Case Study

Bernie Madoff's Ponzi Scheme: Reliable Returns from a Trustworthy Financial Adviser

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A [person] is incapable of comprehending any argument that interferes with his revenue.

Rene Descartes

Overview

This case study is a chronology of the largest Ponzi scheme in history. Bernie Madoff began his brokerage firm in 1960 and grew it into one of the largest on Wall Street. While doing so, he began investing money as a favor to family and friends, though he was not licensed to do so. Over a period of fifty years, these side investments became an investment fund that mushroomed into a $50 billion Ponzi scheme. Bernie[1] pled guilty without a trial on March 12, 2009, and was sentenced to 150 years in prison. Thousands of wealthy clients, philanthropic organizations, and middle-class people whose pension funds found their way into Bernie's investment fund lost their life savings.

What to Do?

Bernie Madoff, at age 69, owned three very successful financial companies—a brokerage firm, a proprietary trading firm, and an investment advisory firm. On December 10, 2008, the brokerage and proprietary trading firms, managed by his brother and two sons, were performing as well as could be expected in the middle of a deep recession. His investment advisory firm, however, was on the verge of collapse. Investors in Bernie's investment fund had requested $7 billion in withdrawals, and he did not have the cash to pay them. Known only to Bernie and a close circle of loyal employees, the investment fund was a $50 billion Ponzi scheme in operation for at least twenty years.

Bernie met with his sons—Mark, age 44, and Andrew, age 42—in his office to discuss his contentious plan to issue annual employee bonuses in December rather than in February, as was typical. Bernie insisted they be chauffeured with him 12 blocks to his $7.4 million penthouse apartment to discuss the matter in greater privacy. Shortly after arrival, Bernie broke down and confessed, "I'm finished. I have absolutely nothing. [The investment fund is] all just one big lie."[2] The Ponzi scheme consisted of tens of thousands of falsified balance sheets and client statements.

The brothers were shocked. They admired their father and looked forward to inheriting the company. They, along with other family members and close friends, were heavily invested in the fund. Now they were all broke, and their father would have to spend the rest of his life in jail. Andrew collapsed in tears. Their mother, Ruth, hovered nearby.

Bernie made one request of his sons. He asked them to remain quiet about the Ponzi scheme for one week, allowing him time to distribute what little money remained left into investment accounts held by family, friends, and a few special clients. Then he would turn himself in to the Securities and Exchange Commission (SEC) and FBI. After forty-five minutes of screaming and heartache, the sons left the apartment. Should Mark and Andrew grant their obviously distraught father the one week he requested, or should they immediately notify government officials about their father's criminal activities?

Becoming a Stockbroker

Bernie Madoff was born on April 29, 1938, the second child of Ralph and Sylvia Madoff.[3] Ralph and Sylvia, married at the nadir of the Great Depression in 1932, were children of eastern European immigrants who had fled the anti-Semitism—persecution and murder of people who are Jewish—in their homeland. The family lived in a small lower eastside Manhattan apartment. Following the birth of Peter, their third child, in 1946, Bernie's parents bought a small home in the Laurelton section of Queens. Laurelton was a predominantly working-class Jewish community near what is now Kennedy Airport.

Ralph worked, mostly off-the-books, as a plumber. The IRS found out, ordered him and two partners to pay $13,000 in back taxes (equivalent to $103,000 in 2010 dollars),[4] and placed a lien on his home. In the late 1950s, desperate for money, Ralph and Sylvia, a homemaker, opened Gibraltar Securities. The business was registered in Sylvia's name to protect its assets from the IRS. Sylvia obtained a stockbroker license, but not an investment adviser license. Ralph had neither license.

A stockbroker and an investment adviser differ according to the type of obligations they have to clients. An investment adviser has a fiduciary duty to *always act in the client's best interest*. A stockbroker, on the other hand, is a salesman who brokers a deal between buyers and sellers. A stockbroker must provide the client "*suitable advice*," which may not necessarily be the best advice.[5]

In 1959, while majoring in political science at nearby Hofstra College, Bernie made a series of decisions that shaped the rest of his life. First, he decided that he, too, wanted to become rich working as a stockbroker. Second, he married Ruth, his high school sweetheart, and they moved into an inexpensive one-bedroom apartment in Bayside, Queens. Third, two days after the wedding ceremony, he registered Bernard L. Madoff Investment Securities as a brokerage firm with $200 of assets and no liabilities. Bernie had $5,000 in working capital, money he saved from summer jobs as a lifeguard and installing lawn sprinkler systems. Ruth agreed to do the bookkeeping.[6]

Growing the Business through Some Illegal Trading on the Side

In 1960, who would trust a 22-year-old political science major trading stocks out of his apartment? Initially, hardly anyone. Ruth's father, Saul Alpern, helped Bernie establish some legitimacy by giving him office space in his mid-town Manhattan accounting firm.

A publicly traded company listed on the New York Stock Exchange (NYSE) and American Stock Exchange (AMEX), had to meet certain size requirements and pay substantial fees. Bernie focused on trading "over-the-counter" penny stocks, valued at less than $1.00, that were traded outside the NYSE or AMEX. An investor would telephone Bernie wanting to buy or sell penny stock. Bernie would then contact other investors or stockbrokers to make the trade at the best price for Bernie's client.

In a short time, Bernie got several big breaks. Alpern, impressed by his son-in-law's work ethic, loaned him $50,000 ($364,000 in 2010 dollars) to invest. Then, a mutual acquaintance introduced Bernie to Carl Shapiro, the very successful owner of a Boston women's apparel company. Shapiro, worth more than $22 million ($3.0 billion in 2010 dollars) at age 45, was intrigued by Bernie's ability to complete trades in three days; most stockbrokers took three weeks.[7] Shapiro gave him $100,000 to invest on his behalf. Bernie used the money he made trading for Alpern and Shapiro to subsidize his penny stock brokerage firm.[8]

Bernie earned substantial fees by investing Alpern and Shapiro's funds, and sought to increase business by offering to pay his father-in-law for each new client he recruited. Alpern told family members, business friends, accounting clients, and acquaintances he met during summer vacations in the Catskills, that Bernie could get them an 18 percent return on their investment. At the time, the SEC had a rule that exempted investment advisers with less than 15 clients from being licensed. Bernie exceeded this limit and was required to obtain a license; this meant passing an examination, paying fees, and filing statements with the SEC. Instead, Bernie joined the ranks of illegal unlicensed investment advisors—including his parents—who escaped the scrutiny of the SEC and state securities regulators.

By 1962, after only two years of operation, Bernie was overwhelmed by the paperwork required for managing his growing number of small investments. Bernie told his father-in-law to do him a favor by collecting money from various investors and then give the total amount to Bernie as one account to invest.[9] This also made it appear to the SEC as though he had fewer clients. Soon, Alpern's accounting business unofficially merged with Bernie's investment business. Alpern assigned Jerry Horowitz, one of his accountants, as Bernie's personal accountant. This allowed Ruth to reduce her company involvement to writing checks and managing her husband's work expenses. Frank Avellino, another Alpern accountant, not only invested with Bernie for a guaranteed 20 percent return rate, but also earned a commission for recruiting other clients. Both Alpern and Avellino were, like Bernie, unlicensed investment advisers.

In 1963, Bernie focused on growing his brokerage clients. That year, the SEC investigated 48 brokerage firms, including Bernie's mother's Gibraltar Securities business, for not filing financial reports. His mother, though not fined, lost her business license and was banned from the securities industry.[10] Nonetheless, Bernie's father continued to earn money as an investment adviser.

As for Bernie, he could have obtained an investment advisory license then to avoid what happened to his mother. But if he did, the SEC or other securities regulators might audit his financial books and discover that Bernie also had been violating SEC licensing laws. He feared that, just like his mother, this could result in being banned forever from the securities industry.

More Growth and Illegalities

Businesses borrow money from banks to pay for expansion. Bernie didn't have to do this because he had a bank account with money flowing in and out from his illegal investment advisory business. He used some of this money, without his client's permission, to avoid interest payments. Bernie moved money between his Bank of New York brokerage bank account and his Chase investment adviser bank account as needed. Whenever he fell short of the guaranteed 20 percent investment advisory returns, he made up the difference by taking money out of his brokerage bank account. If he needed income to grow the brokerage firm, he took money from the investment advisory bank account.[11]

Bernie got another big break when his father-in-law hired Michael Bienes as an accountant in 1968. Bienes' brother-in-law was Jeffrey Picower, a wealthy Wall Street investor.[12] Bienes earned hundreds of thousands of dollars in commissions from money Picower invested with Bernie over the next forty years.

How did Bernie explain his remarkable results to sophisticated investors like Picower? Bernie now sold blue-chip stocks and claimed he invested client money using a complicated three-part "split strike conversion" investment strategy. He told clients that first he purchased common stock from a pool of 35 to 50 Standard & Poor's 100 Index companies whose performance paralleled overall market performance. The S&P 100 Index represents the 100 largest publicly traded companies based on market capitalization, and represented a very sound investment. Second, he bought and sold option contracts as a hedge to limit losses during sudden market downturns. Third, he left the market and purchased U.S. Treasury Bills when the market was declining, and then sold the U.S. Treasury Bills and reentered when the market was rising.[13] Bernie never shared his mathematical calculations for determining when to buy or sell. He considered the information proprietary and did not want competitors to copy it. Later, financial experts would question whether Bernie ever used this method.

Key to Bernie's success was the efficiency and speed of his trading operations. Bernie was one of the first brokers to recognize the role computers could play in the financial industry. In 1970, he hired his younger brother, Peter, to help computerize operations.[14] The speed of their trading transactions attracted a growing number of clients, such as other brokerage firms and investment advisers, to do business through Bernie's operations.

Investment advisers were also intrigued by Bernie's unique one or two pennies commission for each share invested with his company. Although legal, competitors maintained that these commission payments created a conflict of interest for investment advisers, equivalent to paying financial kickbacks to a supplier. As noted earlier, an investment adviser is legally obligated to make the best deal for a client. The possibility of investment advisers earning a commission for directing their client's money to Bernie introduced another motive—doing what was in the investment adviser's financial interest rather than the client's financial interest.

While Bernie was pushing other investment advisers into ethically grey areas with his commission offers, the SEC was trying to break up the virtual trading monopoly the NYSE and AMEX had in the investment community. The SEC encouraged Bernie and others to create a "third market" for trading over-the-counter stocks of small public companies. In 1971, the National Association of Securities Dealers and Automated Quotations (NASDAQ) was founded for public companies not listed on NYSE or AMEX. As the name implies, the buy and sell prices for these stocks were automated by computers. Bernie became one of the first five brokers to join NASDAQ.[15]

Bernie also made trades on small regional stock exchanges. The Cincinnati Stock Exchange, founded in 1885 to raise funds for Cincinnati area businesses, was one of the many regional stock exchanges that floundered under the shadow of the NYSE. Bernie revived the exchange in the 1970s by investing $250,000 ($950,000 in 2010 dollars) to upgrade its computer system. By 1976, the Cincinnati Stock Exchange increased its volume of trades significantly by closing its trading floor and becoming an all-electronic stock market.

Bernie's Ponzi Scheme

Most analysts, particularly litigators, believe Bernie began operating a Ponzi scheme much earlier than 1991, the year he claimed during his sentencing trial. Some date it as early as the mid-1960s.[16] Ponzi schemes are named after a scheme developed by Charles Ponzi. In 1920, Ponzi promised to double the money of investors within forty-five or ninety days if they invested in a complicated security that only he knew how to manage. However, he never invested the money. Instead, he deposited their money into his bank account and paid investors the promised return using new investor income. His scam was uncovered within a year. Investors who withdrew their funds early earned a large profit, while those who had not withdrawn money lost their investment.

A successful Ponzi scheme requires a network of trusted co-conspirators. In 1975, Annette Bongiorno, hired 10 years earlier at age 19 as Bernie's secretary, recommended her Queens neighbor, Frank DiPascali, Jr., an 18-year-old recent high school graduate, for a job assisting Bernie's investment advisory business. DiPascali quickly advanced to managing Bernie's computer systems. DiPascali and Daniel Bonventre, originally hired seven years earlier as Bernie's auditor, created fraudulent records to verify trades that never occurred.

Unlike Ponzi, Bernie owned a successful and legitimate brokerage firm. He used the activities of his booming brokerage business to shield his fraudulent activities. The computer software program developed by Bernie's brother determined optimal trades within four seconds.[17] Clients visiting the brokerage company observed a great deal of trading hustle-and-bustle that generated tremendous profits.

Bernie's fraud was a rather simple scheme. Assume a client, promised a 20 percent annual return, gave Bernie $1 million to invest on January 1. Bernie deposited the client's money in his own bank account. As more clients invested over the course of the year, the amount in Bernie's bank account grew. If the client decided to redeem the entire investment on December 31, Bernie wrote the client a check for $1.2 million from the company's bank account. Then DiPascali and several loyal investment fund employees fed price data from the previous 12 months for stocks, options, and Treasury Bills into a computer to derive a long list of trades that indicated a $200,000 profit. DiPascali mailed these documents and fictitious trading tickets to the client as supporting evidence.[18]

Why would potential clients trust Bernie? Investors are drawn to successful fund managers trusted by others. Bernie had a long track record of successful investing, and was at the forefront of the computerization of stock trading. He served on SEC advisory committees, held a four-year elected term on the NASD Adviser Council, and was elected as non-executive chairman of NASDAQ.[19]

In addition, people were drawn in by Bernie's personality. He was quiet yet charismatic and did not boast about his financial success. Bernie exhibited a strong sense of family, loyalty, and honesty, and did not drink alcohol. Elderly clients treated Bernie as a son, peers treated him like a brother, and younger clients treated him like a friendly uncle.

Bernie also played hard to get. When approached by potential investors, Bernie typically told them his investment fund was closed, having reached its peak capacity. Then he'd re-contact them and offer a huge favor by reopening the fund just for them. For all these reasons, having Bernie manage their money became a status symbol.

Flush with cash, Bernie opened a London office in 1983 to attract European investors. But that was not his only reason: the London office would play a key role in his money laundering operation. Bernie and his co-conspirators deposited client investment money in Bernie's New York City Chase bank account and then transferred the money to his London bank account, creating the appearance of investing in London-based securities. He then transferred the money back to his personal Chase bank account.

The Apex of Hedge Funds

Bernie's investment fund performance caught the attention of large hedge fund managers seeking to maximize their client's financial returns. This put Bernie's fund at the apex of the investment pyramid.

The investment pyramid begins with individuals deciding whether to conservatively deposit money in a highly liquid bank account and earn low interest rates, or pay a broker's fee and invest in riskier mutual funds, consisting of a portfolio of investments. Mutual funds combine money from many investors, are professionally managed, charge management and withdrawal fees, and are highly regulated by the SEC. The most conservative mutual funds contain blue-chip stocks and Treasury Bills, the type Bernie allegedly bought and sold.

Hedge funds, unlike mutual funds, can invest in anything, such as midwestern farmland.[20] They are only available to "accredited investors" with individual income over $200,000, and a net worth of over $1 million. Hedge funds are less regulated than mutual funds and charge higher management, performance, and withdrawal fees. Some hedge funds are very risky and involve aggressive buying and selling and more speculative positions in derivative securities. Other hedge funds are very conservative, they hedge, or reduce, market exposure inherent when investing in stocks.

Bernie's business strategy consisted of marketing his investment fund to feeder hedge funds. A feeder hedge fund is a hedge fund that earns profits by feeding its clients' investments into another investment fund. Feeder hedge fund managers found investing their clients' money with Bernie very appealing because of his consistently high annual returns.

In addition, Bernie paid feeder hedge fund managers a commission instead of charging them fees.[21] Hedge fund managers, then, earned money on both ends of their transactions. They charged their clients a 2 percent fee on assets and 20 percent fee on profits and then passed the money along to Bernie, who paid them commissions instead of charging them fees. However, Bernie would only do business with feeder hedge fund managers if they agreed not to mention his name in their marketing materials. Bernie insisted on this condition because, unknown to the feeder hedge fund managers, he was still an unlicensed investment adviser.

Bernie's feeder hedge funds strategically operated out of New York City, Boston, Palm Beach, Hollywood, Austria, and Greenwich, Connecticut. Bernie's largest feeder hedge fund suppliers included Fairfield Greenwich Group, Ascot Partner, Bank Medici of Austria, and Cohmad Securities. Ascot Partner, owned by Ezra Merkin, had invested a total of $2.4 billion with Bernie before his arrest.[22] Merkin, a well-known money manager, philanthropist, and leader within the Jewish New York City community, was trusted to manage investments for many Jewish charities, Yeshiva University, the American Jewish Congress, and holocaust survivor Elie Wiesel, among others. The Cohmad Securities hedge fund, which rented office space from Bernie, combined the first letters of the last names of its two founders—Maurice "Sonny" Cohn and Bernie Madoff. Robert Jaffee, the son-in-law of Bernie's long time client Carl Shapiro, became the primary recruiter for Cohmad Securities. Professionally, all seemed to be going well for Bernie. In 1986, Bernie's earnings of $6 million put him among the 100 highest paid people on Wall Street.[23] His new computer system, one of the best in the world, could calculate the best price for stock orders of up to 3,000 shares in just 10 seconds.[24] Both of his sons, after graduating from college, worked for Bernie and learned about the legitimate business from the bottom up. The SEC also honored Bernie for staying open for business on "Black Monday," October 19, 1987, when the Dow Jones Industrial Average dropped 508 points (22.6 percent) in one day of chaotic trading.[25] Unknown to the SEC, Bernie was able to remain open because he had a large amount of cash from his illegal investment fund account.

Solidifying Operations

With all this success, Bernie relocated to three floors in the new prestigious Lipstick Building on Third Avenue in mid-Manhattan. The red-granite, 34-story, receding oval skyscraper is considered an architectural masterpiece and, as the nickname implies, looks like a tube of lipstick. The main entrance to Bernie's business was on the eighteenth floor, which housed a conference room, information technology and administrative offices, Ruth's office, and the Cohmad Securities office. A state-of-the-art, glass-enclosed trading floor was on the nineteenth floor, along with offices for Bernie, his brother Peter, and his sons Mark and Andrew. Bernie's traders made 15,000 trades a day, accounting for five percent of total daily business on the NYSE. The illegal investment advisory business was on the seventeenth floor, where DiPascali managed a dozen employees behind locked doors with signs noting "Do Not Enter" and "Do Not Clean."[26] Their operations were so secretive that Bernie's personal secretary of eight years did not know he managed an investment fund until reading about it in the *Wall Street Journal*.

Bernie's company owned two computer servers, "House 05" for the legitimate business and "House 17" for the illegal business. In the early 1990s, Jerome O'Hara and George Perez were hired to develop computer programs and maintain the "House 05" server. Upon earning the trust of Bernie and DiPascali, they were assigned to manage the "House 17" server on the mysterious seveneenth floor. They became responsible for creating fraudulent client statements.[27]

Around the same time, Horowitz retired as Bernie's auditor and personal accountant. Horowitz gave the business to David Friehling, his son-in-law. Friehling quickly became a key member of Bernie's scam. Friehling gave Bernie signed blank SEC forms to complete; when questioned about his auditing duties, Friehling lied to the American Institute of Certified Public Accountants (AICPA).

Almost Caught

Bernie's father-in-law, Saul Alpern, retired in the early1970s and handed his CPA business over to his two employees. They renamed the company after themselves, Avellino & Bienes. The two accountants inherited Alpern's investment advisory clients, recruited more investors, and gave Bernie their own money to invest. Thanks to Bernie, both accountants earned $10 million a year. [28]

In 1992, a client being recruited by Avellino & Bienes shared the company's marketing material with an investment adviser in Seattle. The competing investment adviser researched Avellino & Bienes and found out it was an unregistered investment advisory company. Suspecting a Ponzi scheme, the Seattle-based investment adviser filed a complaint with the SEC.[29] The ensuing SEC investigation revealed that, since 1962, Avellino and Bienes had created nine accounts for 3,200 clients totaling $441 million. Their apparently falsified paperwork claimed the funds had been invested with Bernie.

Bernie admitted conducting some business with Avellino & Bienes, but told the SEC that he had assumed they were a registered investment advisory business, which was an outright lie. Avellino and Bienes, who shielded Bernie from further investigation, were fined $350,000 and required to return $441 million to their victims.

Bernie, seemingly magnanimous, offered to recoup any money Avellino & Bienes could not return. He did this by using his own fraudulent investment advisory client money as collateral for a loan with which to pay them.[30] Bernie also offered victims the opportunity to invest directly in his fund rather than being reimbursed. Many of them accepted the offer. Unknown to the SEC, Bernie also continued to pay Avellino and Bienes a commission for any new clients they directed to another of his feeder funds.

Ironically, Bernie's involvement in this case enhanced his reputation on Wall Street. In a *Wall Street Journal* article about the Avellino & Bienes scandal, Bernie was referred to as an "ace money manager."[31] Bernie not only avoided getting caught, but received free advertising in the nation's largest and most respected financial newspaper, attracting additional clients.

Three years later, in 1995, Bernie purchased a $9.5 million mansion in Palm Beach, Florida, which complemented his Manhattan penthouse and summer home in France. He joined the Palm Beach Country Club and paid the $350,000 initiation fee with company money. One-third of the members would eventually invest with him.[32]

Soon after, Bernie added a second legitimate business to his growing financial empire, a proprietary trading firm that traded stocks, bonds, and other financial instruments using the company's, rather than client, money. Mark and Andrew managed both the new proprietary trading firm and the original brokerage firm.[33]

Almost Caught Again

In 1999, Frank Casey of Rampart Investment Management Company sought to do business with René-Thierry Magon de la Villehuchet, a wealthy French investment fund manager and owner of Access International Advisers. Villehuchet had been investing with Bernie since the mid-1980s and told Casey that Bernie's premier fund outperformed anything Casey had to offer.[34] Casey then gave Harry Markopolos, a highly skilled Rampart hedge fund manager, all of Bernie's marketing materials he could find and asked him to replicate Bernie's investment fund for Rampart. Markopolos studied the materials and within four hours mathematically proved that Bernie's fund was a fraud.[35]

A major red flag noted by Markopolos was that Bernie reported being down only three months out of an 87 month time period. The S&P 500, over the same time period, had been down 28 months. In later testimony before Congress, Markopolos concluded "That would be equivalent to a major league baseball player batting .966 [with] no one suspecting that this player was cheating."[36]

Markopolos hypothesized that Bernie was running one of two possible types of fraud: (1) front-running, which is buying and selling stocks from the broker's account based on having previous knowledge about how the broker's clients would buy and sell, thus profiting from trades the broker planned to make for them,[37] or (2) a Ponzi scheme. Markopolos stood to receive a whistleblower reward windfall of millions of dollars for having reported a multi-billion dollar fraud to federal authorities if either theory was correct.

In May 2000, Markopolos submitted an eight-page complaint explaining his findings to the SEC. The understaffed and underfunded SEC, which received a record 13,599 complaints in 2000,[38] decided not to initiate an investigation of his complaint.

Casey and Markopolos remained persistent in exposing Bernie's fraud. Fortuitously, Casey shared a taxi ride from the airport to a Barcelona conference with financial reporter Michael Ocrant and presented the case against Bernie. Ocrant wrote an article titled "Madoff Tops Charts; Skeptics Ask How" about Casey's concerns in the May 1, 2001 financial newsletter *MARHedge*. The story caught the attention of investigative reporter Erin Arvedlund. She further questioned Bernie's methods in an article titled "Don't Ask, Don't Tell" that appeared in the financial weekly *Barron's*.

Markopolos filed a second complaint to the SEC following the publication of these two articles in highly respected outlets. Once again, the SEC took no action.

Financial and SEC Problems

Bernie's two legitimate businesses lost money in the early 2000s when the economy entered a recession after the dot.com industry collapse. Bernie continued to regularly transfer money among his various bank accounts as needed. He started putting more pressure on feeder funds to recruit new investment advisory clients for his now $7 billion fund.[39]

Deposits in Bernie's bank accounts were treated like the family piggy bank. Over a period of four years, he deposited $21 million in Ruth's account to pay for her Paris shopping sprees and a $2.8 million yacht.[40] Bernie's brother, Peter, purchased an expensive weekend home in the Hamptons for his daughter, and Bernie's sons acquired a manufacturer of fly-fishing equipment, a sport they both enjoyed.[41]

In 2003 and 2004, the SEC received two more complaints alleging that Bernie operated a Ponzi scheme. The SEC finally decided to investigate. Bernie reminded the investigators he had served three years as NASDAQ chairman, had several times provided expert opinions to the SEC on complicated financial issues, and that he was on the short list of people under consideration to be the next SEC chairman, which was a lie.[42]

The SEC investigators were surprised by the tremendous size of Bernie's billion dollar fund, and caught Bernie in several obvious lies and contradictory statements. When questioned about not being a licensed investment adviser, Bernie stated that he had less than 15 clients, the threshold required for licensing, which was a lie. DiPascali falsified records to support Bernie's fraudulent statements.[43] The SEC closed the case without additional follow-up.

After the SEC investigation ended, Bernie rewarded his two computer programmers, O'Hara and Perez, with $116,950 and $108,530 disguised as an investment advisory account transfer.[44] A more chastened Bernie banned the use of company e-mail on the seventeenth floor, and required employees to use their personal accounts for e-mail communications. [45]

November 2, 2005 brought unexpected bad news. For the first time, Bernie had a major liquidity problem with his fund. He had $105 million in client redemption claims but only $13 million in his bank account.[46] Bernie used the balance as collateral for a $95 million loan to cover the difference.

During this crisis, Bernie tried desperately to borrow huge amounts of money from European banks. Frank Casey found out and informed Markopolos, who now worked for a different employer.[47] Markopolos valued Bernie's fund at $50 billion and filed his third SEC complaint. He titled the complaint "The World's Largest Hedge Fund is a Fraud" to catch everyone's attention. Markopolos detailed more than 25 red flags strongly suggesting that Bernie operated a Ponzi scheme. After a short inquiry, the SEC dismissed the complaint.

Why did the SEC dismiss complaints filed against Bernie? A list of factors played into their decision making:

- The SEC annually receives more than 10,000 complaints against brokers. The understaffed SEC assigned cases to investigators who had little experience with Ponzi schemes. As a result, they focused on the more familiar "front-running," which Bernie was not doing.
- The SEC had difficulty understanding the complexity of Bernie's operations. Bernie lied to them multiple times to keep them off track.
- They gave Bernie the benefit of the doubt because he had an impressive track record with NASDAQ and had assisted the SEC on complex issues.

- Bernie never requested the presence of a lawyer when speaking with SEC agents, signaling that he had absolutely nothing to hide.
- When questioned about his consistently high returns, Bernie explained he had a personal "feel" for market fluctuations, which is why he had been a successful investor for decades.
- Markopolos unsuccessfully competed against Bernie, thus leaving himself vulnerable to the "sour grapes" accusation.
- SEC managers and Markopolos had an adversarial relationship.
- The SEC believed Markopolos was primarily motivated by a desire for the whistleblowing reward windfall.

A frustrated Markopolos contacted Taxpayers Against Fraud about getting the *Wall Street Journal* to investigate his findings. The *Wall Street Journal* editors rated the topic a low priority due to other pressing economic issues.[48] Markopolos considered going to the FBI, but dismissed the idea because the issue fell under the purview of the SEC, which had already decided not to investigate further.

Scared Employees and Rule Changes

The SEC investigations made some of Bernie's key conspirators very nervous. In 2006, O'Hara and Perez tried covering up their involvement by deleting 218 of the 225 special programs they had designed for the House 17 server.[49] They refused to create any new programs for producing fraudulent records. Bernie authorized DiPascali to meet O'Hara and Perez' 20 percent salary increase demand to buy their silence.[50] O'Hara withdrew $976,000 and Perez withdrew $289,000 from their respective investment fund accounts.

Joann "Jodi" Crupi, who had worked more than twenty years for Bernie, stepped in and agreed to help DiPascali record fictitious trades and client statements. Crupi also received a 20 percent salary increase for her efforts.

A new SEC rule banned the practice of allowing an entire feeder fund to count as one client. Instead, feeder funds had to be counted according to the number of investors in the fund. Bernie ignored the law because he feared counting one feeder fund as hundreds of clients would lead to greater SEC scrutiny.[51] When the SEC directly asked Bernie for a client count, he lied, stating that he had only nine clients. After further questioning, Bernie admitted he exceeded the 15 client minimum. On August 25, 2006, Bernie finally registered with the SEC, ending 45 years of illegally operating as an unlicensed investment adviser.[52]

Beginning of the End

The onset of a major recession in 2007 marked the beginning of the end for Bernie. Warren Buffet often jokes that you only learn who is swimming naked when the tide goes out. Within two years, Bernie would be caught swimming naked.

At the beginning of 2007, Bernie reported $613 million in net capital and 146 employees, making his the fortieth largest Wall Street brokerage firm.[53] Ruth kept busy doing Bernie's expense accounts and helping to manage the $19 million Madoff Family Foundation.[54]

Then the home mortgage market collapsed and credit availability tightened. The stock market declined dramatically. By August, every major hedge fund reported losses, but not Bernie's investment fund.[55] The growing recession had two contradictory impacts on Bernie's fund. On the one hand, some wealthy clients and hedge funds shifted almost all their money to Bernie's investment fund because it was the only fund reporting positive results. On the other hand, some clients withdrew money to cover expenses because stock they used for collateral had declined in value.

Due to these financial fluctuations, Bernie needed new computer programs. O'Hara and Perez compromised on their earlier refusal to help and created a program for altering data on the House 17 server for DiPascali and Crupi to use.[56] Crupi received another 20 percent salary increase for her involvement, plus money to purchase a $2.2 million beach house in New Jersey.

As the recession deepened, more clients withdrew their money for immediate cash needs, such as margin calls. They intended to reinvest with Bernie when the value of their other investments increased again. Bernie reduced his investment fund's guaranteed payouts to 4.5 percent to discourage this trend.[57]

Two more complaints against Bernie were filed with the SEC during this tumultuous period, one from a "concerned citizen" reporting that Bernie kept two sets of books, and another from Markopolos with new details. The SEC, overwhelmed with trying to stabilize the economy, did not investigate either complaint.

In August 2008, JPMorgan Chase withdrew $250 million from their account, noting that Bernie's investment fund lacked transparency. JPMorgan did not inform the SEC that some of their employees suspected Bernie might be operating a Ponzi scheme. In mid-September, Lehman Brothers' bankruptcy further tightened credit, the stock market continued its slide, and more clients withdrew their investment.

Bernie's Ponzi scheme fell apart in November 2008. Client requests for redemptions reached $1.45 billion, but he only had $487 million in his investment fund bank account.[58] Every day his secretary called the bank at 5:30 p.m. and reported more bad news—the gap between redemption requests and cash on hand kept widening.[59] If the Ponzi scheme collapsed, thousands of clients would lose billions of dollars, family members and friends would lose everything, 200 employees would lose their jobs, Bernie would spend the rest of his life in jail, and his family would spend the rest of their lives in court cleaning up his mess. Bernie's blood pressure soared. He relieved the stress by lying down on the floor in his glass-enclosed office, exposed to all his employees, for extended periods of time.[60]

In a last ditch attempt to save all three businesses, Bernie created a new fund the week of the Thanksgiving holiday. He marketed the new investment fund exclusively to five special clients and required each to invest $100 million.[61] Two of the five, the co-founder of Home Depot and a feeder fund in Spain, declined immediately.[62] Doom seemed inevitable and, on November 25, Bernie instructed Ruth to withdraw $5.5 million from their Cohmad Securities account.

On November 30, Bernie reported $64.8 billion in his hedge fund. However, he had only $266 million in his bank account with $7 billion in redemptions waiting to be paid.[63] Bernie admitted the inevitable. He set up a December 12 meeting with his lawyer, Ira Sorkin, when he planned to turn himself in to federal authorities for operating a Ponzi scheme.[64]

Then an old friend provided some temporary relief. Carl Shapiro, who helped launch Bernie's investment adviser career nearly 50 years earlier, was now 95 years old. His son-in-law, Robert Jaffee of Cohmad Securities, unaware Bernie was operating a Ponzi scheme, convinced Shapiro to invest an additional $250 million with Bernie. This was followed by a $10 million investment from the president of a Bronx fuel company.[65] Bernie deposited the money into his personal account. Both investors would lose it all within a week—Bernie's fund was insolvent.

On December 3, Bernie informed DiPascali there were no assets available to pay the billions of dollars clients requested to withdraw.[66] A distraught DiPascali met Crupi outside the building and told her the investment fund was bankrupt. They coordinated plans to ensure consistency in their explanations to the SEC and FBI. Crupi insisted they should lie and tell federal authorities that they assumed all trading transactions occurred at Bernie's London office.

Bernie wanted to make sure that his family members and a few clients were taken care of before he turned himself in to authorities. On December 9, he informed Mark that he wanted to break with tradition and pay $173 million in employee bonuses immediately, rather than waiting until February when bonuses were typically paid. Mark, concerned about his father's stress level, told Andrew. They demanded an explanation and Bernie agreed to meet with them the following day. That night Bernie confessed everything to Peter, his loyal younger brother, now 62.

First thing on December 10, Bernie instructed Ruth to withdraw another $10 million from their Cohmad account. Then Bernie invited his sons to join him for a car ride to his apartment where he confessed everything.

Mark always thought Bernie and the small group of employees on the seventeenth floor were investing a few billion dollars on behalf of a handful of wealthy friends. He found out otherwise.

After the Fall

Bernie went back to the office after informing his sons. He became suspicious when neither Mark nor Andrew attended the annual holiday party that evening. Mark and Andrew had sought legal advice immediately after leaving Bernie's apartment that morning. Mark contacted his wife's stepfather, a retired lawyer who had also invested with Bernie, who connected them to a litigator. The litigator informed Mark and Andrew that they would be considered partners to Bernie's on-going crimes if they did not inform federal authorities immediately. Acting on this advice, the brothers notified the U.S. Attorney and the SEC that their father had been operating a $50 billion Ponzi scheme.[67]

At 8:30 a.m. on December 11, 2008, two FBI agents knocked on the door of Bernie's luxurious $7.4 million penthouse apartment. They asked Bernie if there was an innocent explanation for what his sons had reported to federal authorities the previous day. Bernie, still in his pajamas, declined the opportunity to contact his lawyer and confessed. He stated that he alone was responsible for the fraud, which was a lie. After nearly 50 years, Bernie no longer had to worry about getting caught.

News about Bernie's arrest spread quickly. Peter informed Bongiorno and DiPascali, and then told the entire trading floor that Bernie had been arrested by the FBI for securities fraud.[68] The shocked feeder fund owners notified their wealthy and influential clients that all of their money invested with Bernie had been lost.

At least 13,500 people had money being managed by Bernie at the time of his arrest.[69] Many were in disbelief.[70] They did not know that their investment adviser had invested client money with Bernie. All their money was gone. Pension funds,

Exhibit 1 Largest Financial Losers

Feeder Funds	Non-Profit Organizations	Individuals
Fairfield Greenwich Advisors: $7.5 billion	Hadassah: $90 million	Carl Shapiro: $500 million
Tremont Group Holdings: $3.3 billion	New York University: $24 million	Phyllis Molchatsky: $17 million
Banco Santander: $2.9 billion	Jewish Community Foundation of Los Angeles: $18 million	Richard Spring: $11 million
Bank Medici: $2.1 billion	Elie Wiesel Foundation: $15.2 million	Zsa Zsa Gabor: $10 million
Ascot Partners: $1.8 billion	Yeshiva University: $14.5 million	Ira Roth: $1 million

A more extreme loss is the loss of life. Thierry de la Villehuchet, the French aristocrat who refused to believe Casey or Markopolos' theory that Bernie operated a Ponzi scheme, lost $1.5 billion. This included his personal fortune along with substantial funds from European royalty and aristocrats. On December 22, 2008, unable to pay his 28 employees or office rent, Villehuchet committed suicide in his downtown Manhattan office.[83]

Family Ramifications

The day before Christmas, while still under house arrest, Bernie instructed Ruth to mail five uninsured packages containing watches, necklaces, bracelets, rings, and other jewelry valued at millions of dollars. The recipients included Mark, Andrew, and Peter. Mark, wanting nothing to do with his father, informed government officials.[84]

On March 10, 2009, the government formally indicted Bernie on 11 counts for securities fraud, money laundering, false statements, perjury, investment adviser fraud, mail fraud, wire fraud, and theft from an employee benefit plan. Two days later, Bernie pled guilty to all counts. In his statement to the court, Bernie told the packed courtroom:[85]

> *As I engaged in my fraud, I knew what I was doing was wrong, indeed criminal. When I began the Ponzi scheme I believed it would end shortly and I would be able to extricate myself and my clients from the scheme. However, this proved difficult, and ultimately impossible, and as the years went by I realized that my arrest and this day would inevitably come. I am painfully aware that I have deeply hurt many, many people, including the members of my family, my closest friends, business associates and the thousands of clients who gave me their money. I cannot adequately express how sorry I am for what I have done.*

Bernie claimed that the Ponzi scheme began in 1991, after which he made no legitimate investments with client money. Government prosecutors believe Bernie used 1991 as the beginning date to protect properties he bought for Ruth and his sons prior to that date. Bernie left the courtroom as prisoner No. 61727-054. He was locked down 23 hours a day while awaiting sentencing.

On July 29, 2009, Bernie received the maximum sentence allowable, 150 years in jail. His projected release date was November 14, 2139, which included reduction for good behavior. Bernie was ordered to forfeit $170 million in assets. Ruth was ordered to forfeit $85 million in assets, leaving her with $2.5 millon.

Bernie refused to cooperate with authorities or to name any conspirators. His indicted co-conspirators had other ideas, particularly considering the anticipated prison sentences they faced if they did not cooperate (see Exhibit 2).

The court granted Irving Picard power of attorney to recover lost money for victims. Picard initiated a $198 million lawsuit against Mark, Andrew, Peter, and Peter's daughter Shana for negligence and breach of fiduciary duty. He sued Ruth for $44.8 million on the grounds that she enriched herself with company funds.[86]

Picard also filed lawsuits against the beneficiaries of Bernie's investment fund, enough to collect $50 billion if he won them all.[87] The defendants included feeder

Exhibit 2 Indicted Co-Conspirators

Name	Role	Maximum Prison Term
Frank DiPascali	CFO	125 years
David Friehling	Accountant/Auditor	108 years
Daniel Bonventre	Director of Operations	82 years
Annette Bongiorno	Manager	75 years
Judi Crupi	Assistant	65 years
Jerome O'Hara	Computer Programmer	30 years
George Perez	Computer Programmer	30 years

QUESTIONS

1. Should Mark Madoff have granted his father's request for a one week delay before notifying government authorities about his crime?
2. Describe the chronological evolution of Bernie Madoff's Ponzi scheme.
3. Why did sophisticated investors trust Bernie Madoff with their funds? Why didn't they perform appropriate due diligence?
4. Why didn't the SEC, which received several complaints about Bernie Madoff, uncover the fraud?
5. Do you believe Mark and Andrew Madoff didn't know about their father's Ponzi scheme prior to their December 10, 2008 discussion at Bernie Madoff's apartment? Why?
6. Should sophisticated investors who withdrew millions from their Madoff accounts forfeit the undeserved gains to people who lost the millions of dollars they invested?

NOTES

[1] Throughout this case, "Bernie" will be used to differentiate Bernie Madoff from Ruth Madoff (his wife), Peter Madoff (his brother), and Mark and Andrew Madoff (his sons). This is not meant in disrespect. He told others to call him Bernie, which endeared him to others.

[2] Andrew Kirtzman, *Betrayal: The Life and Lies of Bernie Madoff* (New York: HarperCollins, 2009), p. 232.

[3] Most of the information about Bernie Madoff's life and Ponzi scheme comes from: Erin Arvedlund, *Too Good To Be True: The Rise and Fall of Bernie Madoff* (New York: Penguin, 2009); James Bandler and Nicholas Varchaver, "How Bernie Did It," *Fortune,* April 30, 2009; Diana B. Henriques, *The Wizard of Lies: Bernie Madoff and the Death of Trust* (New York: Times Books/Henry Holt & Company, 2011); Andrew Kirtzman, *Betrayal: The Life and Lies of Bernie Madoff* (New York: HarperCollins, 2009); Brian Ross, *The Madoff Chronicles: Inside the Secret World of Bernie and Ruth* (New York: Hyperion, 2009); *United States of America v. Bernard F. Madoff* available at http://www.justice.gov/usao/nys/madoff/20090310criminalinfo.pdf; and *Wall Street Journal* articles about Bernie Madoff, available at http://online.wsj.com/public/page/bernard-madoff.html, accessed 4/11/11.

[4] Inflation conversion calculator is available at http://www.westegg.com/inflation/infl.cgi, accessed 4/12/11.

[5] W. Scott Simon, "The Critical Difference Between a Stockbroker and Registered Investment Advisor," 2005, available at http://www.arkadvisor.com/_docs/fiduciary_library/fiduciary.pdf, accessed 4/11/11.

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[7] Seal, "Madoff's World."

[8] Andrew Kirtzman, *Betrayal: The Life and Lies of Bernie Madoff*.

[9] "The Madoff Affair," *Frontline,* Timeline, available at http://www.pbs.org/wgbh/pages/frontline/madoff/cron/, accessed 4/11/11.

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[11] Erin Arvedlund, *Too Good To Be True: The Rise and Fall of Bernie Madoff* (New York: Penguin, 2009).

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[15] Arvedlund, *Too Good To Be True: The Rise and Fall of Bernie Madoff*.

[16] *Matthew Greenberg, Walter Greenberg, Doris Greenberg, and the Estate of Leon Greenberg v. Friehling & Horowitz, KPMG UK, KPMG International, JPMorgan Chase & Co., The Bank of New York Mellon, Paul Konigsberg, Annette Bongiorno, Frank DiPascali, Andrew Madoff, Mark Madoff, Peter Madoff, and John Does 1 through 30* available at http://www.oakbridgeins.com/clients/blog/madoff lawsuits/greenberg.pdf, accessed 4/11/11.

[17] Arvedlund, *Too Good To Be True: The Rise and Fall of Bernie Madoff*.

[18] *United States of America v. Frank DiPascali, Jr.* available at http://www.justice.gov/usao/nys/madoff/20090811dipascaliinformationsigned.pdf, accessed 4/11/11.

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[20] Sebastian Mallaby, *More Money than God: Hedge Funds and the Making of a New Elite,* (New York: Penguin, 2010).

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[23] Arvedlund, *Too Good To Be True: The Rise and Fall of Bernie Madoff*.

[24] Chapman, "Before the Fall."

[25] Arvedlund, *Too Good To Be True: The Rise and Fall of Bernie Madoff*.

[26] Brian Ross, *The Madoff Chronicles: Inside the Secret World of Bernie and Ruth* (New York: Hyperion, 2009).

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[33] James Bandler and Nicholas Varchaver, "How Bernie Did It," *Fortune,* April 30, 2009.

[34] Andrew Kirtzman, *Betrayal: The Life and Lies of Bernie Madoff*.

[35] *Testimony of Harry Markopolos Before the U.S. House of Representatives Committee on Financial Services*, February 4, 2009, p. 7, available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/markopolos020409.pdf, accessed 4/11/11; Harry Markopolos, *No One Would Listen* (Hoboken, NJ: John Wiley & Sons, 2010).

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[46] *United States of America v. Daniel Bonventre, Annette Bongiorno, Joann Crupi, a/k/a "Jodi," Jerome O'Hara, and George Perez.*

[47] *Testimony of Harry Markopolos Before the U.S. House of Representatives Committee on Financial Services*; Markopolos, *No One Would Listen*.

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[64] Kirtzman, *Betrayal: The Life and Lies of Bernie Madoff*.

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