Inside Story of a Financial Scam

Investing With Bernie Madoff: How It Happened,

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What *Happened, And What Might Be Done. Part II.*

Over the years since 1995, Madoff, as often said in the media these days, made steady annual returns — on which one paid ordinary income taxes, not capital gains taxes. The rates of return were unspectacular, especially when compared with the returns made by many hedge funds and, during many years, by mutual funds. But on an annual basis Madoff didn't lose money, which was a major plus. The idea that he made money every month, however, is misleading. There certainly *were* some months when he lost money, and there were months when he made very little if anything, say a quarter or a half a percent. There were also months when he made, say, a percent and a half or two percent, or sometimes even a bit more. The monthly variations made the whole deal look Kosher, at least to an amateur, as did the variations in annual returns. On the all important after- tax basis, the annual returns were generally between seven and ten percent. They therefore were probably not much more than, and *often were certainly much less than*, the annual returns obtained by investors who bought stocks or mutual funds in order to make capital gains. For capital gains are taxed at much lower rates than the more-than-one third rate applicable to ordinary income, plus principal invested in stocks and mutual funds appreciates tax free — so one gets appreciation upon appreciation, as well as on original, tax free appreciation of principal — until the investment is cashed in, in layman's language. (One also can't help remembering that hedge fund managers who were making hundreds of millions or billions per year — one recently made $1.7 billion in a single year — paid a tax rate of only 15% on their earnings.)

Also, every month every investor received a lengthy statement of transactions from Madoff. While I personally lacked the training to fully understand them due to their complexity, accountants did understand them. To the accountants, who of course had the required financial training, they made sense. The idea that someone could be making up complex statements of this nature — and so many of them yet, if the thousands of clients he is recently said to have had is accurate — boggles the mind even today and didn't even enter the mind then. I personally never heard a whisper of the remotest suspicion of such invention, and can only say it must have taken a corps of aiders and abettors. The news reports say that something like 20 people worked in Madoff's "private" office on a separate floor, the 17th, to which no one else in the firm was allowed access apparently. Many of these people must have been involved in making up the false statements and therefore must be coconspirators even though Madoff supposedly claimed to be doing it himself. (Were his brothers, his two sons, and his niece, all of whom were major figures in his firm, also denied access to the private offices? If they were, didn't they consider it odd that they, his nuclear family members, with whom he worked closely in the business for years, and to whom he apparently was very close on the personal level, were denied access to the offices? Didn't it raise their suspicions, even if one assumes, as I frankly don't, that they were innocent of any knowledge of what he was doing?)

So it went for many years. If one wanted to occasionally withdraw money to meet unusual or other expenses, one always dealt with DiPascali (or his assistant) and the check would arrive promptly. If one wanted to invest more money, one again dealt with DiPascali. This was the way it was until December 11, 2008, when Madoff was arrested. Then a lot of information began coming out that must have been deeply unknown to most investors, including me. The information included the shocking fact that the whistle had been blown on Madoff at least as far back as 1999 or 2000, when an investment professional named Harry Markopolos, who had operated with derivatives, had sometimes used the split-strike conversion strategy, and was mathematically expert, had informed the SEC, both orally and in a memo, of reasons why Madoff's business could not possibly be on the up and up. Markopolos kept at this until, most recently, 2008, one gathers. As one can see from the long-confidential but now public 2005 version of his memorandum, with the arresting title (no pun intended) "The World's Biggest Hedge Fund Is A Fraud," Markopolos gave reason after reason why Madoff's operation could not possibly be on the up and up. (The 2005 version of the memo will soon be made available at Velvelonnationalaffairs.com.) Many of Markopolos' reasons were completely comprehensible even to a layman, let alone to financial and regulatory experts. But, as so often during Markopolos' eight or nine years of trying to get the SEC to act, it did not stop Madoff in 1999 or early 2000, from 2001-2004, in 2005, in 2006 or 2007, in early 2008, or at anytime until December 11th.

Equally amazing was that an article blowing the whistle on Madoff had been written in 2001 for a hedge fund-industry publication called *MAR/Hedge (RIP)* by a reporter named Michael Ocrant. This journal was something read by those connected with the financial industry, doubtlessly including at least some regulators, but obviously is not something read by the general public. (I personally, like 99.999 percent of the American population I would bet, did not even know it existed.) The article gave many of the most pertinent, comprehensible reasons given by Markopolos, but the readers of *MAR/Hedge (RIP)* apparently did nothing. Certainly the SEC did nothing.

Also in 2001, a shorter article appeared on Madoff by reporter Erin Arvedlund. The article, which focused on secrecy by Madoff, and ignored some of the signs that even a layman would understand, appeared in *Barron's*. That article was mixed in nature, with much that was favorable to Madoff, and even advised readers how to invest in Madoff if they wished to. In any event, though *Barron's* must be read by a larger audience than *MAR/Hedge* (RIP), this article received no general play from the media (and I personally never heard of it until after December 11th, just as I and most others had never heard of Markopolos or Ocrant). And again the SEC did nothing to stop Madoff. (The Ocrant and Arvedlund articles will also be made available shortly at Velvelonnationalaffairs.com.)

After December 11th, however, the media began covering Madoff's scheme, including the red flags called to the attention of the SEC by Markopolos, several of which were also mentioned by Ocrant and a few of which were mentioned by Arvedlund. I shall focus now on the red flags that would clearly have been of crucial importance even to a layman, had he known of them.

A foremost red flag was that Madoff apparently was not even making the trades of securities shown on the monthly statements. When already suspicious financial experts checked trades shown on Madoff's statements against actual trades all over the country on the given day(s) — which experts knew could be done and knew how to do — they could find no record of Madoff's supposed trades. *The trades shown on the monthly statements were fictitious*, a fact which still seems unbelievable a month after the scandal broke. *Experts* who checked this *got out of Madoff*. Wouldn't you get out if you learned that trades shown on your monthly statement were (amazingly enough) fictitious, had not been made, were purely inventions? *The expert SEC apparently checked out none of this*, *however, so the average investor was again left completely in the dark*.

Another red flag discussed by Markopolos was that the options market was not nearly big enough to support the number of puts and calls necessary for the volume of trading in stocks that Madoff claimed to be doing. Madoff had apparently denied this, when asked about it in the past, by claiming he was buying options on the over the counter markets, where they are not totaled. But experts (like Markopolos) said Madoff's explanation could not be true because the whole options market, on the exchanges, over the counter, or wherever, was not big enough to support Madoff's trading in securities. By a huge multiple, there simply weren't enough people who were willing to put enough money at risk in puts and calls to support Madoff's trades in stocks. This meant that Madoff could not be providing the downside protection, via puts, that was key to the deal, and should have been checked out immediately by the SEC. *The SEC apparently did not check it out, however*, *and the average investor was once again left in the dark*.

There was also the growth in the amount of money Madoff was managing. Lots of us were under the impression, fostered in the 1990s, that Madoff was investing for family and friends. We knew nothing of huge feeder funds, of recruitment of investors all over the United States , Europe and South America , or of the fact that he apparently was running 6 to 7 billion dollars by around the year 2000 and tens of billions apparently by 2008. This was all news to me after the scandal struck.

Had people known it, what would they have done? Would they have considered it a mark of how good he was and stayed invested? Would they have gotten worried, and maybe even gotten out, because this was so different from what they previously had always thought the situation was? — Some believe (like I often do) that when things get too big, disaster often, even usually, occurs. Well, it's impossible to know now what people would have done had they learned the truth about the amount of money Madoff was running and what he was doing to get it. But one thing I do know: the *SEC never saw fit to find out and to tell investors the truth.*

There also was Madoff's secrecy. Hedge funds who invested with him, for example, were not allowed to mention his name in their marketing materials. Yet as Markopolos said, if you ran the world's most successful investment operation, wouldn't you want that fact bruited far and wide in order to increase your business? The reason for Madoff's secrecy says Markopolos, was so that the SEC wouldn't learn what he was doing. And to further maintain secrecy, when huge investors were thinking of putting in money, but wanted to examine Madoff's books in order to do due diligence, which they of course could afford, Madoff would not allow the examination, claiming a desire not to have proprietary strategies disclosed to any one else. (Well, it looks now like he had good reason for nondisclosure, but it wasn't to keep proprietary strategies secret.)

There is also the question of leverage (which was not discussed by Markopolos). I have now read a couple of times that Madoff was using leverage of three to one, which means that for every four dollars invested, three came from loans. The use of leverage is very dangerous because, if the market goes down, with three to one leverage your equity (which is one-fourth the investment) is wiped out if the market drops 25 percent. That Madoff was using leverage was news to me, and I'm not sure the articles which said he was doing so were correct. If they *were* correct, I suppose that the puts (if one assumes he *was* buying puts) would guard against a 25 percent loss by confining a loss to a point far less than that. Nonetheless, the use of leverage was very dangerous, and leverage certainly was *not* the deal people like me signed up for.

This brings up a related point. Madoff said he was hedging by buying puts. Yet, Markopolos says, he did not sell his arrangement as a hedge fund, and one never thought of him as a hedge fund. For hedge funds, it is constantly said in the media, use extensive leverage since this creates the opportunity for huge gains. At leverage of 3 to 1, for example, if the price of the share doubles from, say, 100 to 200, the equity share is now 125, or five times the initial 25 percent invested to buy at 100. (I have recently read that some funds were using leverage of up to 40 to 1, which is frankly not believable because, at 40 to 1, a 2.5 percent loss in the price of a share wipes out one's equity.) Also, hedge funds invest in fancy, complex, incomprehensible derivatives, which always seemed to some of us (I think Warren Buffet for one) a disaster waiting to happen. Since one didn't know Madoff was using leverage *if* he in fact was, nor that he could conceivably be involved with fancy derivatives, one simply didn't think of him as a (potentially dangerous) hedge *fund* even though he was hedg*ing* against losses by (supposedly) buying puts.

Then there were other things, many again mentioned by Markopolos, which were red flags but again the average investor knew nothing of them. There was the now infamous fact that his auditor was a tiny three person shop – – and apparently only one of the three was an active accountant. A major Wall Street firm that is not audited by one of what was the big 8, and is now the big 4, or some similar large firm? How could this *not* have been a major warning sign to the SEC? And where did this small shop come from anyway? How did it get it involved with Madoff — Markopolos claims the accountant was Madoff's brother-in law, and another person at least has claimed the accounting firm was originally Madoff's father-in law's and Bienes and Avellino had once worked for it). And, if it got involved when Madoff started, how did it remain his accountant when he grew into a major firm? A very red flag about which thousands of people were completely unaware. *The SEC, however, should have been all over this one like a blanket. I wonder: can the SEC point to any other major Wall Street firm with a rinky dink shop as auditor*?

There was also the fact that Madoff's own firm handled his trades and the back office administration and kept custody of the securities. I gather this is the way most hedge funds work, but it is *not* the preferred method in the financial industry. The preferred method is to have independent firms do these things, in order to make sure that the claimed securities and money exist. *That Madoff's arrangement lacked this safeguard should have been yet another red flag for the SEC*.

Also peculiar in the extreme is the asserted fact that Madoff's family, as was everyone but those who worked on the 17th floor, apparently was barred from the floor where the chicanery went on. If this was true, didn't his family think it was peculiar that they, who were close to their father, brother, uncle, were barred? And if they weren't barred, and ever went down there, didn't they ever see anything or ask anybody about what was going on?

Curiously, Madoff would sometimes claim that his trades were handled in Europe by counterparties (whatever that means), but would tell other people he was making big money on commissions obtained because his firm was handling the trades. If the counterparties were other than his UK office, didn't his family members ever notice the discrepancy, and didn't they ever wonder why they were being denied the vast financial benefits that would have occurred if his New York office was handling the trades? Yet they never inquired about any of this?

Given the close relationships involved, it is extremely difficult to believe that none of his family members ever had the slightest inkling that something untoward was happening. And his family, of course, also had close professional and personal relationships with the SEC. His niece, an official of the business, even married an SEC official who had worked on the agency's minimalistic investigations of Madoff. The family's relationships with the SEC are, I gather, to be one subject of an investigation being conducted by the SEC's inspector general.

There were, of course, people on Wall Street who suspected, as did Markopolos, that the Madoff deal was not on the up and up. Suspicions were so strong that their companies refused to do any business with Madoff. I believe Goldman Sachs and J.P. Morgan were two of them. In his 2005 memo to the SEC, Markopolos gave the SEC the names of four highly placed Wall Street executives it should speak with — one being at Goldman and a second at Citigroup — because these executives were *convinced, based on their expertise in and experience with derivatives,* that Madoff's returns could not be for real.

There were large institutions, and major-league-rich investors, including Arab investors, which hired due diligence firms to investigate whether the institutions or investors should invest with Madoff, and the due diligence firms, after looking into the situation, cautioned against investing with him because of red flags like some of those mentioned by Markopolos. There were fund managers, whom Markopolos talked with, who had money in Madoff but did not themselves believe that Madoff could make money month in and month out, and thought that he was subsidizing losses in bad months. Translation: they didn't believe him, but left their funds' money with him anyway because he was doing well by them overall. So all these experts and big league money managers thought Madoff was fraudulent but never spoke with the SEC, and thousands of people who invested with Madoff knew nothing of their views.*

TO BE CONTINUED.

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