CASE 11

The Fraud of the Century: The Case of Bernard Madoff

The fraud perpetrated by Bernard Madoff, which was discovered in December 2008, is based upon a Ponzi scheme. Madoff took money from new investors to pay earnings for existing customers. The greater the payout to retiring and withdrawing customers, the more revenue or clients he would need to start an "investment relationship" with. The Ponzi scheme was named after Charles Ponzi, who in the early twentieth century, saw a way to profit from international reply coupons. International reply coupons were a guarantee of return postage in response to an international letter. Charles Ponzi determined that he could make money, legally, by swapping out these coupons for more expensive postage stamps in countries where the stamps were of higher value. While making a significant profit with this system, Ponzi got the idea of enticing investors to provide him more capital to trade coupons for higher priced postage stamps. His promise to investors was a 50 percent profit in a few days.

Touted as a financial wizard and the "Warren Buffett" of his day, Ponzi lived outside Boston; he had a fairly opulent life, bringing in as much as $250,000/day. Part of Ponzi's success came from his personal charisma and ability to con even savvy investors. The promised payout was supported by the new investors anxious to take advantage of these robust returns because he appeared to create an image of power, trust, and responsibility. In July of 1920, the *Boston Post* ran an article exposing the scheme and soon after, regulators raided his offices and charged him with mail fraud, knowing that his fabricated investment reports were mailed to his clients. The foundational operating principle of a Ponzi scheme is that you must constantly attract new investors to pay the old investors the "gains" they were promised. Most Ponzi schemes self-destruct fairly quickly as the ability to keep attracting new investors dwindles. In the case of Bernard Madoff, he may have perpetrated the fraud for many years.

BERNARD L. MADOFF INVESTMENT SECURITIES LLC: "ALL IN THE FAMILY"

Bernie Madoff started in the investment business by legally buying and selling stocks not listed on the New York Stock Exchange (NYSE). Starting in 1960 as a sole proprietorship,

Copyright Linda Ferrell, 2009. This case is designed exclusively for classroom discussion rather than to illustrate effective or ineffective handling of an administrative, ethical, or legal decision of management. All sources were obtained through publicly available sources.

he served as a "wholesaler" between institutional investors. In the early days, working with investment firms such as A.G. Edwards, Charles Schwab, and others, he made his money based on the variance between the offer price and sales price of stocks. In the 1990s, Madoff Securities was trading up to 10 percent of the Nasdaq shares on certain days. Early success and competitive advantage came from Bernie working with his brother Peter (the first of several family members to join his firm), who after graduating from law school joined Madoff's company and developed superior technology for trading, buying, and selling at the best prices. Madoff did not operate a hedge fund, which charges a fee for services and holds the money at a custodial bank. Madoff controlled the funds in-house and made his money, in this division, from commissions on sales and profits and as far as has been revealed, the profits were not based on fraud.

As Madoff became more successful, he moved the company's headquarters from Wall Street to Third Avenue to the red granite "Lipstick Building" built by famed architect Philip Johnson. Not unlike Ken Lay and his lobbying efforts to deregulate the energy and gas industry, Bernie became more involved in lobbying for regulatory changes which would make it easier to trade electronically. Peter took on more oversight of the firm's securities business. Bernie served as Chairman of the Nasdaq in 1990, 1991, and 1993. Through his successful networking, visibility at the Nasdaq, and promise of consistent returns (10–12 percent) Bernie was drawing billions of dollars from hundreds of investors. In addition, he held a seat on the government advisory board on stock market regulation, served on charitable boards, and started his own foundation, which added to his credibility. He developed respectability and trust as a highly knowledgeable investment specialist. His inaccessibility and "invitation only" approach to new investors created an air of exclusivity and desire to be involved. It could be equated to the most exclusive of country clubs—the greatest enjoyment is the status of membership. Ruth Madoff, Bernie's wife, also worked at the firm for a time, indicating a family network of relationships in the firm.

Peter's niece, Shana Madoff, was a rules and compliance officer at Madoff's firm and worked under her father who was head of compliance in the market making arm (not the firm's money management business). Shana, although not charged with any crimes, is married to Eric Swanson, a former SEC compliance lawyer. Shana Madoff has a respected career and was honored by the Girl Scouts of America as a "woman of distinction."

Although under investigation, neither of Madoff's sons, Mark or Andrew, has been charged with any wrongdoing. They were responsible for turning their father in when he confessed to the fraudulent nature of his investment firm. Andrew did have money invested in his father's firm whereas Mark took his money out of the firm eight years earlier. The two deny any knowledge of the fraud. The family emphasizes the separation of the stock trading business (run on the 19th floor) and the investment management business (run on the 17th floor) by Bernie Madoff.

In March, 2009 when Bernard Madoff stated his guilt, he never indicated the involvement of any other company employees or family members. He stated in the Allocution that, "I want to emphasize today that while my investment advisory business—the vehicle of my wrongdoing—was part of Bernard L. Madoff Securities, the other businesses that my firm engaged in, proprietary trading and market making, were legitimate, profitable, and successful in all respects. Those businesses were managed by my brother and my two sons" (Madoff Plea Allocution, p. 2). Further investigation will determine the extent and level of external support which Madoff had in defrauding thousands. His hiring philosophy for the investment business was to hire inexperienced individuals with no background in finance. They may have been unknowing participants.

EXPLAINING THE GROWTH NUMBERS

Madoff claimed he could consistently generate 10 to 12 percent returns for investors. Many of his clients were already wealthy and looking for a stable and constant rate of return. His stated investment strategy was to buy stocks while also trading options on those stocks as a way to limit the potential losses on those stocks. His market timing strategy was called the "split strike conversion." With the large financial portfolio Madoff managed, many indicate at least one "red flag" would have been the fact that he would have overtaken the market had he traded the options in the volumes necessary to meet his financial goals. In his "Plea Allocution" statement in March of 2009, he indicated that he never invested any of his client's funds. Madoff simply moved money between Chase Manhattan Bank in New York and Madoff Securities International Ltd., a United Kingdom Corporation. Madoff stated that his fraud began in the early 1990s.

Madoff had relationships with intermediaries also known as "feeders" to his investment fund. These "feeders" trusted Madoff and at this point do not appear to be integrally involved in the fraud. One such middleman, Rene-Thierry Magon de la Villehuchet committed suicide on December 23, 2008, after losing his life savings to Madoff. The middlemen profited by receiving fees, and Madoff had a stream of money flowing into his operation. Robert Jaffe operated as a middleman for Madoff starting in 1989 when he became the manager of Boston-based Cohmad Securities, a firm co-owned by Madoff to attract investors. Jaffe was the son-in-law of one of Madoff's earliest investors and was a member of the Palm Beach Country Club, where he solicited new investors. He earned a small profit when Madoff took on an investor Jaffe introduced to him.

Stanley Chais was a private investor from Beverly Hills who consistently brought in returns of 10 to 15 percent. Chais was funneling all his clients' money to Madoff. Investors with Chais claim they thought he was personally managing their money and were not aware of the Madoff connection. In June, Chais sent a letter to clients informing them that he was moving to Jerusalem for six months for medical reasons and his son would take over in his absence. Chais's fortune is claimed to be devastated as is that of his clients. In addition, Chais lost significant money in his own charitable fund.

Jeffrey Tucker was an attorney for eight years at the SEC. Tucker also facilitated the meeting between Fairfield Greenwich Group and Madoff resulting in the loss of $7.3 billion (the biggest known single loss). Andres Piedrahita wed one of the daughters of Fairfield Greenwich's co-founder Walter Noel. Piedrahita joined Greenwich and attracted significant revenue from Europe's wealthiest families, operating out of a London office. Wealthy Spanish clients invested just under $50 million with the Group and Madoff.

Robert Schulman operated Tremont Group Holdings after gaining experience working with Smith Barney and Shearson Lehman Brothers. Investors with Tremont, who ended up with Madoff, lost an estimated $3.3 billion. Tremont is part of Massachusetts Life Insurance Company that oversees billions of dollars in Oppenheimer Funds mutual fund assets. Tremont helped Mass Mutual enter the hedge fund business. Schulman, at the age of 62, retired from Tremont in the summer of 2008 (nearly six months before Madoff's fraud was exposed). Schulman claims to have lost money in the Madoff funds and now operates a charity helping women and children who are poor or abused. None of his charities' funds were invested with Madoff at the time the scandal broke.

Swiss Bank Union Bancaire Privee (UBP) placed $700 million of wealthy clients' money in Madoff's Ponzi scheme. Top management received warnings from the bank's research department that Madoff's fund should be eliminated from a list of approved funds. The bank's senior executives were aware of the concerns and continued to leave hundreds of millions of investor funds with Madoff. UBP told its clients it was the victim of "massive fraud" and that it had conducted due diligence in managing client funds.

FINANCIAL SUPPORT NEAR THE END AND THE ARREST

The week and a half before Madoff admitted to his sons that he was operating a Ponzi scheme, 95-year-old Palm Beach philanthropist and entrepreneur Carl Shapiro gave Madoff $250 million. Shapiro lost the $250 million that he provided to Madoff as well as the loss of $100 million in a charitable organization he had invested with the firm. Madoff had made requests of many others for funds to save his business and Martin Rosenman provided $10 million. Rosenman is the President of a fuel company in New York. Rosenman is suing Madoff for the money, alleging that Madoff proposed the solicitation was for a new fund and he was sent a nineteen-page promotional piece in advance of the investment.

Madoff was arrested on December 11, 2008, accused of operating a $50 billion Ponzi scheme after confessing his failure to his sons Andrew and Mark, who worked with their father in the firm. The official charge is criminal securities fraud. Madoff declared to his sons that he had roughly $200 to $300 million left in the business and that he wanted to provide the money to employees before turning himself over to authorities. The sons thought the investment arm of the business held between $8 billion and $15 billion in assets. SEC records showed that the firm had $17 billion in assets at the beginning of 2008.

THE INVESTIGATION AND CHARGES

Investigators in this case include the Securities and Exchange Commission (SEC), FBI, federal prosecutors from the U.S. attorney's office for the Southern District of New York, and the Financial Industry Regulatory Authority. Forensic accountants will try to pull together the trail of investments and spending to determine where the money went. There is a belief that multiple offshore funds have been created by Madoff to shelter assets prior to the collapse of the firm. Madoff's business was not registered with the SEC until 2006 after a SEC investigation.

Bernard Madoff is charged with fraud. Investigators are evaluating documents dating back to January 1, 2000. The charges were not new when exposed to the SEC. Beginning in 1992, federal regulators investigated allegations of wrongdoing by Madoff. Table C11-1 is a summary of the nature of these investigations.

INVESTORS IMPACTED

The list of Madoff clients is a who's who of organizations, nonprofits, successful entrepreneurs, and businesspeople as well as entertainers. The Fairfield Greenwich Group had around $7.5 billion or more than half of its assets invested in the firm. Tremont Group Holdings, owned by Oppenheimer, had $3.3 billion invested. Ezra Merkin, head of GMAC, operated a hedge fund which lost $1.8 billion to Madoff. For a list of selected victims of the fraud see Table C11-1.

TABLE C11-1 Government and Regulatory Investigations of Bernard Madoff

Year	Nature of the Investigation
1992	SEC—Madoff's name came up in Florida accounting investigation
1999	SEC—reviews Madoff's trading practices
2001	SEC—Harry Markopolos, securities industry executive, raises question regarding Madoff's returns
2004	SEC—review into allegations of improper trading practices
2005	SEC—interviews Madoff and family finding no improper trading activities
2005	Industry-based regulatory group finds no improper trading activities
2005	SEC—meets with Harry Markopolos who claims Madoff operates world's largest Ponzi scheme
2006	SEC—enforcement investigation finds misleading behavior and Madoff registers as an investment advisor
2007	Financial Industry Regulatory Authority investigates and no regulatory action was taken

SOURCE: Associated Press, "The Many Fruitless Probes into Bernie Madoff," *APNewswire,* January 5, 2009, http://news.moneycentral.msn.com/provider/providerarticle.aspx?feed=AP&date=20090105&id=9486677 (accessed January 5, 2009).

Several victims have shared their "stories" and relationship with Bernie Madoff. Richard Sonking met with Madoff in the mid-1990s after his father, who had an account with Madoff, recommended the investment for the steady 8 to 14 percent returns. Sonking pulled together the minimum $100,000 required for investment at that time and was reminded how selective Madoff was in developing relationships. After selling his business, importing porcelain collectibles from France, he placed additional funds in Madoff's hands. He was pleased with the returns and pleased with the monthly, detailed seven- to eight-page statements provided (including detail on equity trades). Upon retiring in 2005, Sonking requested quarterly distributions from his account and the amount could be increased with a faxed request. Until the news stories in December 2008 there was no warning of any fraudulent activities.

Loretta Weinberg, a New Jersey state senator and conservative investor, embraced her late husband's philosophy that you live on half of what you make and save the rest. She was invested with Stanley Chais, a Los Angeles money manager who provided quarterly investment reports and a 10 to 14 percent annual return. Until the Madoff scandal hit the press, Weinberg had not heard of Madoff. As a 73-year-old state senator making $49,000/year she will have to cope with the loss of her $1.3 million in life savings. In addition, she is concerned for her family who were all invested with Chais and, unknowingly, Madoff.

Joseph Gurwin is 88 years old and lives in Palm Beach. He came to know Madoff and became his friend through the Palm Beach social and philanthropic community. Gurwin noted Madoff's reputation for secure and conservative financial management. Gurwin's Foundation (The J. Gurwin Foundation, Inc.) operating with around $28 million in assets donated $1.2 million in one year. The Foundation was invested heavily with Madoff. He indicated no warning signs and when he requested withdrawals, the money came quickly. Gurwin's Foundation supports health care, as well as services and programs for frail, elderly, or disabled younger adults.

Law firms in Florida are representing clients who believed they were investing with Westport National Bank (a regulated banking institution in Connecticut) not Madoff Investments. On December 12 the investors received a letter from Westport National indicating that they had a custodial agreement with Westport, giving full discretionary authority to Bernard L. Madoff Investment Securities.

RESTITUTION FOR INVESTORS

Some investors are suing the SEC for negligence in its regulatory responsibility and not being able to identify the fraud. Such attempts represent the first time investors have sought restitution from a regulatory agency. Christopher Cox, SEC Chairman at the start of the fraud investigation, indicated that the SEC examiners had missed "red flags" in reviewing the Madoff firm. Allegations of wrongdoing started nearly ten years ago. Repeated investigations and examinations by the SEC showed no investment fraud. Because many SEC employees end up working in the investment business on Wall Street, there was speculation that an overall lack of objectivity clouded these investigations.

Most investors are looking for minor compensation from the Securities Investor Protection Group (SIPC), which is a security-industry group started by Congress to provide up to $500,000 per customer for theft in a relationship between a broker and direct investor. The trustee has mailed claim forms to more than eight thousand Madoff customers. Many experts believe that third-party investors (those who invested indirectly in the Madoff accounts) will not be eligible for SIPC funds.

Some investors are engaging in "clawback suits." This litigation would attempt to secure funds from "investors" who had been able to successfully withdraw funds and reallocate that money among the defrauded clients. To protect their assets, many who have received payout funds from Madoff are transferring the money to irrevocable trusts, homes, annuities, or life insurance policies to protect them from seizure (Kim, 2009).

A search of Madoff's office by federal prosecutors and investigators found about 100 signed checks for nearly $173 million. The court-appointed trustee has obtained $29 million in assets and identified another $830 million in liquid assets, which could be recovered and returned to investors.

Perhaps the greatest restitution for some investors came as Bernard Madoff was handcuffed on March 12, 2009 and taken to prison after his 12-minute confession of guilt in a Lower Manhattan court house. Some victims asked the judge for a trial to uncover more about this extensive fraud and to determine why the governments' regulatory system failed many investors. Judge Chin indicated there would be no trial as there was a plea of guilt and ongoing investigation at hand (Lucchetti, 2009).

THE FUTURE OF CHARITABLE GIVING

Due to the widespread impact of the Madoff-related losses upon charities, nonprofits, and educational institutions, donor skepticism and withdrawal are not unexpected consequences. As mentioned earlier, some of the organizations affected include the Elie Wiesel Foundation for Humanity, Yeshiva University, and Wunderkinder Foundation (Steven Spielberg's Fund). This wariness comes at a time when the global recession has resulted in losses of around 30 percent for many foundation endowments. The vast majority of nonprofits indicate that the economy was having a negative/very negative impact on fund-raising, before the Madoff scandal was exposed. There is an increased care and sensitivity that will accompany charitable giving and shape the questions and

stipulations placed upon donations. Some guidelines provided for evaluating responsible charities include the following:

1. See what materials are readily available to potential investors/donors from the organization (annual reports, audited financial statements, payroll, and overhead)?
2. Who is the charity invested with and how much of their funds are invested?
3. Who is managing the fund/charity and is there an independent investment committee (who's on this committee)?
4. Is the investment portfolio appropriately diversified?
5. Who is auditing the fund/charity?
6. Is there objectivity among board members through written "conflict of interest" statements that prevent direct business dealings while serving on the board?

CONCLUSION

Bernard Madoff is accused of creating a Ponzi scheme that destroyed $50 billion in investments. Many people are trying to understand how so many experienced investors, including banks, insurance companies, and nonprofit foundations lost billions of dollars to an individual who was able to deceive them as well as regulators. Investigators are trying to determine who helped Madoff carry off what some say could be a thirty-year scheme that caused the $65 billion in losses and may have impacted over 4,800 people. Accountants, auditors, and regulators are supposed to be gatekeepers who protect the public interest. Investigators believe that Madoff had a trading strategy that failed, then after a while, he made few trades for many years and his operation consisted of taking money from new clients and paying it out to existing clients, a classic Ponzi scheme.

From an ethical perspective, this would be an example of white-collar crime. White-collar crime creates victims by establishing trust and respectability. As in this case, victims of white-collar crime are trusting clients who believed there were many checks and balances that certified the Madoff investment operation as legitimate. Madoff appears to be the classic white-collar criminal. He was an educated and experienced individual in a position of power, trust, respectability, and responsibility who abused his trust for personal gains. From the inception of his investment business, he knew that he was operating a Ponzi scheme and defrauding his clients. In the end, he said he "knew this day would come."

An important question is how one individual could deceive so many people who certified his operation as legitimate. Madoff's accountants, family, and other employees will have to answer to authorities about their knowledge of the operations. For example, investigators have issued a subpoena for David Friehling, a New York accountant, who audited Madoff's financial statements. Frank DiPascili, who dealt with client accountants and worked at Madoff's firm for twenty-two years, "responded evasively" and many of his answers to investigators were "incomprehensible." While only Madoff has been charged with misconduct at this time, if there were other participants, they will face responsibility for their actions.

White-collar crime is unique in that it is often done knowingly by a rogue individual to steal, cheat, or manipulate in order to damage others. Often, the only way to prevent white-collar crime is to have internal controls and compliance standards that detect misconduct. Perhaps the most difficult white-collar crime and fraud to expose is

that perpetrated by the top executive. We count on leadership within an organization to create, manage, and motivate an ethical organizational culture with all the checks and balances in place. In the Madoff case there was the opportunity to deceive others without effective audits or transparency and an understanding of the true nature of his operations. As a result of this case, individual investors, institutions, and hopefully regulators will exert more diligence in demanding transparency and honesty from those who manage investments.

QUESTIONS

1. What are the ethical issues involved in the Madoff case?
2. Do you believe that Bernard Madoff worked alone, or do you think he had help in creating and sustaining his Ponzi scheme? Would this represent a conflict of interest?
3. What should be done to help ensure that Ponzi schemes like this one do not happen in the future?

SOURCES: "Madoff's Victims," *Wall Street Journal,* http://s.wsj.net/public/resources/documents/st_madoff_victims_20081215.html (accessed January 9, 2009); "Plea Allocution of Bernard L. Madoff," http://online.wsj.com/public/resources/documents/20090315madoffall.pdf, March 12, 2009, accessed March 12, 2009; "Victims of Scandal Reflect on Shocking Turnabout," *Wall Street Journal,* online.wsj.com/article/SB122972955226822819.html (accessed December 23, 2008); Elizabeth Bernstein, "After Madoff, Donors Grow Wary of Giving," *Wall Street Journal,* online.wsj.com/article/SB122999068109728409.html (accessed December 23, 2008); Cassel Bryan Law, "Inside a Swiss Bank, Madoff Warnings," *Wall Street Journal,* January 14, 2009, 1A; Thomas Catan, Christopher Bjork, and Jose De Cordoba, "Giant Bank Probe Over Ties to Madoff," *Wall Street Journal,* online.wsj.com/article/SB123179728255974859.html (accessed January 13, 2009); Amir Efrati, "Q&A on the Madoff Case," *Wall Street Journal,* online.wsj.com/articles/SB123005811322430633.html (accessed January 9, 2009); Amir Efrati, "Scope of Alleged Fraud Is Still Being Assessed," *Wall Street Journal,* online.wsj.com/article/SB122953110854314501.html (accessed December 23, 2008); Amir Efrati and Chad Bray, "U.S.: Madoff Had $173 Million in Checks," *Wall Street Journal,* online.wsj.com/article/SB123143634250464871.html (accessed January 9, 2009); Amir Efrati, Aaron Lucchetti, and Tom Lauricella, "Probe Eyes Audit Files, Role of Aide to Madoff," *Wall Street Journal,* online.wsj.com/article/SB122999256957528605.html (accessed December 23, 2008); Robert Frank and Amir Efrati, "Madoff Tried to Stave Off Firm's Crash Before Arrest," *Wall Street Journal,* online.wsj.com/article/SB123129835145559987.html (accessed January 7, 2009); Robert Frank and Tom Lauricella, "Madoff Created Air of Mystery," *Wall Street Journal,* online.wsj.com/article/SB12297320870502294.html (accessed December 23, 2008); Kara Scannell, "Investor Who Lost Money in Alleged Scheme Seeks Relief from SEC," *Wall Street Journal,* online.wsj.com/article/SB122999646876429063.html (accessed December 22, 2008); Jane J. Kim (2009) "As 'Clawback' Suits Loom, Some Investors Seek Cover," *Wall Street Journal,* March 12, p. C3; Aaron Lucchetti, (2009) "Victims Welcome Madoff Imprisonment," *Wall Street Journal,* March 12, http://online.wsj.com/article/SB123687992688609801.html, accessed March 12, 2009; Jenny Strasburg, "Madoff 'Feeders' Under Focus," *Wall Street Journal,* December 27–28, 2008, A1, A8; Jenny Strasburg, "Mass Mutual Burned b Madoff," *Wall Street Journal,* December 22, 2008, C1; Ethan Trex, "Who Was Ponzi—What the Heck Was His Scheme?" CNN.com, http://www.cnn.com/2008/LIVING/wayoflife/12/23/mf.ponzi.scheme/index.html (accessed December 23, 2008); Elizabeth Williamson, "Shana Madoff's Ties to Uncle Probed," *Wall Street Journal,* online.wsj.com/article/SB122991035662025577.html (accessed December 23, 2008).