**Bernard L. Madoff Investment and Securities: Broker-Dealer Fraud**

**Synopsis During 2008**

 Bernie Madoff became famous for a Ponzi scheme that defrauded investors out of as much as $65 billion. To satisfy his clients’ expectations of earning returns greater than the market average, Madoff falsely asserted that he used an innovative “split-strike conversion strategy,” which provided the appearance that he was achieving extraordinary results.1 In reality, he was a fraudster. Madoff was arrested on December 11, 2008, and convicted in 2009 on 11 counts of fraud, perjury, and money laundering. As a result, Madoff was sentenced to 150 years in prison. The Beginning Bernard Madoff created Madoff Investment Securities in the 1960s with $5,000 that he had earned from installing refrigeration systems and working as a lifeguard. His brother Peter, who joined the firm in 1965, was the head of trading and the chief compliance officer for the firm’s investment advisory and the broker-dealer businesses. Madoff’s nephew, Charles Wiener, joined the firm in 1978 and became the firm’s director of administration. Madoff’s sons, Mark and Andrew, joined the business in the 1980s (becoming directors), and in the 1990s, Madoff’s niece (Peter’s daughter) Shana came on board as in-house legal counsel.

A Ponzi Scheme A Ponzi scheme is any fraudulent investment plan that pays its returns to an investor from either that investor’s own principal or principal paid by future investors, not from legitimate investment returns. To carry out his plan, Bernie Madoff repre- sented to clients and potential clients that he would invest their money in “shares of common stock, options and other securities of well-known corporations, and upon request, would return to them their profits and principal.”2 In fact, Madoff never invested the funds in the securities that had been promised. Rather, the funds were deposited into a bank account at Chase Manhattan Bank, based in New York City. If clients requested to receive “profits earned” or redeem their investment principal, Madoff merely used the money in the bank account at Chase Manhattan Bank that had belonged to either that client or other clients to pay off the requested sum.3 The Split-Strike Conversion Strategy In the early 1990s, Madoff began to receive investment commitments from key institutional investors. While he did not promise specific rates of return to clients, Madoff knew that the investors expected that their investment would perform at a level higher than the market average. To meet their expectations, Madoff claimed to have mastered a “split-strike conversion strategy.”4 Under his split-strike conversion strategy, Madoff promised clients and prospective clients that their funds would be invested in a “basket of stocks that would closely mimic the price movements of the Standard & Poor’s 100 Index.” He further promised to “opportunistically time these purchases and would be out of the market intermittently, investing client funds during these periods in United States Government-issued securities such as United States Treasury bills.” Madoff also promised to hedge the investments in common stocks “by using client funds to buy and sell option contracts related to those stocks, thereby limiting potential client losses caused by unpredictable changes in stock prices.” Madoff promised that his strategy would lead to consistent returns for his investors. And, the strategy appeared to be working. Harry Markopolos, the whistleblower that informed the SEC about Madoff, commented that “in 1993 when the S&P 500 returned 1.33%, Bernie returned 14.55%; in 1999 the S&P returned 21.04%, and there was Bernie at 16.69%. His returns were always good, but rarely spectacular. For limited periods of time, other funds returned as much, or even more, than Madoff’s. So it wasn’t his returns that bothered me so much – his returns each month were possible – it was that he always returned a profit. There was no existing mathematical model that could explain the consistency.”5 Madoff, in reality, never made the investments that he promised to clients.6

Concealment Techniques “For many years up until my arrest on December 11, 2008, I operated a Ponzi scheme through the investment advisory side of my business, Bernard L. Madoff Securities LLC,” admitted Madoff on March 12, 2009. He continued: To conceal my fraud, I misrepresented to clients, employees and others, that I purchased securities for clients in overseas markets. Indeed, when the United States Securities and Exchange Commission asked me to testify as part of an investigation they were conducting about my investment advisory business, I knowingly gave false testimony under oath to the staff of the SEC on May 19, 2006, that I executed trades of common stock on behalf of my investment advisory clients and that I purchased and sold the equities that were part of my investment strategy in European markets. In that session with the SEC . . . I also knowingly gave false testimony under oath that I had executed options contracts on behalf of my investment advisory clients and that my firm had custody of the assets managed on behalf of my investment advisory clients . . . Another way that I concealed my fraud was through the filing of false and misleading certified audit reports and financial statements with the SEC.” In addition, Madoff created “false trading confirmations and client account statements that reflected the bogus transactions and positions” and then sent them to investment clients. According to Madoff, “The clients receiving trade confirmations and account statements had no way of knowing by reviewing these documents that I had never engaged in the transactions represented on the statements and confirmations.”7 Interestingly, auditors of nonpublic broker-dealers were not subject to over- sight by the Public Company Accounting Oversight Board(PCAOB) at this time. However, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 provided the PCAOB with new authority over the audits of brokers and dealers that are registered with the SEC. As a result of the act, the financial statements of such brokers and dealers must now be audited by a public ac- counting firm that is registered with the PCAOB. In addition, the Act gave the PCAOB the authority to inspect the audit workpapers for broker-dealer audits. Title IX of the Act focuses in part on the role of the Securities and Exchange Commission (SEC) in protecting investors. The Act established a whistleblower program to help produce tips about securities fraud. The program features a generous reward structure for suppliers of original information (10–30 percent of the recovered capital, when more than $1 million is recovered). In addition, the Act expands the oversight of the SEC to be completed by the Government Accountability Office (GAO) and calls for changes that are designed to improve the management of the SEC.

Case Questions

 1. Define a Ponzi scheme. Next, describe why the Madoff fraud is considered a Ponzi scheme. Please be specific in your explanation.

2. Describe what is meant by a “split-strike” strategy. Do you believe that this strategy is viable? Why or why not?

3. Consider the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. According to the Act, the PCAOB now has authority to inspect the work of audit firms auditing broker-dealer firms. Do you believe that this provision is going to make a difference? Why or why not?

 4. Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 appears to be driven in part by the Madoff Ponzi scheme. Indeed, after the SEC’s investigations failed to detect the Madoff fraud (see Case 1.12), many sections of Title IX sought to improve the performance of the Securities and Exchange Commission (SEC). How?