# Financial Fraud. How It Works. The Truth behind the Madoff Investment Scandal

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ANDOVER, MA—The mass media is not telling the entire truth about the Bernie Madoff scandal and that is contributing to the suffering of the victims of the largest investment scandal in history. Massachusetts School of Law Dean Lawrence Velvel ought to know; he's one of them.

"Let me tell you the things you don't know," said Velvel, who has written extensively on the complex subject in books and blogs and hosted several television programs dealing with the Madoff affair. "The media isn't telling the whole story because they generally focus only on the very wealthy people who were taken in. But the vast majority of the victims are ordinary people, like you and me, and they are the ones who are now left twisting in the wind. It looks to us like the wealthy are being helped now while the average bloke who put in $500,000 or $750,000 and who needed to use the income in order to live is being hurt."

Velvel is actively involved in the appeal of a recent federal decision that denied recoveries to thousands of small investors.

> "Now every investor is at risk because you don't know until the whistle is blown that you've been investing in a Ponzi scheme. You think you've got some protection, but you don't. That's because they won't use your final statement (to determine a settlement). And your final statement is all you have these days now that you don't get securities anymore."

Velvel brought up the example of the Federal Depositors Insurance Corporation (FDIC), which is designed to protect bank deposits up to a six-figure amount and insure that people's hard-earned money and life savings don't go up in smoke.

"Imagine if you get a statement from your bank every month," he said. "It's got on it what you think you've got in your account, but then one day someone sends you a letter that says 'Sorry; the whole thing is worthless. It was a fraud!'".

That is what happened to those taken in by Madoff. As far back as 2000, Gretchen Morgenson, who writes the Market Watch column in the Sunday New York Times Money and Business section, published an article about the Securities Investor Protection Corporation (SIPC), which was created to be the first line of defense in the event a brokerage firm fails while owing investors cash and assets. Yet nobody did anything about the Madoff fraud despite the rumors all over Wall Street that Madoff's way of doing business just wasn't "kosher." Nobody that is, except for Harry Markopolos, who has subsequently written an expose. There was at least one other financial professional who believed the investors were

at risk.

“There was a fellow whom the SEC Inspector General said was a respected hedge fund manager, but his name was kept secret,” said Velvel. “He sent materials to the SEC in 2003, but he was ignored. Lots of other people on Wall Street knew that Madoff wasn’t kosher, including Goldman Sachs. But ordinary people, small investors, knew nothing of this.”

In Velvel’s opinion, some of the biggest financial concerns on Wall Street are also to blame.

“How is it that Chase Manhattan and JP Morgan did not know?” he wondered. “Chase and then JP Morgan Chase held Madoff’s account there, and he put all of the money into a single account. There was up to $17- to $20 billion in that account. They made a fortune off of him. Somehow or other, they never took into account that he wasn’t receiving or sending any money to brokers. Somehow, Chase and Morgan never noticed that money wasn’t coming into this huge account from stocks and other investments.  If he had been trading securities and trading options, he would have to have been sending money to brokers and they would have had to have been sending money to him. It is unbelievable.”

Velvel said that it is also difficult to understand why there was no external custodian in place for those accounts and the disgraced financier was allowed to act as his own custodian. He said that the big firms which sent business to Madoff, and in turn were making a fortune from feeding clients to him, received the de facto equivalent of bribes.

“All the SEC had to do was call the Depository Trust Company and ask how many shares Madoff had in any given corporation,” Velvel explained. “The SEC can do that. Ordinary investors cannot; the DTC won’t give them information.  As an investor, all you have is that last statement from the broker. But the day after the story finally broke, Madoff didn’t have anything there. The SEC did call finally, but only after the story broke.”

The majority of those who held a large position with Madoff only to become his victims are highly intelligent, well educated, and successful people. Yet they were caught in the greatest investment scam of the century, and arguably, of all time.

Velvel detailed how Madoff was able to get away with so much for so long. The now convicted felon employed the “split strike conversion” strategy of using options to insure against any losses and limit an investor’s downside as well as an upside. Even though there are funds, such as Gateway, which actually use that system successfully, it is a strategy that is not widely used in the financial world but is fairly well known nonetheless.

“In 1992, the Securities and Exchange Commission(SEC) did what it never does, and that was to make a public announcement that there was no fraud going on with Madoff. Had they not done that, many people, including me, would not have invested,” said Velvel. “They also are partly responsible for what happened.”

Madoff was getting away with defrauding his investors because, as the Dean explained by using a baseball analogy, he was swinging for singles.

> “This strategy was explained to me by none other than the sainted Frank DiPascali (Madoff’s now disgraced former chief financial officer),” he said with irony. “People question whether the returns were too good to be true, but they were actually conservative. Madoff’s returns were no more successful that

> those of Warren Buffet or Bill Miller, who beat the S&P returns for 11 or 12 straight years. Those of us who invested thought it was a conservative investment. It seemed like a very intelligent investment. It didn't seem inconceivable that Bernie Madoff was some kind of genius like Buffet and Miller who could do what he said. It was a plausible deal because they were going for singles and not swinging for the fences."

The other reason that Madoff and his strategy seemed conservative rather than greedy was investors were paying federal income taxes at the ordinary rate of 33 to 35 percent, not capital gains taxes that were around 15 to18 percent. Moreover, Madoff demanded absolute secrecy about his dealings and he got it.

"He was bribing all the hedge fund managers," said Velvel. "They were getting a four percent commission every year on all of the money they brought in. They also took 20 percent of the profits, and there were no years when there were no profits. People say now that we should have done more due diligence. We didn't have the power to see his books and he wasn't going to answer any questions from anyone. We depended on the professionals and the SEC, and they sold investors down the river."

Madoff also used the age-old tactic of "affinity investment" successfully. Because he was Jewish, he insinuated himself with the Jewish communities of New York, Boston, Florida, Minneapolis, and Los Angeles. People felt comfortable giving their money to him. That is not to say that suspicions were not raised along the way in the minds of wealthy institutions and investors who could afford to use financial professionals to perform "due diligence."

"There were red flags," Said Velvel. "Some of the rich — like Wall Street movers, wealthy Arabs and huge domestic and foreign banks — concluded that there were not enough options in the world to float Madoff's strategy. If he were buying and selling, they couldn't see the slight movements in the markets that you would have expected. Madoff was not even buying securities. On the days that Madoff said he was making huge trades, there was no movement in the market." But those who suspected fraud did not blow the whistle to the SEC, with only very few exceptions — whom the SEC ignored.

Velvel said that although the SEC investigated Madoff on five occasions, the agency never once tried to find out if enough options had been available to be traded. That would have exposed the Ponzi scheme immediately.

He's just as bad as Allen Stanford," the Dean said. "Stanford stole $7 billion or $8 billion in another Ponzi scheme from 1997 onward and he was never investigated either, although he was crooked too."

Velvel said that the only reason Madoff's scheme collapsed was that the world financial markets went into deep decline in 1997-98 and people needed to get their money back from Madoff. Velvel explained that of the $17 billion that had been in Madoff's account, only about $170 million remained by December 11, 2008.

After Madoff's thievery was exposed, he eventually struck a plea bargain and was sentenced to 150 years in a federal prison.

"This is what's happened since it all collapsed," said Velvel, who is part of some groups trying to obtain restitutionary legislation to help the victims. "I think it was a tremendous mistake to accept his guilty plea. I filed a paper asking the judge (Denny Chin) not to accept

the guilty plea. The plea permitted the government and Madoff to keep everything hidden. It would all have come out in a trial and that would have been helpful for the victims to obtain restitution. But there was a public outcry to put Madoff in jail and throw away the key. A lot of things remain unexplained and I think the acceptance of the guilty plea is a major problem."

Velvel then took aim at SIPC for not helping the smaller investors who have been so gravely damaged. "SIPC is ignoring Congressional intent in order to protect its own funds and the jobs of its managers, whom I correctly said were making $400,000 to $700,000 even a few years ago," he said. "SIPC will not provide the information needed to know what kinds or classes of people are being hurt by what it is doing or what kinds of classes of people are being helped."

Velvel said that in the Madoff case SIPC, which was designed to protect victims, changed the methodology of how people get paid if their broker went bankrupt. It said that, if an investor took out more money than he or she had put in, because his statements showed he had far more in his account, that investor would receive no restitution even if the final statement recorded that his or her account was worth millions of dollars more than she put in.

"They changed the way they were calculating what people were owed," he said. "So now so many victims will get nothing. The investors were portrayed as rich, greedy New Yorkers, which was a synonym for Jews. The truth is that the vast majority of the victims are ordinary people just like you and me. Many are in their seventies and eighties and were taking the money out of their accounts to live on. They had planned their retirements around this and had no other monies. There are people who are now contemplating suicide. I know of a 92-year-old man who has been forced to find work in a grocery store wearing a sandwich board advertising specials. That is the real tragedy of Madoff. What SIPC is doing is a serious threat to everyone in this country who invests with brokers."

Velvel charged that the judge in this case does not appear impartial, since he has been particularly receptive to the position of Irving Picard, the trustee presiding over the liquidation of Madoff's investment firm.

"The judge did everything the trustee wanted and nothing the other side wanted," he said. "So the die was cast the day he was appointed to the case because he was so one-sided that it just staggers the imagination. He ignored Congressional intent and he refused all discovery that would have revealed SIPC's machinations."

In discussing the complicated case, which is currently on appeal, the Dean later added in conversation and in a brief that the judge had cribbed wholesale what the trustee wrote in his argument.

"He put it right there in his opinion that I'm going to take the alleged facts from Picard's papers," exclaimed Velvel. "He said I'm going to take it from him, and from the allocutions of Madoff and DiPascali, who are two of the world's most notorious liars. Their allocutions have been subject to claims that they were not entirely true. The judge accepted everything the trustee said and nothing the plaintiffs said."

What many people are unaware of is that even indirect investors have been hurt by Madoff. They are the ones who unwittingly invested their money through hedge funds, mutual funds, banks, and other vehicles. Velvel noted that covers a lot of people and they will get nothing

back.

Then there is the matter of the Internal Revenue Service (IRS) and all of the tax revenue it collected from the victims. “There are possibilities for theft deductions and for refunds on taxes paid on phony income,” said the Dean. “The treasury is fighting against much of this. The biggest beneficiary of Madoff is the United States Treasury. It took in between $15- to $20 billion in taxes on profits that were never made. It doesn’t want to give back the money. The IRS developed a safe harbor protection for theft refunds. But it’s worded in such a way that you would have to give up all of your rights if you take it. Moreover, it excludes the indirect investors. The people with IRAs are excluded and that is just awful.

> “The IRS never had any right to that money. The 16th Amendment to the Constitution only gives it the right to tax income. This was not income. It was phony, non-existing profits. And it is very arguably unconstitutional for the IRS to keep the tax paid on phony income.”

Velvel went on to say that the U.S. Congress is now looking at net equity as a result of the Madoff scandal. “I think that Barney Frank can have a great deal to say on everything other than taxes,” said Velvel.

One thing that is certain is that the matter will not be settled for some time to come. Hundreds of lawsuits have already been filed and it is expected that there will be a multitude more against entities from the SEC to JP Morgan, Chase Manhattan, the feeder funds, and many others. Meanwhile, the victims continue to suffer.

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