



This paper outlines the background of the Bernie Madoff fraud case, how accounting information was used, and how the fraud, or others like it may be prevented. At \$50 billion, it was probably the biggest theft in history, dwarfing the famous \$100 million dollar Harry Winston heist in Paris. It was detected in 5 minutes by Harry Markopolos in the year 2000 (after as many as 20 years of existence) and proven within a single day's accounting math,

yet it went undetected and unpublicized due to incompetence, lethargy and other factors at the Securities and Exchange Commission (SEC) and Wall Street Journal. To prevent it in the future we need regulatory reforms suggested by Markopolos and a fundamental change in society's values and attitude toward political and economic justice.



Background:

The Bernard Madoff case represents one of the worst cases of fraud, harming thousands of people financially, which has been going on for decades. Referred to as a \$50 Billion dollar Ponzi scheme (Katz, 2009), the details of this long term accounting fraud are still unfolding. The case comes at a time of economic downturn and has exacerbated an already negative attitude regarding public and investment community confidence in the economy, markets and regulation.

The CFO.com article mentioned above reviews the details of government officials grilling the Inspector General H. David Kotz from the Securities and Exchange Commission (SEC), the regulatory body charged with the mission of "protecting investors, facilitating capital formation and maintaining fair, orderly and efficient markets," as Kotz put it. The SEC did in fact fail to do their job, as the fraud went on for at least two decades, and it has only been detected because the cash flow due to the poor economy created a failure in the "cash in, cash out" scheme Madoff orchestrated which relied on constant growth of inflows from unsuspecting investors.

The bankruptcy and ensuing confession by Madoff to the fraud scam as "one big lie" in his words, on December 11th, 2008, led to his arrest for securities fraud that day (David Glovin, 2009). The "largest Ponzi scheme in history" according to Bloomberg.com went on

for at least 20 years, while his firm existed for at least 33 years, as the article states that his CFO, Frank DiPascali was with him for that duration. On 60 minutes Sunday night, they mentioned that the fraud had been going on for "20 to 30 years", during a feature where Steve Kroft interviewed fraud investigation professional who detected it and reported it repeatedly to the SEC and Wall Street Journal and others; Harry Markopolos, who was volunteering his time to expose it.

Three cases exist related to the Madoff fraud. He had an investment business and a brokerage operation. The investment business, Bernard L. Madoff Investment Securities, LLC, the company that committed the fraud, filed for bankruptcy. The Bankruptcy Court case is Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities LLC, 08-01789, U.S. Bankruptcy Court, Southern District of New York (Manhattan). He has an SEC violation case pending where he has agreed not to challenge their findings and penalties. He has not entered a formal plea in the criminal charges case being brought against him by the FBI.

The SEC failed to detect the fraud in the past despite evidence that fraud protection finance and accounting savvy professional Markopolos "did the math" to expose it and presented it to them repeatedly. In fact, the SEC actually investigated Madoff for fraud in a case opened in January of 2006, which didn't end until November of 2007, with a finding of no fraud. The failure obviates a lack of vigilance, productivity and accounting knowledge within the commission and is perhaps also an indicator of more insidious factors like potential payoffs, or just a trend of fear and/or respect for powerful "monied" people and organizations within society today. Markopolos gave testimony indicating as such, suggesting that the WSJ may have prevented a reporter from pursuing the story because they respected and feared Madoff. He went further to say that he feared for the safety of his family after the initial report led to no action. His *testimony* that the SEC was protecting financial predators from the investors, rather than the opposite, and that the Financial Institution Regulatory Authority (FINRA), a self regulating body was and is corrupt, also speak to the dire circumstances which served to subdue proper process to detect and correct the fraud. He explained that because Madoff was a "fund of funds" with low risk, in a down market it is better for his feeder funds to come to him for redemption of cash than to try to redeem their own more risky portfolios into cash. He had too many redemption requests and couldn't meet the requests of his feeder funds, and had to file bankruptcy.

Ponzi schemes are always affinity frauds, which means the fraudster preys on those in his own socio-economic or ethnic group. As Madoff is Jewish, many of his first victims were also Jewish. Driven to take in more and more cash to keep the scheme alive, he branched out

internationally and attracted money from all kinds of groups, perpetuating other "affinity referral chains, many of which were non-profit charitable organizations, and also royal families in Europe!

How Accounting Information Was Used:

Details of exactly how the scheme worked haven't been fully discovered nor explained yet. Madoff's firm managed to fool thousands of clients that they were invested in a money management vehicle which consistently reported that they were receiving approximately 12% returns or better on their money year after year (Applebaum, 2008). It is likely that very little if any trading actually went on, and money from new investors was used for paying gains to older investors.

When Madoff confessed that his firm was "one big lie", back in December 2008, he claimed that it was his own personal doing and that he was making trades for clients. However, authorities believe that he made no trades on his own in the past 10 or more years, and that he couldn't have possibly provided the information flow and customer service necessary to perpetuate the fraud without assistance from other staff people, particularly accountants. James Ratley, President of the Association of Certified Fraud Examiners expressed this sentiment in the Bloomberg article cited above. Sophisticated customer statements were provided to investors identifying holdings of treasury bills and blue chip stocks, like GE and Exxon, and "accountants had to be involved in order to make the internal documents consistent with those being sent to customers, at least on a superficial basis".

The investment strategies Madoff claimed he used were the basis for Markopolos's ability to identify the fraud "within 5 minutes". Markopolos deduced that Madoff's claims of investment returns had to be fraudulent because they were inconsistent with his strategies ("split strike conversion strategy").

It is reported that Madoff presented one set of numbers to investors, and a different set of numbers to the SEC.

Markopolos had a team of people he worked with to determine fraud at Madoff Investments through the use of accounting information. Nick Chelo analyzed data from various feeder funds and obtained financial statements for Greenwich/Fairfield Sentry (more on Greenwich/Fairfield Sentry below). Frank Casey analyzed marketing documents and feeder funds and calculated Madoff's cash position. He determined Madoff was in need of funds in 2005 and 2007 and calculated Madoff's estimated assets under management. Michael Ocrant made contributions with investigative work, actually meeting with Madoff himself. They obtained marketing documents related to a Broyhill All-Weather Fund, LP and quickly

realized that he couldn't be using the strategy he said he was because the split strike strategy couldn't possibly earn the kinds of returns he was reporting. His strategy was allegedly tied to the S&P 500 performance and yet he got it confused with the S&P 100 in his marketing, and even still, the math he did was unsophisticated and never made any sense. The returns were too much higher than they should have been to be credible to a person of Markopolos's investment savvy. The correlation between his performance and the S&P 500 stock index was only 6%. Markopolos would have assumed fraud from anything below a 30% correlation. Further, Madoff's marketing boasted of being down only 3 out of 87 months, whereas the S&P 500 index was down for 28 of those months. The performance curve for the 7 years was a straight rising 45 degree angle – too good to be true, and it should have been a fraud signal to all the feeder funds who promised their clients "due diligence" for their investments. He also analyzed OEX index options associated with the claim of a split strike strategy to find that there weren't enough in existence to support the volume extrapolated from Madoff's data.

In 2007, they noticed that Madoff got into a leveraged product which allowed investors to leverage their investment and borrow more money to invest – a sign that Madoff was getting short on cash, and this gave him a way to get even more cash into the Ponzi scheme, defrauding investors and now banks as well. In 2007, they also noticed that the Fairfield Greenwich Group (60 Minutes reported that the husband and wife owners of Fairfield Greenwich Group are now retired on a private tropical island), a feeder fund, had "stepped down" returns, showing only single digit returns, compared to double digit returns in earlier years, showing some signs of difficulty meeting the expectations of the investors. They did note that performance charts continued to show linear increases which defied any capital market return rate records in history, as there are always down cycles in capital markets, but somehow there never were in Madoff's marketing reports, despite claims of a strategy tied closely to the capital markets performance averages.

Greenwich Sentry was the largest of feeder funds and the financial statements had numerous red flags. They had three different auditors in three different years. Also, they had nothing but treasury bills on hand at year end to mark to market, so there were no trading positions to audit and no securities for auditors to inspect!

How the Fraud and others could have been or can be Prevented in the Future:

The fact that the Madoff fraud went on undetected by regulators after being spoon fed analysis by Markopolos as long as it did is hard to believe, in view of all we have learned about it so far. There were numerous "red flags" indicating that the financial community in

general had some knowledge of it, or at least avoided it (the largest and most well established firms like Goldman and others weren't participants). Markopolos's reports to the SEC began in 2000 and they were provided with information which today seems as though it would have easily exposed the fraud had they been paying attention and doing their job. In order to prevent this fraud, the SEC should have had more sophisticated analysts understand Markopolos's submissions and brought action against Madoff. The fact that there were no major wall street firms like Goldman Sachs and others involved, should have been a red flag they could have discovered, had they paid attention to the multiple allegations made by Markopoulos. The fact that the firm had an investment track record that was never negative, but always positive, is another piece of evidence that should have led them to engage Madoff in a more intense investigation to expose the fraud.

During the 60 minutes piece, it was mentioned that Markopolos originally suspected that Madoff was involved in insider trading, and he expected to earn a reward for exposing it. That may or may not have been his primary motive for coming forward, but perhaps if there were rewards for exposing any accounting fraud, in addition to insider trading, then there may have been motivation for others to come forward.

On February 4th, 2009 Markopolos testified before the house explaining that he alerted the SEC and the Wall Street Journal (WSJ) of the fraud three years ago. Not only if the SEC listened and paid attention, but also if the leading financial newspaper in the world listened to him, this may have been prevented at least for the past few years. Freedom of the press is a constitutional right, and the role of journalism in society is considered a deterrent against fraud and corruption by many. The WSJ may not consider this part of their role as a financial news source. He sent multiple emails to the editors begging them to look into the Madoff fraud and they did nothing. A reporter from the WSJ was anxious to pursue it, but WSJ management never allowed him to undertake the assignment, it appears.

I agree with Markopolos's recommendations for holding regulators accountable for their lack of effectiveness. He also observes that there are too many regulators with barriers to effectiveness created by the division between the FED and the SEC. Consolidation of regulation for control and jurisdiction is required to avoid people in banks dodging regulators from each side by jumping to the other for convenience (two business cards, one for investing, and the other for banking). I like the structure he outlined in his testimony where the regulatory bodies work together to avoid any gaps in enforcement or knowledge. I won't replicate his recommendations herein, as they are available in detail in his testimony. However, some recommendations worth mentioning herein are better education and certification for SEC staff people so they may be better equipped to ferret out the

weasels. And it's beyond belief that the SEC doesn't provide industry periodicals for their employees to read, like the Barron's and Mar Hedge articles from 2001 that included data that exposed the Madoff fraud!

Markopolos makes good points about staff qualifications. If they don't know derivatives math, portfolio construction math, arbitrage pricing theory, the Capital Asset Pricing Model, normal and non-normal statistics, financial statement analysis, balance sheet metrics, or performance presentation formulas, then they shouldn't be hired for anything other than clerical or administrative roles at the SEC. Comments about competitive compensation programs and lack of tolerance for unethical behavior within the boundaries of the law are other gems to garner from his thorough overview of the SEC with recommendations listed in his testimony.

One last idea he puts forth which may help prevent frauds like Madoff's in the future, is a reference to adopt something like the whistle-blower incentive program offered by the IRS, which seems to be working very well. The SEC or whatever body is left to regulate the capital markets should adopt a similar program.

There is a tolerance for injustice in society which has contributed to this kind of transgression going undetected and prosecuted for so long. Americans believe in incentive and competition and that this is a land of plenty and that the spoils go to the victors. The "greed is good" doctrine is viewed by many as a tenet of capitalism, and people are desensitized from questioning gross economic disparity. Perhaps there is also a vestige of imperialism and feudalism which contribute to tolerance of aggression, overt consumption, and the super rich. With the belief that resources are unlimited and that extreme wealth concentrations are normal and harbor no adverse affects on the world, I believe a majority of Americans aren't troubled by it. In fact, Americans appear to respect, coddle, and patronize those in positions of extreme wealth and power, believing that it's a patriotic and democratic phenomenon to have this class of people emerge from capitalism's competitive forces. This tendency to tolerate extreme financial success without question, and to be open to membership and friendship in hope of joining the elite upper class with some help from the "friends inside", can explain why so few went out of their way to expose Madoff's fraud. His success was probably respected and his "friendship" in a way, perhaps sought.

On the other hand, many Americans are born into a system controlled by ownership of capital, whereas they begin poor, and it becomes apparent quickly, that they will need the help and support of those with capital, in order to elevate themselves economically. They learn that making waves with those in power economically may impair their ability to earn a living. They also may learn that protest, or "whistle-blowing" to bring transgressions or

suspected fraudulent behavior into the public eye may be met with force or intimidation, when the subjects of such claims may be powerful financial firms or even the federal government. In this post-911 era which produced the Patriot Act and many constitutional challenges, like invasion of privacy and incarceration of suspected U.S. Government opposition, stories abound where citizens involved in special interest protest groups were raided and incarcerated in threatening and demeaning ways. Speaking truth to power becomes less attractive in this kind of atmosphere.

Had a new national conscience emerged in the past 5 or 10 years with a greater focus on intolerance of injustice and praise for high moral behavior, then this case may have been prevented from going on so long. High moral behavior in our country, led from the top down, went out of style with Jimmy Carter. However, in 2000 and 2004 Americans elected a President who had a history of dereliction from military service, evidence of past insider trading violations and economic policies which catered to the super rich on the principle that strengthening the super rich would benefit society as a whole through a theory known as "trickle down" (Begala, 2000). Allegations exist that the first election was rigged and the second one stolen. This is not an atmosphere where one can expect people to be pre-

disposed toward challenging apparent financial success and questioning ethics. Many believe it was a fraud that George W. Bush claimed to be qualified to lead the country and the concept got sold, or "ram-rodged" to the public. Percentage-wise, the largest financial contributions funding Bush's campaign originated from the leader of one of the worst frauds in our country's history (Ken Lay and Enron).



There were days when "robber-barons" motivated labor unions and anti-trust legislation because of their abuses of workers and competitors. Their behavior was anti-social in their fervor to accumulate wealth. That's why they were called "robber-barons". When those same robber barons contribute(d) portions of their wealth in later years to build libraries and other monuments to their immortality and egos, they gain(ed) favor in society and people say they are/were good. I don't think the families that missed their Dads at the dinner table because those Dads were working 12 hour days for mere subsistence pay or worse, to line the pockets of robber-barons, really cared much about a new educational wing at a university, for example, in later years, after the damage to their quality of life was already done. Bill Gates is a modern day robber-baron, having illegally harmed competitors, while proclaiming for years, that despite being the richest man in the world, "he had no time nor plans for charity". Now that he has whitewashed his reputation with charity, people seem to forgive the anti-social behavior he engaged in which ruined so many businesses

and lives. His first acts of charity involved tax breaks where he invested his money in an art collection and then "donated the collection" temporarily on a national tour. While some observed that he donated a large sum in recent years to fight disease overseas, others pointed out that he invested more than that in anti-competitive campaigning against open source software, software known for being written "by the people, for the people" on a largely voluntary basis.

Until the myth of unlimited growth and tolerance for gross economic injustice are re-fashioned in the belief system of American's, there is less hope for prevention of a case like Madoff's. Whistle blowing, self regulation, and even aggressive enforcement of regulations were all subdued in the atmosphere of the past couple decades, with robber barons glorified, and dishonest - appearing, super-rich families leading the country. The economic meltdown late in the last presidential campaign may have contributed to a positive change in society – a wakeup call and evidence that we cannot continue with the attitudes and atmosphere of arrogance and overconsumption by the few to the detriment of the many on a national or global basis.



The fact that a man of Barack Obama's modest economic stature and high moral reputation won the Presidential election in 2008, is probably evidence of an awakening, and harbors hope for a more just future ahead, where the excesses of people like Madoff may be prevented. This, along with some good forensic accounting by good people like Harry Markopolos and a more competent, educated, incentivized, accountable and aggressive regulatory agency can avert a similar disaster.

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