**Bernard L. Madoff Investment and Securities: The Role of the Securities & Exchange Commission (SEC)**

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. 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. Background Between June 1992 and December 2008, the SEC received several complaints regarding Madoff’s hedge fund, including those from Harry Markopolos, a portfolio manager at Rampart Investment Management in Boston; yet, ultimately the SEC was unable to uncover Madoff’s Ponzi scheme.

In May 2000, Markopolos submitted evidence to the SEC that questioned the legitimacy of the returns on Madoff’s hedge fund. In his submission, Markopolos wrote that Madoff’s reported performance, which when charted, rose roughly at a 45-degree angle, did not exist in finance. He wrote, “In 25 minutes or less, I will prove one of three scenarios regarding Madoff’s hedge fund operation: (1) They are incredibly talented and/or lucky and I’m an idiot for wasting your time; (2) the returns are real, but they are coming from some process other than the one being advertised, in which case an investigation is in order; or (3) the entire case is nothing more than a Ponzi scheme.”1 Markopolos e-mailed a second submission (less than a year later) to the SEC on March 1, 2001, in which he presented additional analysis of Madoff’s returns. Markopolos wrote that Madoff reportedly earned over 15.5% a year for over seven years with an extremely low standard deviation of 4.3%. This was in contrast to the S&P 500 which earned over 19.5% but with an annual standard deviation of 12.9%. In addition, Madoff’s fund had only three down months in contrast to the market being down 26 months during the same period. “For example, in 1993 when the S&P 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 mathematical model that could explain the consistency.”2 “This program earned 80% of the market’s return with only one third of the risk. Think about it! Is this really possible, or is it too good to be true?” wrote Markopolos.3 In October 2005 Markopolos made his third submission titled “The World’s Largest Hedge Fund Is A Fraud,” to the SEC. Markopolos’ submission included 30 red flags that indicated that it was “highly likely” that Madoff was operating a Ponzi scheme. Each red flag fell into one of three categories: 1) Madoff’s obsessive secrecy; 2) the impossibility of Madoff’s returns, particularly the consistency of those returns; and 3) the unrealistic volume of options Madoff was supposedly trading.4 Reasons that the SEC Discounted Markopolos’ Submissions In an investigation conducted on why the SEC failed to uncover the Madoff Ponzi scheme, one of the SEC’s examiners testified that the credibility of Markopolos’ submissions were discounted because he was not an employee or an investor. The examiner testified that it’s challenging to develop evidence in Ponzi scheme cases “until the thing actually falls apart.”5 Another SEC examiner testified that part of the problem was that Markopolos could not technically be considered a “whistleblower” because he did not have “inside” or nonpublic information. In addition, the examiners testified they were skeptical of Markopolos’ motives. One examiner testified she “had concerns that he was a competitor of Madoff’s who had been criticized for not being able to meet Madoff’s returns, and that he was looking for a bounty.” The investigation at the SEC found that the examiners were also skeptical of Markopolos’ claims because Madoff “didn’t fit the profile of a Ponzi scheme operator;” the chief ex- aminer acknowledged that there is an “inherent bias towards [the] sort of people who are seen as reputable members of society.”6 SEC’s Investigation The SEC’s Enforcement staff began investigating Madoff in 2005. Although the complaints from Markopolos suggested that Madoff was operating a Ponzi scheme, the SEC’s investigation primarily focused on relatively insignificant registration and disclosure matters. During the investigation, the SEC Enforcement staff was comparing documents that Madoff had provided to the examination staff to documents that Madoff had sent his investors – both sets of documents had been fabricated by Madoff. In December 2005, during the investigation, the SEC Enforcement staff reviewed documents that Madoff had sent to his largest hedge fund investor. There was a discrepancy in the information, revealing that Madoff had lied in his previous representations to the SEC. “He seems to have failed to disclose to the examiners several billion dollars worth of options accounts,” wrote one examiner to another in an e-mail exchange. On December 29, 2005 the SEC’s Enforcement staff faxed a voluntary request to Madoff for certain documents related to three of his hedge fund clients— Fairfield, Kingate, and Tremont. Specifically, the SEC requested account opening documents, trading authorizations, account statements, trade confirmations, trade tickets, agreements (including options agreements), correspondence, audio records of telephone conversations, and documents sufficient to identify all persons who had custody of the assets in the accounts identified. After receiving Madoff’s documentation, one examiner wrote in an e-mail to another examiner: “What’s annoying is that he clearly created special write-ups in response to our request, instead of producing existing documents. The write-ups are helpful, but he should also be producing everything that existed.”7 In January 2006, an examiner summarized the investigation to that point as follows:

this business as a Ponzi scheme. The complaint did not contain specific facts about the alleged Ponzi scheme, and the complainant was neither a BLM insider nor an aggrieved investor. Nevertheless, because of the substantial amounts at issue, the staff, in the abundance of caution, requested voluntary production of certain documents from BLM and two of its hedge fund customers . . . The staff found, first, that neither BLM nor [the hedge funds] disclose to investors that the investment decisions for [the hedge funds] are made by BLM . . . and that, in substance, BLM acts as an undisclosed investment adviser to [the hedge funds].8 Second, the staff found that, during an SEC examination of BLM that was conducted earlier this year, BLM—and more specifically, its principal Bernard L. Madoff, – mislead [sic] the examination staff about the nature of the strategy implemented . . . and also withheld from the examination staff information about certain of these customers’ accounts at BLM . . . The staff is now seeking additional evidence, in the form of documents and witness testimony from BLM and its hedge fund customers, on the issues of BLM’s role in those hedge funds’ investment activities and the adequacy of related disclosures. Additionally, the staff is trying to ascertain whether the complainant’s allegation that BLM is operating a Ponzi scheme has any factual basis.9 In February 2006 the SEC sent a second voluntary request to Madoff, and in May 2006 Madoff testified before the SEC. Eventually, however, the SEC’s investigation stalled. When interviewed about why the investigation stalled, one of the examiners attributed it to the SEC’s lack of resources: “I think given the resources that we had available to us and given what else we all had to do at the time, this was the best we could do.

1. Consider the Securities Act of 1933 and the Securities Exchange Act of 1934. What is the role of the SEC in regards to protecting individual investors?

2. Consider the information brought to the SEC by Harry Markopolos. Please explain the primary reasons why Mr. Markopolos believed that Madoff’s fund was nothing more than a “Ponzi” scheme.

3. After the Madoff case, the SEC instituted a number of reforms to its operations. Please visit the SEC’s website (www.sec.gov) and search for Post- Madoff reforms. Next, please identify the two reforms that you believe will have the best chance of catching a criminal like Madoff. Make sure to provide justification for your choices.

4. Consider the Dodd-Frank Wall Street Reform and Consumer Protection Act. Please explain the whistleblower provision that was mandated by the act and elaborate about the role of the SEC.