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Ten Years After: An Overview of the Madoff Fraud and Lessons Companies Can Learn From It

Presented by:
Brian W. Johnson
CPA, CFE, CCIFP

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downside

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Top Broker Accused of \$50 Billion Fraud

Sons Turned In Madoff After He Allegedly Told Them His Investment-Advisory Business for the Wealthy Was "Giant Ponzi Scheme"

Bernard L. Madoff, a former chairman of the Nasdaq Stock Market and a force in Wall Street trading for nearly 50 years, was arrested by federal agents Thursday, a day after his sons turned him in for running what they said their father called "a giant Ponzi scheme."

By **Andi Axton**,
Tom Ichniowski and
Dionne Searcy

The Securities and Exchange Commission, in a civil complaint, said it was an ongoing \$50 billion scheme, and asked a judge to seize the firm and its assets. "Our complaint alleges a stunning fraud that appears to be of epic proportions," said Andrew M. Calomiris, associate di-

rector of enforcement in the SEC's New York office.

In a separate criminal complaint, Federal Bureau of Investigation agent Theodore Corioppi said Mr. Madoff's investment advisory business had "deceived investors by operating a securities business in which he traded and lost investor money, and then paid certain investors purported returns on investment with the principal received from other, different investors, which resulted in losses of approximately billions of dollars."

Dan Flawitz, a lawyer for Mr. Madoff, declined to elaborate on the allegations. "Bernard Madoff is a longstanding leader in the financial services industry with an unblemished record," Mr. Flawitz said in an interview. "He is a

person of integrity. He intends to fight to get through this unfortunate event."

The 70-year-old Mr. Madoff is the founder and primary owner of Bernard L. Madoff Investment Securities LLC. The firm is primarily known for its business in market-making, or serving as the middleman between buyers and sellers of shares. But Mr. Madoff also oversaw an investment-advisory business that managed money for high-net-worth individuals, hedge funds and other institutions.

According to the complaints, Mr. Madoff ran the investment advisory as a secretive business, independent from the firm's proprietary trading and market-making operations. The SEC complaint said that the alleged fraud

Client Shock Waves

Country-club investors targeted. Please see A34.

was run through this arm of Mr. Madoff's company.

The FBI complaint quotes two senior Madoff employees as saying Mr. Madoff ran the investment arm on a separate floor of the firm's offices. The two employees said Mr. Madoff kept the financial statements from the firm under lock and key and was "cryptic" about the firm's investment business.

The complaint did not name the two senior employees. But according to people familiar with the matter, they are Mr. Madoff's

sons, Andrew and Mark. Mark Madoff is the firm's senior managing director and chief compliance officer. Andrew Madoff is its director of trading.

A call to the sons' attorney was not returned.

Both complaints say Mr. Madoff told his sons he believed losses from his fund exceeded \$50 billion. That figure couldn't be confirmed. But such a loss is plausible, had money been flowing in and out for years. At the beginning of 2008, according to the SEC filing, his operation had more than \$27 billion under management.

Such a scheme would dwarf past Ponzi schemes. It would also be nearly five times larger than the accounting fraud that



Money manager Bernard Madoff, at a party earlier this year.

Please turn to page A24

Early Beginnings



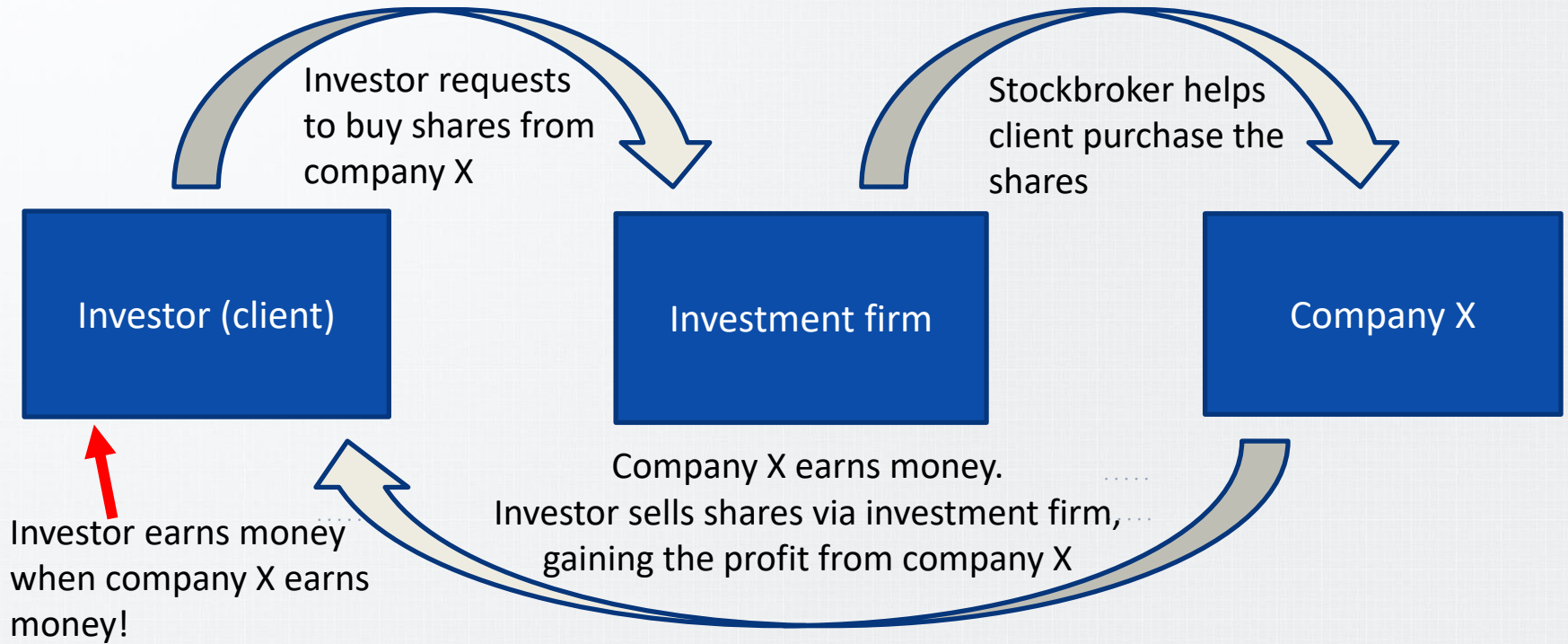
- 1960 - Bernard L. Madoff Investment Securities LLC (BLMIS) is formed and soon becomes a small company trading via the National Quotation Bureau's Pink Sheets.
- In order to compete with firms that were members of the NYSE, Madoff's firm develops innovative technology to bypass the NYSE trading floor to make markets (this technology eventually becomes NASDAQ).
- Soon after BLMIS opens a non-publicized investment management and advisory division to handle investor funds (all being traded through BLMIS).

Career Take-off

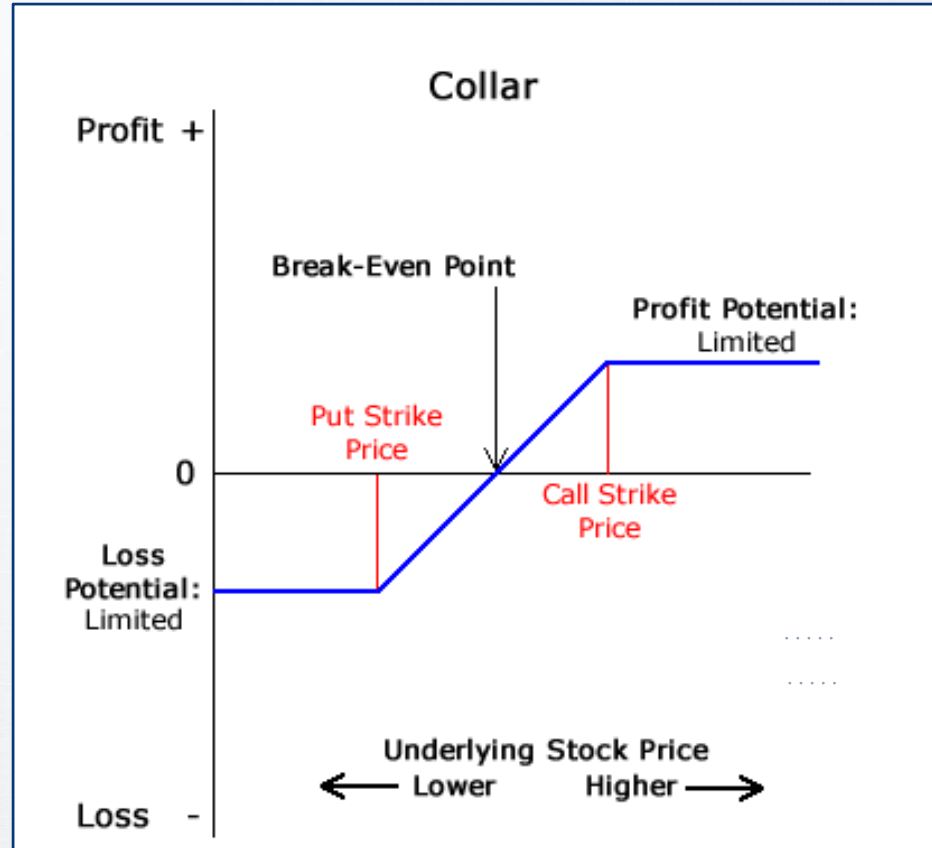
- By the end of the 1980s BLMIS is one of the largest buying-and-selling “market makers” at the NASDAQ, at one point trading about 15% of the NYSE transaction volume.
- Madoff’s purported “split-strike” investment method claims to cushion the returns against the market’s ups and downs and consistently shows strong returns.
- Rather than offer high returns to all comers, Madoff offered modest but steady returns to exclusive clientele.
- Madoff kept his financial statements closely guarded and marketed his investments as “too complicated for outsiders to understand”.

What Was Actually Happening

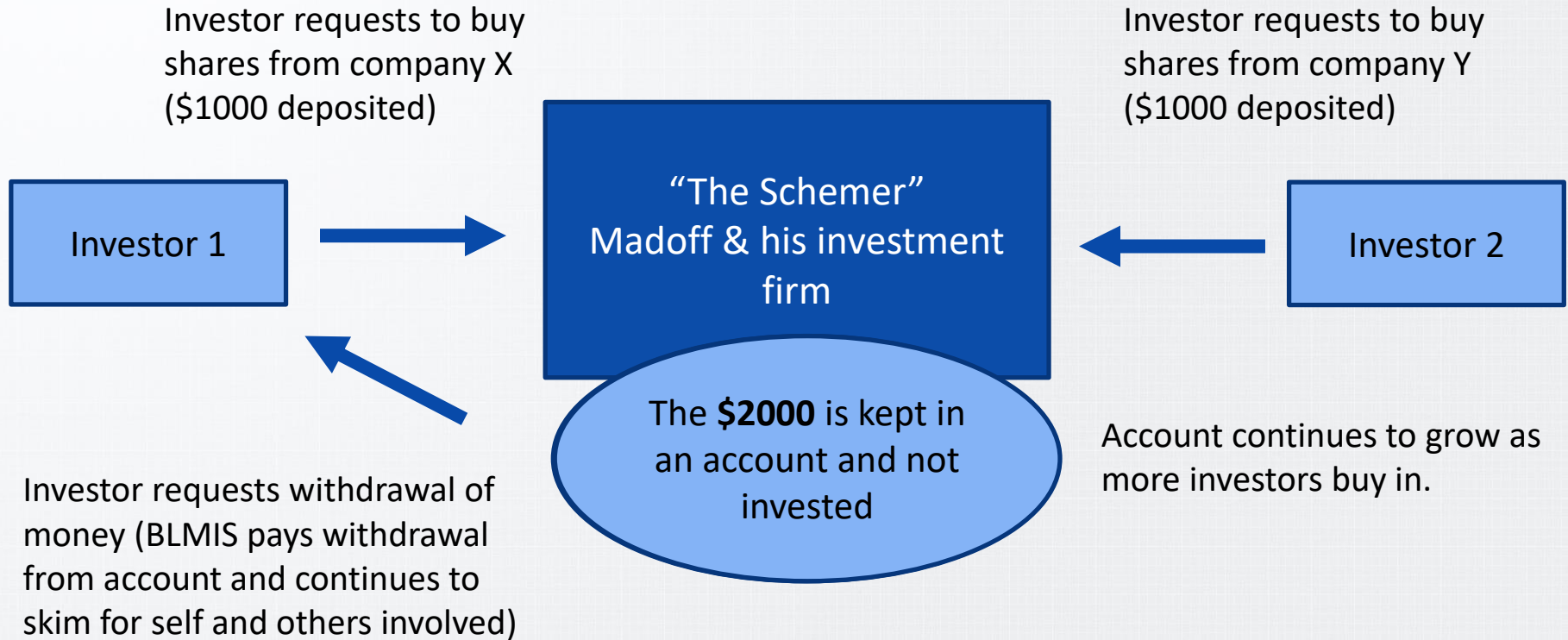
How the Investment is Supposed to go



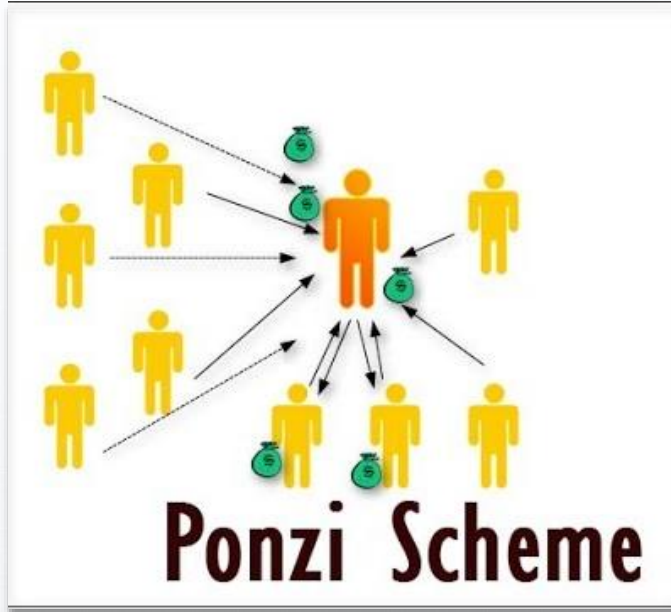
"Split-Strike Conversion" Investment Concept



How a Ponzi Scheme Works



What Was Actually Happening



- Madoff was taking money from new investors to pay old investors.
- “Stealing from Peter to pay Paul” tactic.
- No investor funds were actually invested, they were instead deposited into Madoff’s bank account at Chase Manhattan.
- In some cases the return on investment was determined before an account was even opened.

What Was Actually Happening

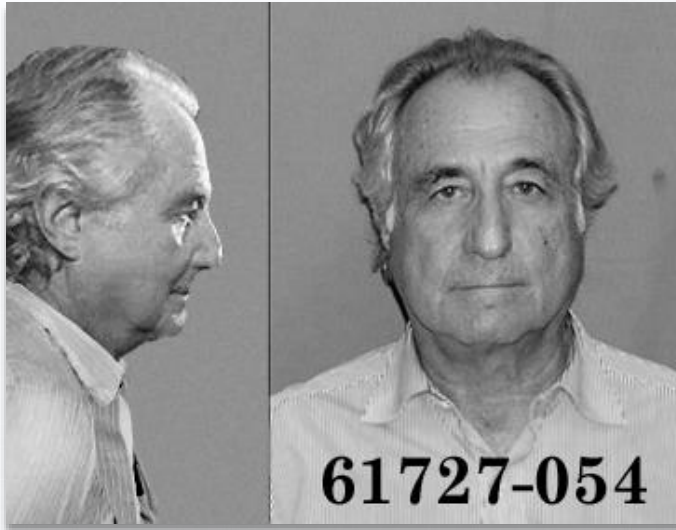
- Madoff's private brokerage operation (where all "investment transactions" were processed through) was very real and completely unmonitored outside his company.
- Two back-office workers (Annette Bongiorno & Joann Crupi) created false trading reports based on returns Madoff ordered for each customer.
- Through a specially designed computer program trades were backdated and account statements were manipulated to create false trading records.

Catching the “Wizard”



- Madoff begins accepting leveraged money beginning as early as June 2008 to continue his scheme.
- Market collapse of 2008 leads to halt on lending and investors attempt to withdraw investments up to \$7 billion, which ultimately begins to reveal Madoff is penniless.
- December 10, 2008 Madoff reveals to his sons that BLMIS is a Ponzi scheme, who in turn alert the FBI.
- Madoff is arrested the following day by federal prosecutors and the SEC on charges of securities fraud.

Securities and Exchange Commission v. Madoff



- Madoff refused to cooperate, alleging that he acted solely with no help.
- Madoff's crimes were literally off the chart. Federal sentencing guidelines for fraud only go up to \$400M in losses.
- Madoff was sentenced to 150 years (maximum possible under federal sentencing).
- Madoff admitted to running a Ponzi scheme and alleged that his scheme had begun in the early 1990s in order to satisfy his clients' expectations of high returns.

Key Alleged Co-Conspirators



George Perez

Computer
Programmer,
sentenced to
2½ years.



Jerome O'Hara

Computer
Programmer,
sentenced to
2½ years.



Annette Bongiorno

Staff Supervisor,
sentenced to
6 years.

Key Alleged Co-Conspirators



Joann Crupi

Investment
Advisor,
sentenced to
6 years.



Daniel Bonventre

Operations
Director,
sentenced to 10
years.



Frank DiPascali

Director of Options
Trading and Chief
Financial Officer, faced
up to 125 years but
died before sentencing.

Key Alleged Co-Conspirators



David G. Friehling

Sole practitioner of Friehling & Horowitz CPAs, avoided prison through government cooperation (sentenced to 1 year of home detention and 1 year of supervised release).



Peter Madoff

Chief Compliance Officer, sentenced to 10 years.

The Aftermath

Aftermath

Madoff is arrested on suspicion of committing the largest Ponzi scheme in history

**DEC
2008**

**FEB
2009**

US Bankruptcy Court in Manhattan released affected client list with at least 13,500 different accounts (not including individual investors who invested through large groups)!

SEC released 477-page report on how they missed red flags and repeated opportunities to find the fraud. Eight SEC employees were disciplined, none were fired.

**SEPT
2010**

**DEC
2010**

Mark Madoff (Bernie's Son) commits suicide.

Madoff tells his biographer that banks knew he was committing fraud but chose not to do anything about it.

**JAN
2011**

**JAN
2014**

JP Morgan Chase paid \$1.7B settlement to resolve any potential criminal case against the bank. The bank has since admitted to failing to file a “Suspicious Activity Report”.



**FEB
2009**

Court appointed trustee, Irving Picard, announced \$1.42B had been authorized by US judges to distribute to victims.

Financial Aftermath

- Investors and clients of Madoff were defrauded of approximately \$65 billion.
- Over 15,000 claims filed with court appointed trustee.
- Banks, hedge funds, charities, universities, and thousands of investors report massive losses, with some losing their entire life savings.

Potential Losses of Investors

- Eight investors had potential losses of over \$1 billion, with a total loss of \$21.32 billion.
- Eleven investors had potential losses between \$100 million and \$1 billion.
- Twenty-three investors with potential losses of \$500,000 to \$100 million were also listed, with a total potential loss of \$540 million.
- The grand total potential loss in The Wall Street Journal table is \$26.9 billion.

Largest Stake Holders

- Fairfield Greenwich Group - \$7.50B
- Tremont Capital Management (Owned by MassMutual) - \$3.30B
- Banco Santander - \$2.87B
- Bank Medici - \$2.10B
- Ascot Partners - \$1.80B
- Access International Advisors - \$1.40B
- Fortis - \$1.35B
- HSBC - \$1B

Fairfield Greenwich Group



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Notable Clients

- Steven Spielberg
- Jeffrey Katzenberg
- Kevin Bacon and Kyra Sedgwick
- Sandy Koufax
- The Wilpon family
- Larry Silverstein
- Zsa Zsa Gabor



How Did This Occur?

How Could This Occur?

- All trades were made through Madoff's brokerage firm (at one point being the largest market maker at the NASDAQ).
- Madoff was active in NASDAQ, serving as its chairman for 3 terms.
- Madoff was active in National Association of Securities Dealers (NASD), which merged with the Bond Market Association in 2006 to form Securities Industry and Financial Markets Association (SIFMA), at one point serving as chairman of its board of directors.

How Could This Occur?

- Madoff family gained unusual access to Washington lawmakers and regulators through the industry's top trade group (including SEC Chairmen and Commissioners).
- Madoff's niece, Shana Madoff, served on Executive Committee of SIFMA's Compliance & Legal Division.
- Madoff required extreme discretion from his investors and the fear of losing an opportunity to invest with his infamous returns insured people would refrain from asking questions.



How Could This Occur?

- Numerous feeder funds provided a constant stream of new investors.
- Madoff's was a persuasive salesman and had an immaculate resume .
- Breakdowns in SEC oversight.

Red Flags



- Madoff's industry peers and outside analysts suspected something was not right from the beginning when trying to replicate his investment methods.
- First real concern was raised in May 2000 by Harry Markopolos, then financial analyst at Boston based Rampart Investment Management.

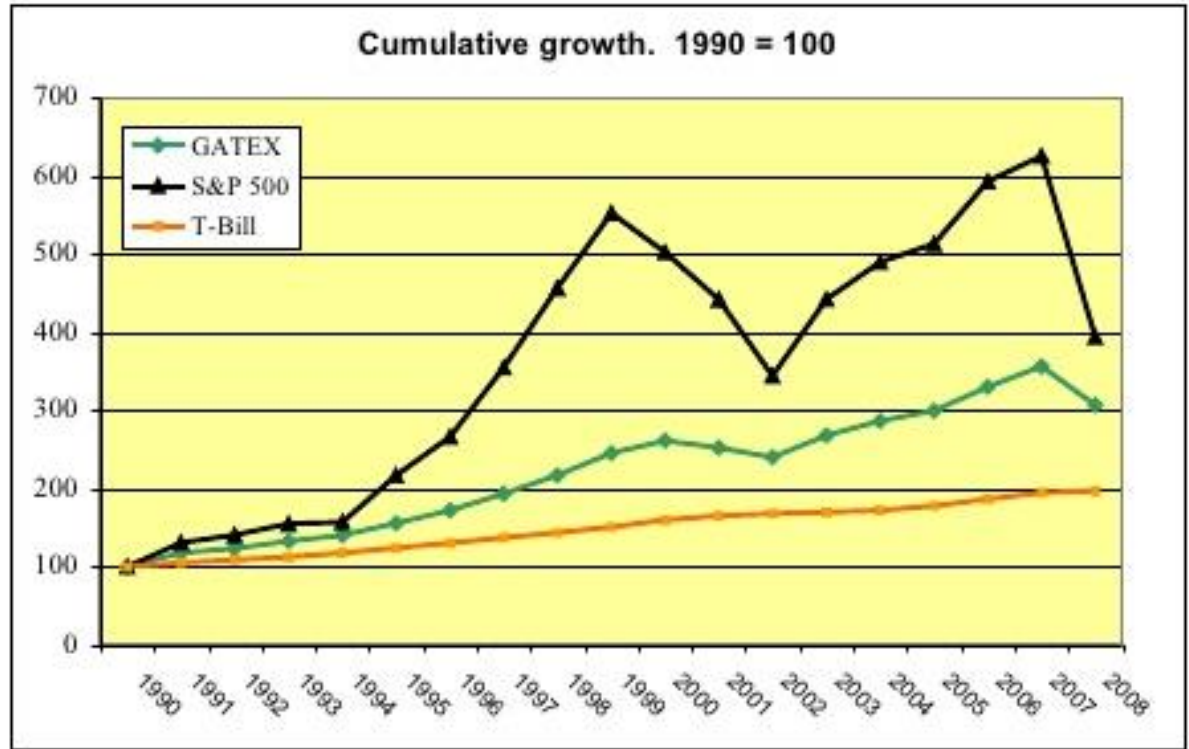
Red Flags

- Markopolos analyzed Madoff's investment performance but the numbers did not add up.
 - In one case, Markopolos mathematically proves that for Madoff to deliver 12% annual returns, he needed to earn 16% to distribute the standard 4% fee to feeder fund managers, a near impossible feat.
- He alerted the SEC multiple times with more than sufficient information for investigation between 2000 – 2007, but no action was taken.

Red Flags: Markopolos Statistical Considerations

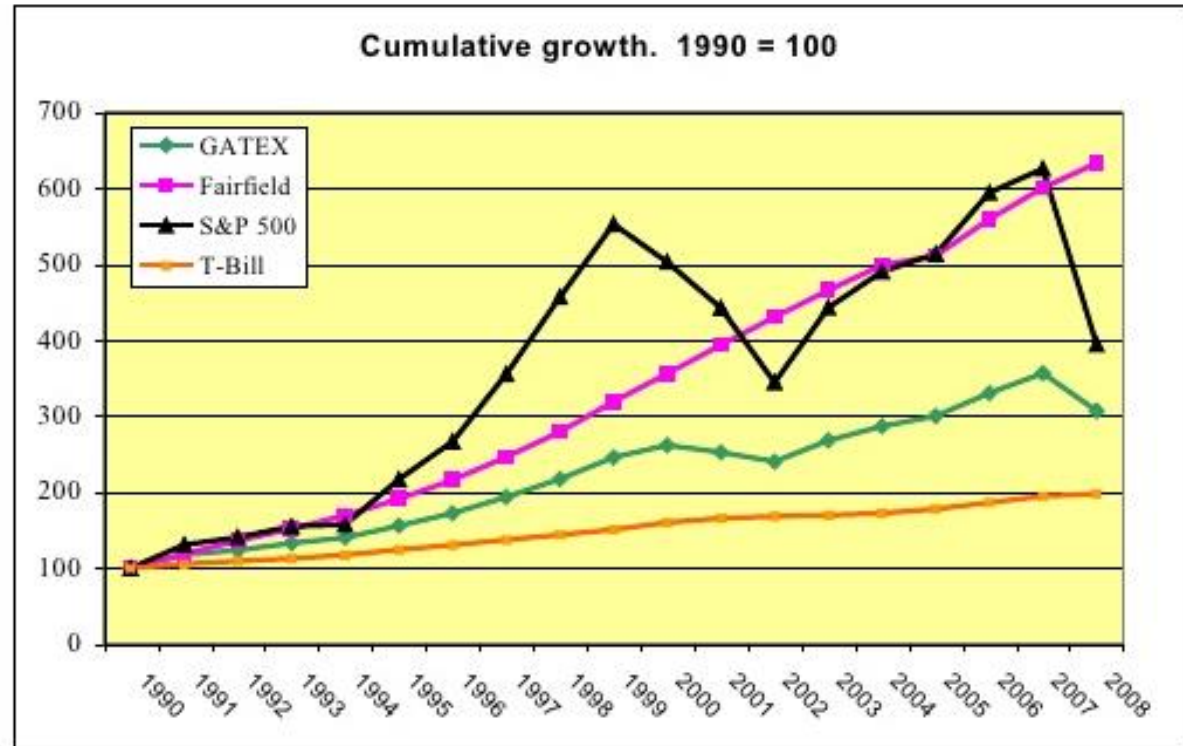
What
Markopolos
expected
Madoff's returns
to be

*S&P 500 tracks
performance of
the top 500
companies in the
U.S.*



Red Flags: Markopolos Statistical Considerations

What Madoff's
returns
supposedly
were for
Fairfield Sentry
"The investor"
who invested
through Madoff's
scheme.



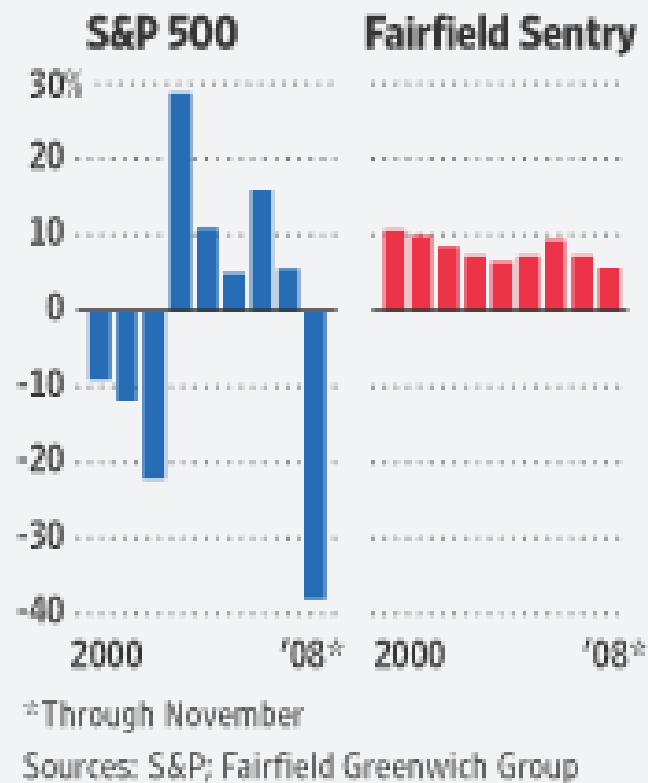
Red Flags: Markopolos Statistical Considerations

- Why is Fairfield Sentry gaining profit when the market is losing money???
- Argument: Maybe Madoff was so talented that he predicted which stocks will outperform the index and only invested in those stocks.
- Counter-argument: The probability of doing this for years is extremely low.
- Any person with some background in statistics should have noticed this inconsistency in data.

Red Flags: Statistical Considerations

Beating the Odds

One fund invested in Madoff's operations showed smooth annual returns



Additional Red Flags

- Madoff avoided filing disclosures of BLMIS's holdings with the SEC.
- Madoff was known for adamantly rejecting any call for an outside audit for "reasons of secrecy".
- Madoff's auditor of record was Friehling & Horowitz, a two-person accounting firm in Rockland County, run by David G. Friehling, a close personal friend of Madoff.
- Madoff Securities, LLC was investigated 5 times between 1999 – 2006 by the SEC.

Additional Red Flags

- As early as 2004, articles were published accusing Madoff of frontrunning.
- Madoff (a pioneer of technological advancement) refused to issue any form of statements via email or provide investors with an online service to view their investment portfolios.
- Madoff's investments have only had 5 down months from 1996 – 2008.
- Madoff managed the largest hedge fund in the world, trading between \$3B - \$6B as early as 2000 and his trades never showed an impact on market volatility.

Additional Red Flags

- Major Hedge funds around the world reduce their exposure to Madoff's fund and large financial institutions stop lending to customers for investment in BLMIS amid suspicions about the consistency of Madoff's returns.
- In 2007 Financial Industry Regulatory Authority (FINRA), the industry-run "watchdog" for brokerage firms reports that parts of Madoff's firm have no customers.

Oversight in SEC Investigations



- 1999 & 2000: investigate concerns about BLMSI hiding its customers' orders from other traders
 - SEC claims it did not find any violations or major issues of concern
- 2004: investigate claims of the firm front-running
 - SEC's Washington office cleared Madoff

Oversight in SEC Investigations



- 2005: investigate Madoff's brokerage firm for violations in his strategy used for customer accounts, requirement of brokers to obtain the best possible price for customer orders, and operating as an unregistered investment advisor
 - SEC finds no evidence of fraud
- 2006: investigate Madoff's firm under potential Ponzi scheme allegations
 - SEC clears Madoff in 2007 (months before his eventual collapse)

Oversight in SEC Investigations



- SEC investigators were young and inexperienced
- There was no proper supervision or instructions
- Lack of due diligence and professional skepticism
- No confirmation of assets by third parties
- Madoff was subpoenaed in May 2006
 - SEC lawyers chose to believe Madoff's lies over examiners who pointed out Madoff's contradictory explanations

The Outcomes

SEC Post-Madoff Reforms



- Revitalizing the Enforcement Division – fully staffed and launched in May 2010.
- Revamping the Handling of Complaints and Tips – created the Office of Market Intelligence (OMI) to gather all tips and complaints in one database to match investigative resources.
- Encouraging Greater Cooperation by ‘Insiders’ – Whistleblower Program.
- Enhancing Safeguards for Investors’ Assets – Surprise Exams, Third Party Reviews, Audit Enhancements, Auditor Access, Custody Reports.

SEC Post-Madoff Reforms



- Improved Risk Assessment Capabilities.
- Improving Internal Controls.
- Improving Fraud Detection Procedures for Examiners.
- Enhancing the Licensing, Education and Oversight Regime for 'Back-Office' Personnel.

Industry Impact



- Accounting profession was highly criticized
- Loss of public trust
 - Madoff's fraud was responsible for approximately \$363B withdrawn from investment funds
- Called for greater transparency to investors
- Majority of public still remains skeptical of the financial industry and Wall Street

Measures of Prevention

- If it looks too good to be true, it probably is.
- Don't put all your eggs in one basket.
- Returns that vary significantly from established markets should be considered suspect
- Invest with known, reputable firms and approach investment with sole market makers cautiously, or not at all.
- Don't bet more than you can afford to lose.
- Research, Reevaluate & Rebalance
- Learn how to identify and spot red flags of potential fraud.

10 Years After

- Of the \$65 billion in fictitious amounts owed to customers, \$17.3 billion was actually invested by customers.
- Only \$7.6 billion has been recovered, but pending lawsuits, only \$2.6 billion is currently available to repay victims.
- On November 9, 2017 the U.S. government announced it would be paying \$772.5 million to over 24,000 victims.
- Law firms tasked with tracking down Madoff's stolen assets for redistribution have been paid over \$800 million in fees.

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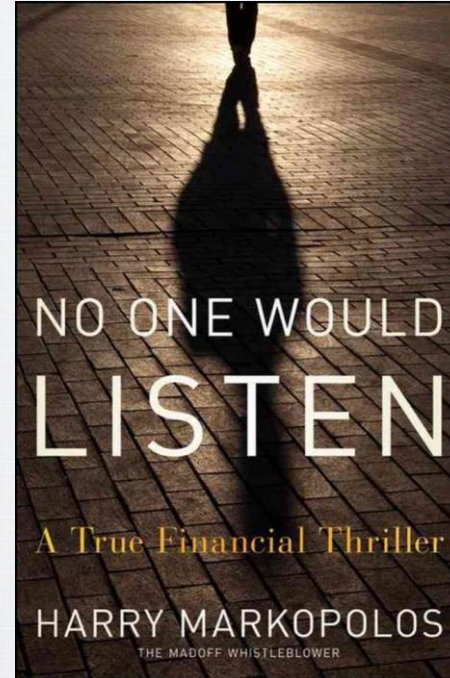
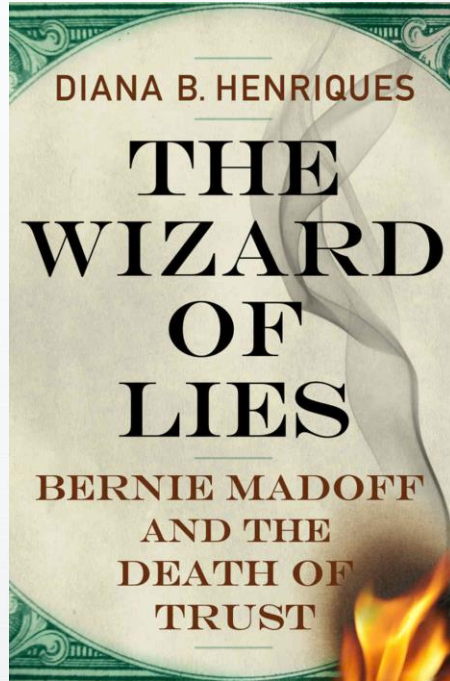
10 Years After

- Madoff resides at the Federal Correctional Institution Butner Medium, Butner, NC

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Additional Reading



Questions





*Thank you to all our clients, colleagues and friends for
your support over the last forty years!*

Brian Johnson, CPA, CFE, CCIFP



Email: bjohnson@dmcpas.com

Web: www.dmcpas.com

Address:

DM Financial Plaza
221 S. Warren St.
Syracuse, New York 13202

Phone: 315-472-9127



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Johnson to your
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