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Investing with Bernie Madoff: How it Happened, What Happened, and What Might be Done

National Affairs

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The SEC's failure to investigate and put an end to Madoff's crime, its announcing in 1992 that there was no problem with Madoff and its failure ever to correct that statement, its consequent sabotaging of thousands of investors with the literal impoverishing of countless numbers and the crippling of many charities, medical research organizations and injury to pension funds, must be one of the greatest regulatory failures in American history, if not *the* single greatest failure.

Time after time the SEC had the opportunity to act. Time after time it was warned. Time after time it did little or nothing. Time after time, in fact every single time, according to both witness testimony and Congressional statements at the hearing of January 5th, it did not subpoena Madoff's books and records or testimony, but instead merely accepted whatever he chose to voluntarily tell it and whatever records he chose to voluntarily give it. Had it *just once* demanded his books and records, had it *just once* demanded to see securities he claimed to be buying and selling, had it *just once* checked whether claimed trades of securities and purchases of puts had occurred, the game would have been over for Madoff. But instead of stopping his crime, the SEC allowed him to continue as a one-man wrecking-crew.

The SEC was, at minimum, willfully, horribly negligent. There are those, including at

least one member of Congress, who think it was complicitous.

As discussed previously, the SEC investigated the situation existing with regard to Bienes and Avellino in 1992, and said Madoff was doing nothing wrong. As indicated at the January 5th hearing, it must not have subpoenaed and inspected his books and records then; otherwise it couldn't have said there was nothing to indicate fraud. Later, Markopolos warned it both verbally and in writing in 1999 or early 2000. *But the SEC did little or nothing*, including not warning the public that serious red flags had been presented by a sophisticated, mathematically-expert analyst who worked with derivatives and had used the same investment system as Madoff. Then, when little known articles, the major one in a *highly* obscure professional publication unknown to the general public, appeared in 2001, after Markopolos' warning, *the SEC again failed to protect the public*.

The SEC received more complaints about Madoff in the years between 2001 and 2005, I understand, and one gathers it may have "sort of" looked at the Madoff situation in a truncated way. *But it did nothing to protect the public*. Then in 2005, Markopolos sent it the 2005 version of his memo.

Starting in 2005 or 2006, the SEC apparently did inspect Madoff, perhaps sparked by Markopolos' 2005 memo. It found some violations in his broker-dealer conduct, which have been passed off, rightly or wrongly, as technical and trivial. But it also found, *after at least 20 years and maybe after 45 years of his doing so, that he also had been running an unlawfully unregistered investment management business*. What did it do after finding out, *after decades*, that he was running an unregistered management advisory business? Did it make him stop running the business? Did it closely examine the business to find out whether a business that had been kept secret from it by Madoff for 20 or 45 years was on the up and up? No and no. *All it did was it merely required him to register*. *It did not conduct an examination of the investment manager business, nor did it subpoena the books and records*. I reiterate: *after two to 4½ decades of illegality, it merely required him to register.* It is little wonder that some think there *had* to be SEC complicity.

It is my understanding, at least I have read - and please correct me if I am mistaken - that the SEC is obligated to examine an investment manager when he first registers. If this is true, the SEC failed in this too, *and thus failed again to protect the public*, as it did so many other times.

You know, as I read over what I have written here, it seems desirable to quote the exact language used by Karen Scannell of the *Wall Street Journal* on January 5th. Speaking of the SEC's examination, she says:

> "In 2005, the New York staff began a broader examination, interviewing Mr. Madoff, his brother, two sons and a niece, all of whom worked at the firm. The SEC found that his investment-advisory business had 16 clients and managed $8 billion. Any firm that offers advice to more than 14 clients is required to register with the agency and undergo review.
>
> The [SEC] examination uncovered some technical trading violations.
>
> The SEC also found that Mr. Madoff *misled the agency in 2005 about the*

> *strategy he used for customer accounts, withheld information about the accounts and violated SEC rules by operating as an unregistered investment adviser*. "The staff found no evidence of fraud," according to the SEC case memo. Mr. Madoff agreed to register his business that September, *and the SEC didn't make its findings public*." (Emphases added.)

This is frankly staggering. The SEC interviewed Madoff, his brother, his son and his niece, and found that the investment advisory business had only 16 clients when he was running money for *thousands* of people? *Thousands.* And his relatives are supposed to be *innocent*? What did *they* tell the SEC?

And the SEC found Madoff had "*misled* the agency in 2005 about the *strategy* he used for customer accounts" and "*withheld information* about the accounts." (Emphases added.) What does this mean? It sounds to me like "misleading the agency ... about the strategy he used for customers' accounts" could very well mean, perhaps even probably means, that he falsely told it he was using the split-strike conversion strategy, as he told everyone else, but in reality was not doing so. (Or maybe the reverse of these facts, but either way he had lied.) He *lied* to the SEC about his strategy, yet "the SEC *didn't make its findings public*," so the customer would know, but instead left his thousands of customers to twist in the wind, to be left in the lurch, to be unable to "defend themselves" and to lose all their money a few years later when they lost even more than they would have then? Wow!

One wonders as well about complicity of a slightly different form. With the extensive revolving door between Wall Street and the SEC, a revolving door that goes from young lawyers to midlevel bureaucrats to commissioners, and with so many people on Wall Street knowing that Madoff was investing money for large numbers of people (and probably often knowing as well of the wide disbelief about Madoff on Wall Street), how is it that nobody at the SEC, who had been on Wall Street, thought to inquire whether Madoff was registered as an investment adviser?

So, as said, *the SEC was a 16 year (or maybe a 45 year) perfect storm of the most thorough, willful negligence, if not de jure or defacto complicity*. But it was not the only agency which failed the public. There is also FINRA, the Financial Industry Regulatory Authority and its predecessors.

FINRA's website says that its "overarching objectives" are "investor protection and market integrity." FINRA was formed in 2007, as a combination of two prior investor protection bodies, the regulation and enforcement branch of the New York Stock Exchange and the NASD, which had a regulatory function. Its president is Mary Schapiro, who was an SEC Commissioner from 1988-1994, was head of the NASD until 2007, became head of FINRA when it was created in 2007, and is now slated to become head of the SEC.

My understanding is that FINRA, unlike the SEC, is a private, self-regulatory organization, not a governmental organization, and that its members pretty much constitute the whole brokerage industry. That was the case with its predecessor organizations, I gather, and is the case with their successor, FINRA. If this is right, as I believe it is, it could be a crucial fact for reasons discussed below.

FINRA investigates broker dealers, as did its predecessors, the NASD and the regulatory arm of the NYSE. In 2007, FINRA investigated Madoff, as had the NASD before it, most lately in 2005. (Representative Kanjorski said at the January 5th hearing that FINRA, obviously meaning FINRA and one of its predecessors, had inspected Madoff's broker-dealer operation at least once every two years since 1989, and it has subsequently been confirmed that Madoff was inspected every two years since he started his business.) I also gather that FINRA found little wrong with Madoff in 2007, concluding only that he violated some technical rules and had not reported some transactions on a timely basis. It found nothing with regard to Madoff's Ponzi scheme. Let me again quote Karen Scannell of the *WSJ* on January 5th:

> "FINRA ... conclude[ed] in 2007 that it [Madoff] violated technical rules and failed to report certain transactions in a timely way.
>
> A predecessor to FINRA conducted its own review in 2005 and found no violations.
>
> FINRA's full-scale examination in 2007 indicated that parts of Mr. Madoff's firm had no customers. It doesn't provide an explanation for this finding."

So FINRA, for whom an "overarching objective" is 'investor protection," found nothing significant to be wrong, and said some part of his business had no customers when he had *thousands*? What part of his business supposedly had *no* customers? This is some kind of incredible hogwash. It is obvious that FINRA was as willfully, grossly negligent and incompetent as the SEC.

It is claimed on behalf of FINRA that it could not detect the fraud, the Ponzi scheme, because it has authority only over the broker-dealer side of Madoff's business, not the investment management scale. This excuse is hogwash, as a number of Congress members pointed out on January 5th. *Madoff was one single overall company,* even if it was organized in three parts, proprietary trading, broker-dealer and investment management. *If FINRA had so much as competently checked whether the <u>company</u> had the securities and money it claimed, it would have uncovered the fraud*.

That is the major point. Moreover, if FINRA could deal only with the broker-dealer part, how could it have known some other part had no clients? Or was it saying the broker-dealer part had no clients - that would be an amazing conclusion. If it was saying the proprietary trading part had no clients, well, the firm itself was the client and, anyway, why would FINRA have bothered to mention this if it regarded the proprietary trading part as being without clients, since the same would be true of *every* proprietary trading desk on Wall Street.

And did FINRA, like the SEC, think it was hunky dory to have a one man accounting shop as the auditor for a major broker-dealer? - for a broker-dealer claiming to FINRA and the SEC to have *17 billion dollars in assets*? Gawd!

The bottom line is that FINRA and the NASD before it - private regulatory organizations who were supposed to protect investors - fell down on the job just as badly as the SEC.

The amount stolen is currently impossible to know. When arrested, Madoff said $50

billion was lost. It is widely surmised that, in saying 50 billion, he was claiming the amounts shown on the latest monthly statements to investors, which were dated November 30, 2008. It's also possible that 50 billion is the total amount of principal actually invested over the years, not all of which was lost to investors because lots of them must have fully redeemed their investments over the 20 to 45 years or so of his Ponzi scheme. And recently, one reads, the government is estimating the loss at about 37 billion, but whether this is the amount shown on the latest statements or the amount actually invested is uncertain.

One thing all the estimates of loss have in common, though, is that they are all big numbers. Even when they are based on the most recent statements, it is clear that many, many billions of invested principal was lost. So where did the money go?

Just for kicks, assume that, over the years, 60 billion dollars of principal was invested with Madoff, that a third of it, or $20 billion, was redeemed, and that another third, or another $20 billion, was taken out by investors who thought they were getting income. What happened to the remaining $20 billion, to the earnings that this $20 billion were making when Madoff invested it, and to the earnings of the other, redeemed and withdrawn $40 billion while it remained with Madoff? You can change the assumed numbers I've used, but the question of what happened to the money will remain unless one supposes that every dollar of the enormous sums Madoff took in over the years, plus the money he earned investing those sums, was withdrawn over the years as a redemption of principal or as withdrawal of (falsely supposed?) earnings. And personally, I won't believe such a supposition until it is shown to be true; the sums are too large and my suspicion is that too many people put in huge sums and let the money ride rather than withdrawing it.

So, if I am right, where are the many billions that are liable to be left? Where did they go? Has Madoff stashed them in Swiss banks? Are they in real estate or stocks and bonds all over the world? Was Madoff the king of bad investors, so that he lost tens or scores of billions in the market over the years so that there truly is nothing left? Was this, as at least a few suspect, a Mafia operation in which billions upon billions were siphoned off by the mob? Who knows? All I can say is that one hopes the government finds out the answers and that until shown the contrary, it is hard to believe that every nickel Madoff took in and every nickel he made by investing was lost.

Indeed, it has been written that Madoff got into trouble this autumn because he was having difficulty coming up with enough money to meet a $7 billion dollar request for redemption by one of his feeder funds, Fairfield Sentry. Doesn't this seem to imply that he had several billions? - Was he really trying to raise fully *seven* billion in just a few weeks?

Now for the question of what can be done.

Before discussing specific courses of action, though, I want to make three preliminary but vital points. As you will see, the current law is seriously ill equipped to remedy this horrible situation. Such a disaster as a $50 billion dollar Ponzi scheme, that wiped out thousands, left old people destitute by the many hundreds or thousands, destroyed or injured charities, injured pension funds, and demolished confidence in the market, was simply never foreseen by the law and never prepared for in the law.

As well, many of the investors in Madoff were people who did exactly what is supposed to be done in a capitalist system. They worked like dogs all their lives, they saved up a million or two million dollars for their old age, and then invested it with someone whose eminent positions, leadership in the financial world, and decades of putative success made him seem eminently trustworthy; and they depended upon government - upon the SEC - to protect them against a fraud, particularly because their own ability to ferret out Madoff's scheme was very limited or nonexistent.

Protecting against fraud has been the SEC's duty to citizens, its *duty* to them, since its creation in the 1930s, and small people, as said, had no ability to ferret out Madoff's scheme on their own. These are not the billionaires, or the huge institutions, that could hire expensive experts in due diligence. Nor did they even know that such due diligence experts-for-hire existed. These are the plain people who worked hard and saved all their lives, as capitalism says they should, and who, as so many legislators and witnesses said at the hearing of January 5th, depended on their government to protect them. They had every right to do so, but were failed by their government, were horribly failed by it, because of one of the most willfully negligent, incompetent, and perhaps even complicitous courses of action in which any agency has ever engaged.

Finally, there is this. Several have indicated to me that there is a current of prejudice running through the position of those who say the government should do little or nothing to alleviate what Madoff did to people and that it is politically unpalatable to help the victims. The idea underlying these comments is that people think that those who suffered are just a bunch of rich Jews, so the hell with them. This is sheer anti-Semitism. It's also wrong on crucial facts. Yes, there were very wealthy Jews who lost fortunes, the kinds of people who, along with large institutions, the mainstream media has so extensively focused. But there were lots of small people in their 60s and 70s and 80s who now don't know how they are going to live.

There were people of every faith / non-faith. There were small charities that sponsored vital medical research that has and will benefit *billions* of people of *all* races and religions. There are pension plans for firemen. And the refusal, the claimed unpalatability, of helping the *victims* of Madoff contrasts badly, does it not, with the fact that huge banks, investment houses, huge insurance companies, and giant auto companies, each of which was itself worth scores or hundreds of billions of dollars, are *each receiving scores and even hundreds of billions of dollars in* bailout monies. They are receiving it although these companies and their executives, who make tens and scores of millions each year, were not victims of any fraud or illegality, much less criminal fraud or illegality that the government had a duty to stop. Instead, they made stupid, greedy decisions that ran the companies into the ground - decisions, moreover, perpetrated by the very executives whose multimillion dollar salaries will be saved by the bailouts, whose salaries of ten and twenty million dollars and more will be saved by the bailouts.

To Be Continued

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