sort of scheme, the easiest of which is to always know what their investing in. If there is any of these warning signs such as lack of information or a promised return that sounds too good to be true, it is

best to avoid it even if it sounds tempting. This would have helped a lot of the investors in the Madoff case.

Further reading

For those interested in learning more about the ongoings around Bernard Madoff and his scheme the following is recommended:

- *No One Would Listen: A True Financial Thriller,* by Harry Markopolos. A book about how he discovered Madoff's scheme and the fight to make people believe him. Available from Chalmers library.
- A list and some comments on all of Bernard Madoff's known victims: http://s.wsj.net/public/resources/documents/st_madoff_victims_20081215.html

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