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Money, Manipulation, & Madoff: What are Ponzi Schemes and How to Avoid Becoming a Fraud Victim

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MONEY, MANIPULATION, & MADOFF:

WHAT ARE PONZI SCHEMES & HOW TO AVOID BECOMING A FRAUD VICTIM

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Introduction

Trust. This is imperative to have in order to make a sound investment decision whether it is in the stock market or saving for one's 401K. An investment decision can determine whether someone can retire and when it can happen. It also influences a person's retirement lifestyle and how they are able to live their final years. People often invest their money with the assistance of financial managers to take advantage of good investment opportunities that provide quality returns on investments. A financial manager's job is to steer their clients into stocks that deliver consistent returns rather than riskier stocks that could end in monetary losses. Trust in financial managers is key because people often invest large sums of money, if not one's life savings, in the hopes of making a profit. The investment manager, Bernard L. Madoff, is a master manipulator of trust and employed it to mastermind the largest Ponzi scheme in history which ultimately caused the loss of about $20 billion of investors' life savings.

According to *A Guide to Forensic Accounting Investigation,* Ponzi schemes are defined as "illegal investment scams that use funds received from subsequent investors to pay returns to earlier investors, rather than distributing revenues generated from any actual business" (Skalak 495). The fraudsters that manage Ponzi schemes lure investors into their ploy by promising high rates of return on their investments over short periods of time. By consistently handing out above average returns back to their investors, the investors are more likely to cycle their money back into the scheme and talk about it to others looking to invest. One of the primary tactics Madoff used to operate his $20 billion fraud was gaining financial trust by targeting members of the Jewish community through an affinity fraud. According to the ACFE's *FRAUD Magazine*, affinity frauds are when "fraudsters use their similar characteristics to others to gain trust —

ultimately exploiting that trust for their own financial gain" (Perri 1). Being a prominent member of the New York Jewish community, Madoff easily exploited Jewish investors such as Holocaust survivor Elie Weisel, and numerous Jewish charities into funneling millions of dollars into his scheme.

Bernie Madoff's Ponzi scheme could have continued operating for many more years if it was not for the economic recession of 2008 that forced thousands of Madoff investors into withdrawing their money from Bernard L. Madoff Investment Securities LLC. This sudden outflow of cash from the investment firm made it difficult for Madoff to pay out all his clients that were leaving and caused the scheme to crumble around him. Knowing that the scheme was falling apart, Madoff confessed what he had done to his wife Ruth, and sons Mark and Andrew, and started to divide the remaining millions amongst his family members, friends, and employees. Thrown into shock and despair, Madoff's sons turned their father into the authorities soon after. The aftermath of Bernie Madoff's Ponzi scheme left thousands of investors in financial hardship and directly caused four suicides including his son Mark.

This type of fraud allows anyone to be susceptible to it. By educating more people on the red flags of Ponzi schemes, it will better their chances of not falling victim to a fraud themselves. It is also imperative for auditors and investigators to be properly educated on the red flags associated with frauds, such as Ponzi schemes, so future frauds can be stopped. Such education will improve trust and would promote confidence within the business community and society.

Charles Ponzi & His Scheme

How do Ponzi schemes work? The concept of Ponzi schemes began in early 1900s Boston with Charles Ponzi, an Italian immigrant that dreamt of making it big in America. Once in America, Ponzi spent his time hopping around from job to job because he frequently got into trouble for theft or scamming customers. After living for a few years in the U.S., Ponzi moved to Canada and tried his luck at a different con. Ponzi attempted to cash forged checks but was quickly caught and sent to prison.

Ponzi's infamous 'get rich quick' scheme was orchestrated once he moved back to the U.S. after serving his three year prison sentence in Quebec. In 1907, the International Postal Congress issued postal reply coupons around the world that could be redeemed for postage stamps in participating countries. People that would receive the coupons in foreign countries would then redeem them for stamps at their local post office. These stamps would then be used as postage for mail sent back to America. This scheme made Ponzi very wealthy because Europe's inflation rates were rather severe compared to the United States which made U.S. currency more valuable. Ponzi would then sell the stamps at a slight discount to generate a steady cash flow. Ponzi would "then purchase more coupons with his profits and cash those in there by generating even higher returns" (Mathosian iii). To advertise his scheme, Ponzi "promised investors a return of 50% in 45 days or double your investment if you were willing to invest your money for up to three months" (Mathosian iv). After Ponzi's calculations, he proved to be making an astonishing 230% gross profit with his innovative 'no lose' scheme. Charles Ponzi was a wildly successful fraudster his time, raking in an estimated $250,000 per day according to *Biography.com* and $15,000,000 overall. According to *Mental Floss,* within two years Ponzi ordered his “employees all over the country [to] recruit new takers for this foolproof investment strategy”. Charles Ponzi’s fraudulent antics gave birth to the modern day Ponzi scheme.

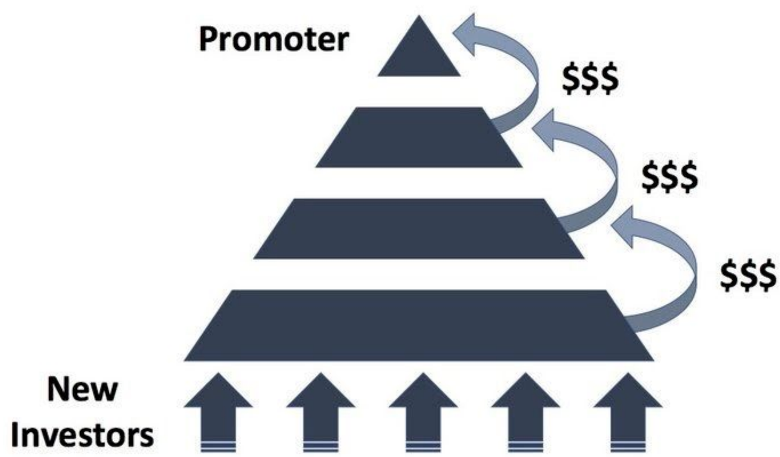
One would believe that Ponzi’s scam would be completely fraudulent and criminal in the eyes of the state, but it was actually legal. Ponzi was operating within the mailing regulations for the foreign postal reply coupon program. He was simply playing the system very well. Everything about Ponzi’s business was running smoothly until journalist Clarence Barron, owner of the *Wall Street Journal* and founder of *Barron’s*, started looking into how Ponzi operated his successful company. He hypothesized that it was probable that Ponzi could be making a small profit by operating the scheme the way he advertised. After further research, Barron realized “that Ponzi would have to be moving 160 million coupons around to raise the cash he needed to support the business… there were only 27,000 postal reply coupons circulating in the world” (Mental Floss). This means that Ponzi’s ironically named Security Exchange Company was definitely fraudulent since it needed almost six thousand times more postal reply coupons to exist in order to generate the profits his company was delivering.

Barron later published his evidence in the *Boston Post* in 1920 in an attempt to expose Ponzi’s fraud. Despite all of the compelling evidence, people ignored Barron’s article and continued investing with Ponzi. The element of trust aided Ponzi after the article was printed. Hundreds of investors had trusted Ponzi with their life savings so “few believed that their hero, the man who had ‘tripled’ their life savings, was anything less than 100% legitimate” (Mental Floss). Markopolos agrees that “[investors] refused to believe [Ponzi’s scheme] was a scam” (Markopolos 51). About a month later, financial regulators uncovered that Ponzi had a very minimal amount of postal coupons in his office. The scheme was uncovered with this discovery. Eighty-six mail fraud charges were brought against Ponzi in two indictments. He pled guilty to one charge and served three and a half years in prison. Ponzi then received a state sentence of nine years. After his release, Ponzi was deported back to his home country of Italy and then moved to Brazil where he later died poor in 1949.

There were red flags that were ignored by Ponzi's investors and the Boston Police Department. Harry Markopolos stated, "one of [Ponzi's] former publicity men wondered why Ponzi had deposited several million dollars in a Boston bank that paid only 5 percent interest when [Ponzi] could easily have doubled it by investing in his own company" (Markopolos 50). This was the most prominent red flag because why would Ponzi invest his money somewhere else rather than his own company? If Ponzi himself did not want to risk his money in his own business then why should his investors risk their money with the Securities Exchange Company.

<u>What is a Ponzi Scheme?</u>

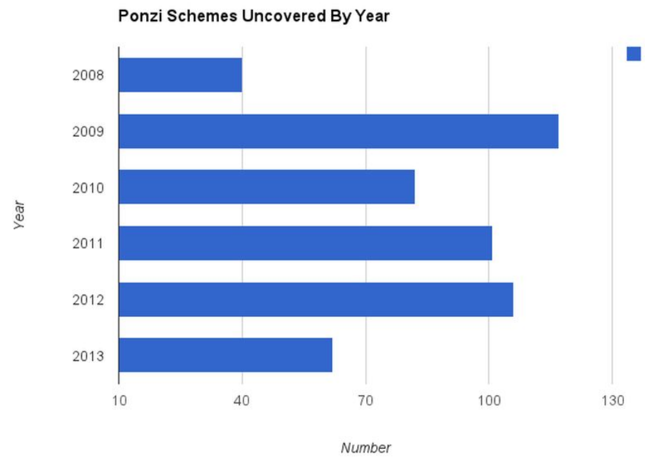
According to the Securities and Exchange Commission or SEC, "a Ponzi scheme is an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors. Ponzi scheme organizers often solicit new investors by promising to invest funds in opportunities claimed to generate high returns with little or no risk" (SEC.gov). A typical Ponzi scheme involves luring many investors into the fraudsters 'investment fund' with promises of high returns received in a short period of time with minimal risk. Markopolos states that "these initial investors get every dollar they were promised; they usually earn a profit large enough to make them boast about it to everyone they know" (Markopolos 49). Once the first set of investors' return period is up, the schemer gives back the investors' money at an above average return rate that is then flipped back into the scheme because the investor wants to keep receiving profits from their investment. This cycle of money inflates as more investors are drawn into the scheme by all of the positive publicity from earlier investors, (see the diagram below). As long as a steady cash flow is established, a Ponzi scheme can operate indefinitely until outside forces, such as a stock market crash or investors withdrawing large amounts of money, halt investors from funneling money into the scheme. As time goes on, more and more confidence is built between the investor and the fraudster. This element of trust allows the Ponzi scheme to continue indefinitely.

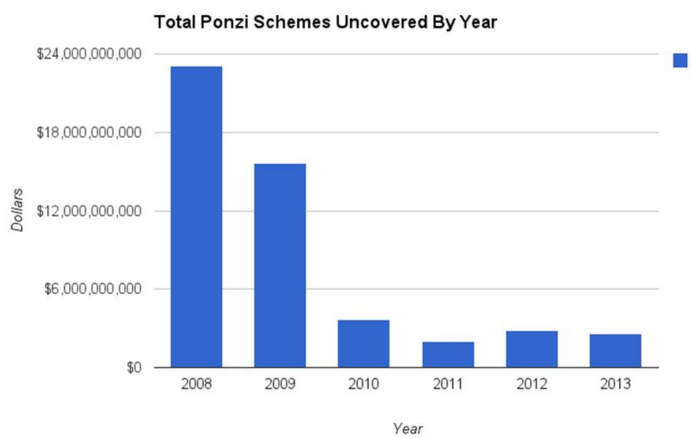


Ponzi schemes are a subsection within the category of occupational fraud. Occupational fraud is "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the organization's resources or assets" according to the Association of Certified Fraud Examiners (ACFE). Bernie Madoff's Ponzi scheme was solely operated through his investment firm Bernard L. Madoff Investment Securities LLC and falls directly under the criteria for occupational fraud. The ACFE's *Report to the Nations* is a highly regarded survey, compiled by the ACFE from its members' experiences that outlines the various attributes of fraud, including the devastating impact it has on its victims. The 2016 document disclosed that "2,410 cases of occupational fraud around the world that caused a total loss of $6.3 billion" (Howell 3). Bernie Madoff's fraud caused roughly three times the amount of monetary losses in 2016.

<u>Ponzi Scheme Statistics</u>

According to a study conducted by *Forbes'* magazine's investing expert Jordan Maglich, between the years 2008 to 2013, over five hundred Ponzi schemes were uncovered across numerous states, (see the first graph below). Maglich stated that "the average size [of each scheme] was approximately $98 million" (Maglich), (see the second graph below). Without including the largest schemes like Bernie Madoff and a handful of other schemes, the average dollar amount stolen per scheme dropped to approximately $43 million. Extrapolating this across the cumulative investment community, this accounts for a significant portion of investor wealth across the United States specifically, making it a very prevalent issue in the investing community.

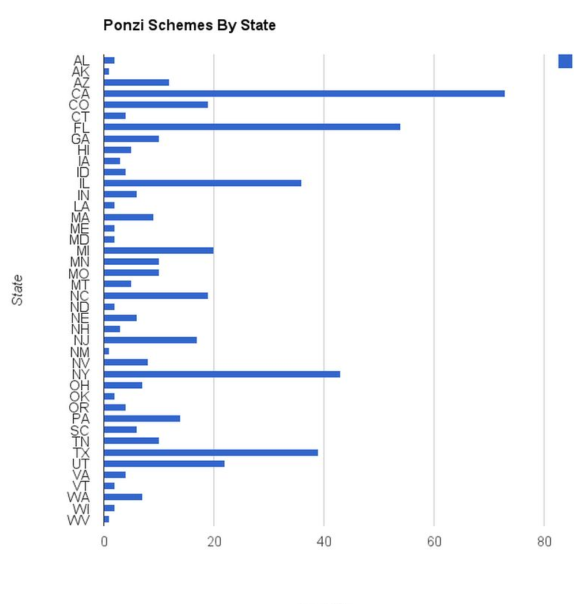




When looking at the graph below, the states with the highest amount of Ponzi schemes to be uncovered are California (70), Florida (55), and New York (43). Specifically looking at the state of Florida, according to the Aging & Disability Resource Center (ADRC), roughly 28% of the state's population is above the age of 60. Compared to other states, "California, with 3.3 million, led the way [for the largest population of senior citizens], followed by Florida, New York, Pennsylvania, Texas, Ohio, Illinois, Michigan, and New Jersey" (Duffin). This information strongly correlates to the information on the graph seen below in the exact order of the top three states with the most Ponzi schemes uncovered.

This information suggests that a large amount of Ponzi scheme victims tend to be senior citizens. According to the FBI's *Fraud Against Seniors* warning, "people who grew up in the 1930s, 1940s, and 1950s were generally raised to be polite and trusting. Con artists exploit these traits knowing that it is difficult or impossible for these individuals to say 'no'..." (FBI.gov). Ponzi schemes are a very prevalent issue in the general investment community but more specifically the senior population because senior citizens are more likely to go along with whatever the fraudster is proposing to them no matter what. With proper education on the potential risks of investing and investment frauds like Ponzi schemes, the elderly population would be better equipped to recognize fraudulent activity and therefore protect their investments.

California, Texas, and Florida: A Ponzi Mecca



Ponzi Scheme Red Flags

Some common red flags of a Ponzi scheme that should not be overlooked according to the SEC are “above average consistent returns even when the market is in a downturn, unregistered investments, promises of high investment return with minimal risk, unlicensed sellers, secretive or complex strategies, and issues with paperwork” (SEC.gov).

1. Above average consistent returns are an obvious red flag for Ponzi schemes because stock prices are constantly fluctuating. If one’s investment manager is consistently delivering positive returns even when the market falls and everyone else is losing money, they are most likely operating a Ponzi scheme. No investment manager or firm has a marketing strategy that is so distinct and successful compared to other strategies that it delivers positive returns in a recession.
2. Typical investment practices include registering all investment activity with state regulators and the SEC to ensure that no fraud or inaccuracies occur during the investment process. When a firm registers with one of these institutions, it provides the investor with important information about the firm they are funneling their money into such as who is managing the company, the products they sell and services offered as well as the financial situation of the firm. When the firm one is investing with is not providing proper investment registration credentials, it means the firm is purposefully not disclosing the proper information to the

investor in order to hide improper investment practices and potential fraudulent activity.

3. When a firm offers high investment return with minimal to no risk it is most likely fraudulent. This is because there is no obscure investment trick that is legal that allows for that to exist in the stock market. Every single investment opportunity that exists carries some form of risk, some opportunities have lower risk but the element of risk can never not exist. Also, opportunities that advertise high investment returns typically come with more risk. More risk, more reward. Always be highly suspicious of this type of investment opportunity when it comes around.
4. Unlicensed sellers are a huge red flag because federal and state security laws require all firms and sellers to be licensed. The nature of the risk and fiscal responsibility around guiding an investor has required sellers of investments to be licensed and regulated. If the firm one is investing with or investment manager is unlicensed to be doing their "job" then it is wise to turn down that investment opportunity because they are most likely hiding illegal practices. A lack of license could also mean that the seller may not have the proper education needed to guide investors and may not be properly vetted for a criminal past.
5. Another red flag to note for Ponzi schemes is when one's investment manager cannot properly explain how they are investing money. This is a crucial red flag because if one's investment manager cannot simplify the strategy for investors to fully understand exactly how their money is being used, then it is a shady

investment opportunity and should not be pursued. If this occurs, the investment manager could be deliberately attempting to conceal illegal investment practices that are typical for Ponzi schemes.

6. The final Ponzi scheme red flag to keep an eye out for is paperwork issues. If one cannot receive the investment information that is entitled to them then that is a big red flag. Also, inconsistencies and errors throughout investment paperwork (if any are provided) means it is very likely the investment is not legitimate and therefore fraudulent.

It is imperative not to ignore these red flags when considering making a sizable investment because the element of trust can con anyone into falling victim to a Ponzi scheme.

<u>The Master Manipulator and his Scheme Team</u>

> *"[Madoff] was the Wizard of Oz, and he made [his investors] so happy that they did not want to look behind the curtain" (Markopolos 38).*

Bernie Madoff first established his fraudulently successful investment firm in 1960 "when Bernard L. Madoff Investment Securities LLC was founded as a penny stock trader. It was started with $5,000 of seed money Madoff earned through his job as a lifeguard" (Globe and Mail). Senior financial writer for *The New York Times,* Diana B. Henriques explained that "Madoff started his own brokerage business while he was still a senior at Hofstra University, in the winter of 1959/60" (Henriques 24). Henriques also discussed how Madoff specialized in the over-the-counter (OTC) stock market. According to *Investopedia*, over-the-counter (OTC) “refers to the process of how securities are traded for companies not listed on a formal exchange.” (Murphy). These OTC securities “are traded via a dealer network as opposed to on a centralized exchange” (Murphy). This dealer network is primarily made up of hedge funds that are managed by numerous investment firms such as Bernard L. Madoff Investment Securities.

Madoff explained in a 2007 panel discussion, "over-the-counter stocks were traded always over the telephone with no automation. So you would call a broker; the broker would call up over the telephone any number of dealers like myself, and there were hundreds of dealers around the country that were making these markets" (Bandler & Varchaver). Back when Madoff first started his firm, it was very easy to fraudulently misrepresent trades and trade paperwork because there was no automation or technology involved in any transactions. Anything that was recorded was written on paper and could easily be tampered with. Bandler and Varchaver explained that “there was no technology to provide up-to-date prices, over-the-counter dealers could - and did - take all sorts of liberties with their quotes” (Bandler & Varchaver). This lack of automation in the 1960s practiced in the investment industry aided Madoff in covering up his phony gains because there was no way to track if what he was “investing” was the correct amount or even operating legally because there was a lack of paper trail and information available.

Although there is no concrete answer as to when his Ponzi scheme began, experts estimate that Madoff began his multi-billion fraud in the 1970s or 1980s as his trading company rapidly grew through that time due to an economic boom fueled by President Reagan and his tax reforms (ThoughtCo.). Over the approximated thirty to forty year scheme, Madoff amassed

37,346 investors (Madoffvictimfund.com) and manipulated a large portion of the New York area Jewish community.

Madoff was able to operate his colossal scheme by dividing Bernard L. Madoff Investment Securities LLC. into two companies: one company running the scheme on the seventeenth floor of his office building that operated illegally and the other operating on the nineteenth floor which was a legal security trading company that was controlled by his innocent sons, Mark and Andrew. Madoff appointed Frank DiPascali as his protege by teaching him the ins-and-outs of the scheme so he could run it discreetly with a small team of employees on the seventeenth floor. Among these employees were Annette Bongiorno, JoAnn Crupi, Jerome O'Hara, George Perez, and David Kugel. Madoff made sure that his sons had no contact with the employees or knowledge of the mission of the seventeenth floor workplace.

Frank DiPascali was Madoff's Chief Financial Officer and oversaw the operation of the scheme on the seventeenth floor. According to SEC Litigation Release No. 21174:

> "DiPascali helped generate bogus annual returns of 10 to 17 percent by fabricating backdated and fictitious trades that never occurred. The SEC further alleges that DiPascali helped Madoff cover up the fraud by preparing fake trade blotters, stock records, customer confirmations, Depository Trust Corporation (DTC) reports and other phantom books and records to substantiate the non-existent trading" (SEC).

DiPascali also helped Madoff cover the tracks of the scheme when the firm fell under suspicion. The SEC reported that "when Madoff grew concerned that showing positive returns every month would be suspicious, he occasionally instructed DiPascali to enter phony trades designed to lose money in order to make their investment strategy and returns more credible" (SEC). Madoff and DiPascali went as far as developing a phantom computer trading platform that mimicked real trading. If a surprise visit from the SEC happened, "one BMIS [Bernard L. Madoff Investment Securities] employee was to enter trades on a computer screen and another employee was to go into an office nearby and play the role of a counterparty trader in Europe" (SEC). DiPascali went out of his way to cover up Madoff's scheme for years and was one of the many reasons why Madoff's scheme was not found out sooner.

Annette Bongiorno ran Madoff's investment-advisory business. Bongiorno was first brought into the scheme when she was hired by Madoff to be his secretary at 19 years old. Bongiorno had no prior education in finance but was taught how to fraudulently "create fake trades and account statements to dupe customers" (Larson). Joann Crupi was the account manager after working with Madoff for almost thirty years. She started as a keypunch operator and worked her way up to account manager. Crupi worked alongside Bongiorno in creating the fake trades for account statements. Crupi was a significant player in Madoff's scheme with many responsibilities including:

> "Crupi handled the receipt of funds sent to BLMIS by its clients for investment; transferred clients' funds between and among various BLMIS bank accounts; handled requests for redemptions sent to BLMIS by clients; monitored, on a daily

> basis, funds transferred into and out of the BLMIS bank account that principally was used to perpetrate the fraud; and prepared and assisted in the preparation of fabricated documents designed to deceive regulators and outside auditors" (Justice.gov).

According to the SEC's complaint against Joann Crupi,"she handled the bank accounts used in BMIS' investment advisory business (the "Ponzi Scheme Accounts"), and she created false trading portfolios and account statements for the 0 Funds" (SEC).

Jerome O'Hara was responsible for coding programs that forged documents that "fooled auditors and regulators who attempted to understand the business" (Larson). George Perez worked with O'Hara as a computer coder. When Madoff's scheme began to expand, Perez was brought in to automate a program that created millions of the fraudulent documents listed above. David Kugel was Madoff's 'top trader'. Kugel was the former supervisor over Madoff's proprietary trading unit. He gave Bongiorno and Crupi historical pricing data beginning in the 1970s to assist the women into creating realistic looking trades for customer statements. As compensation, Madoff let Kugel backdate some trades to make a profit which is illegal.

The seventeenth floor employees knew that their actions were covering up a massive fraud. These actions were not innocent mistakes but rather premeditated criminal activity that concealed a monumental crime.

Gaining Trust and the Affinity Approach

Being a Jewish man himself, Bernie Madoff utilized his polished and prominent reputation in the business world and his religion to coerce many prominent Jews, like Holocaust survivor Elie Weisel and his charity, to invest into his scheme. Madoff effectively exploited his religious identity to funnel in more money into his Ponzi scheme. This is known as an affinity fraud. According to the ACFE's *FRAUD Magazine*, affinity frauds are when "fraudsters use their similar characteristics to others to gain trust — ultimately exploiting that trust for their own financial gain" (Perri 1). These similar religious beliefs between Madoff and his investors were a major reason as to why so many investors trusted Madoff with their investments. This is a typical tactic used by most fraudsters in more frauds other than Ponzi schemes as well. Certified Fraud Examiner Donn LeVie Jr. stated that "fraudsters preying on individuals work hard to be likeable and communicate a sense of familiarity and empathy." (LeVie Jr. 27). Fraudsters like Bernie Madoff prey on people that they can relate to and build trust with them to better perpetrate their fraud schemes. By building a trusting relationship based upon similar attributes, Madoff successfully convinced his investing victims that their money was in good hands and not in any risk.

What are Feeder Funds?

Bernie Madoff first recruited his close friends and family to invest through his firm when he first opened his business in the 1960s with promises of high investment returns with little risk involved.. Over time, this small circle of friends and family amassed to thousands and thousands of investors across the world. Madoff primarily received new investors through feeder funds.

According to *Investopedia,* feeder funds are " one of a number of funds that put all investment capital into [a] … master fund, for which one investment advisor handles all portfolio investments and trading" (Chen). Madoff operated his scheme as the 'master fund' where hundreds of firms across the world funneled in thousands of investors into Madoff's scheme. Rather than Madoff single-handedly recruiting investors into his scheme, he had several feeder funds such as Gabriel Capital LP, Fairfield Greenwich Group (FGG), Bank Medici (Silver), and Access International Advisors to bring in new investment money into the scheme.

Although feeder funds do not directly operate a Ponzi scheme, these firms reap tremendous benefits by doing business with fraudsters like Bernie Madoff. According to *Market Watch*, Madoff feeder fund Gabriel Capital LP through hedge fund manager J. Ezra Merkin "directed $2.4 billion clients money to Madoff without their permission, taking in $470 million in feeds". This $470 million are hedge fund fees that hedge fund firms charge their clients in order to have their money invested into other funds. These fees incentivize feeder funds to funnel millions of dollars into larger hedge funds in order to get a good payout like Gabriel Capital LP. This is known as the Two and Twenty.

According to *Investopedia*, the Two and Twenty rule is a standard fee arrangement in the hedge fund industry. The arrangement states "hedge fund management companies typically charge clients both a management and a performance fee" (Picardo). The two of the Two and Twenty belongs to the 'assets under management' 2% annual fee that hedge fund managers charge for handling client assets. The Twenty represents the 20% incentive fee hedge fund managers charge when they clear a predetermined profit benchmark. When feeder funds invest billions of dollars into Madoff, the personal gain for the feeder funds is so profitable, the funds are more likely to funnel in as much money as possible to receive their payout no matter what red flags are apparent.

<u>Blinded by Success</u>

> *"[Bernie] was the man that everyone wanted to be. His business was successful; he had the admiration of his colleagues and the respect of government officials. But it was more than simple praise. To us, it felt like constant glorification from heads of business, regulatory bodies, and exchanges, I knew my father to be one of the leaders of Wall Street, not [a] master criminal" (Madoff Mack 208).*

Being a master manipulator of trust, Madoff's "investors were blinded by [his] résumé, his perceived wealth, and his lofty status in the community and therefore didn't feel the need to dig beneath the surface when conducting due diligence." (Carozza 2). Among the items on Madoff's impeccable résumé were "launch[ing] the Nasdaq stock market. He sat on the board of [the] National Association of Securities Dealers [NASD] and advised the Securities and Exchange Commission on trading securities." (Business Insider). Madoff's exceptional reputation on Wall Street played a major role in not finding out his scheme sooner. Many option traders would say "'Well, we don't want to call him a fraud or anything…' And because of Madoff's reputation, they would not finish that sentence." (Howell 3). Business professionals working in the same industry as Madoff even considered the fact that he could be a fraud. However, no one stepped up and accused Madoff of operating illegally because of his powerful reputation on Wall Street. Taking into account that Madoff was previously the president and chairman of Nasdaq and was highly regarded in the business community, his stellar reputation in business and distinguished reputation in the Jewish community shielded him from people deciphering his scheme sooner.

<u>“Investment” Strategy</u>

It is essential to understand that different firms on Wall Street offer differing investment products in order to take advantage of the constantly evolving stock market. With each invention of new investment strategies, the stock market industry became increasingly more complicated and difficult to understand for average investors. Chartered financial analyst Harry Markopolos (and Madoff whistleblower) stated that “rather than simply picking stocks in companies whose names they recognized and whose products they used, investors suddenly had a supermarket of esoteric - meaning sometimes speculative and risky - investment opportunities from which to choose” (Markopolos 16). Every investment firm has their own theory as to what is the best way to invest in the stock market and advertises this theory or product in order to draw investors into their company. These investment firms essentially become experts in their investment theory in order to educate average investors on how they manipulate the stock market for them. Bernie Madoff’s ‘investment strategy’ is known as split-strike conversion.

Madoff’s hedge fund was supposedly utilizing a split-strike conversion tactic to achieve the ‘returns’ they were making. Split-strike conversion is a complex strategy that worked best to perpetrate the scheme because it seemed safe, diversified, and should have protected investors from market declines. According to CBS News, Madoff’s split-strike conversion strategy “involved investing in a basket of 35-50 stocks from the S&P 100 (the 100 largest publicly-traded companies in the United States). [Madoff] promised to "opportunistically time" his purchases and he said he was pulling out of the market occasionally and rolling the money into Treasury notes" (Millstone 1).

To utilize this strategy, money managers usually pick stocks that have high dividend payouts and choose a diverse group of stocks to invest in to limit the risk of losing money. According to *Investopedia*, "a dividend is the distribution of reward from a portion of the company's earnings and is paid to a class of its shareholders" (Chen). It is always better to choose stocks with higher dividend payouts because it means that the investors, or shareholders, will get a portion of the money they had invested back when the company they had invested into makes profits. It is also important to invest in a diverse group of stocks because it will drastically reduce the overall risk of one's investment and will better protect an investor from losing money.

For example, say an investor invests all of their money into one company's stocks. A week later, the company's stock prices plummet which causes the investor to lose a significant portion of their investment. This investor put all of their eggs into one basket and did not shield themselves properly in the event that the company's stocks lost value. The investor should have divided the money they were willing to invest amongst a few carefully selected stocks. So if one of the company's stocks loses value, the investor will not lose all of their money at once because it is protected and saved in other stocks. This is why hedge fund managers are supposed to invest their clients' money into diverse stock options using the split-strike conversion strategy.

Next, investment managers would sell back these call options at a price above the current index price. According to *Investopedia*, call options are "financial contracts that give the option buyer the right... to buy a stock, bond, commodity or other asset or instrument at a specified price within a specific time period" (Kuepper). This act will generate a small inflow of cash. Money managers then use the profits from selling the call options to buy new options at the current index value. If at any time the current index prices fall, the investments are more protected from losing a lot of money (Rice). This strategy is rather complex and is hard to understand. Madoff knew the SEC did not have experts that knew of this strategy or understood it and neither did any of the Madoff feeder funds.

The purpose of picking a split-strike conversion strategy was to be "vague and/or secretive, which schemers claim is to protect their business [trade secrets]" (Business Insider). Madoff in actuality never used split-strike conversion, but instead "Madoff's 'hedge fund' was nothing but a checking account at JPMorgan Chase, from which he and his lieutenant, Frank DiPascali, would regularly wire money in and out. No real 'buy' and 'sell' orders ever took place" (Arvedlund 3). This is also an example of the unregistered investments red flag because Madoff never invested his clients' money, so therefore his scheme had no registered investments to document.`

This strategy is an example of the secretive or complex strategy Ponzi scheme red flag. Madoff advertised that he always used the split-strike conversion strategy, which is a complex investment strategy that few investment professionals understand as is but Madoff also did not disclose what his private fund utilized as a strategy to others within his company that did not help operate the scheme. Madoff did not even explain the inner workings of his firm's 'private fund', (the scheme), to his sons Mark and Andrew who both played a prominent role in running the legitimate securities trading company within Bernard L. Madoff Investment Securities LLC. To plan for Madoff's eventual retirement, Mark asked his father what exactly he did at work so he could make the proper arrangements to have someone take over. Mark's wife recalled that "whenever [Mark] asked his father to explain his private fund and how the golden egg of Wall Street was managed, though, Bernie balked. 'You do your job and I'll do mine' he would snap" (Madoff Mack 82). Madoff revealed after he was arrested in 2008 that he did not want to include his sons in the scheme, so they would not face jail time. Madoff could not even explain any details of this separate fund to his own sons let alone his investors.

Rather than operating legally, Madoff paid off programmers and clerical workers to manufacture paper statements using old stationary from his pretend fund. Handling customer investments directly also breaks a standard imposed by the SEC. Madoff essentially "held direct custody of client money without a third-party audit…" (Arvedlund 4). Bernie also advertised that his 'investment strategy' "never hit home runs but instead earned a steady 1 percent a month and also couldn't lose much money because he owned protective stock market put options. If such a product had really existed it would be the Holy Grail of investment products." (Carozza 2). Bernie Madoff's investing strategy was essentially too good to be true. By picking a vague and seemingly complicated investing strategy, Madoff successfully lured more investors into his Ponzi scheme with the guarantee of steady returns from their investments.

To keep investors from cashing out their money from the scheme, Madoff often encouraged investors to stay in his fund to earn more money. Madoff's vague 'investment strategy' mentioned above got him out of explaining exactly how his hedge fund operated but he needed to provide proof to investors that they were in fact making money on their investment. Madoff had often told "investors how much they are making periodically, without actually providing any real returns." (Business Insider). Madoff usually handed out physical return statements to investors on old stationary that stated false information to keep his investors at ease and in his scheme. This is a good example of a Ponzi scheme red flag that no one bothered to report. Madoff often used old stationary that lacked important investment information, and often included simple errors that should have been detected. On top of the false investment information on the paperwork, Madoff displayed obvious errors which represents a red flag with respect to paperwork issues.

The Fraud Triangle

The act of committing fraud is commonly referred to as attempting to gain an advantage over others by means of trickery and unfair tactics. To be clear, an act of fraud is nonviolent, intentional and a major crime. When investigating frauds, it is imperative to allude to the Fraud Triangle to properly understand the intricacies of the scheme. According to Certified Fraud Examiner (CFE) John D. Gill, the Fraud Triangle "states that individuals are motivated to commit fraud when three elements come together: 1) some kind of perceived pressure 2) some perceived opportunity 3) some way to rationalize the fraud as not being inconsistent with one's values" (Gill 19). The Fraud Triangle is a highly regarded model used in the fraud examination and forensic accounting field because it is a basic formula that encompasses most of the behaviors and motivations observed by fraudsters when they commit a crime.

The Fraud Triangle concept was first coined in 1951 by renowned criminologist Dr. Donald Cressey when he went to prisons to interview inmates to get a better grasp on what motivated these criminals to commit their crimes. According to Cressey, the three most common factors observed throughout all of his interviews were: "a non-shareable problem, a perceived opportunity for a trust violation and a set of rationalizations that allowed them to believe their actions were acceptable under the circumstances" (Gill 20). The Fraud Triangle is vastly recognized as a helpful tool by Certified Fraud Examiners (CFE) around the world and gives insight into how the parts of the principle can be referred to in court cases. The Association of Certified Fraud Examiners (*ACFE*) or any fraud examiner professionals have never claimed that every case follows The Fraud Triangle. The Fraud Triangle is simply a list of observances that occurred in almost every white collar criminal's fraud case in Dr. Cressey's survey. However, it is still an effective tool to follow when attempting to understand a case.

1. Perceived pressure is the first side of the Fraud Triangle. It is important to acknowledge that financial crimes do not happen in the spur of the moment. Fraudsters do not steal on a whim, there is usually a factor that motivates them to

steal. This type of crime is premeditated and planned and are most likely fueled by pressures such as “greed, living beyond one’s means, inability to pay bills or personal debt, poor credit, personal financial losses, [and] unexpected financial needs” (Albrecht 36).

2. Perceived opportunity means that when a fraud is committed, circumstances were present that allowed the fraudster the chance to commit the fraud. Examples of such opportunities are: “Lack of internal controls that prevent and/or detect fraudulent behavior. Inability to judge quality of performance. Failure to discipline fraud perpetrators… Ignorance, apathy, or incapacity. Lack of an audit trail” (Albrecht 39). Of these factors, the most important factor that organizations must change is the lack of internal controls because with increased internal control, frauds are better prevented within companies.
3. Rationalization is when the fraudster attempts to justify the reasoning for committing their crimes. Rationalization gives a definitive reason as to why a fraudster commits a fraud. Some common rationalizations according to *Fraud Examination* are “The organization owes me. I will pay back the money. Nobody will get hurt. I deserve more. It’s for a good purpose” (Albrecht 51). Most fraudsters believe that they have been unjustly wronged, so therefore they must commit a crime to ‘even out the playing field’.

Madoff & The Fraud Triangle

From 1980 to 1987 "the Dow Jones Industrial Average (DJIA) went from 800 to 2,722… (a growth rate of about 15% compounded per year)" (Pavlo). With the market average return reaching about 15%, Madoff could have invested into the stock market legally and would have received quality gains on his investments without having to run a Ponzi scheme. After the market crashed in 1987, experts believe that Madoff's *perceived pressure* to give the impression to clients of being successful was induced by low returns and a crash in stock redemptions. To try and fool his clients into believing his firm was still profitable, Madoff "borrowed from investor capital to pay out redeeming investors and began falsifying results showing big returns" (Forbes). By handsomely paying out these investors during the crash of the stock market, these winning investors advertised their great returns to their friends and family members. This is how Madoff drew in more investors in the early days of his Ponzi scheme.

Bernie Madoff's *perceived opportunity* correlates directly with many investors not performing proper due diligence. Due diligence is the act of looking into a business to appraise whether or not it will satisfy your needs in a correct and legal manner. Many large investing banks such as Banco Santander and UBS recognized the exceptional returns Madoff was handing out to his investors and they desperately wanted to invest with him. Following the typical Ponzi scheme red flag of not explaining investment strategy with clients, Madoff never disclosed how he was maintaining his consistent returns. These large banks and investors never further questioned Madoff regarding the statuses of their investments because they were believing the phony statements Madoff was handing out every month or so. According to *Forbes*, "Madoff was taking the money, sticking it in treasuries yielding 2% and started printing false statements showing holdings in stocks yielding far more”(Pavlo). These false statements fooled his clients and gave Madoff the opportunity to defraud his investors for as long as he did.

In a 2016 interview with Bernie Madoff conducted by Harvard Professor Eugene Soltes, Soltes asked the convicted fraudster “How would you explain your actions and misconduct to a group of students?” (Nobel). Over the course of a fifteen minute response, Madoff disclosed his best explanation of how he *rationalized* his massive fraud. An unremorseful Madoff replied:

> “It wasn’t like I was being blackmailed into doing something, or that I was afraid of getting caught doing it. I, sort of, you know, I sort of rationalized that what I was doing was OK, that it wasn’t going to hurt anybody.”

This is a rationalization that is typical for most white collar criminals like Madoff - it was not going to hurt anyone in the process. In reality, Madoff financially decimated thousands of people and the impact of the fraud left four people with severe mental health issues to the extent that it may have contributed to their untimely deaths. Madoff’s rationalization is discussed more in *The Scheme According to Bernie.*

The Problem with Exclusivity

The aura of exclusivity of Madoff’s hedge fund made it easier for him to swindle money from investors from inside and outside the Jewish community. According to *The Atlantic*, “many practitioners of affinity fraud imply that they have secret and timely information, which can turn into serious money if one acts quickly and discreetly” (Pollack 4). Madoff often pressured potential investors, both Jewish and non-Jewish, into making time-sensitive decisions in regards to investing in his ‘highly exclusive’ fund. Madoff made it seem as though he was never looking for new investors; that his hedge fund was at capacity and no new investors could be accomodated. When the investor displayed how interested they were in investing with Madoff, he would act indifferent which would then pressure the potential investor even more, often enlarging the investment sum to convince Madoff to let them into his exclusive fund. Once Madoff ‘gave in’ he would say “‘because I like you I’ll give you special access and allow you, and only you, to invest.’ Then he would give them a flattering reason why he considered them to be special, and they’d fall for it hook, line and sinker” (Carozza 2). By effectively personifying indifference towards potential investors and exhibiting an illusion of exclusivity in his fund, Madoff made it easier for new investors to fall victim to his scheme. Making people feel special and playing with their emotions is an effective way Madoff also induced them to fork over a couple more million dollars into his scheme.

Madoff not only played his mind games with random strangers, he also defrauded his own family and friends into investing into his scheme. Bernie’s daughter-in-law’s step father Marty London invested one million dollars of his retirement savings with Madoff’s ‘full’ fund in 2007. Bernie recited the same rehearsed lines about having a ‘full fund’ but allowed Marty to invest his savings because he was family. Madoff’s daughter-in-law Stephanie recalls, “Bernie stole Marty’s money as readily as he stole everyone else’s” (Madoff Mack 167). Marty trusted a significant portion of his life savings to Madoff in the hopes of making a profit but was left with nothing in the end because Marty did not perform his due diligence into the firm and invested with Madoff solely out of familial trust:“‘The person who can financially ‘harm’ the most is the one who is trusted the most'… said Don Rabon, CFE." (LeVie Jr. 27). Stephanie also stated that "[Madoff's] family, like his unsuspecting investors, held him in awe… The facade was highly polished" (Madoff Mack 104). Blind trust in Madoff is what made thousands of his victims succumb to his empty promises of riches including unknowing family members.

Bernie Madoff left no room for due diligence to be performed by his investors with his exclusive deals. Madoff always advertised a take it or leave it deal: "If you asked detailed due diligence questions and wanted full transparency and an independent third-party bank to custody assets and clear trades, then Madoff would tell you, "It's a take-it or leave-it black-box strategy" (LeVie Jr. 30). The investors who did not perform their proper due diligence were the ones conned into Madoff's scheme. The people who asked questions were told not to invest.

Madoff also knew how to properly respond in any situation to con investors into the scheme. Certified Fraud Examiner Donn LeVie Jr. analyzed that "[Madoff] was brilliant in letting smart investors walk away and not being offended by it. He knew his targets were investors who didn't ask too many questions. You don't need to be the smartest man in the world to be a Ponzi artist; you only have to be smarter than your victims" (LeVie Jr. 30). The combination of Madoff's professional reputation, 'trustworthiness', and aura of exclusivity of his fund aided him in effectively conning thousands of people into his Ponzi scheme.

Harry Markopolos & His Fight for Justice

> *"Numbers can't lie, but the people who create those numbers can and do" (Markopolos 15).*

Harry Markopolos was a portfolio manager at Rampart Investment Management Company located in Boston. Later on, Markopolos became a Chartered Financial Analyst and Certified Fraud Examiner. As a work assignment, Markopolos was tasked with reverse engineering Bernie Madoff's investment tactics in order for his company to replicate the same strategy. After analyzing Madoff's methods, it became very clear to Markopolos that Madoff was operating some sort of fraud in order to create the returns he was generating.

Over the course of eight years, Markopolos had made five separate submissions to the SEC that detailed the red flags he identified when observing Bernie Madoff's investment strategy and practices. Markopolos and his team had submitted five separate filings to the SEC hoping for the organization to open a serious investigation into Madoff's fraudulent behavior. As detailed through Harry Markopolos's third submission to the SEC in 2005 regarding Bernie Madoff's financial misconduct, Harry outlined thirty red flags that he observed when analyzing Madoff's financial reports and talking to fund of fund investors. Harry compiled this evidence with the assistance of his investigative team Frank Casey, Neil Chelo, Michael Ocrant, and Gaytri Kachroo that were not mentioned in the submissions for safety reasons. At the beginning of the submission, Harry included that he had requested for his name only to be made known to the Branch Chief and Team Leader of the New York region SEC office to keep him and his family safe. This safety concern stemmed from the amount of money and powerful people connected in the Madoff fraud. If these people had knowledge of the scheme and wanted to keep receiving exceptional returns, they would have the means to stop Harry and his team and to keep them quiet. This is why only Harry included his name on the SEC submissions: to limit the danger the team would be exposed to.

Markopolos recalled that he had “tried but couldn’t replicate [Madoff’s] results. I later concluded it was impossible. One red flag led to another, until there were simply too many to ignore” (Markopolos 3). Markopolos worked alongside three other men in the financial industry to attempt to bring Bernie Madoff’s scheme to the attention of the SEC, with the first submission being completed in May of 2000, eight years before the scheme collapsed. The group’s plight to expose Madoff failed, but their actions exposed the incompetence of the Securities and Exchange Commission and the agency’s inability to properly perform their duties as financial regulators.

Markopolos is considered a “quant”, or quantitative analyst. A member of his group to take down Madoff, Neil Chelo, claimed that “quants look at numbers and see associations that other people aren’t even aware exist, and then understand the meaning of those associations in a unique way” (Markopolos 9). Being a quant allowed Markopolos to calculate his own trade options faster than a computer could because computers are constantly tracking stock prices that are changing at infinite rates so the calculations that computers provide take longer to give an answer. During his investigation into Madoff’s investment strategy, Markopolos’ quant ability is what enabled him to immediately determine that Madoff’s hedge fund was fraudulently generating returns after the marketing senior vice president for Rampart, Frank Casey, told him to look into Madoff’s strategy.

When first investigating Bernie Madoff’s investment strategy, Markopolos had to understand how his hedge fund operated and generated profits. He started with the basics: “Madoff Securities was a well-known market maker, meaning he both bought and sold stocks, making his profit by selling for a few cents more per share than his purchase price” (Markopolos 26). The normal difference that market makers paid for the stock and what they sell it for is roughly 12.5 cents according to Markopolos. This 12.5 cents is considered the market maker's profit. Madoff operated his firm differently. Markopolos explained that "instead of taking a fee for this service, as was normally done, Bernie actually paid firms as much as two cents per share for their business" (Markopolos 26). Mentioned in Harry's third SEC submission in red flag number 23, Madoff's agreement with "fund of funds [allowed them] to pocket their 1% and 20% fees… typically FOF's [or feeder funds] charge only 1% ["tip"] and 10% [in fees for giving Madoff investors], yet [Madoff] allows them the extra 10%. Why?" (Markopolos 318). This stood out to the Harry because the typical set up for feeder fund agreements is that 1% of the money brought in to the hedge fund goes back to the feeder fund to pay them off and 10% of the investment brought in also goes back to the feeder fund to compensate them for bringing the hedge fund (BLMIS) business. In Madoff's case, he is allowing feeder funds to rake in another 10% in compensation for their business. Markopolos believes this to be a red flag because Madoff is shelling out a lot more money than what is necessary. Was Madoff paying off feeder funds in order to keep Madoff's name out of feeder fund marketing literature? Markopolos strongly believes this to be the case claiming that "investors have a right to know who's managing their money?" (Markopolos 318). If investors do not have all of the information regarding where their money is being invested and through which firms, then they are prohibited from making a sound investing decision.

This issue of investors not knowing who their money is being invested with was another concern in Markopolos' 2005 submission to the SEC as red flag number 3 out of 30. Harry critiqued how Madoff fought for secrecy, and why he would want this for his firm. Harry claimed that "if I was the world's largest hedge fund and had great returns, I'd want all the publicity I could garner and would want to appear as the world's largest hedge fund in all of the industry's rankings" (Markopolos 304). This publicity as the world's largest hedge fund would bring in more business for Madoff's firm so why would Madoff not want anymore business? What was Madoff hiding that he did not want feeder fund investors to know about?

Even though Madoff was generating less profit than other market maker firms with this strategy, his hedge fund was creating a lot of business: "in the early 1990s Madoff Securities was reputed to be responsible for almost 10 percent of the daily trading of New York Stock Exchange - listed securities" (Markopolos 26). Madoff's strategy made him a major hit on Wall Street and generated substantial profits in the process.

Next, Markopolos dissected Madoff's advertised strategy: split-strike conversion. This strategy is notorious for setting a "floor" and a "ceiling" for investment gains and losses because this strategy is well diversified to limit financial risks. By utilizing split-strike conversion, Markopolos states that one "limits your potential profit if the market rises sharply, but in return you've protected yourself against devastating losses should the market drop" (Markopolos 27). The fact that Madoff was generating returns of 12% annually did not match up to the potential returns that split-strike conversion users typically expect to receive. Receiving 12% annually in returns was definitely possible to achieve in some years. However, Markopolos stated that "it was the consistent 1 percent a month return - month after month almost without exception, no matter how the market moved" (Markopolos 28) is what was concerning considering that split-strike conversion should not provide steady returns like Madoff was reporting. Markopolos highlighted this issue as red flag number 27 in his third SEC submission.

Co-founder of Madoff feeder fund Access International Advisors, Rene-Thierry Magon de la Villehuchet, provided Frank Casey with various types of paperwork to prove that Madoff's returns were legitimate using split-strike conversion. Several of these papers outlined sales confirmations, such as which options Madoff bought for de la Villehuchet and which options were sold and typical stock data such as how many of each share were bought and on what date it was completed. After analyzing the paperwork, Markopolos confirmed that this paperwork "was like opening the hood of a car and looking at the engine. All that confirmed was that there was an engine, but there was no evidence that it ran… the only thing these papers confirmed was that Madoff was producing paperwork" (Markopolos 28). Within five minutes of analyzing the documents, Harry knew that Madoff's returns were impossible. Harry outlines these concerns with Madoff Securities's paperwork in red flags 9 and 16.

Red flag number 9 discusses how in Harry's experience with trading OTC using split-strike conversion, "extensive and voluminous paperwork would be required to keep track of and clear each OTC trade" (Markopolos 310). By looking at Access International's paperwork provided to them by Madoff's firm, Harry could tell that this paperwork was not up to par with what the industry standard is when reporting OTC trades using split-strike conversion as a strategy. Furthermore, red flag number 16 also discusses how easy it is for Bernie Madoff to manufacture this type of paperwork (although it was not done well). Since Madoff owns a broker-dealer firm, "he can generate whatever trade tickets he wants" (Markopolos 315). This power of owning a broker-dealer firm gave Madoff the ability to easily falsify investment documents to better mask his Ponzi scheme and to fool investors into not asking questions.

Markopolos justified his rapid conclusion by going through what he already knew about split-strike conversion. Markopolos recalled,

> "I knew what a split-strike strategy was capable of producing, but this particular one was so poorly designed and contained so many glaring errors that I didn't see how it could be functional, much less profitable. At the bottom of the page, a chart of Madoff's return stream rose steadily at a 45-degree angle, which simply doesn't exist in finance. Within five minutes I told Frank [Casey], 'There's no way this is real. This is bogus'" (Markopolos 30).

This brief analysis was what led Harry Markopolos to launch a full investigation into Bernie Madoff. What Markopolos did not know at this point was that his detailed evidence outlining the exact red flags Madoff's firm was exhibiting would be ignored for almost a decade until it was too late to save the victims of Madoff's fraud.

<u>The Madoff Model</u>

In the weeks following his initial discovery of Madoff's bogus returns, Markopolos began to create a model for Madoff's split-strike strategy to see if he could replicate the exact returns Madoff was reporting. Before doing this, Markopolos observed that Madoff's returns have remained consistent for years which is practically unheard of in the financial industry. To illustrate his claim, Markopolos included that "in 1993 when the S&P 500 returned 1.33 percent, Bernie returned 14.55 percent; in 1999 the S&P 500 returned 21.04 percent, and there was

Bernie at 16.69 percent. His returns were always good but never spectacular" (Markopolos 33). Madoff's return percentage shifted by roughly 2 percent in six years while the S&P 500 rose by 19.71 percent in the same time period. Regardless of what the market is returning, Madoff always reported rather consistent returns.

With this information, Markopolos began to create his Madoff model. Markopolos started his model with the same standards that Madoff claimed he operated by. This means that Markopolos choose the 35 strongest stocks available in the S&P 100 in order to fit his assumption that Madoff could not afford for even one of the 35 stocks to go down for his returns to stay as good as he was reporting. Harry brought this up in red flag number 12: "Ask yourself how [Madoff's] trading experience could be so much better than all of the other firms on Wall Street. Either he's the best trading firm on the street and rarely ever has large losing months unlike other firms or he's a fraud" (Markopolos 312). Markopolos knew fully that it was next to impossible to choose 35 different stocks that would not cause returns to go down, but for the sake of replicating Madoff's returns for this experiment, Markopolos ignored this fact.

Markopolos created a basket with the 35 best performing stocks and applied Madoff's split-strike conversion strategy. The next week, he chose another basket to invest in. In a typical relationship of the correlation coefficient or "the relationship between Bernie's returns and the movement of the entire S&P 100 - legitimately [should] be around 50 percent" (Markopolos 35). After analyzing the correlation coefficient, Madoff's percentage came in at 6 percent which is extremely low in comparison to the S&P 100. Madoff's number was so low that Markopolos began to second guess himself and believed his model was incorrect. This is because Madoff's 6 percent meant that "there was almost no relationship between [Madoff's] stocks and the entire index" (Markopolos 35). In other words, Madoff's consistently high returns barely correlated to how the market was behaving at the same time. Harry made a point to mention this concern in red flag number 10 stating that "it is mathematically impossible for a strategy using index call options and index put options to have such a low correlation to the market where its returns are supposedly being generated from" (Markopolos 310). For a second opinion, Harry asked his associate, Neil Chelo, and math whiz and founder of Northfield Information Services, Dan DiBartolomeo, to recheck his work. Both men agreed that Markopolos had made no mistakes in his calculations.

DiBartolomeo also agreed that the 45 degree return line and 6 percent correlation coefficient "doesn't look like it came from a finance distribution. We don't have those kinds of charts in finance" (Markopolos 35). Furthermore, "volatility is a natural part of the market. It moves up and down - and does it every day" (Markopolos 35). Harry highlights in red flag 22 the unusual nature of the 45 degree return line: the "performance chart is misleading, it is almost a straight line rising at a 45 degree angle" (Markopolos 317). Both the 45 degree return line and 6 percent correlation coefficient lead to the conclusion that Bernie Madoff's firm apparently lives in a world where market volatility does not occur, which is impossible. Madoff was using his split-strike conversion "strategy" to cover the tracks of his illegal activities. In other words, Bernie Madoff is definitely a fraud.

Despite this compelling evidence that proves that Madoff's strategy is actually criminal, Markopolos' associates believed that Harry was wrong and that Madoff's strategy could for sure be reverse engineered and replicated. Frank Casey persistently pressured Harry to work on replicating Madoff's returns. From that point forward, Harry and Neil teamed up to further investigate Madoff, while more senior employees at Rampart still considered Bernie Madoff to be correct due to his reputation on Wall Street.

Other evidence that the pair gathered while investigating Madoff included a fund description obtained by Broyhill All-Weather Fund, (a Madoff feeder fund). The fund description detailed that the manager's (Madoff's) objective was to achieve long term growth consistently with low market volatility while utilizing a split-strike conversion strategy. The fund description continued, "the manager then sells out of the money OEX [or S&P 100] index call options and buys out of the money OEX index put options. The amount of calls that are sold and puts that are bought represent a dollar amount equal to the basket of shares purchased" (Markopolos 41). Harry emphasizes how feeder funds like Broyhill All-Weather Fund do not disclose that they are funneling money into Madoff's firm as red flag number 3 in his 2005 tip, arguing that investors have the right to know where their money is being invested (fully explained above). As an experienced portfolio manager at Rampart, Harry had traded OEX options before but has since converted to S&P 500 options.

Due to this experience, Harry knew that by selling thousands of options at once, those trades show up on the market. Markopolos writes, "at the volume [Madoff] had to be trading to produce the results he claimed, his trades should have been reflected in the market activity… [Madoff] supposedly got in and got out, bought and sold, without leaving a trace" (Markopolos 41). Since Madoff's firm was responsible for about 10 percent of trades on the New York Stock Exchange, his trades would have greatly impacted the markets because of the volume of business he was generating. The fact that Madoff had left no physical footprint on the stock market is impossible because of the amount of trades Madoff's firm claims to complete each day. With this conclusion, Harry started calculating the math involved in the OEX index.

> "I knew that there was in existence a total of $9 billion of OEX index put options on the Chicago Board Options Exchange (CBOE). Madoff claimed to be hedging his investment with short-term (meaning 30 days or less) options. You can realistically purchase only $1 billion of these, and at various times Madoff needed $3 billion to $65 billion of these options to protect his investments - far more than existed… There simply were not enough options in the entire universe for him to be doing what he claimed to be doing. If that wasn't sufficient proof, then assuming that those options actually existed, the cost of purchasing those puts would eat up the profits he was claiming (Markopolos 41-42).

With all of this being true, it appeared to Harry that Madoff's firm was undoubtedly operating fraudulently because there were simply not enough options available through the S&P 100, the index Madoff claimed he was buying and selling in, for Madoff's "strategy" to work in a volatile market. Harry covers this significant problem within red flag numbers 4 and 6 of his 2005 submission. Red flag number 4 states that "$9.017 billion in total OEX listed call options outstanding is not nearly enough to generate income on [Madoff's] total amount of assets under management which I estimate to range between $20-$50 billion" (Markopolos 306). In addition, red flag number 6 claims that Madoff "would have to be over 100% of the total OEX put option contract open interest in order to hedge his stock holdings… there are not enough index option put contracts in existence to hedge the way [Madoff] says he is hedging!" (Markopolos 308).

Throughout his book *No One Would Listen,* Markopolos continually discussed the importance of networking and utilizing contacts within the industry in order to help with his investigation into Bernie Madoff. Both Neil and Harry reached out to Wall Street professionals to get more information on Bernie's operations and other people's opinions on Bernie. After speaking with numerous types of professionals on Wall Street such as traders, portfolio managers, and investors, Harry and Neil discovered that most people in the investing industry knew Madoff was a fraud. Markopolos recalled that "as soon as I started asking questions, I discovered that people had been questioning Madoff's claims for a long time; but even those people who had questioned his strategy had accepted his nonsensical explanations - as long as the returns kept rolling in" (Markopolos 45). Other Wall Street professionals knew of Madoff's fraudulent activity and knew that his explanations for how he obtained consistent returns were lies but these people turned a blind eye to Madoff's criminal activity because they were some of the investors that were being paid handsomely.

Harry touched upon this fact in red flags number 11 and 20 in his third submission. Number 11 cited two press articles that had since been published since Markopolos's first SEC submission in 2000 claiming that Madoff's returns were bogus. One of these articles published by *Baron's* and written by Erin Arvedlund entitled "Don't Ask, Don't Tell; Bernie Madoff is so secretive, he even asks his investors to keep mum". Markopolos included that "no resulting investigation by any regulators" (Markopolos 311) followed the publication of the article even though it presented compelling evidence about Madoff that should have sparked an investigation.

Red flag number 20 discussed how “Madoff is suspected of being a fraud by some of the world’s largest and most sophisticated financial services firms” (Markopolos 316). Markopolos chose to conceal the identities of the three individuals mentioned in this section of his submission for safety concerns. Harry listed that “an official from a Top 5 money center bank’s FOF [or feeder fund] told me that his firm wouldn’t touch Bernie Madoff with a ten foot pole and that there’s no way he’s for real” (Markopolos 317). Even professionals within the same industry as Madoff realized what he was doing was wrong. But why did no one report the red flags that Madoff was displaying?

Madoff’s Fraud = Ponzi Scheme

After weeks of investigating Madoff’s firm, Harry and Neil observed that Madoff was definitely perpetrating a fraud, but they were not entirely sure what kind of fraud it was at first. The pair tossed around possible solutions like front-running or insider trading, but concluded that Madoff’s fraud must be a form of a Ponzi scheme. “We found out very quickly that Madoff was continually on the prowl for new money… by definition a Ponzi scheme requires a continuous flow of new money to pay old investors" (Markopolos 51-52). Madoff’s fraud could not be front-running because that type of fraud does not require new money to work. According to Eugene Soltes’s book *Why They Do It*, “front-running is the practice of trading securities in advance of a client’s order to gain a better price” (Soltes 303). Madoff was obviously not front-running, because Madoff admitted “the reality was that there obviously was no front-running because I was not doing any actual trading” (Soltes 303).

Markopolos addressed this in red flag number 13 in his 2005 SEC submission stating the facts that led him to believe was more likely a Ponzi scheme than front-running stating :

> "The elaborateness of [Madoff's] fund-raising, his need for secrecy, his high 16% average cost of funds, and reliance on a derivatives investment scheme that few investors (or regulators) would be capable of comprehending lead to a weight of the evidence conclusion that this is a Ponzi Scheme" (Markopolos 314).

The question that Harry and Neil could not answer was why would Bernie Madoff orchestrate a Ponzi scheme if he was making a good living as a successful broker dealer? What was Madoff's rationalization for his scheme? Why would Madoff risk everything if he did not have to? Markopolos could not figure out the answer because Madoff could have easily made more than enough money just by opting to sell the broker-dealership and retiring. The answer to this burning question would be answered by Madoff over the course of several prison interviews which are discussed at length in *The Scheme According to Madoff* below.

<u>Madoff's Thirty Red Flags</u>

The aforementioned 2005 SEC submission with 30 red flags methodically outlines Markopolos's conclusions with respect to Madoff's activities. Throughout his investigative process, Markopolos could conclude that there was definite illegal activity happening within Madoff's firm, but he was not sure of the nature of the crime. He had narrowed it down to one unlikely scenario and one most likely scenario, both of which he had included in his third submission to the SEC. The unlikely scenario was that Madoff was front-running customer order flow which is a form of insider trading and definitely illegal. The second and most likely scenario that Harry included was that "Madoff Securities is the world's largest Ponzi scheme" (Markopolos 299). Harry proceeded to list the reputation and credentials of both Bernie Madoff and his brother Peter. He utilizes this information in one of the red flags later on in the submission. Other preceding information included Harry's theories about Madoff Securities like the amount of assets he believes the firm is managing ("at least $20 billion to perhaps $50 billion" (Markopolos 300)) and the relationship between Madoff's hedge fund and his feeder funds (mentioned in the submission as Fund of Funds or FOF's).

The red flags within this submission that I want to highlight are as follows: Red Flag Number 3, 4, 6, 7, 9, 10, 11, 12 13, 14, 16, 17, 20, 22, 23, 25, 27, 29, and 30. I have already noted at length about Harry and his investigative team's findings for red flags 3, 4, 6, 9 through 13, 16, 20, 22, 23, and 27 in the sections above. Below, in the section entitled *The Scheme According to Bernie*, I will discuss red flags 7 and 14. This leaves me to detail red flags 17, 25, 29, and 30 here.

Red flag number 17 focuses on how Bernie Madoff does not allow outside audits to be performed on his firm. When smart investors who were conducting their proper due diligence asked Madoff if they could audit his firm with their own auditors, Madoff always declined and let the investors walk away if they were not satisfied with his answer. These investors were often told that "only Madoff's brother-in-law who owns his own accounting firm is allowed to audit performance for reasons of secrecy in order to keep Madoff's proprietary trading strategy secret so that nobody can copy it" (Markopolos 315). Madoff's auditor, David Friehling, was not

Bernie's brother-in-law. Madoff only claimed this familial relation in order to somewhat justify hiring his auditor from a small accounting firm that was easy to manipulate (as discussed later in *Other Schemer Arrests*). By not allowing other auditors to audit his firm, Madoff limited the risk of his scheme being uncovered.

Red flag number 25 discusses how the prominent reputations of both Bernie Madoff and his brother Peter deterred people from reporting the red flags of the Ponzi scheme. At the beginning of the submission, Markopolos listed the various merits of the two men and later on in this red flag included his reasoning which stated:

> "The Madoff family has held important leadership positions with the NASD, NASDAQ, SIA, DTC, and other prominent industry bodies therefore these organizations would not be inclined to doubt or investigate Madoff Investment Securities, LLC" (Markopolos 318-319).

By Madoff having strong connections to most of the organizations within the securities industry, people were less likely to report Madoff because they assumed that since he is affiliated with these organizations then he must be conducting his business correctly. Why would someone question Bernie Madoff who was once the chairman of NASDAQ and one of the most prominent figures in the securities industry of being a fraud?

Red flag number 29 claims that Madoff's fund is full, and is not looking for any new investors. Markopolos heard from a handful of feeder funds which claimed that Madoff "has so much money under management that he's going to close his strategy to new investments"

(Markopolos 321). By telling people that he is turning new investors away, Madoff is creating an aura of exclusivity for his fund. This effectively drives up potential investor enthusiasm more until they are begging for Madoff to let them invest money with him. On many occasions, Madoff granted "special access" for many clients and allowed them to invest with them. By letting new investors into his scheme with this impression of special access to one of the most successful firms on Wall Street, investors are less likely to pull their money out of the scheme because they fear that they will not be allowed back in to reap more profits.

The final red flag Markopolos noted in his submission summarized the mathematics involved in proving Madoff to be a fraud, even citing other red flags in his analysis. Utilizing inputs such as Madoff's lowest monthly loss, the rarity of these losses, and Madoff's cost for trading etc, Markopolos comes to find that Bernie Madoff is earning 170% just by picking stocks, and not including the investor money that is coming through his firm. Red flag number 30 part D concludes that either Madoff is a fraudster because he is earning 170% per year from stock-picking alone or he must be an alien. The comical excerpt from the submission reads as follows:

> "170% per year from stock-picking is not likely for any human born on the planet earth so if [Madoff] is achieving these types of returns then he may be an alien species from another planet. A DNA test would be sufficient to determine whether this might be the case. However, if [Madoff] is an alien being possessing superior stock-picking skills of this magnitude, this would be seen as an unfair

advantage in the marketplace and likely would panic the financial markets. Or maybe he's human and just a fraudster - take your pick" (Markopolos 323).

Markopolos is comparing Bernie Madoff to an alien because his actions are other-wordly outstanding when it comes to picking stock the way he had been doing so for years. No other investing firm in existence had been able to successfully pick stock like Bernie Madoff. Markopolos offered the options of Madoff having an unfair advantage as an alien being with an edge of securities knowledge or the great Bernie Madoff must be a fraudster.

Markopolos included many recommendations for the SEC to follow if they were to open an investigation into Madoff after verifying the evidence presented in Harry's submission. However, the SEC ignored each of Harry's five submissions in 2000, 2001, 2005, 2007, and 2008 (Carozza). Although the evidence presented in each of Harry's submissions were well detailed and organized, the SEC officials who read the submissions did not understand the mathematics and the terms included throughout the documents because they were unqualified for their jobs, so therefore they could not understand the full magnitude of Madoff's crimes. This topic is talked about at length in *Harry Markopolos's Testimony* and *The Securities and Exchange Commission's Investigations.*

<u>The Scheme According to Bernie</u>

For years, it has been widely questioned throughout the financial industry about how Bernie Madoff orchestrated his Ponzi scheme for so long without being caught as well as what drove him to start the fraud in the first place. In *Why They Do It* by Harvard Business School professor Eugene Soltes, the author analyzes the many phone calls he had with Bernie as the fraudster explained his side of the story.

Madoff described the initiation of his Ponzi scheme as accidental. Bernie stated that "wrongdoing arises when an executive 'finds himself trapped in a business situation and makes the tragic mistake that he believes will eventually work itself out'" (Soltes 288). Apparently, Bernie was pressured under tough circumstances that led him down the wrong path to begin the fraud rather than seeing his firm fail by doing nothing. It all started when changing market conditions increased competition within the investment advisory industry which caused Madoff's profitable arbitrage strategies no longer were effective. As a result, Madoff's investment advisory business was failing. Madoff recalled, "although I could have admitted failure and returned the money, I knew I would never get another chance with these funds after losing my credibility. In hindsight, this would have been the smart thing to do" (Soltes 296).

The transition into fraudulent activities was seamless according to Madoff. Up until this point in time (Madoff estimates this to be the 1980s), Madoff was conducting legal trades and provided the correct paperwork to verify these trades to his clients. Bernie remembered that "the disclosure always stayed the same. When I was doing a strategy… I was disclosing exactly what I was doing… What I did not disclose was the point that I wasn't doing the strategy anymore" (Soltes 296). According to Bernie, he was just "shorting" the investment strategy. As a market maker, Madoff legally "shorted" investments every day. Bernie stated that "there was no violation in shorting customers - market makers do it every day. It's part of the business" (Soltes 297).

According to *Investopedia*, shorting is the act of "borrowing shares of a stock or other asset that the investor believes will decrease in value by a set future date… the trader is betting that the price will continue to decline and they can purchase them at a lower cost" (Chen). This is an investing tactic that is legal, however Madoff turned this typical strategy criminal by failing to record the investments he shorted on the books for the record. Bernie argued all of the paperwork that his customer received were done properly, but "the trades shown on clients' statements were the trades he wanted his clients to take to generate the desired level of return" (Soltes 297). Madoff investors believed that their money was being invested in the open market but it was actually only fake 'trading' with Madoff.

By claiming that shorting stocks to clients within his market making business was legal in a sense justified Madoff's criminal activity when he shorting his investors in his investment advisory business. Instead of taking the loss in his investment advisory business, Madoff continued to collect investor money in the hopes that everything he was doing would work itself out in the end. Bernie asserted that he "figured that eventually things would change and then I'll get to actually start doing the model trades. As I took in more money to work with, I'd recover. I saw this as an opportunity to earn my way out of the hole" (Soltes 297). However, this was not the case.

Madoff's problems began to compound on themselves and multiplied to the point that he needed more money to keep up his charade. His capital amounts were dwindling because he reported to his customers "returns of 10 percent annually, but earning only 4 percent or 5 percent on the capital" (Soltes 298). When Madoff was reporting returns of 10 percent profits to clients, he was taking the losses which ate away at the capital that was coming into his business. To cover these losses that he was paying out to clients, Bernie “decided to take in money from hedge funds. And in order for me to do that, I had to commit to a long-term strategy that I wouldn’t send the money back. I kept taking more money, figuring that once the market allows me to do the [old] strategy I will be able to fix it” (Soltes 299). The main characteristic of a Ponzi scheme is that the fraudster needs a steady inflow of cash in order to pay out older investors. This was exactly what Bernie was doing when he sought out hedge fund capital to cover his losses. This was also touched upon in Markopolos’s red flag number 14 of his 2005 tip which states that Harry had received information from Madoff feeder funds that confirmed “that Madoff ‘subsidizes’ their investors in down months, so that they will be able to show a low volatility of returns. These types of stories are commonly found around Ponzi Schemes” (Markopolos 314). Bernie claimed that he “kept waiting for the environment to change and of course it never did… It turned into a total fiasco” (Soltes 299). This is how the largest Ponzi scheme in history began: by the fear of failure.

Over time, the investment advisory business recovered successfully. The great inflow of cash provided by hedge fund capital gave off the impression that Madoff’s investment advisory business was flourishing. This incited more investors to bring in their capital into Madoff’s business which heightened the pressure Madoff faced to keep up with the demands of investors' needs. Madoff recalled, “the money just kept pouring in from these people. I wasn’t accepting the fact myself, foolishly, that the more money I took in, the more difficult it was going to be” (Soltes 300). With the newly heightened pressures of the rapid inflows of cash, Madoff recruited Frank DiPascali to help fabricate the trading paperwork needed to fool investors into believing that the investing never stopped.

Soltes' numerous conversations with Madoff also went over some of the SEC investigations that Madoff passed through the years. The SEC in 2006 received several conflicting tips that Madoff was acting "as an unregistered investment advisory, he misled investors about the nature of his investment strategies, and the investment management business itself was a Ponzi" (Soltes 301). Although all of these allegations turned out to be absolutely true, SEC investigators failed to see any of the red flags that Madoff's actions were displaying. As part of the investigation, the SEC brought Madoff in for a deposition to answer questions including the holdings of securities that supported his investment management business were being held. Madoff gave the SEC officials everything they asked for including specific locations and account numbers at the Depository Trust Company (DTC). After relinquishing this information, Bernie believed he was done for and that the scheme was finished. He assumed that the officials would follow up on his information with the DTC to discover that "Madoff held less than $24 million worth of S&P 100 securities in the account on the day of his testimony. At the same time, a single hedge fund investing with Madoff reported $2.5 billion of S&P 100 stock on its statement" (Soltes 301).

All the SEC officials did with the information Madoff provided was make a hasty call to the DTC, but did not verify any of the numbers Madoff provided with the records that the DTC held. Bernie was baffled at the minimal effort the SEC officials put into their investigation against him. When talking to Soltes, Bernie even conjured an example of what the officials should have done to find that his business was a fraud. Bernie explained that "[the SEC officials] could have said to me - 'we want to see your copy of the depositary trust agreement.' What they normally do is have the depositary trust send it directly to the SEC. They could have done that, but they didn’t do that” (Soltes 301). Even Harry Markopolos recommended in red flag number 7 in his 2005 tip that the SEC should ask [Madoff] for trade tickets showing he has traded OTC options” (Markopolos 309). Did the SEC not fully investigate Madoff with the DTC because his brother Peter was on the board of directors for the DTC (Markopolos 300)? Was the reputations of both Bernie and Peter enough to deter the investigators from performing a proper investigation? The answer is yes.

Even the SEC’s investigation into their negligence in uncovering Bernie Madoff’s Ponzi scheme revealed that they should have followed up with the DTC more closely:

> “when [staff attorney Simona] Suh subsequently spoke to a representative at DTC, she learned that Madoff’s claimed advisory positions were not segregated in his DTC account. However, Suh does not appear to have recognized that Madoff had lied during his testimony by claiming to have segregated positions at DTC and, more importantly, concluded incorrectly that the lack of segregation in Madoff’s DTC account made it impractical to use DTC records to verify whether Madoff was placing any trades for his investors.. [Branch Chief of the New York SEC Enforcement Division Meaghan] Cheung admitted that had the Enforcement staff obtained DTC records for Madoff’s account after his testimony, the Enforcement staff most likely would have discovered his Ponzi scheme” (SEC 312).

Simona Suh had been hired straight out of law school by the SEC in 2004 and had been assigned to the Madoff investigation in 2006. Two years of working for the SEC is very minimal experience to have to be working on a high status case like Bernie Madoff's. Furthermore, the quote above reveals that after calling the DTC and being informed about Madoff had lied during his testimony, Suh elected to end her examination with the DTC and recommended to close the Madoff case which both the Branch Chief of the Enforcement Division in New York Meaghan Cheung and the assistant regional director of the New York office Doria Bachenheimer signed off on. The *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme* document claimed that "due to the Enforcement staff's failure to appreciate the significance of DTC verification, allowed the Ponzi scheme to continue for an additional 2 1/2 years." (SEC 313). If Suh had taken the DTC verification process more seriously, Madoff fraud would have been caught years before the scheme collapsed.

In the beginning of 2008, the SEC ended their investigation into Madoff and found no evidence of fraudulent activity within Madoff's firm. That same year in December, Madoff's scheme would collapse.

So how did the SEC miss Bernie Madoff's Ponzi scheme? Madoff's impeccable reputation within the investing industry led the officials to believe that the allegations that Madoff was running an illegal Ponzi scheme were completely ludicrous. These assumptions influenced the officials to exercise minimal efforts to investigate the allegations against Madoff properly and that is how Madoff got away with his crimes until the scheme collapsed on its own. The only thing that came out of the SEC investigation was that Madoff had to register as an investment advisory with the SEC (which he had not completed for years even though he was operating as an investment advisory business).

One of the main reasons that Bernie rationalized his criminal actions to be acceptable was because he constantly received praise from his investors due to the good returns he consistently returned to them. In addition to *Madoff & The Fraud Triangle,* Bernie claimed "I sort of rationalized that what I was doing was okay - you know, that it wasn't going to hurt anybody" (Soltes 302). Bernie also claimed that his deceptive actions were justified because they were typical to other professionals' behavior on Wall Street. After stating several other criminal actions, Bernie went on to say

> "find me a person that has not padded or filed false insurance claims. I acknowledge there are different degrees of these activities and I am not suggesting that all are acceptable. My point is simply to state that I believe that this is the reality of life, and those that don't accept this are either delusional or less than honest" (Soltes 302).

Bernie Madoff believed that his fraudulent actions were somewhat justified because most professionals within the securities industry practiced deceitful behavior on the daily. Madoff's claim was that if average people believe that Madoff was the only person on Wall Street to perform illegal acts in the workplace they were being naive.

The Collapse of an Investment Empire

In 2005, Bernie Madoff began to realize that his Ponzi scheme was collapsing around him. A member of Madoff whistleblower Harry Markopolos's investigative team, Frank Casey, found anonymous sources that declared "that Madoff was actively trying to borrow money from several European banks. That was our first indication that the scheme was running short of cash." (Carozza 4). Madoff had active feeder funds operating internationally so seeking loans in foreign countries would mask his money problems for the next three years until it all fell apart in December of 2008.

According to *Globe and Mail*, Madoff's scheme "fell apart as investors began taking money out faster than Madoff could bring new investors in." The reason why investors rapidly withdrew their funds from Madoff's scheme was because of the economic freefall of the Great Recession when the housing market crashed, which caused great economic uncertainty. According to *Investopedia*, the housing boom of the mid-2000s saw "financial institutions [handing out] marketing mortgage-backed securities and sophisticated derivative products at unprecedented levels. When the real estate market collapsed in 2007, these securities declined precipitously in value." Banks took unnecessary risks buying and selling mortgages beyond the value of the properties that the notes were written against. The real estate markets declined and the mortgages held no value causing some banks to fail and therefore causing the stock market to plummet in value. Madoff's scheme "unraveled as markets declined and many investors who lost money elsewhere sought to withdraw money from their investments with Mr. Madoff" (Henriques & Berenson 1). Investors withdrew their money as a precaution during this unpredictable time and this caused Madoff's scheme to crumble because Ponzi schemes need a steady inflow of cash to keep it running efficiently.

As claimed by his daughter-in law Stephanie, Bernie Madoff first exhibited the sense of impending doom in the summer of 2008. Madoff Mack recalls: "[Bernie's] soul simply lacked the square footage for ego and emotion to comfortably coexist" (Madoff Mack 105). Both Mark and Andrew Madoff recollected that for a few weeks, they saw "Bernie sitting in his glass office at the Lipstick Building, staring at the ceiling all day" (Madoff Mack 9). This bizarre, disinterested behavior was not at all typical to be associated with Bernie Madoff. The investment mogul always "spent his work days glued to the phone, ushering important investors into and out of his office, and intently monitoring every twitch, shudder, and surge on his trading room floor" (Madoff Mack 9). Madoff always made the effort to control every aspect of his investment firm but in the summer of 2008, his lack of interest in the business led his immediate family to believe that he was suffering from a disease. His sons, Mark and Andrew, would soon find out that a disease did not afflict their father but instead the death of his life's work, his Ponzi scheme, was constantly occupying his thoughts.

On the morning of December 10, 2008, Bernie Madoff asked both of his sons to prepare proposals for employee bonuses because he decided to award them early that year. Both Mark and Andrew became suspicious because "that never happened, and it made no sense. Bonuses were based on year-end performances… Wall Street bonuses are doled out in January or February, and Madoff Securities had always paid theirs out on the later side" (Madoff Mack 15). Wall Street bonuses are usually awarded after the close of the fourth quarter of the stock market a couple of months after December. This business behavior was not the norm for Wall Street.

Bernie Madoff was certain at this point that his scheme was going to be found out in the coming weeks and was planning to turn himself in after his 'bonuses' had cleared the banks. These 'bonuses' were actually the only remaining funds of his Ponzi scheme. After the scheme fell apart, investigators discovered several "checks totaling $173 million, made out to friends, employees, and relatives cashing out their accounts" (Henriques 6). Business Insider reported that Madoff's "clients requested a total of $7 billion back in returns… [Madoff] only had $200 million to $300 million left to give" after all of the previous client withdrawals." Rather than paying the $200-300 million out to investors, he issued checks to his close family, friends, and employees to take care of them after he turned himself into the police. However, Madoff's sons did not let him cash out those checks.

Mark and Andrew Madoff confronted their father about the early 'bonuses' that he was handing out. Bernie took his sons to his East 64th Street penthouse apartment to break the news that his investment firm was a fraud: "'Basically, a giant Ponzi scheme'" (Henriques 8). Bernie's son Mark Madoff recalled, "Bernie betrayed no emotion or remorse, calmly delivering his bombshell with the cool demeanor of an anchorman reading a wire report on the evening news" (Madoff Mack 16). In dismay, his sons stormed out of the apartment and immediately contacted lawyers, the U.S. Attorney's Office, and the Securities and Exchange Commission, which is in charge of handling financial crimes and regulations. Stephanie Madoff Mack recollected that her husband Mark "told the appropriate authorities that his father, the King Midas of Wall Street, the great, vaunted Bernie Madoff, was a fraud. A con man. A phony. A criminal." (Madoff Mack 18). Since Bernie was still in the process of committing crimes by dealing out stolen money in 'bonuses', his sons were forced to report their father to the authorities. If they did not report

Madoff, Mark and Andrew Madoff would have been accomplices to their father's scheme even though they had nothing to do with it. Knowing of Bernie's crimes, the sons had to turn him in before he handed out the bonus checks because it would have made them co-conspirators for not stopping Bernie's crime in action. The sons contacted the SEC and the U.S. Attorney's Office and told them of their father's crimes.

<u>Madoff's Arrest</u>

On December 11, 2008, Bernie Madoff was arrested for orchestrating the largest Ponzi scheme in history. Madoff was initially charged with one count of securities fraud after a criminal complaint was issued. Upon further investigation ten more counts were added. Altogether, Madoff faced eleven counts including:

- Securities Fraud
- Investment Advisor Fraud
- Mail Fraud
- Wire Fraud
- International Money Laundering to Promote Specified Unlawful Activity
- International Money Laundering to Conceal and Disguise the Proceeds of Specified Unlawful Activity
- Money Laundering
- False Statements
- Perjury
- Making a False Filing with the SEC

➢ Theft From an Employee Benefit Plan

The maximum prison sentence summed up from all of Madoff's charges is a maximum of 150 years in prison as well as millions of dollars in fines (FBI). According to the FBI, Madoff "is also subject to mandatory restitution and faces criminal fines up to twice the gross gain or loss derived from the offense… to forfeit the proceeds of the charged crimes, as well as all property involved in the money laundering offenses and all property traceable to such property" (FBI).

The same day Madoff was arrested, the "Securities and Exchange Commission brought a civil action against Mr. Madoff, and filed a motion to freeze certain assets and to appoint a receiver" (United States Department of Justice). It is important to understand that the SEC does not have the authority to arrest or charge anyone that they are investigating. However, the SEC can compile all of the evidence of the wrongdoings of the suspect in question, their recommendations for what should be the punishment for the suspect, and the regulations the suspect violated to the appropriate law enforcement agency. The SEC can also impose fines on the suspects of the crime.

For the SEC's formal complaint against Bernie Madoff, the SEC claimed that Madoff had "violations of the anti-fraud provisions of the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940" (SEC). These securities acts that Madoff violated are the most fundamental securities laws that investment managers and firms should follow.

The Securities Act of 1933 has two main objectives: "require[s] that investors receive financial and other significant information concerning securities being offered for public sale; and [to] prohibit deceit, misrepresentations, and other fraud in the sale of securities" (SEC).

Madoff clearly had violated this securities act because his investment firm was operating fraudulently for decades as a Ponzi scheme.

The Securities Act of 1934 “empowers the SEC with broad authority over… the power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as the nation's securities self regulatory organizations (SROs)... The Act also identifies and prohibits certain types of conduct in the markets and provides the Commission with disciplinary powers over regulated entities and persons associated with them” (SEC). Basically, this securities act grants the SEC authority to investigate anyone that they want as long as it applies to an aspect with the securities industry. Madoff violated this act by conducting false trades and tricking his investors for decades into believing that his business activities were legal.

The Investment Advisers Act of 1940 states “that firms or sole practitioners compensated for advising others about securities investments must register with the SEC and conform to regulations designed to protect investors… advisers who have at least $100 million of assets under management or advise a registered investment company must register with the Commission” (SEC). This means that Madoff had to register with the SEC claiming the full amount of investor money he was handling. This obviously did not happen because Madoff’s auditor David Friehling “had signed off on a report to the SEC indicating that Madoff’s firm had $1.09 billion in assets and $425 million in liabilities” (Geis) when in reality, Madoff was handling tens of billions more in investor dollars.

On top of claiming that Madoff violated the three securities acts listed above, “the SEC seeks a final judgment permanently enjoining the defendants from future violations of the anti fraud provisions of the federal securities laws and ordering them to pay financial penalties and disgorgement of ill-gotten gains with prejudgment interest" (SEC). Under the SEC's complaint, the agency is requesting that Madoff should be fined for his crimes as well as requesting that Madoff return the ill-gotten gains he took from investors.

By December 15, the courts ruled to begin liquidating Bernard L. Madoff Investment Securities LLC. Mark Madoff's wife Stephanie wrote that "the market-making division run by Mark, deemed to be operating legally, had been successfully sold to another company for many millions of dollars" (Madoff Mack 147) as part of the liquidation process. The liquidation of the firm and the Madoff family's assets was approved in an effort to help regain the lost investor money. Madoff's case was also handed over to a bankruptcy lawyer named Irving Picard who was named the trustee of the case. Picard was in charge of sueing anyone involved in the case for money to give back to the victims of the scheme. This element is explained at length in *Loss Recoveries.*

The courts established a hefty bail agreement with Madoff following his arrest. He needed four co-signers on his $10 million bail agreement. Madoff and his wife Ruth asked for their sons Mark and Andrew to sign the agreement but both declined to help their father. The shock of their father's crimes raised a major divide within the Madoff family. The sons cut ties with their father immediately following his confession on December 10th. Furthermore,"the judge noted that not a single person - even his own family - had written a letter in support of Bernie" (Madoff Mack 102).

According to Stephanie Madoff Mack, "in a voice reporters would later describe as devoid of emotion, [Bernie] expressed remorse and insisted he had acted alone. The judge declared him a flight risk and ordered his bail revoked" (Madoff Mack 98) after Bernie failed to meet the requirements for the first bail agreement. This led federal prosecutors to modify the agreement to allow Madoff to stay out of prison until his trial date. Instead “Mr. Madoff has agreed to a nightly curfew, and his wife, Ruth, will surrender her passport, according to a federal court filing” (Berenson). Both Madoff and Ruth surrendered their passports, but they were allowed to travel throughout Connecticut, Southern New York, and Long Island as long as Bernie was back at his $9 million Manhattan apartment by 7pm. This curfew from 7pm to 9am was regulated by a court ordered electronic monitoring device.

Although Bernie’s wife Ruth was not criminally charged for any crimes, she still had to abide by court appointed rules issued for the entire Madoff family: “All Madoff assets were frozen… Ruth was still forced to report any expenditure over $100 to the court-appointed trustees” (Madoff Mack 112). All members of the Madoff family were scrutinized by the media for anything they did in the few weeks following the crash of the scheme.

On March 12, 2009, Bernie Madoff pleaded guilty to all eleven counts he was charged with. On this day, Madoff was ordered to stay at Metropolitan Correctional Center until his sentencing in June. By April 1, 2009, “federal marshals seized Madoff’s yacht, a smaller boat, and one of his homes in Florida as court-ordered seizures of the financier’s assets began” (CNN). On June 29, 2009, Judge Denny Chin sentenced Madoff to 150 years in prison (the most severe punishment). Two weeks later, Madoff was shipped down to North Carolina to Butner Federal Correctional Complex to begin his sentence.

For the years following Madoff’s arrest, Picard and federal marshals had auctioned off Madoff family assets in order to raise money for the victim fund. Bernie Madoff and his wife lived extravagant lives which included trips to South France to vacation on his 55 foot yacht named ‘Bull’ (which sold for $700,000 in November of 2009). Picard even auctioned off small items that belonged to Madoff in order to raise money like a life preserver from his yacht that sold for $7,500 at auction according to Kayla Webley at *Time.* Bernie’s lavish lifestyle also boasted three multi-million dollar homes like a beach house Montauk, New York that sold for $9.41 million, a 4,000 square foot Manhattan penthouse which sold for an undisclosed amount (but listed for $8.9 million), and a Palm Beach mansion that was listed for $7.25 million (Webley). Other smaller items that were auctioned off for the victim’s fund included Ruth’s jewelry and Bernie’s Rolex collection. In June of 2011, the final auction of Madoff’s assets was held. Kayla Webley reported that “to date, the total recovery from the Madoff’s has been approximately $24 million in property sales and $80 million in cash assets” (Webley). This roughly $104 million seized from Madoff went directly to the victim’s fund.

Other Schemer Arrests

When initially talking to the FBI after his arrest, Madoff claimed that he had operated the largest Ponzi scheme in history alone. The investigators were highly skeptical about Madoff’s story of acting alone. One person fraudulently handling billions of dollars by themselves for decades is a tough story to believe. Even Wall Street professionals agree that “it would be nearly impossible for Mr. Madoff to have carried out the fraud, which encompassed thousands of clients and lasted for many years, without substantial help” (Berenson). After further investigation by SEC officials and FBI agents, the seventeenth floor employees Frank DiPascali, Annette Bongiorno, Joann Crupi, Jerome O’Hara, George Perez, and David Kogel were all arrested.

Madoff's right hand man Frank DiPascali pleaded guilty to ten counts in 2009. These charges included conspiracy, securities fraud, investment adviser fraud, falsifying books and records of a broker dealer, falsifying books and records of an investment adviser, mail fraud, wire fraud, international money laundering to promote specified unlawful activity, perjury, and federal income tax evasion (Justice.gov). After the SEC's investigation, one of their complaints was that DiPascali misappropriated investor funds for his personal gain. The firm "contributed more than $2 million in salary and bonus that DiPascali received each year" (SEC). Between 2002 and 2008 DiPascali withdrew roughly $5 million from the firm to fund his personal expenses and the purchase of a new boat.

Since DiPascali was the one of the leaders that oversaw the scheme, prosecutors believed that his testimony would be crucial in convicting the other seventeenth floor employees. The judge assigned to the Madoff case, Laura Taylor Swain, "assailed [DiPascali's] testimony as largely unbelievable. All five [employees] received far shorter terms than the government requested" (Larson). Before he could be sentenced, DiPascali died of lung cancer in 2015. If he was still alive, DiPascali would have faced a maximum sentence of 125 years in prison (Clark).

According to Justice.gov, "[Annette] Bongiorno, 62, faces a statutory maximum sentence totaling 75 years in prison: five years on Count One (Conspiracy), 20 years on each of Counts Two and Three (Securities Fraud and Falsifying Books and Records of a Broker- Dealer), five years on Count Four (Falsifying Books and Records of an Investment Adviser), and five years on each of Counts Ten through Fourteen (Tax Evasion)" (Justice.gov). After DiPascali's testimony was dismissed, Bongiorno was convicted in 2014 and was sentenced to six years in prison which is a considerably light sentence compared to the 75 years she was facing. Bongiorno was also ordered to forfeit $155 billion in restitution on the order of Judge Swain according to Rich Calder at *The New York Post*. This amount ensures that Bongiorno will be broke for the rest of her life.

After the investigation, it was uncovered that "Bongiorno managed hundreds of IA [investment advisory] accounts purportedly having a cumulative balance of approximately $8.5 billion dollars as of November 2008" (Justice.gov). Judge Laura Taylor Swain said during her trial that "[Bongiorno] could and should have looked at what was in front of her" (Raymond). It was also uncovered that Bongiorno "deposited only approximately $920,000 into her own IA accounts… she withdrew more than $14 million" (Justice.gov) of investors's money from 1975 to the end of the scheme in 2008. On top of her salary, she was also compensated with $325,000 in off book income from Bernard L. Madoff Investment Securities LLC for her work in concealing the fraud. Bongiorno is being held in a medium-security prison in Florida until her release in May 2020.

When the investigation into the Madoff scheme concluded, it was found out that Joann Crupi "managed several BLMIS IA accounts purportedly having a cumulative balance of approximately $900 million as of November 2008" (justice.gov). As compensation for her efforts to cover up the scheme, Crupi "received payments of more than $2.7 million from Madoff directly out of the BLMIS bank account that held investor funds" (Justice.gov). Crupi "faces a statutory maximum sentence totaling 65 years in prison: five years on Count One (Conspiracy), 20 years on each of Counts Two and Three (Securities Fraud, Falsifying Books and Records of a Broker-Dealer), five years on Count Four (Falsifying Books and Records of an Investment Adviser), and five years on each of Counts Fifteen through Seventeen (Tax Evasion)"

(Justice.gov). In the end, Crupi was convicted in 2014 and sentenced to only six years due to DiPasali's dismissed testimony.

Jerome O'Hara played a vital role in the scheme as a programmer. While at the firm "O'Hara wrote, modified and maintained computer programs that processed investor account records and related data to create thousands of investor account statements and trade confirmations, as well as programs that created reports designed to mislead investor representatives and regulators reviewing BMIS' operations" (SEC). Without O'Hara's program, the scheme would not have operated as effectively as it had for as long as it did. All of the other seventeenth floor schemers relied on O'Hara's program to carry out their parts of the scheme. As a result, O'Hara was sentenced to two and a half years in prison and was ordered to pay $19.7 billion by Judge Swain (Raymond).

George Perez's role in Madoff's scheme was very similar to O'Hara's. Perez teamed up with O'Hara to develop and maintain the computer programs that operated the scheme. For his crimes, Perez was sentenced to two and a half years in prison in 2014 (Raymond). Judge Swain stated "[Perez] must be punished in a way that's severe and commensurate with his crimes" (Raymond). According to *Reuters,* Perez was also ordered to forfeit $19.7 billion in restitution.

David Kugel was responsible for giving historical pricing data to Annette Bongiorno and Joann Crupi. According to *Bloomberg*, "Kugel's data helped them mimic real trades when they doctored customer statements" (Larson). As a result, Kugel avoided prison time and was sentenced to ten months of home detention and two hundred hours of community service (Ax).

Other people that were involved in the Madoff scheme that also were charged include Bernie Madoff's brother Peter and Madoff's accountant David Friehling. Peter Madoff was charged with many crimes including lying to securities regulators, falsifying documents, and filing bogus tax returns. Peter worked as the Chief Compliance Officer (CCO) at the firm. According to *Tech Target*, a Chief Compliance Officer's job is to ensure that "a company is complying with regulatory requirements and that the company and its employees are complying with internal policies and procedures" (Tech Target). Peter was supposed to be the first line of defense between Madoff investors and potential fraud and he failed to execute his job as CCO. Prosecutors argued that if Peter had done his job properly "regulators would likely have detected the fraud years earlier" (Lattman & Henriques). Peter Madoff should have exercised professional skepticism in regards to his brother's fraudulent activities at BLMIS. According to David Stone CPA, MBA, CFE a staff accountant at *Berry Dunn*, professional skepticism is "an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence" (Stone). Professional skepticism is an imperative tool to utilize as a Chief Compliance Officer or anyone within corporate governance because it ensures that no fraudulent activity is sneaking through the cracks of the business. Chief Compliance Officers are supposed to ensure that everyone in the company is complying with any applicable rules and regulations. If a CCO notices anything unusual within a company, it is their job to correct this behavior and or report this activity to the authorities. If Peter Madoff had implemented professional skepticism during his time as CCO at Bernie Madoff's firm, the Ponzi scheme could have been stopped and reported years ago.

Peter insisted in court that he did not learn about the Ponzi scheme until 36 hours before Bernie was arrested and has not been charged for that. Peter pled guilty and was sentenced to 10 years in prison and was ordered to pay $143 billion for his crimes. The courts set the dollar amount that high “to send a clear signal that it would seize all of his and his family’s assets and distribute them to the victims” (Lattman & Henriques).

Judge Laura Taylor Swain was skeptical of Peter’s assertion that he had no knowledge of his brother’s scheme. Judge Swain said, “Peter Madoff’s contention that he did not know that anything was wrong with the investment advisory business is beneath the dignity of a sophisticated Wall Street executive” (Lattman & Henriques). Peter’s failure to catch the red flags of his brother’s Ponzi scheme is an indicator of his blind trust in Bernie. Peter Madoff’s lawyer John Wing argued that “ Peter seemed to be blind to his brother’s flaws” (Lattman & Henriques). Peter had idolized Bernie his whole life because his brother was admired as a successful and reputable businessman and trader. Peter’s lawyer John R. Wing argued that “Peter revered [Bernie] and trusted him implicitly” (Lattman & Henriques). The devastation of the scheme could have been drastically reduced if Peter Madoff would have exercised professional skepticism with respect to his brother's activities.

Bernie Madoff’s accountant David Friehling pled guilty to “single counts of securities and investment advisor fraud, four counts of making false filings with the SEC, and three counts of obstructing and impeding the administration of the federal tax laws” (Geis). According to *MFI Miami,* Friehling had been working for Madoff since 1988 through his father-in-law’s auditing firm Friehling & Horowitz.

Before becoming a witness for the prosecution, Friehling was looking at 100 years in prison for his actions in Madoff’s scheme. Ultimately, Friehling did not serve any time in prison because he claimed that he was unaware of the extent of the scheme as he “‘abdicated’ his responsibilities as the firm’s auditor and approved the financial statements Madoff gave him without asking any questions" (MFI Miami). Friehling essentially failed to properly perform his job as an auditor and signed off on bogus financial statements because he was too lazy to check the statements's validity.

When coming clean about his failure to conduct a proper audit, Friehling stated that "I would rather be regarded as dumb than crooked" (MFI Miami). Rather than serving time in prison, Friehling was sentenced to a year of home detention plus another year of supervised release for cooperating with the prosecutors. According to *Forbes,* "Friehling lost his CPA license on July 19, 2010, over a year after his arrest" (Pavlo). The courts were also more lenient with Friehling's sentence because he had already lost $500,000 of his savings to the Madoff scheme (Geis). Friehling also had to forfeit $3.18 million in compensation he received from his work with Madoff according to *FRAUD Magazine's* Gilbert Geis. For more on David Friehling's role in the fraud, see *An Auditor's Role in Preventing Fraud and the Importance of Professional Skepticism.*

<u>Present Day</u>

Madoff is still serving his 150 year prison sentence in the Federal Correctional Complex in Butner, North Carolina. As of July 2019, Madoff filed a petition through the Justice Department requesting that President Donald Trump reduce his prison sentence. To be clear, this petition is not Madoff asking for a pardon rather "he is requesting clemency from [President] Trump in the form of a sentence commutation, or reduction" (Mangan). It is not clear whether or not President Trump will review Madoff's petition but a Justice Department statistic revealed that "the department received 1,003 petitions for pardons and another 5,657 for sentence commutations… Trump has granted 10 pardons and 4 commutations" (Mangan) during his time in the White House. These statistics show that Madoff's request will probably be ignored by the President.

In February of 2020, Madoff asked for early release because he claims that he has less than eighteen months to live as a result of end stage kidney disease. The prior July, Madoff reported that he had been using a wheelchair, a back brace, and admitted to receiving palliative care which is a type of care used to provide "relief from the symptoms and stress of the illness" (Get Palliative Care). According to the *New York Times*, it is also known that Madoff "also suffers from cardiovascular disease [and] hypertension" (Yaffe-Bellany). Although Madoff committed a severe crime, "under federal guidelines, prisoners who receive a diagnosis of an incurable illness that is expected to kill them in 18 months or less can be eligible for early release" (Yaffe-Bellany). In Madoff's prior request for early release, Ken Hyle The Bureau of Prison's general counsel denied Madoff's request claiming that "his release at this time would minimize the severity of his offense" (Yaffe-Bellany).

In regards to this latest request, there is definitely a higher chance of Madoff receiving an early release than before due to the fact that his request is grounded with medical evidence that coincides with federal prison guidelines. However, the amount of devastation Madoff induced when his scheme crashed is a very hard thing to ignore. The possibility of Madoff being released would ensure a public outcry and would definitely seem like Madoff is not receiving the punishment that he deserves for perpetrating the most devastating Ponzi scheme in history.

Madoff Scheme Court Statistics

For the federal court of the Southern District of New York, all of the criminal cases associated with Bernie Madoff's Ponzi scheme were the lengthiest set of white-collar crime trials in history. In total, fifteen people were charged with crimes associated with Madoff's fraud including the seventeenth floor employees I mentioned previously. According to Richard Behar from *Forbes*:

> "Given the notoriety of the fraud, it required, Judge Swain concluded, a jury pool of 400 people to try and ensure impartiality. It produced more than 40 witnesses, 12,000+ pages of transcripts, more than 1,242 filings to date in the court's docket system, and 500 gigabytes of government exhibits. (Millions of documents were kept in thousands of large banker boxes in a warehouse that was made available to the defense.)" (Behar).

All of the trials associated with Bernie Madoff's fraud required a significant amount of manpower to prosecute and convict. It was also very difficult to assemble all of the participants of the jury in order to ensure impartiality because Madoff's scheme sucked in thousands of investors in the New York area where the trials took place. It was imperative to find jurors that were not connected to the fraud in any way to ensure fair judgements could be reached for the defendants of each trial.

The Stories of Madoff's Victims

"Dreams and trust were shattered, charitable foundations wiped out, and innumerable victims left to wonder what's next [after the fall of the scheme]" - Judge Laura Taylor Swain

On December 11, 2008, Bernard L. Madoff was arrested for orchestrating the largest Ponzi scheme in history. His arrest catapulted his immediate family into immense turmoil as well as the 37,346 investors he conned into his scheme. In total, Madoff investors lost roughly $20 billion as opposed to the outrageous sum of $65 billion Madoff himself estimated his scheme to be.

Due to the financial devastation and severe emotional distress that Madoff incited with the collapse of his fraudulent actions, four people took their own lives. Among these people that committed suicide were Access International Advisors co-founder Rene-Thierry Magon de la Villehuchet, British army veteran William Foxton, Wall Street executive Charles Murphy, and Madoff's son Mark. These four suicides were the deaths that were confirmed to directly be linked to Madoff's scheme but the true number of suicides cannot be definitively agreed upon. These four people were innocent victims to Madoff's monstrous crimes and they paid the ultimate price for entrusting their money and lives with Bernie Madoff.

Rene-Thierry Magon de la Villehuchet was a sixty five year old co-founder of Madoff feeder fund Access International Advisors. When Madoff's scheme fell apart, de la Villehuchet lost $1.4 billion. Access International Advisors acted as a feeder fund for wealthy European investors according to Gogoi and McCoy at ABC news. Although de la Villehuchet's company operated with European funds, Access International Advisors was managed in New York City in close proximity to Madoff's firm. The Frenchman gave Madoff full control over his clients' investments: "I opened an account with Madoff Securities and he gets to use the money any way he wants. I've given him full discretion to put my client's money with his personal money when it's needed" (Markopolos 26). De la Villehuchet justified his decision by claiming "'it's secured by his good name.' In other words, if you couldn't trust Bernie Madoff with your money, then there was no one who could be trusted" (Markopolos 27). Madoff's impeccable reputation in the financial industry presented an aura of trust which aided him greatly when it came to sucking in feeder fund leaders like de la Villehuchet into his scheme. After trying to concoct a way to recoup his financial losses, de la Villehuchet gave up and committed suicide by ingesting many pills and slitting his wrists due to the burdens left on him from the Madoff scandal. Rene-Thierry Magon de la Villehuchet was survived by his wife Claudine.

William Foxton was a decorated British army veteran that had invested his life savings of over one million dollars between two Madoff feeder funds, Herald USA Fund and Herald Luxembourg Fund. The sixty-five year old "had lost an arm in a grenade explosion, served in the French Foreign Legion, and went on multiple UN humanitarian missions" (Rothschild). The financial devastation Foxton experienced as a result of Madoff's scheme directly influenced his decision to shoot himself in the head in a Southampton park to avoid filing for bankruptcy. Foxton was survived by his son William who was shattered by the death of his father. William stated to Cahal Milmo at *Independent:* "I think it's disgusting that Bernie Madoff is sitting in his New York property, thinking that all he did was steal money, when, in fact, what he was really doing was ruining lives."

Charles Murphy was a wealthy Wall Street executive that worked for the feeder fund Fairfield Greenwich which lost $7 billion to Madoff's Ponzi scheme according to *Inside Edition.* After trying to seek clinical help with his mental health, Murphy leapt from the twenty-fourth floor of the Sofitel Hotel in Manhattan and landed on a fourth floor balcony. Murphy was 55 years old when he committed suicide. Author of *Betrayal: The Life and Lies of Bernie Madoff* Andrew Kirtzman stated for an interview with *Inside Edition* that "people are still suffering [from Madoff's scheme]. There are people who are trying to reclaim their lives after losing everything and this was a case where someone could not continue [to live]" (Inside Edition). Murphy suffered for nine years with mental anguish caused by Bernie Madoff's fraud before killing himself in 2017. Charles Murphy is survived by his wife Annabella and five children.

<u>Mark Madoff's Story</u>

> *"It should not come as a surprise that the one who idolized him the most, his son, would not see his own father as a criminal. My father was a wolf in sheep's clothing. He was not the man that anyone thought he was" (Madoff Mack 210).*

Mark Madoff worked alongside his father Bernie and brother Andrew at Bernard L. Madoff Investment Securities LLC as a licensed securities broker since 1987. Mark worked on the legitimate side of Madoff's firm and never had any knowledge of or contact with the illegal operations of his father's Ponzi scheme. Mark's wife Stephanie backed up this fact by writing that "Bernie would always imply in later interviews and interrogations that he had been protecting his sons by erecting an impenetrable firewall between his legitimate business, which the boys ran, and his criminal operation, which he alone oversaw" (Madoff Mack 83). Although Mark and Andrew had no knowledge of their father's Ponzi scheme and had never been formally charged with any crimes, this did not stop the media and public from attacking them and criticizing their every move after the scheme fell apart.

Mark and Andrew were berated constantly by the Madoff investors, persistently accused of knowing about their father's crimes for years. The court-appointed trustee Irving Picard consistently attacked both Mark and Andrew and insisted that the brothers had to have been involved in their father's scheme. Picard filed multiple lawsuits against both Mark and Andrew "accusing [Mark] and his brother of having full knowledge of their father's scheme and using it as their "personal cookie jar" that they tapped through sham loans, fictitious trades and deferred compensation" (The Guardian). Picard further claimed that "the money that Mark Madoff got from the firm "paid for all aspects of his lavish lifestyle, from the purchases of his high-end homes to the mattress and box spring he slept on, the television he watched in his home gym, and the outdoor shower in his home'" (Henriques).

In a civil lawsuit filed by Picard, the trustee "sought to recoup $153.3 million from the sons' estates alone" (Stempel). Picard asserted that "[Mark and Andrew] either failed to detect or failed to stop the fraud… simply put, if the family members had been doing their jobs honestly and faithfully the Madoff Ponzi scheme might never have succeeded, or continued for so long" (Henriques). Picard declared that if they had performed their jobs honestly, the scheme may have been discovered sooner. The courts had never claimed that the brothers knew about the scheme before Bernie revealed it to them on December 10th, 2008. In an interview with *60 Minutes*, Picard never gave evidence that Mark or Andrew were involved in the scheme, (because there was not any), but that did not stop him from saying that he was going after their assets. According to Madoff Mack, during the interview it was left out that "the market-making division run by Mark, deemed to be operating legally" (Madoff Mack 147). The fact that this liberating information was not made widely known in the media crippled Mark's name and reputation. Picard also added that "we will pursue them as far as we can pursue them… and if that leads to bankrupting them, then that's what will happen" (Madoff Mack 147).

The new-found stress triggered by Bernie's confession to running the largest Ponzi scheme in recorded history created a major divide within the Madoff family. The Ponzi scheme caused a major fallout between Mark, Andrew, and their mother Ruth because she refused to leave Bernie after his fraudulent activities were revealed. The sons gave Ruth an ultimatum: "she would have to sever all ties with Bernie and publicly divorce him, or be cut off completely by us, losing not only her son but her grandchildren as well" (Madoff Mack 153). Before the arrest of Madoff, Ruth and Bernie were extremely close with Andrew and Mark's families. Ruth had to choose between her sons and her husband. Ruth stayed loyal to her husband for a couple of years following his arrest. This familial divide also weighed down Mark and impacted his declining mental health.

The legal trouble that engulfed the lives of both Mark and Andrew also caused a strain between the two brothers. Madoff Mack wrote that "Mark and Andy had gone from working side by side every day of their adult lives and spending vacations fishing together to speaking only when they met at the offices of the legal team they shared" (Madoff Mack 118). Furthermore, Madoff Mack recalled that "where there had once been such solidarity, there was now just tension, emptiness, and heartache" (121). The fallout of the Ponzi scheme essentially alienated Mark Madoff from the rest of his family and had a hand in causing his severe depression.

With his father now under investigation, the rest of the Madoff family had to follow strict financial rules while the FBI and SEC sorted out which parts of BLMIS were illegal and what money was made fraudulently. This investigation constricted all finances of anyone with the Madoff name, regardless of if they had a hand in the Ponzi scheme. Mark's family had to follow spending limits while his father was being investigated. Madoff Mack recalled that "within one week of Bernie's arrest, the government has established a monthly spending limit for our basic living expenses, and kept close tabs on our bank balances; we were to turn in regular accounts of every dime we had spent" (Madoff Mack 95). Mark and his wife Stephanie's bank accounts were constantly frozen by the banks because the name Madoff appeared on the account.

All of the public inspection that Mark was under caused him to become obsessed with all news articles about his father's case and his supposed involvement. Mark's wife recalled that "Mark passed the time by obsessively following every scrap of news and commentary about the Madoff scandal, stewing in his own indignation about its effects on him" (Madoff Mack 122). Mark analyzed and took to heart all of the negative and hateful comments about him and his family which catapulted him further into a deep depression. Mark lived in a constant cycle: every time a new article was released he would freak out about it and go to his lawyers about the content of the article. Mark's lawyers would then calm him down temporarily "but then he would head straight back to the computer, and the cycle of disbelief and despair would start all over again" (Madoff Mack 131). Stephanie added that "the fear of being unjustly accused was always in Mark's gut. It tortured him" (Madoff Mack 143). She later reported in an interview with *ABC*

News that Mark had “physically changed. He wasn't doing the things he liked to do anymore. He grew in a beard to try to disguise himself, he was physically hunched over" (Cuomo, Rhee, & Druckerman).

The constant scrutiny associated with the Madoff name caused Mark to not want his family to be associated with the most hated name in America. Stephanie Madoff Mack remembered that she “hastily settled on Mack, which combined my husband’s first initial with the airport code for our favorite place, Nantucket” (Madoff Mack 116). Mark was planning to change his last name to Mack as soon as his lawyers gave him the okay to do so. However, Mark mentally began to spiral out of control.

The combination of intense public scrutiny, never-ending civil lawsuits, and family turmoil forced Mark Madoff to attempt to take his own life in October of 2009 when he “checked himself into a hotel and swallowed 60 sleeping and anti-anxiety pills” (Cuomo, Rhee, & Druckerman). Mark had left behind a suicide note reading ““Bernie: Now you know how you have destroyed the lives of your sons by your life of deceit. Fuck you.” (Madoff Mack 152). After swallowing the pills, Mark wandered back to his apartment very groggy and Stephanie rushed him to a hospital to save his life. To help Mark recover, he was admitted into a psychiatric ward where he made some good progress with his mental health. By summer of 2010, Stephanie was confident that Mark had made a major improvement when he began to be interested in his life again. Mark was offered a short-term job from his friend Joe. Things seemed to be looking up.

After recovering from his suicide attempt, Mark slowly began to lose hope again for the future. His father’s crimes had left him unemployable and desperate for money to provide for his family. In December of 2010, the trustee even named Mark's four-year-old daughter Audrey as a defendant in a lawsuit. Madoff Mack recalled "I got a text message from [Mark] saying that the trustee was going to sue Audrey for $11,000 that Ruth and Bernie had gifted her" (Madoff Mack 165). After almost two years of lawsuits fighting over Mark's family's finances, this was a routine occurrence. The fact that Audrey was named as the defendant in the trial for a small sum of money compared to the millions Picard was suing Mark over was maddening. At the moment, Mark was calm and instructed his lawyers to get on the case. However, Mark could not keep his composure soon after.

The next day, Mark exploded over the latest online article by the *Wall Street Journal* entitled "Madoff's Kin Eyed as Probe Grinds On". The article focused mostly on Annette Bongiorno and Joann Crupi's arrests and did not mention any specific allegations against Mark or Andrew. The article did feature a quote from Mark's lawyer saying that the brothers had no prior knowledge of their father's crimes and turned their father in as soon as they could after learning what he had done. Mark was infuriated after reading the article and claimed that he had no idea that it was being published. He forwarded the article to Stephanie's step-father Marty who attempted to calm Mark down by replying "a nothing new story with a manufactured bullshit headline… Pay it no mind, plse" (Madoff Mack 170). Marty's response did not mitigate Mark's anger and he forwarded the article to his wife stating "I'm beyond devastated… " (Madoff Mack 170). The headline of the article was essentially slandering Mark's name for no reason. The article made no new allegations towards Mark or Andrew but they still were mentioned in the title to make it seem like that there were new developments to the Madoff case. This article threw both Mark and Stephanie over the edge because their legal and PR teams could not stop any of these types of headlines from being published. Mark texted his wife "I don't know what to do anymore" (Madoff Mack 171).

Mark's mental health rapidly declined after reading the article, catapulting him into an angry frenzy. Mark called Marty to say "Look at that headline! These people are destroying my reputation. I am ruined. Ruined. My reputation has been my livelihood. I have spent my professional life building that reputation. Now [the articles] have destroyed it" (Madoff Mack 171). The cycle was starting again and Marty attempted to show that Mark was overreacting. Marty's effort was too late: "fear, frustration, anger, and humiliation had formed a rock-hard core inside Mark that no amount of reason could penetrate" (Madoff Mack 172). Mark believed that these constant accusations and slandering in the media would never cease. He had completely lost hope in the future that he was attempting to rebuild.

On December 11, 2010, the second anniversary of the arrest of his father, Mark hung himself by a dog leash in his New York apartment while his wife and daughter were on vacation in Disney World. His two year old son Nicholas was asleep in the next room. Before killing himself, Mark sent his wife two short emails. One email saying "Help" in the subject line with the email saying "Please send someone to take care of Nick" (Madoff Mack 173). The second email only had bolded text in the subject line: "**I Love You**" (Madoff Mack 173). Once Stephanie read the emails the next morning, she sent her step-father Marty to her apartment where he found Mark hanging from a steel beam in the living room.

Mark Madoff's suicide shows that the detrimental effects of Ponzi schemes can effect more than just the investors who lost money, it also effects the lives of the fraudster's family as well. Author of *Betrayal: The Life and Lies of Bernie Madoff* Andrew Kirtzman said in an interview with *Inside Edition* that "as Bernie Madoff sits in jail, the wreckage of what he's done is still taking place. Four people have now committed suicide including his son, all because they trusted him" (Inside Edition). Two years had gone by at the point when Mark took his own life. This shows that the devastating effects of Ponzi schemes can continue to wreak havoc on the victims for years after it falls apart. Mark was pushed to commit suicide because he blindly trusted his father for decades and believed that BLMIS was a legal business but instead it was harboring the largest Ponzi scheme in histroy. The combination of the betrayal by his father, the division of his family, financial uncertainty, and the slandering of his reputation urged Mark to end his life. Mark was survived by his wife Stephanie and his young children Daniel, Kate, Audrey, and Nicholas.

<u>Andrew Madoff</u>

While Bernie Madoff sits in prison, both of his sons passed away. Four years after Mark committed suicide, Andrew was diagnosed with mantle-cell lymphoma and died at the age of 48. He had fought off the cancer before in 2003, but it had returned again in 2012. The year before Andrew passed away from his ongoing battle with cancer, "a British judge in 2013 rejected the trustee's case there against the Madoff sons, affirming their "honesty and integrity" and ruling that there was no evidence that they were involved in the crime" (Henriques). Regardless of this criminal judgement, Picard still went after Mark and Andrews assets. In a 2017 settlement, Picard stripped "the estates of Andrew and Mark Madoff of 'all assets, cash, and other proceeds' of their father's fraud, leaving them with a respective $2 million and $1.75 million" (Stempel).

Ruth Madoff

In June of 2009, Bernie and Ruth made an agreement with prosecutors to allow federal marshals to sell their assets. As part of the agreement, Ruth was permitted to keep $2.5 million to live off of (CNBC). Ruth was then evicted from her multi-million dollar Manhattan penthouse shortly after as part of the liquidation process by Picard. With her finances being severely diminished as a result of the agreement, Ruth was left with very little to live off of. In an effort to hide from the media, Ruth Madoff changed her name to Jane Green. Stephanie Madoff Mack stated that “Jane Green became a nomad dependent on the charity of others, including those her husband had ruined. For months on end, Ruth bounced between the homes of her sister, a niece, and the few friends who hadn’t shunned her” (Madoff Mack 114). Before December of 2008, Ruth was a very social person with a large group of friends. Over the years, most of these friends had been swindled into investing their money with Bernie. After the fall out of the scheme, this circle of friends abandoned Ruth. Ruth lost her old lifestyle, her large group of friends, and the love of her children as the result of her husband’s crimes.

In May of 2019, Ruth reached a settlement with the bankruptcy trustee Picard where she agreed to “pay $250,000 in cash and give up $344,000 of trusts for two [of her] grandchildren” (CNBC) upon her death. This money will go straight to the victims of the scheme.

Celebrity Victims

The collapse of Bernie Madoff’s Ponzi scheme also impacted some well known celebrities and charitable organizations . Many celebrities including actor Kevin Bacon and his wife actress Kyra Sedgwick, Dreamworks animation executive Jeffrey Katzenberg, Nobel Peace

Prize winner and Holocaust survivor Elie Weisel, actor John Malkovich, and TV and radio host Larry King.

Kevin Bacon and his wife Kyra Sedgwick had invested millions of dollars into Madoff's firm. Although the exact dollar amount was never disclosed, Bacon stated that "I think there's a good cautionary tale there, to be cognizant of what's happening with your money" (Pak). No matter how much money one invests, it is very important to understand how you are making or losing money. Otherwise, one may end up as a victim of a multi-billion dollar Ponzi scheme like these unknowing celebrities.

Jeffrey Katzenberg lost both $20 million of his personal savings and a substantial amount of money linked to his charity, the Marilyn & Jeffrey Katzenberg Foundation. Even though the dollar amount that was lost by the foundation was not disclosed to the public, before the collapse of the scheme, the charity had recorded $22 million in assets (Pak). The producer of both *Shrek* and *Kung Fu Panda* had invested his money through a business manager that then forwarded Katzenberg's money to Bernie Madoff's firm. About one month after Madoff was arrested, Katzenberg mentioned that "the first time I heard the name Bernie Madoff was about three weeks ago" (Pak). Katzenberg had no clue that his charity's money or his personal savings were invested with Madoff because he was not informed by his business manager of where his money was going after he had invested it. Katzenberg blindly trusted his business manager to make an investment decision for him and his charity.

Elie Wiesel was a Nobel Peace Prize winner, Holocaust survivor, and best selling author who lost both $12 million of personal savings as well as $15.2 million from his charity the Elie Weisel Foundation for Humanity. Weisel met Madoff through a trusted mutual friend. After consulting with a handful of financial experts, Weisel finally invested with Madoff. The $15 million that Weisel's foundation lost to the scheme caused the charity great financial trouble. Weisel's wife Marion had submitted a letter to federal prosecutors to read during the trial of Peter Madoff stating "the crime that flourished under Peter Madoff's neglect caused 'the immediate and dramatic loss of a lifetime's worth of work and savings'" (Lattman & Henriques). After the news broke that the foundation was struggling to stay afloat, Weisel stated to Oprah Winfrey in an interview that "all of a sudden, we began receiving hundreds and hundreds and hundreds of letters and donations, small donations, from all over America, Jews and non-Jews... " (Pak). The sudden spike in donations helped the foundation recover from the devastating financial blow the scheme inflicted.

Elie Weisel is widely known as a preacher of peace after he told his terrible experiences as a prisoner in the Nazi concentration camp Auschwitz through many best selling books such as *Night*. His beliefs of peace for humanity stretched farther than his Jewish religion and have impacted millions of people across the world. The Nobel Peace Prize Committee stated that "[Weisel's] belief that the forces fighting evil in the world can be victorious is a hard-won belief" (The Nobel Prize). Elie Weisel is a symbol of human resilience. By taking Weisel's money from both his foundation and his savings emphasizes that Bernie Madoff did not care about who he stole from and manipulated, even one from of the greatest humanitarians who ever lived.

John Malkovich lost a $2 million investment to Madoff's scheme. It was reported by Eudie Pak at *Biography.com* that Malkovich had personally met Madoff years ago so there was no third-party that funneled his money into the scheme. When recalling his experience with

Madoff's scheme, Malkovich said in an interview with *Vanity Fair* that "for me, in all honesty, it was a good life lesson" (Miller). As of April of 2010, *The Wall Street Journal* reported that Irving Picard had recovered $670,000 of Malkovich's pension plan and trust investment.

Larry King was introduced to Madoff by a childhood friend named Fred Wilpon, the owner of the New York Mets. When the scheme fell apart, King lost $700,000 to Madoff. Wilpon lost much more money to Madoff; roughly $500 million.

<u>Charitable Organizations Affected</u>

The downfall of Bernie Madoff's Ponzi scheme not only decimated thousands of investors' savings, it also made many charitable organizations take large financial hits that impacted how they operated and in some cases forced charities to shut down their operations entirely.

Marilyn & Jeffrey Katzenberg Foundation specializes in "giving primarily for higher education, the arts, particularly for film and television, environmental conservation and protection, and health and human services" (Foundation Directory Online). The foundation lost an undisclosed amount to Madoff's scheme.

The Elie Weisel Foundation for Humanity lost $15.2 million to Madoff's scheme as mentioned previously. Weisel's foundation "mission is to combat indifference, intolerance and injustice through international dialogues and youth focused programs that promote acceptance, understanding and equality" (Elieweiselfoundation.org).

A prominent Madoff investor, Jeffry Picower, shared a foundation with his wife Barbara. According to Mike Rothschild at *Ranker*, the "Jeffry M. and Barbara Picower Foundation was one of the biggest medical research grantmakers in the United States" (Rothschild). When Picower's family was sued by the Madoff victims to forfeit the billions of profits that he obtained by investing with Madoff, the charity folded which took away millions of dollars in brain research and education.

Other prominent Jewish charities that were impacted from their involvement in Madoff's affinity fraud scheme were the "Carl & Ruth Shapiro Family Foundation, which lost $145 million; the Chais Family Foundation, which granted tens of millions to Jewish causes and had to close; New York's Yeshiva University… the Jewish Community Foundation of Los Angeles, which had $18 million vanish; and the Robert I. Lappin Charitable Foundation, which financed trips for Jewish youth to Israel, and had to lay off its entire staff"(Rothschild).

Even some charities were indirectly impacted by Bernie Madoff's fraud. According to Jason Szep at *Reuters*, the "Gift of Life Bone Marrow Foundation suffered indirectly [from Madoff's scheme] because donors who invested money with Madoff scaled back contributions" (Szep) to the foundation. Philanthropists also took major financial hits from the scheme. A prominent Madoff investor Carl Shapiro and his wife Ruth were significant donors for many organizations and schools such as "the Museum of Fine Arts in Boston, Brandeis University and the Beth Israel Deaconess Medical Center" (Szep).

Other Victim Facts

Average investors that were tied up in Madoff's fraud experienced severe financial devastation. According to the bankruptcy trustee, Irving Picard claimed that he was only approving victims' claims that had their money invested directly through Madoff with no third party feeder funds involved. This is because it is very difficult to go after feeder fund investments. The courts claim that bankruptcy trustees do not have jurisdiction to go after feeder fund money in these types of cases because the investments from feeder funds are not directly linked to the origination of the fraud (in this case it was with Madoff). This means that victims who invested their money through feeder funds that they did not know funneled their money into Madoff's fund, will not get any form of restitution for their lost investments. This fact will cause many elderly victims to be forced back into the workforce just to make ends meet because the majority of their retirement savings was wiped out.

The various stories of elderly Madoff victims are heartbreaking. In 2009, 90-year-old Ian Thiermann was forced to abandon his twenty-five year retirement to stock shelves at a local grocery store in order to make ends meet. According to Jason Szep at *Reuters*, Thiermann lost upwards of $750,000 in savings to Madoff when his personal friend funneled Thiermann's investment to Madoff's firm.

Six days after losing $7.3 million in savings, 60-year-old widow Maureen Ebel found work as a maid and sold her car in order to recoup some of the losses. Ebel recalled "on the first day I went to work...I came home and said to myself 'this is what my life has come to,' and I held onto my dog and I cried" (Szep).

The story of Abby Frucht's parents is the most heart-wrenching. Frucht's parents, her father is 85 and her mother is 79, live in a retirement home in Sante Fe, New Mexico and had $1 million in savings invested with Madoff. Her father suffers from Alzheimer's and is unable to go back to work. In a phone interview conducted by *Reuters*, Frucht said that her parents "are very elderly and can't possibly go back to work" (Szep). Frucht reported that her parents have enough savings to stay in the retirement home for another two months before they run out of money entirely.

Madoff's Ponzi scheme also greatly diminished the finances of several New York area pension funds. According to *Reuters*, "local branches of United Union of Roofers Waterproofers & Allied Workers Local 195, Plumbers & Steamfitters Local 73', and the Empire State Carpenters Fringe Benefit Funds told members they had lost money" (Reuters). The amount of money lost to Madoff was not disclosed. The report also stated that "the plumbers and steamfitters in Syracuse had about $155 million in trust funds, including the pension, health, annuity and general funds" (Reuters). It is unknown what amount was lost to the scheme in total.

Other pension funds were heavily impacted by Madoff's fraud. Fairfield, Connecticut's pension fund which covered about 800 police officers and firefighters lost about $40 million to Madoff (Anantharaman). According to *Investopedia,* pension funds are a "retirement plan that requires an employer to make contributions to a pool of funds set aside for a worker's future benefit. The pool of funds is invested on the employee's behalf, and the earnings on the investments generate income to the worker upon retirement" (Whiteside). In the case of Fairfield's pension fund, they funneled millions into Madoff's scheme. According to Fairfield's First Selectman Kenneth Flatto, "we are assuming the worst case, which is we could have lost up to $40 million out of the approximately $290 million that we felt we had last month" (Anantharaman). Upon the collapse of the Ponzi scheme, the financial hit took away pension plan payments away from hundreds of retired people that otherwise can not go back into the workforce.

Flatto's main take away from his city's exposure to Madoff's fraud was that the city was not diversified enough while investing pension money. Flatto told *Reuters* that "we were always diversified, but we were not diversified enough" (Anantharaman). Flatto continued to say that Fairfield's fund will likely "adopt strict diversification regulations… [to] cap exposure to a single investment firm at 10 percent. Its exposure to Madoff was about 14 percent" (Anantharaman).

Expert on risk management and professor at Boston University, Mark Williams, believes that some of the responsibility for the lost finances should fall upon the pension funds themselves. Williams claimed that pension funds need a proper protocol to conduct due diligence whenever they invest with a new hedge fund to prevent these substantial losses from occurring again. Williams told *Reuters* that pension funds "are outsourcing the duty [of investing pension money], but it doesn't mean that [they should] relinquish responsibility [of keeping client money safe]"(Anantharaman). If proper due diligence was performed before investing with Madoff's hedge fund, Fairfield's pension fund would have noticed numerous red flags that would have deterred them from investing with Madoff. If this due diligence occured, Fairfield's pension fund could have saved millions of dollars.

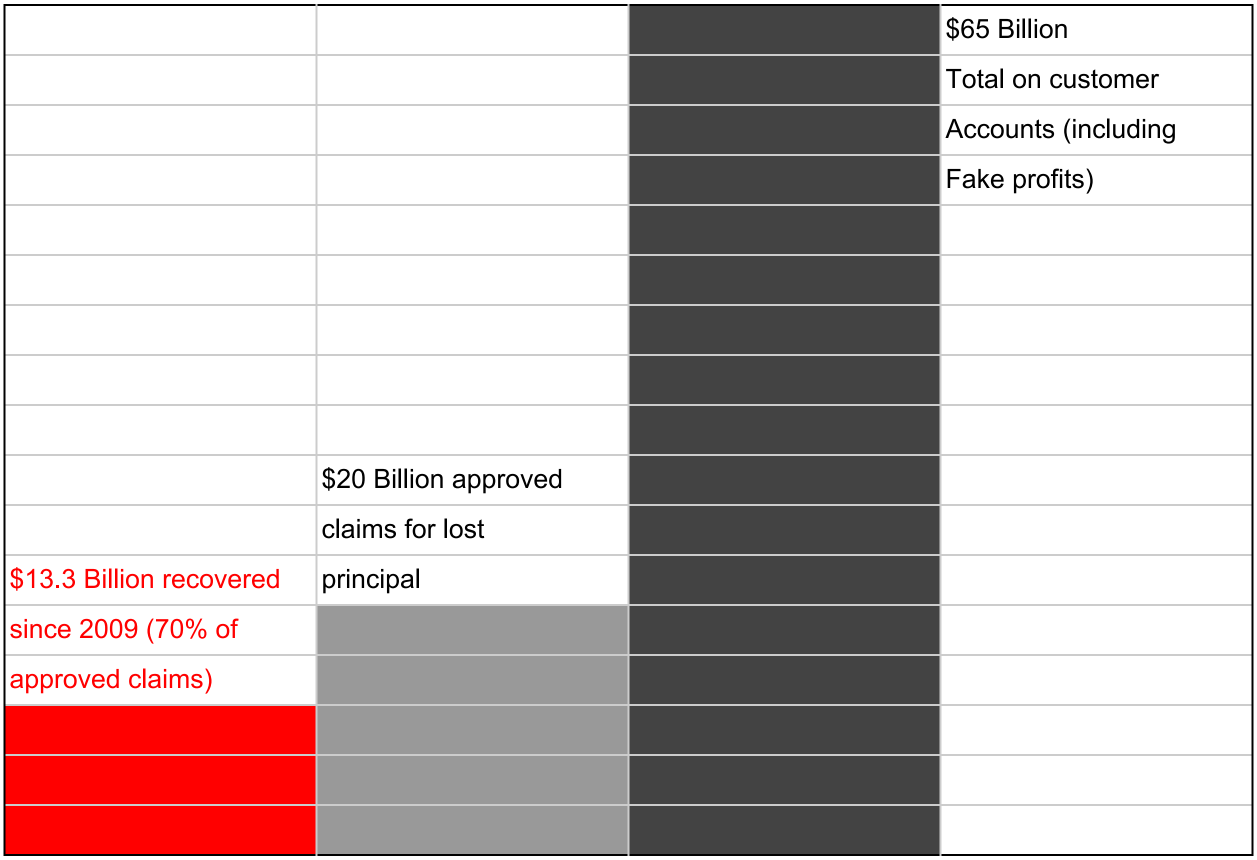
Madoff specifically preyed on the elderly population because he could connect with them easily because of his own age. The Palm Beach area residents were one of the most victimized groups of investors that Madoff preyed upon next to the Jewish community. For years, Bernie Madoff was a member of the exclusive Palm Beach Country Club where he and his wife Ruth developed a large group of friends in the area. Investment adviser to the Community Foundation of Palm Beach Jon Prime stated that "[Bernie] was a personable guy and had a lot of personal relationships with people at the Palm Beach Country Club. People said having money with Madoff was like having money in a savings account" (Dargan). Over the years, most of this circle of friends begged Bernie to let them invest in his fund. Palm Beach victim Lord Anthony Jacobs, recalled Madoff being "a nice, affable guy. He was persuasive, but never put on any pressure. He didn't approach anyone to invest. They approached him" (Dargan). Jacobs reported that he had lost tens of millions of dollars to Madoff.

Another Palm Beach resident Irwin Levy had invested with Madoff three years before the scheme fell apart. At the time, Levy had asked two close friends for investing advice after he had sold his real estate trust business. Both of his friends were investing with Madoff so they recommended Levy to invest with him also. Levy then met Madoff at his home in Palm Beach to discuss his investing options. Levy recalled that "[Madoff] said to me, 'I've had three SEC investigations and they all gave me a clean bill of health,'" Levy said. "And I said, 'That's good enough for me.' I didn't think he'd be lying about that" (Dargan). While convincing Levy to invest in his fund, Madoff did not lie about the SEC investigations. SEC investigators had looked into Madoff's firm three times at this point in time and had found nothing. The SEC failed to find any of the obvious red flags that Madoff's scheme was displaying and this in turn had a role in the scheme victims losing $20 billion.

Loss Recoveries

After four years of court dates and investigating the crime, in December of 2012 the victims of Madoff's scheme had "recovered about $9.3 billion and distributed about $3.7 billion of that to eligible victims. An additional $2.35 billion has been seized by federal prosecutors under forfeiture laws and will be distributed separately by the Justice Department" (Lattman & Henriques). The Madoff case was initially assigned to a bankruptcy trustee, Irving H. Picard from Baker & Hostetler LLP, to track down as much money and assets as he could to help the victims of the fraud. According to New York bankruptcy laws, "the trustee can sue to retrieve money a firm paid out within six years of bankruptcy, or longer if he can prove some degree of responsibility" (Henriques). Just from sueing the Madoff family alone, Picard was seeking to collect "a total of $198.7 million, $141 million paid in the last six years and $57.7 million paid earlier" (Henriques) as of October of 2009. Right after the Ponzi scheme fell apart "all four Madoff homes and their contents were being auctioned, with proceeds going to the victims' fund" (Madoff Mack 111).

As of December of 2018, Picard had recovered about $13.3 billion, or 70% of the losses, by sueing those who profited from the scheme. When the news of the fall of Madoff's scheme broke in the media, many news outlets projected the Ponzi scheme to be worth roughly $50 to $65 billion dollars. Even Bernie Madoff himself estimated the scheme to be worth that much money when he was questioned by investigators. In reality, the $65 billion total included about $45 million in fake profits that Madoff's scheme team manufactured with phony trades. Overall, Madoff investors lost a total of about $20 billion in actual money according to *Bloomberg*. See the below graph to view the astonishing difference between the projected lost dollar amount of $65 billion to the actual amount lost of $20 billion.



(This graph depicts the up-to-date numbers from December of 2018 from *Bloomberg*).

The fact that Picard recovered a staggering 70% of the approved investor loss claims is a monumental achievement. On average, "recoveries in Ponzi schemes range from 5 percent to 30 percent, and many victims don't get anything, [bankruptcy lawyer Kathy Bazoian] Phelps said" (Larson & Cannon). Picard arrived at the roughly $20 billion total by totaling the verified victim claims of who lost money to Madoff's scheme. "'A substantial amount of money' remains to be collected through pending court claims" according to Picard (Larson & Cannon). This means that the $20 billion estimated losses may increase if more victim claims are approved by Picard. According to *Bloomberg*, Picard had already asked the U.S. appeals court to reconsider about 80 lawsuits that could add $4 billion to the total. This last $4 billion is believed to be money "transferred from feeder funds to foreign banks before Madoff's arrest" (Larson & Cannon). According to the *Observer*, "[Picard's] fund doesn't accept claims from anyone who didn't invest directly with Madoff, making cash payouts simpler" (Bonazzo). It is up to the courts to determine whether or not it is within Picard's jurisdiction to recover that sum from the foreign banks and other feeder funds.

Picard initially had the strategy of targeting any Madoff investor who withdrew more money than they put into Madoff's firm. He thought that these people may have had an idea that something illegal was occurring but were profiting from it anyways. This strategy was approved by the courts. One of these targeted investors who made substantial profits from the scheme was accountant Jeffry Picower. Picower began investing with Madoff early on in the 1970s and withdrew from his firm to make billions in net profits (Larson). The *Observer* reported that Picower was "a Madoff investor and beneficiary who reportedly netted $5 billion from the Ponzi scheme (more than Madoff himself). Madoff's victims sued Picower prior to his death in 2009" (Bonazzo). As a result of the suit, the billions in profits that Picower reaped was forfeited to the victim fund.

Picower was one of four major investors, "The Big Four", that Madoff claimed contributed to the rise and downfall of his scheme. Madoff claimed in a jailhouse interview with *Financial Times* that he "was at their mercy"(Bernstein). The remaining three investors were

Beverly Hills money manager Stanley Chais, realtor Norman Levy, and philanthropist and Palm Beach resident Carl Shapiro.

Stanley Chais first began funneling millions of dollars into Madoff's scheme in the 1970s. Chais invested both his own money and his investors' money into Madoff's scheme. Picard claimed that "Chais and his entities reaped about $1 billion in profit from fake securities transactions" (Larson). Chais passed away in 2010. After his death, Picard sued Chais' estate for over $1 billion dollars according to the *Wall Street Journal*. The estate of Stanley Chais reached settlement with Picard and returned $277 million to the victims of the scheme (Palank).

The estate of Norman Levy was ordered to pay Madoff victims $220 million in 2010. Levy had invested millions of dollars with Madoff since the 1970s until his death in 2005. Upon his death, Levy named Bernie Madoff the executor of his estate which gave "him the power to make unilateral decisions about its no-real-estate assets and allowing him to siphon off more money for his fraud" (Larson).

According to *Fortune,* "Carl Shapiro, an apparel executive who had met [Madoff] and been impressed by him, gave him tens of thousands to invest in the early '60s. Shapiro would stick with him for close to half a century, losing around $545 million when Madoff's scheme collapsed" (Bandler & Varchaver). Picard accused Shapiro of withdrawing roughly $1 billion in fake profits from the scheme. According to *Bloomberg*, "In 2010, Shapiro and his family members agreed to forfeit $625 million to settle [Picard's] suit" (Larson).

Not one of "The Big Four" investors were ever criminally charged for their roles in the Ponzi Scheme.

So far, Picard has "distributed $11.3 billion out of the $13.3 billion recovered, with the rest being held in reserve pending the outcome of legal disputes and appeals" (Larson & Cannon). Of the $13.3 billion recovered, "about $1.7 billion in the fund came from JPMorgan Chase, which was fined under the Bank Secrecy Act because it turned a blind eye to Madoff's activities" (Bonazzo). The Bank Secrecy Act according to the *Internal Revenue Service (IRS)* was passed by Congress "in 1970 as the first laws to fight money laundering in the United States. The BSA requires businesses to keep records and file reports that are determined to have a high degree of usefulness in criminal, tax, and regulatory matters" (IRS).

Although Picard is required to keep about $200 million for his work on the case, the rest of the customer fund will be paid out to the victims of Madoff's scheme in the future.

Of the billions that have been distributed to the victims, "almost 1,400 victims who had claims of $1.38 million or less have been repaid in full" (Larson & Cannon). Although $1.38 million or less does not seem like a lot of money in comparison to the full amount of money lost to Madoff, these 1,400 victims that were already paid in full represent the average American investors that were investing their life savings with Madoff. The 'big money' investors that lost millions to the scheme are being paid off in small chunks of their original investment amounts.

An Auditor's Role in Preventing Fraud and the Importance of Professional Skepticism

Auditors are vital to any organization because their professional opinions determine whether or not a business is operating legally. An auditor's job is to analyze the financial statements of a business in order to develop an opinion on whether or not the business is properly reporting what it should be reporting. According to *GRF,* auditor's have the role of rendering "an opinion on whether a company's financial statements are presented fairly, in all material respects, in accordance with financial reporting framework" (GRF). Audits are a trusted instrument in business that are meant to provide confidence to stakeholders in the investing public regarding the financial results of the entity audited.

Madoff's fraud could have been caught years earlier if proper due diligence was performed by auditors of Ernst & Young. It is also imperative to note that the role of auditors for any business is not to identify when a fraudulent scheme is occurring. Their job is to confirm the legitimacy of the financial statements of the business and identify the risks associated with what could be fraudulent activities. Certified Fraud Examiner Ralph Summerford states that "although [auditors] might be qualified in assessing risks and identifying where a fraud might occur, they don't know how to recognize the indicators of fraud" (Summerford 22). Auditors are responsible for sifting through financial reports in order to catch errors that could potentially lead to fraudulent activity. Auditors see first hand the financial reports of the business they are auditing. If auditors are not properly educated to see red flags of fraudulent activity within financial statements then the fraud may not be caught if any errors are missed. Auditors are also trained to analyze internal control systems of businesses to ensure it is adequate for preventing fraudulent activity.

The accounting firm Ernst & Young was in charge of auditing Madoff feeder fund Rye Funds's financials presented to them by Madoff's paid off auditor Friehling & Horowitz. Rye Funds was managed by Tremont Group Holdings Inc. which was the second largest Madoff feeder fund behind Fairfield Greenwich Group. The firm conducted their audit on Rye Funds based upon these manufactured statements which concealed Madoff's scheme. Ernst & Young performed their audit on "Rye from 2000 to 2003 and performed surprise audits of Tremont during that period until 2008" (Amon & Pearson) and failed to look into the credentials of Friehling & Horowitz, the source of the documents they were confirming the validity of. If Ernst & Young had researched who they were receiving the reports from, the firm would have found out that a tiny accounting firm located in a strip mall was approving financial statements for one of the largest hedge funds on Wall Street. This is a huge red flag because large investment funds from Manhattan do not typically reach out to small suburban accounting firms to handle their audits.

The auditing firm itself should be considered a red flag when looking at Bernie Madoff's case. This is because Friehling & Horowitz occupied a "tiny storefront office in a New York City suburb" (Rashbaum & Henriques). The numbers that Madoff was tallying on his books, although fake totals, were still filed to be in the billions of dollars range. According to Gilbert Geis PH.D., CFE at *FRAUD Magazine,* prosecutors of the Madoff case brought up that Friehling "had signed off on a report to the SEC indicating that Madoff's firm had $1.09 billion in assets and $425 million in liabilities" (Geis). The typical business practice for a large hedge fund like Madoff's is to hire an auditing firm that was large and experienced enough to handle that amount of work to prove the validity of the vast financial statements hedge funds usually have. Madoff specifically chose a small accounting firm because he knew that he could manipulate Friehling into signing off on incorrect BLMIS statements without proof reading them because of the enormity of a task it would be to actually put in the work. Even Friehling admitted that “Madoff was said to have referred to [me] as a ‘dumb auditor. I did not question what I should have questioned’” (MFI). By overwhelming the auditors, Madoff got the control he needed to have his firm’s audits approved for so many years even though none of the financial information was accurate.

In other words, Friehling lacked professional skepticism while working for Bernie Madoff. Professional skepticism is a very useful tool in the workplace especially for auditors because if an auditor constantly questions if the data they are given is correct, they are more likely to discover fraudulent activity than auditors who do not question the data given. In Friehling’s case, he took Madoff’s word that the financial statements and totals were correct out of blind trust and laziness. If Friehling had taken the time to properly complete his job as an “auditor”, the thousands of victims who lost money to Madoff would have lost a significantly less amount in the end.

In addition, attorney Steven Thomas argued that “Ernst & Young failed to inquire about Friehling & Horowitz’s professional reputation… had it done so it would have found out that the accountant wasn’t vetted to do audits as required by industry standards" (Amon & Pearson). Although he had his CPA certification and experience in the accounting field, David Friehling did not have the qualifications to perform audits. Ernst & Young failed to perform their due diligence on the small accounting firm and neglected to confirm the legitimacy of Friehling & Horowitz’s qualifications to perform audits before conducting their own audit based upon the small firm's information. If the auditor's of Ernst & Young were properly trained to acknowledge the red flags Friehling & Horowitz were prominently displaying, Madoff investors' money could have been saved years before the scheme fell apart in 2008 due to the economic recession.

Madoff's auditor David Friehling had a major role to play in the prolonging of Bernie Madoff's Ponzi scheme. This is because Friehling failed to uphold his duties as an auditor and did not properly analyze all of the reports Madoff handed over to him for review. Let us not forget that Friehling was not even a qualified professional to audit Madoff's firm in the first place so whatever minimal review Friehling was performing was not even meeting industry standards of audit review. According to the SEC's complaint against David Friehling, the organization claimed that he "enabled Madoffs misconduct by falsely representing to investors that BLMIS was financially sound and that Friehling and F&H were independent auditors that had conducted audits of BLMIS each year" (SEC). Also included in the SEC's complaint were true claims that Friehling knowingly and falsely stated that Madoff's firm's financial statements met the requirements of the Generally Accepted Auditing Standards (GAAS), that the reports conformed to the Generally Accepted Accounting Principles (GAAP), and that Friehling performed an adequate review of the firm's internal control environment "including internal controls over the custody of securities, and found no material inadequacies" (SEC). By falsely confirming that he had executed adequate reviews of the three items listed above, Friehling aided Madoff in concealing his scheme for the seventeen years he worked for the fraudster.

In addition, Friehling could have caught the trading security number inadequacies if he had assessed Madoff's financial reports according to auditing industry standards rather than rubber stamping them immediately. Since Friehling "did not perform procedures to confirm that the securities BMIS purportedly held on behalf of its customers even existed" (SEC). If Friehling had literally just glanced at the numbers on the financial reports and had done research to confirm the security numbers, he could have caught one of the largest frauds in history.

Rather than conducting an adequate review of the documents, the SEC accused Friehling of "merely pretending to conduct minimal audit procedures of certain accounts to make it seem like he was conducting an audit, and even then failed to document his purported findings and conclusions as required under GAAS" (SEC). These actions were enough to fool people who were not privy to auditing standards. In an attempt to hide his illegitimate auditing skills, Friehling also "falsely represented to the American Institute of Certified Public Accountants (AICPA) that he was not engaged in audit work" (SEC). By claiming that he was not actually performing audits to the AICPA, Friehling avoided AICPA peer review requirements that all auditors must complete. If the AICPA review process was ever conducted for Friehling, Madoff's scheme would have surely been found out sooner than it was in 2008.

Overall, Friehling did a shoddy job performing his fake audits on Bernard L. Madoff Investment Securities, and did not do a great job covering up that he was not a qualified auditor in the first place. If Friehling was not so lazy in performing his job in general, regardless if he was an auditor or not, he would have found that there many mathematical errors throughout BLMIS financial reports that would have been a prominent warning that a fraud was occuring in the firm.

Another factor that aided the concealment of the Ponzi scheme was Joann Crupi's creation of fraudulent financial records for the "audits" to verify. According to the SEC, "as part of a concerted effort overseen by MADOFF to deceive both the SEC... CRUPI participated in creating numerous false and fraudulent books and records" (SEC). As stated in a previous section, Crupi held a major role in falsifying financial documents and trading information to hide the extra billions of dollars that Madoff held in his Ponzi scheme. This information was then presented to Madoff and then passed along to David Friehling for an "audit" review. Everything about this "audit" into Madoff's financials was done based on incorrect information which came from Crupi.

The auditing work or lack there of throughout the last two decades of Madoff's Ponzi scheme were atrocious and aided the concealment of the scheme. The element of laziness that the qualified auditors possessed when conducting their audit of Friehling's work was baffling considering Ernst & Young's superb reputation in the accounting industry. David Friehling's initial rubber stamping of Madoff's financial reports strongly played into the concealment as well. The AICPA should have a system in place to perform background checks on all "auditors" especially for huge businesses like BLMIS even if the "auditor" does not report to the AICPA. If this was the case, the AICPA would catch fake auditors like Friehling that are being unknowingly manipulated by fraudsters and can force them into the peer review requirement that auditors must meet. This will hopefully improve the likelihood of frauds being caught through the auditing process. Of course, proper due diligence and professional skepticism, as noted, by all the auditors involved may have prevented much of this scheme and the subsequent damage it inflicted.

Harry Markopolos's Testimony

On February 4th, 2009, Harry Markopolos testified his experiences with the SEC during his investigation of Bernie Madoff before Congress. More specifically, Markopolos testified before the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises to assess Bernie Madoff's Ponzi scheme and the SEC's incompetency in handling whistleblower tips. Nancy Pelosi described that the Congressional hearings will help direct the subcommittees "in undertaking the most substantial rewrite of the laws governing the U.S. financial markets since the Great Depression" (Pelosi). Markopolos's twelve minute statement chronicled his experiences submitting each of his five tips to the SEC and how each tip had failed to be taken seriously. Markopolos commented on his first submission to the SEC from May of 2000 stating that his team "knew that we had provided enough red flags and mathematical proofs to the SEC for them where they should have been able to shut [Madoff] down right then and there at under seven billion dollars" (Markopolos Testimony). At the time of his first SEC submission, Madoff's scheme was significantly smaller in size compared to the final $20 billion dollars in lost investor funds. The SEC had the chance to minimize the devastation of this fraud but failed to do so for a variety of reasons.

One of the reasons why the submissions to the SEC were not taken seriously was because Markopolos's confidant at the SEC Ed Manion was not a credible source according to other SEC staff. After analyzing the submission and realizing that all of the proofs and red flags outlined in the submission were a credible threat to the securities industry, Manion attempted many times to take Markopolos's submission to his superiors at the SEC. SEC superiors consistently ignored Manion's requests to investigate the Madoff case because Manion "was not a securities lawyer, only a chartered financial analyst with twenty-five years of trading and portfolio management experience in the industry" (Markopolos Testimony). Even though Manion had substantial experience and knowledge of the securities industry and knew that Madoff's case should not be ignored, SEC senior officials declined to investigate the case because apparently Manion's twenty-five years of experience in the same industry Madoff was perpetrating a fraud in did not hold enough credibility.

After the SEC's failure to investigate Madoff after Markopolos's first submission, he wanted to end his investigation. A major reason as to why Harry did not give up on his Madoff investigation was because Manion urged him to keep going despite the SEC's incompetence. Markopolos stated that "Mr. Manion told me that his agency had dropped the ball but that I had the public duty to keep investigating because the Madoff Ponzi scheme was such a clear and present danger to the nation's capital markets" (Markopolos Testimony). Manion's push was enough to keep Markopolos's hopes up and to continue his investigation.

Ed Manion was not the only SEC employee to vouch for the validity of Harry's submissions. Branch Chief of the SEC's Boston office Mike Garrity also believed that Markopolos's tips were credible points that should warrant an investigation. After reading Markopolos's 2005 submission, Garrity "examined my evidence, investigated, and found irregularities, vouched for my credentials and put me in touch with the appropriate SEC staff in the New York regional office" (Markopolos Testimony). For reasons explained in *Harry*

Markopolos's Recommendations for the SEC, this submission was also ignored by the New York regional office due to an interoffice rivalry.

Markopolos also highlighted in his testimony how the lack of experience and knowledge of the investing industry played a role in the SEC's neglect to investigate Bernie Madoff. Markopolos asserted that he "told the SEC exactly where to look [within his submissions], providing them with a long series of clear warnings that any trained investment professional would have immediately understood inexplicably" (Markopolos Testimony). If the SEC had staff with relevant experience in trading securities or investment strategies, it would have become clear to the SEC that this case must be investigated. Markopolos further claimed that "the SEC is over lawyered, has too few staff with relevant industry experience and professional credentials to find fraud even when a multi-billion dollar case is handed to them on a silver platter" (Markopolos Testimony). This is one of the issues SEC officials faced when determining whether a case should be investigated. If these officials had proper education to realize that what Madoff was doing in his firm was abnormal compared to the rest of the industry, they may have approached his case differently.

At the time of Markopolos's testimony, it had been almost three months since Bernie Madoff was arrested. The only public comments that senior SEC officials have made up until this point regarded how they could not comment on the ongoing Bernie Madoff investigation and how they are swamped with thousands of tips to comb through. No one from the organization had stepped forward to publicly apologize about how terribly they had handled tips about Madoff prior to his arrest or how they had failed the thousands of investors that were caught up in the scheme. Markopolos highlighted how the SEC was too occupied with other cases to be able to work on Madoff's:

> "[The SEC] lacks both staff and resources while telling us that they received thousands of tips each year and that they have to conduct triage and can only respond to the highest priority matters. I gift-wrapped and delivered the largest Ponzi scheme in history to them and somehow they couldn't be bothered to conduct a thorough and proper investigation because they were too busy on matters with higher priority. If a 50 billion dollar Ponzi scheme does not make the SEC's priority list, then I want to know who sets their priorities" (Markopolos Testimony).

The SEC neglected to launch a proper investigation into Bernie Madoff because they could not properly prioritize which whistleblower tips were more serious than others. Harry Markopolos and his team had provided the SEC with enough ammunition in their submissions to go forth and arrest Madoff immediately but a lack of manpower, experience, and education caused the SEC to not properly investigate Bernie Madoff.

<u>The Securities and Exchange Commission's Investigations</u>

> *"[Bernie Madoff] admittedly was astonished that he hadn't been caught by the SEC. He was extremely critical of that agency, calling its investigators idiots, assholes, and blowhards" (Markopolos 2).*

After the discovery of Madoff's Ponzi scheme, the SEC received major backlash for not having investigated Madoff's firm properly and for ignoring Harry Markopolos's SEC submissions that detailed many red flags that he had observed. In the months following the downfall of Bernie Madoff, the SEC conducted an internal investigation to analyze where they had gone wrong and how they could have missed Madoff's fraud.

The SEC disclosed in a 477 page document all of the missteps their examination teams took during the five separate investigations into Bernie Madoff and his firm over the years. The *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme* also outlined all of the tips received from Harry Markopolos and the SEC team's opinions and actions regarding the handling of his submissions. Throughout the document, it was apparent across several different instances that the SEC's investigative team did not handle the Madoff case in the correct manner. The biggest aspect that played into this was the team's lack of experience with handling Ponzi scheme investigations.

At the time of the Madoff investigation in 2003, the SEC's Office of Compliance Inspections and Examinations (OCIE) "didn't have many experienced people at all. … we were expanding rapidly and had a lot of inexperienced people at the time. … I guess you could say we were all effectively inexperienced." (SEC 90) according to ------ Daugherty. A separate unnamed OCIE examiner that joined the SEC in 2003 testified "there was no training. … And I was told that when I came in that this was a trial by fire kind of job that you get trained as you come in." (SEC 90). Another examiner on the Madoff team also had an opinion on the lack of experience most of the examiners possessed in the OCIE: "[I] observed many people who appeared to be hired by the SEC more for their personal connections to other SEC employees than for any substantive experience or knowledge they possessed." (SEC 91). In the early 2000s, the SEC did a lackluster job at training their employees to be able to properly examine fraud cases and the employees they were hiring had no relevant industry experience to be able to properly carry out an investigation. This combination caused instances such as when Simona Suh recommended to close the Madoff investigation after failing to follow through on a red flag with the DTC as explained in *The Scheme According to Bernie.*

The same examiner also testified in the SEC's internal investigation that their "'view' of the team assigned to the Madoff investigation was that they did not have much experience in equity and options trading. Rather, their experience was in general litigation.'... Similarly, Wood expressed that the SEC 'need[s] to make sure you have people in the office who have industry experience who have been in the industry and can spot these issues based on experience'" (SEC 91). The overall lack of industry experience that was personified in the Madoff investigations greatly hindered the SEC's ability to uncover Bernie Madoff's fraudulent actions. In order for the SEC to properly carry out investigations in the future, the organization would need to hire qualified examiners with industry experience rather than hiring people that have law experience exclusively. Hiring new employees with pertinent industry experience will raise the SEC's chances of recognizing red flags during investigations. If the SEC had done this in the first place, fraud schemes like Bernie Madoff would have been caught years sooner and this is one of the major reasons why the SEC should be considered liable for not catching Bernie Madoff sooner.

When the Madoff investigation continued into early 2004, staff examiner Walker noticed that Madoff's trade strategy did not match up to his generated returns "it has always been my understanding that 'collars' – (Madoff's strategy is a variation of this) … is a more protective type of position (meaning protective of underlying profits on the stock).” (SEC 103). Even when the examination team noticed this prominent red flag in Madoff’s case, they still did not want to pursue the case further. Walker detected this inconsistency in Madoff’s split-strike conversion strategy and did not ask any more questions. Madoff’s case was later dropped even though the team had lingering questions such as this one that could not be justified by legal actions.

Even though the investigative team had unresolved questions regarding Madoff’s case, the investigation concluded. But why would the SEC halt a potentially large investment fraud case if the team still had questions about the suspect and their firm? The examination team, up until this point, had not found any evidence that Madoff was perpetrating a fraud, whether it be front-running or an alleged Ponzi scheme. The SEC document claimed that even though the examiners had questions about Madoff’s operations, “there was no evidence that the answers to the questions were ever pursued” (SEC 128). The reason why Madoff’s case was put on the back burner was because of his reputation in the industry. A testimony revealed that since “Madoff was a well-known figure, [it] may have played a role in the decision to put it on the back burner because the exam supervisors may have thought it was unlikely he was engaging in fraud.” (SEC 128-129). In addition, “examiners had the impression Madoff referenced his influential connections at the SEC and on Capitol Hill in an effort to both impress and intimidate them” (SEC 181). Madoff’s stellar reputation as one of the top experts in the securities industry granted him immunity in this investigation. The SEC examiners believed that there was no way that the great Bernie Madoff could be perpetrating a fraud since he has held high positions at various regulation agencies and prominent organizations in the industry. Since Madoff has held these senior positions in many organizations, SEC examiners assumed that he must know the rules that govern this industry so therefore he could not possibly be breaking them. The SEC's credulous examiners were blinded by Madoff's resume to further pursue their investigation. This is an example of another huge misstep the SEC committed during their Madoff investigations.

In response to not pursuing Madoff's case further, the SEC added to their analysis of their internal investigation that considering the serious allegations about Madoff's actions "this matter should have been given priority and not pushed aside in favor of other projects. Where there are significant unresolved questions, examinations should not be pushed aside for long periods of time and left unresolved" (SEC 144). The SEC handled this case horrendously. Normally in any conventional investigation of any kind, investigations with massive allegations that include potentially billions in losses do not get put on the back burner when examiners cannot determine what happened in the case. If there are questions stemming from a case, the examiners should be more eager to solve them instead of neglecting to investigate the case further.

Even though the Madoff investigations were cut short, the examiners still caught on to some major red flags. However, the examiners did not follow through on the inconsistencies and failed to investigate the red flags any further than just acknowledging something seems fishy about them. Among the red flags listed in the SEC's report included questions about David Friehling and the absence of volatility in Madoff's returns. In 2003, examiner Broder was taken aback by the size of Madoff's auditing firm: "similarly, the small size of Madoff's auditor was an issue for Broder because Madoff was reportedly managing billions of dollars for investors" (SEC 150). As mentioned before, the large investment firms like Madoff's typically seek audit work from larger firms. Broder also commented that Madoff "should have more volatility in his returns than he actually stated. … It was just too steady" (SEC 150). This was also mentioned previously as being a red flag because Madoff only experienced 7 down months out of 174 months analyzed by Harry Markopolos in his 2005 SEC submission (Markopolos 323). Legally operating investment firms experience many more months of negative returns than just 4% of the time.

Another question that investigators had that was previously noted was why Madoff would give feeder funds more money for their business than what was typical. Examiners saw that Madoff's fee structure was atypical and "did not understand why Madoff would allow feeder funds to take hundreds of millions of dollars in fees that Madoff could have kept for himself: '[W]hen you see a situation where it would appear that he's only making money off of his … brokerage fees, why is he letting the Fairfield Greenwiches of the world take 2 points? I don't know'" (SEC 150). As mentioned in the SEC document, this red flag was left hanging and was not pursued as well which was a massive mistake that the SEC had made.

The SEC's report also stated how their offices handled the processing of Harry Markopolos's submissions. A handful of SEC officials had read Markopolos's 2005 submission and all agreed that the amount of details provided within the thirty red flags mentioned was not customary for most whistleblower tips that the SEC receives. An examiner testified that this submission was "much more detailed than your average tip. It would clearly call for a follow up" (SEC 240). Markopolos's advocate, SEC Boston Office's Branch Chief Mike Garrity also testified noting that it "is unusual to have something of this breadth this detailed. That is rare" (SEC 240). Although the two SEC officials that testified above believed the submission was credible, the Northeast Regional Office (NERO) did not find the submission credible.

After reading the 2005 submission, assistant regional manager of the New York SEC office Doria Bachenheimer, Branch Chief of the Enforcement Division in New York Meaghan Cheung, and staff attorney Simona Suh each testified that they could not trust Markopolos's investigative work because he had no direct link to Madoff's firm. The SEC document noted that

> "Bachenheimer, Cheung and Suh all testified that they discounted the 2005 submission somewhat because Markopolos was neither a Madoff employee nor an investor. Bachenheimer testified that: [Markopolos] was not working– he had no inside information… he was not an employee… [and] received no information from Madoff directly" (SEC 240).

Despite Markopolos's dead on warnings included in each of his submissions to the SEC, these three women overlooked his work because he was an outsider to Madoff's firm. Markopolos had no immediate connection to the supposed crime in progress so his credible work was ignored by SEC staff. Plausible tips that are mathematically sound should not be ignored regardless of the tipster's connection to the crime or lack thereof. Even when Bernie Madoff's case was handed to the SEC with all of the warnings spelled out for them, they pushed the submission aside and failed to uncover the largest investment fraud in history.

Additionally, Cheung was not qualified as a Branch Chief to even carry out a Ponzi scheme investigation. Cheung stated "I don't think anybody ever said to me here's how you investigate a Ponzi scheme and here is what you should do here" (SEC 245). As the Branch Chief of the SEC's Enforcement Division, Cheung should have the knowledge and the expertise to be able to address a Ponzi scheme investigation. The SEC should either train their employees adequately so they are able to handle any fraud investigation or the organization should hire qualified employees in the first place so this problem never arises.

The Office of Inspector General (OIG) conducted the SEC's investigation of the agency's failure to uncover Bernie Madoff's scheme. The OIG is a separate office within the SEC which "conducts, supervises, and coordinates audits and investigations of the programs and operations of the SEC" (SEC). After their investigation into the Madoff matter, the OIG discovered that

> "the SEC received numerous substantive complaints since 1992 that raised significant red flags concerning Madoff's hedge fund operations and should have led to questions about whether Madoff was actually engaged in trading and should have led to a thorough examination and/or investigation of the possibility that Madoff was operating a Ponzi scheme" (SEC 456).

The OIG also found that throughout five separate examinations of Madoff the SEC "never took the necessary and basic steps to determine if Madoff was misrepresenting his trading. We also found that had these efforts been made with appropriate follow-up, the SEC could have uncovered the Ponzi scheme well before Madoff confessed" (SEC 456). The SEC was proven to be incompetent throughout each of the five examinations into Bernie Madoff's fraudulent behavior according to the OIG's conclusion. If the SEC had carried out the examinations properly and had adequately trained employees to carry out these examinations, Bernie Madoff's Ponzi scheme would have been uncovered years before Madoff was arrested in 2008.

In the SEC's defense, the organization cannot be expected to follow up on each tip they receive from a whistleblower. According to the *2019 Whistleblower Program Annual Report to Congress*, the SEC "received over 5,200 whistleblower tips" (SEC). For the year of 2008, the year that Madoff's scheme was discovered, the whistleblower program was not established so the relevant statistics for comparison could not be found. The Office of the Whistleblower was not established until July of 2010 under Section 922 of the Dodd-Frank Act.

However, SEC investigators were definitely busy throughout the year of 2008. Throughout that year, the SEC was actively investigating "the role of the various parties involved in the securitization of mortgage-backed securities and collateralized debt obligations" (SEC). This was one of the major causes of the Great Recession of 2008 so this excuse would understandably take up a significant portion of the SEC's investigative resources. The SEC reported that they were involved in investigating other parts of the financial industry throughout 2008 as well. According to the *SEC's 2008 Performance and Accountability Report* (published in November of 2008, one month before Madoff was arrested), "the Enforcement Division [of the SEC] undertook a sweeping investigation into market manipulation of financial institutions, focusing on broker-dealers and institutional investors with significant trading activity" (SEC). In other words, the SEC spent a good portion of their investigative resources into examining the exact business that Bernie Madoff was one of the most successful broker-dealers in as well as having on average 10% of the New York Stock Exchange's daily trading activity flowing through his firm (Markopolos 26) and they still did not feel the need to investigate him. On top of blatantly missing the red flags of Madoff's Ponzi scheme through their investigation into broker-dealers specifically, the SEC also neglected to investigate Bernie Madoff under the recommendation of Harry Markopolos in his 2008 submission that outlined the specific red flags of Madoff's fraud.

The sad part about this is, this only outlines the SEC's disregard to investigating Bernie Madoff in the year of 2008. This is not counting the other four submissions Harry Markopolos brought to the SEC's attention almost a decade before this point. All of these facts mentioned in this section highlight how incompetent the SEC was at protecting the public's interests and investigating the real threats in the financial industry.

<u>Harry Markopolos's Recommendations for the SEC</u>

During his testimony before Congress, Markopolos concluded his speech by recommending the SEC to change some of their processes in order to better handle credible tips. One of Markopolos's arguments was that the SEC was terrible at regulating their own regional offices. Instead of processing his claim on the spot, Markopolos had to jump through many hoops just to get his submissions read because of a SEC regional office rivalry between Boston, where Markopolos submitted his claims and New York where Bernie Madoff was committing his fraud. Since Madoff was committing his fraud in the New York area, that SEC office had jurisdiction over handling the Madoff case but did not want the tip handed to them by the Boston office. Markopolos criticized the SEC while testifying saying that "regional turf battles definitely played a part, a determining factor in fact in how disastrous this case was handled by the SEC" (Markopolos Testimony).

Since there was no central office of the whistleblower that oversees all regional SEC offices, the rivalry between New York and Boston could not be refereed and the Madoff case was not taken seriously. Markopolos commented that “relations between the New York and Boston regional offices were about as warm and friendly as the Yankees Red Sox rivalry, and that New York does not like to receive tips from Boston” (Markopolos Testimony). If a hierarchy was established, regional office feuds would not get in the way of handling credible whistleblower tips.

When concluding his testimony, Markopolos urged the incoming SEC chairwoman to make radical changes throughout the organization. Markopolos commented that the new chairwoman “needs to come in and clean house with a wide broom. The SEC needs new senior staff because the current staff has led our nation’s financial system to the brink of collapse” (Markopolos Testimony). The senior staff within the SEC at this point were responsible for the petty rivalry between regional offices. Instead of holding a grudge against each other, the officials should have done their jobs and brought Bernie Madoff and other fraudsters to justice regardless of where the tips come from. The staff were also inadequately trained to acknowledge industry standards and how Madoff was breaking them at his firm. With proper education and the hiring of new staff with relevant industry experience, the SEC can better detect and analyze fraudulent behavior within the securities industry.

Post-Madoff Reforms

"[The SEC] has single handedly defused the American public of any sense of confidence in our financial markets. If you are the watchdog, you have totally and thoroughly failed in your mission" - Congressman Gary Ackerman

In an attempt to improve their reputation, the SEC reformed fourteen of their policies to reduce the likelihood of another large fraud like Madoff's from happening again. The Enforcement Division of the SEC saw major reforms after Bernie Madoff was arrested. One of the reforms to this division that should be highlighted include the SEC's enhancement of safeguards for investor's assets.

One year after Madoff's arrest in December of 2009, the SEC adopted rules that specialize in providing better assurance to investors that their investment accounts actually contain the funds that their investment advisors claim they are holding. This reform states that "the new rules encourage registered investment advisors to place their clients' assets in the custody of an independent firm, unlike Bernie Madoff did" (SEC). To better protect investor capital, if an independent firm is not used by the investment firm then the SEC will mandate surprise exams and third party reviews to protect the assets. The surprise exams consist of hiring an independent public accountant to verify if the assets the investment manager claims are under their possession actually exist. The third party reviews would be required if investment advisors do not leave client assets with an independent firm. The review would be performed by a registered accountant approved by the Public Company Accounting Oversight Board (PCAOB). The PCAOB's duty is "to oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports" (PCAOB). The review should detail "the controls that are in place to protect [client] assets, the tests performed on the controls, and the results of those tests" (SEC). These reviews will greatly improve the quality of disclosures for clients and will help them to consider the risks associated if they invest their money with a particular investment advisor. By including outside parties to check in on investment advisors, it takes control out of the fraudsters hands to manipulate whoever is under their employment to try and conceal a fraud.

This reform assures additional protection against fraud in the investment industry. This rule specifically addresses how Bernie Madoff never let outside auditors examine his financial reports willingly if a potential investor was conducting due diligence on Madoff's firm. This reform better protects existing investments already funneled into the investment firm as well as potential investors looking to practice proper due diligence like they should be conducting.

In June of 2011, the SEC added new rules to this reform to better protect investor assets if they are given to a broker-dealer (like Madoff was). These new rules include audit enhancements, auditor access, and custody reports so the SEC and SRO (Self-Regulatory Organization) have better knowledge of broker-dealers asset custody methods. For audit enhancements, broker-dealers are required to take part in a compliance examination if they have custody of their clients's securities and cash. This compliance examination would be performed by a PCAOB registered accounting firm that will involve an audit of internal controls that the broker-dealer maintains to protect client assets.

Furthermore, if the broker-dealer maintains custody of their clients assets, they would have to "allow SEC and SRO examiners to access the work papers of the registered public accounting firm that audits the broker-dealer and discuss any findings with the personnel of the registered public accounting firm" (SEC). This auditor access is meant to ensure that the auditor of the broker-dealer is following the correct auditing standards and is not being manipulated to produce false reports like David Friehling was.

The final new rule under this reform requires broker-dealers to file a quarterly report with the SEC that will include information such as if the broke-dealer has custody of client cash and assets. These custody reports give SEC examiners a better starting point if there is ever a problem determining who is holding custody of client assets. By having a custody profile of client assets, this makes operating a Ponzi scheme like Madoff's much more difficult to pull off because custody reports eliminate the element of broker-dealers concealing where client money is being held. For example, Madoff kept all new investor money in a bank account that only Frank DiPascali and him had access to rather than actually investing the money in the stock market like it should have been. These quarterly custody reports make hiding the money like Madoff did much more difficult to do because these reports will reveal the inaccuracies of trading reports if any exist.

A major problem that was mishandled in the Madoff investigation was that the SEC officials on the case lacked the knowledge of how a split-strike conversion strategy worked. This is why Madoff advertised this strategy, to better protect his scheme because he knew that the SEC did not have any experts that specialized in this particular strategy due to its complexity. To prevent this lack of knowledge from happening again in a future investigation, the SEC produced a new reform that will bring in new staff in the examination unit with more diverse knowledge "in areas such as derivatives markets, derivatives trading, private funds, clearing, risk management, trading, operations, portfolio management, options , compliance, valuation, new instruments and portfolio strategies, and forensic accounting" (SEC). The SEC was basically hiring more staff that resembled the experience that Harry Markopolos possessed as a portfolio manager.

This was also an issue when Markopolos's submissions to the SEC were ignored. He was ignored five times because his extremely detailed reports on Madoff's behavior could not be understood by the SEC officials that received the submissions. Markopolos testified before Congress in February 2009 that "unfortunately, the SEC staff lacks the financial expertise and is incapable of understanding the complex financial instruments being traded in the 21st century" (Markopolos Testimony). These officials lacked the knowledge of how split-strike conversion strategies specifically operated and therefore ignored the Markopolos's submissions.

In relation to the reform explained above, the SEC established a similar reform that expanded the training SEC staffers will receive to better recognize fraud red flags. According to this reform, "hundreds of staffers have been training to become Certified Fraud Examiners, and the SEC is expanding the availability of programs for staffers to become Certified Financial Analysts and Chartered Alternative Investment Analysts" (SEC). These certifications will give SEC staff the knowledge to properly identify fraud red flags and the ability to better analyze financial reports and tip submissions like Harry Markopolos's. In addition to the staffers being certified in these areas, the SEC has also provided training "related to hedge funds and specialized products; derivatives and options; the verification of trades and custody arrangement…" (SEC). This new education will give SEC staff the ability to properly comprehend how securities trading works so if another scheme like Madoff's is discovered, the SEC will not dismiss any red flags because they did not know any better.

Did any of these reforms work? It is hard to say for sure. Most of these reforms do not have distinctive signs that display that they were effective. It is like locking your car doors, you cannot definitively know how many car thefts you prevented just by doing that act.

The Office of the Whistleblower

An important reform that the SEC made that should be noted is their advocacy for a Whistleblower Program. *Investopedia* states that a whistleblower is "anyone who has and reports insider knowledge of illegal activities occurring in an organization. Whistleblowers can be employees, suppliers, contractors, clients, or any individual who becomes aware of illegal business activities" (Kenton). In 2009, the SEC had requested Congress for expanded authority "to protect whistleblowers from retaliation and to reward those who bring forward substantial evidence about significant federal securities violations" (SEC). In the Madoff case, Harry Markopolos was considered the whistleblower and garnered massive media attention following the arrest of Bernie Madoff because of his ignored submissions to the SEC. This whistleblower program was established so if tipsters are afraid to come forward with crucial information about a financial crime, they will receive protection so they are incentivised to come forward. Throughout the years Harry Markopolos and his four man team investigated Madoff, they were concerned for their safety. This is why only Harry submitted his name on the submission because he claimed that "Mr. Madoff was already facing life in prison if he were caught so he'd face little to no downside to removing whatever threat he felt we posed" (Markopolos Testimony). If

Madoff was desperate enough to keep Markopolos quiet, he had the financial means and capabilities to stop any whistleblowers from stepping forward against him.

Prior to this point, not many crimes applied for whistleblowers to receive financial compensation for the crimes they tipped off. Even Harry Markopolos outlined this in his 2005 SEC submission stating "Madoff Securities is the world's largest Ponzi scheme. In this case there is no SEC reward payment due the whistle-blower so basically I'm turning this case in because it's the right thing to do" (Markopolos 299-300). However, if Madoff's fraud was deemed to be insider trading or a crime similar to that which Markopolos deemed to be unlikely, Section 21A subsection E of the Securities Act of 1934 states that the whistleblower "shall be paid from amounts... recovered by the Commission or the Attorney General, such sums, not to exceed 10 percent of such amounts, as the Commission deems appropriate, to the person or persons who provide information leading to the imposition of such penalty" (Columbia). This act grants whistleblowers of certain financial crimes the incentive of up to 10% of the recovered sum that the SEC or Attorney General had found in their investigations as compensation for their tip.

This new Whistleblower Program that the SEC advocated for was established in 2010 to open up to whistleblowers of any financial crime. This program gives this new SEC office the authorization "by Congress to pay tipsters a bounty of 10% to 30% of any sanctions it collects above $1,000,000" (Alpert). The SEC first awarded a whistleblower through this program in 2012 and has paid out about $387 million to 67 individual whistleblowers (SEC). Although the SEC has paid out 67 whistleblowers for their tips, this number was generated over the course of seven years according to the SEC's *2019 Whistleblower Program Annual Report to Congress.* Just in 2019 alone, the SEC's Office of the Whistleblower reported receiving 5,200 tips and "the

Commission ordered whistleblower awards of approximately $60 million to eight individuals" (SEC). Out of the 5,200 cases tipped in 2019, only 8 people received payment for their tips as a whistleblower. This is equal to 0.0015% of the whistleblowers that tipped off the SEC in 2019. The SEC's payout rate is so low that it is almost not worth it for whistleblowers to come forward. If whistleblowers are only reporting tips for the money, they probably will not come forward anymore if they learn of the dismal payout rate the SEC is currently averaging.

Since the arrest of Bernie Madoff, Harry Markopolos has made his living by reporting frauds to the SEC under their whistleblower program. Since 2010, Markopolos and a team of accountants have reported nine insurance companies to the SEC and they still have not gotten paid for their work. When interviewed by *Barron's* in 2019, Harry Markopolos commented on the SEC's dismal payout rate: "I calculate that they have a backlog of 89.7 years… So I'm doing these cases for my great-grandchildren" (Alpert). The deplorable payout rate that the SEC is averaging per year is effectively discouraging whistleblowers from coming forward because the possibility of them receiving compensation is next to impossible. The Office of the Whistleblower was established to better protect whistleblowers and to encourage more tips to be made because tipsters will now be compensated for tipping on a variety of more crimes. However, the payout rate of the program is terrible and the process the SEC goes through in order to payout whistleblowers must be amended in order for this reform to be considered a success in the wake of Bernie Madoff's fraud.

How Not to Fall Victim to an Investment Fraud

Bernie Madoff was not the first person to steal investors's money and he will not be the last. Although Madoff's crimes proved to be severely devastating to the victims and families intertwined in the scheme, Madoff's Ponzi scheme is a perfect example to illustrate how blind trust, inadequate due diligence practices, and ignorance towards red flags can cause great financial turmoil for victims of frauds. The purpose of this thesis was to illustrate all of the components of Bernie Madoff's Ponzi scheme to show how earlier investors' mistakes can be a teaching opportunity to prevent other investors from falling victim to Ponzi schemes.

Blind trust is one of the major reasons as to why victims get sucked into frauds like Ponzi schemes. According to *Horne*, "[trust] is probably the biggest reason why owners and executives ignore red flags. They may see the red flags, but they cannot believe there is any possible way that the person they trust could be committing fraud" (Aucoin). As discussed before, Madoff built trust between himself and his investors by targeting people within the Jewish community through an affinity scheme. In addition, Madoff also swindled his own family and friends into investing with his firm. By relating to investors through his religious identity, Madoff secured hundreds of millions of dollars in investments into his fraud because these people trusted Madoff to make the right decisions with their money. *Forbes* claims that "trust is important when dealing with a financial advisor, but blind trust can be abused. A prudent verification process is essential" (Armstrong III). Investors should be responsible for individually verifying the legitimacy of the investment manager or firm they are investing with through a due diligence process to ensure that their money is being handled effectively and legally. Without this verification process, investors are more vulnerable to being manipulated by fraudsters and are more exposed to losing their investments.

Due diligence can take on many forms depending on what financial decision one is potentially partaking in, whether it is investing in a particular company on your own or investing with an investment manager. For the purposes of this thesis, I am focusing on the latter.

It is important to recognize that anyone can be a fraud victim, especially if they do not put in their due diligence. One way of conducting due diligence is to verify a firm's legitimacy by asking for an outside, third-party audit to be performed by an auditing firm of your choice. This takes control away from the investment manager or firm because an outside auditor ensures that legitimacy of the internal controls of the business (the controls that limit the possibility of frauds to occur) and will reveal if there are any suspicious errors in the firm's financial statements that could be linked to fraud. It should be noted that conducting an outside audit on an investment firm takes a significant amount of money and time to complete. I only recommend going to these lengths if you plan on investing a significant sum of money with an investment manager or firm.

Another way to conduct due diligence into an investment manager or firm is by performing a basic google search. Search the name of the manager and or firm and analyze what information comes up. Does the firm or manager have a good or bad reputation in the industry? How large is the firm? By simply searching the firm or manager, it can reveal basic information that can help you to determine whether or not investing with them is a good decision or not. Also look into which businesses and other firms your investment advisor is associated with. Are these other firms reputable or do they have a sketchy past? Will your investment manager funnel your money into a feeder fund or will they operate the trades themselves? Many victims involved in Bernie Madoff's Ponzi scheme did not know that their money was invested with him before it was too late because their investment managers failed to disclose that they were a part of a feeder fund. By asking these questions and researching them, it will give you more knowledge of the investment manager's business practices and will give you the ability to make a more informed decision about where your money is going.

In addition to googling the potential manager or firm, it is important to utilize free online tools provided by both the FINRA or the SEC to check if the manager or firm is licensed to broker and to see if they have any past or present disciplinary actions against them. BrokerCheck provided by the Financial Industry Regulatory Authority (FINRA) at https://brokercheck.finra.org/ is an excellent research tool to use because by inputting basic information like the investment manager's name, the name of the firm, and the zip code where the firm is located, it reveals whether or not they are licensed to broker investments. Obviously, if BrokerCheck reveals that the investment manager or firm is not licensed to broker, do not conduct business with them. Furthermore, if the investment manager's name appears on a disciplinary search on the SEC's Action Lookup page at https://www.sec.gov/litigations/sec-action-look-up, do not conduct business with them because this shows that the manager had trouble complying with regulations in the past. This is a sketchy situation so do not invest with them if this appears.

Additionally, it is also important to research which auditing firm conducts the investment firm's annual financial statement audits. *Forbes* states that "to avoid vulnerability to accounting fraud, investors should shoulder the responsibility and learn more about the auditors" (Scott). If

Madoff investors had researched into what auditing firm was conducting the massive audits on BLMIS, they would have found that a tiny, minimally staffed auditing firm from the New York suburbs was verifying extensive financial statements from one of the largest investment firms on Wall Street. This was a huge red flag that was missed by thousands of people because high profile investment firms typically seek audit work from larger, well-recognized firms. These larger audit firms have stringent quality control processes and internal compliance standards that they must comply with to ensure the audit is carried out properly. It is important to verify the auditing firm in charge of the investment firm's audits because it could reveal malpractice and fraudulent activity.

It is also important to check the status of individual auditor's CPA licenses. A CPA license is the basic certification accountants and auditor's need to earn in order to have the proper knowledge and expertise to perform their jobs. This can be verified at the state level using various, publicly available state government online tools such as CPA Verify at https://cpaverify.org/. If the firm's auditor is not a licensed CPA, this is a strong indicator that the investment firm's financial statements are not being handled correctly and may be misrepresented.

In relation to this idea, also research whether or not the firm's auditors have changed repeatedly throughout the years. The consistent audit firm changes could signal disagreements in accounting treatments towards the investment firm. This could be an indicator that the investment firm was attempting to manipulate financial statements and previous firms disagreed with it, and refused to be a part of it. If an investment firm is behaving fraudulently, they will keep searching for an auditing firm that will comply with their manipulative demands.

Another factor that played into investors blindly trusting Bernie Madoff with their life savings was because of Madoff's exemplary reputation in the securities industry. Bernie Madoff was one of the leading experts in this industry and owned a highly regarded firm on Wall Street. He had a hand in creating the modern day stock market scene in New York and has held many senior level positions in various organizations that govern the securities industry as noted previously. Many investors were swindled into Madoff's Ponzi scheme because they believed that since he has held numerous high-level positions at many organizations in this industry, then he must know what he is doing. This reputation is what shielded Madoff from questions regarding his business practices because everyone, including his investors, assumed that he must be operating his fund legally since he had a hand in creating the rules that govern this industry. It is crucial to not blindly trust an investment manager with your savings solely based on their reputation because that reputation may have been attained through illegal means like Madoff's was. A way to avoid falling victim in this situation is to perform proper due diligence to vet one's potential investment manager to affirm whether or not they will handle your investment in an appropriate way.

An additional factor that one should be wary of is if your potential investment manager is pressuring you to commit to a deal. Bernie Madoff did this constantly with his victims. Although most of his investors begged to be accepted into his "exclusive" fund and he did not go out and search for investors, Madoff played mind games to secure new investor money into his scheme after they initiated a conversation. As mentioned before, Madoff also offered take it or leave it deals that needed to be accepted on the spot which put high amounts of pressure on his investors. This was a smart move on Madoff's part because it prevented investors from conducting proper due diligence into him and his firm’s investment practices. If your potential investment manager is pushing that your future investment is an exclusive and or time-sensitive business arrangement, do not fall for it. It is perfectly acceptable to take time to think through this decision and perform due diligence to ensure that your money is going to be in the best possible hands in order to make a profit. If the investment manager pushes you to make a quick decision, it is alright to walk away. Do not be greedy and intimidated to impulsively make a decision like the majority of Bernie Madoff’s victims were.

It is also important to not be a “dumb” investor. Bernie Madoff preyed upon thousands of investors in which he deemed to be “dumb” because he managed to convince them to invest significant amounts of money with him with little to no information offered to them about how he would manage their money. Madoff exploited people who did not ask questions and fell for his exclusive fund and time-sensitive deal spiel. Some questions that are reasonable to ask when interviewing investment managers are: How does your investment strategy work? In which stocks do you regularly invest in? How will I know if my investment is making or losing money? Can I have regular contact with you regarding my investment? Can I have an outside audit performed on your firm? When determining which investment manager or firm one would trust their money with, it is important that the manager discloses in the exact manner in which they are investing your money. A major issue for victims in the Madoff case was that they did not ask questions about how his split-strike conversion strategy operated. If you cannot understand fully how your money is being handled, this is a red flag that should not be ignored when conducting due diligence. If the investment manager fails to answer these relevant and standard questions, that should be your warning to look somewhere else to invest.

Let's assume that you have invested your money with an investment manager that you deemed to be acceptable. Your investment manager tells you that you have received substantial returns for this month. On the surface, this seems like great news. Your job as an investor is to validate if these returns are consistent with what the rest of the market is experiencing at the same time. This can be accomplished by researching how the New York Stock Exchange, NASDAQ, Dow Jones, and other indexes have reacted in the stock market at the same time you received these returns. If these indexes reacted proportionally to what your investment return was then your returns were most likely achieved legally. However, if the indexes experienced negative returns during the same period in which you received positive returns, this is a huge red flag. The same is true if you receive consistently positive returns for months on end with very minimal negative months. It is critical to not be an idle investor and to validate if your returns match the rest to the stock market because if you consistently receive positive returns for months on end without losing money, that situation could be too good to be true. This situation is highly unlikely to occur because the stock market is highly volatile meaning that it fluctuates daily. If you have been given reports that your investment has been consistently making money while the rest of the stock market is struggling, it is a good idea to request evidence of your stock performing well. If you cannot independently verify this evidence then it is a very good idea to remove your money from this investment manager.

Furthermore, if your investment manager sends you statements that lack important information this is also a red flag. For example, if the name of the investment firm or specific information like account numbers or stock options quantities and names are not included in your investment statements this is a red flag. In addition, if simple spelling or mathematical errors are included in your statements it is most likely because they were fabricated.

One should be suspicious when your investment manager refuses to send you statements regarding the status of your investment. This is a massive red flag because as an investor, you have the right to know the status of your investment, where your money is currently and how it got to that point. Information that should be included on these trade statements include the stock names, dates of the transactions, and quantities of each stock that was bought or sold and the amounts of each stock. If you are being deprived of this information, it is advised to move on to a different investment manager who can disclose all available information to you. For more information about other Ponzi scheme red flags that should not be ignored, please see *Ponzi Scheme Red Flags*. As an investor, it is vital not to ignore red flags as they are exposed because that could be the difference between you losing your investment or rescuing your savings. If you experience any of these red flags, it is imperative to report them to the SEC. The previously mentioned improvements made by the SEC as a result of the Madoff case will improve the chances that your tip will be investigated.

It is also imperative not to assume proper due diligence was performed before one makes an investment. Madoff's exceptional professional reputation and immense power in the business world guarded his scheme and charmed junior SEC investigators from finding his fraud. Always research which investment firms are better and how they are being operated.

While these diligence activities can mitigate the possibility that you will fall victim to a Ponzi scheme, they do not entirely eliminate that possibility. Fraudsters always conjure new methods of defrauding others that may not be known by Certified Fraud Examiners or regulatory agencies like the SEC. However, if you do practice these safeguards mentioned above, it will give you a significantly better chance of recognizing the red flags of Ponzi schemes and investment frauds that are known by industry professionals at this point in time.

In conclusion, it is critical for you as an investor to do your due diligence. This is to ensure that your hard earned money is safe and secured away from fraudulent activity. Investors should not rely on the SEC or other regulatory agencies to catch all frauds, no matter their size and scope, as demonstrated in Madoff's tale.

Conclusion

> *"Madoff was the face of the catastrophic failure of the regulatory system, and the personification of the rot on Wall Street" (Armstrong III).*

The Bernie Madoff Ponzi scheme victimized thousands of people - 37,346 people to be exact (madoffvictimfund.com). Thousands of retired people, prominent Jewish organizations, philanthropists, various charities, celebrities, friends, and family had lost their hard-earned savings as well as their dignity, and in some cases, their lives to a manipulative fraudster. It was not just Bernie who failed in this case. The SEC failed multiple times over a nine year span to bring Madoff to justice even though they were served on a silver platter all of the warnings and mathematical proofs needed to investigate Madoff's firm from Harry Markopolos and his team. Bernie Madoff's investment fraud emphasized the SEC's ineptitude to effectively regulate the investment industry and further accentuated the organizational deficiencies the SEC did not fix to better investigate large frauds that span over multiple states.

Overall, I believe Bernie Madoff's actions were profoundly manipulative and evil. His lack of remorse for his crimes against thousands of investors including his own family is jaw-dropping. Madoff's infamous Ponzi scheme was the largest in history at roughly $20 billion dollars and to prevent a similar scheme from occurring, it is imperative to critically analyze all of the facts of Madoff's case to protect innocent people from becoming victims of fraud. The overall end goal of this project is to educate people who are not familiar with the red flags of Ponzi schemes in the hopes of preventing them from falling victim to an investment fraud in the future.

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