3.6 Madoff Investment and Securities: Understanding the Client’s Business and Industry

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 launder- ing. As a result, Madoff was sentenced to 150 years in prison. Not a Typical Hedge Fund In 2001 Madoff Securities had 600 major brokerage clients and over $7 billion in assets under management in its hedge fund portfolio.1 By the end of 2005 the company had assets under management estimated at $20 billion.2 Interest- ingly, Madoff had not registered with the SEC as an investment advisor until September 2006, following an SEC investigation into his business.3

Unlike a typical hedge fund, Madoff Securities did not charge a fee on the money it managed. It only earned money by charging commissions on trades ex- ecuted for the accounts of its third party hedge funds. “We’re perfectly happy to just earn commissions on the trades,” said Madoff in an interview in 2001.4 In so doing, Madoff Securities was operating differently than largely all other hedge funds. To some observers, it was shocking that “Madoff was voluntarily giving up huge profits. Nobody anybody of us ever knew in the industry voluntarily left money on the table - except for Bernie.”5 In addition, while the third party hedge funds (referred to as “feeder funds”) obtained the investors, 100% of the money raised was actually man- aged by Madoff. Interestingly, investors were unaware that Madoff was actu- ally managing the funds. In fact, the feeder funds were not allowed to name Madoff as the actual money manager in their marketing literature or perfor- mance summaries.6 A typical hedge fund uses a network of third-party providers, including an in- vestment manager, one or several brokers to execute trades, and some custodians to hold the investment positions. Typically, these providers are independent of one another to reduce the risk for fraud. In Madoff’s firm, all of these functions were performed internally with no independent oversight by any third-party provider. Instead of providing electronic access to their accounts, Madoff mailed his feeder funds paper statements showing account activity. Sometimes, the 





