Financial Market Losses

Bernie Madoff

Facts

Loss	Involved	Year
$64.8 bn	Bernard L. Madoff Investment Securities LLC (BMIS)	2008

How a Ponzi scheme works

In the center of the Ponzi scheme is a charismatic, credible, and successful person who promises high returns at little risk. The new investors' funds are used to make payments to earlier investors. The scheme unravels when many investors cash out and there are no new ones to cover the withdrawal.

Story

How the "Bernie scheme" worked

- Bernie Madoff's success story began in the early 70s with the booming trading business of Bernard L. Madoff Investment Securities LLC (BMIS). Madoff built a network within elite country clubs, earned a reputation as a prominent businessman and gained the trust of investors who vouched for his credibility.
- In the late 80s, Madoff announced that his investment advisory firm was using an options strategy that allowed his investments to yield attractive and steady returns (between 10-20 %) at very little risk. However, no securities were traded, and all of the investors' money was collected and simply deposited into a Chase Bank account. Moreover, false statements with fictional profits were provided to clients.
- Madoff created exclusivity and mystery around the investment firm. Initially, he turned down clients, and only worked with business magnates, charitable foundations, and hedge funds. A considerable accelerator for Madoff's scheme was the feeder fund Fairfield Greenwich Group, which started investing exclusively with him in 1990. With approximately $7 billion in investment, the feeder fund was Madoff's largest victim. In 2008, Madoff reported that roughly 50-70 % of his clients were pooled investment vehicles (like Fairfield Greenwich).
- In 2000, 2001, and 2005 the early whistleblower Harry Markopolos sent out a report to the Securities and Exchange Commission (SEC), warning of the "Bernie scheme", but no investigation was launched.
- In 2008, as credit markets froze and many investors cashed out following the collapse of Lehman Brothers, the scheme was revealed. Despite Madoff's effort to raise more money, the firm could not cover $7 billion in redemptions. Madoff turned himself in on 11th December 2008 and was sentenced to 150 years in prison the following year, along with the firm's auditor.
- In addition to BCIM and the auditing firm, many others were blamed for turning a blind eye, missing the red flags and enabling the "Bernie scheme". SEC was also widely criticized for its incapability to detect the fraud despite the numerous reports from early whistleblowers. In 2014, Madoff's banker, JP Morgan Chase, agreed to pay damages of approximately $2 billion for being complicit in aiding his operations.

Timeline

- 1960 – Bernard L. Madoff Investment Securities LLC founded
- 1990 – Feeder Fund investments and Fund grows
- 2000 – First Insider report of Madoff's scheme sent to SEC
- 2008 – Madoff's scheme revealed
- Madoff sentenced to 150 years in prision
- Total loss of $ 64.8 bn was reported

Facts

- Criminal action involved
- Risk management issue
- Compliance issue

Red Flags

- Unlike other hedge funds, BMIS commissioned **no independent brokers** for trade execution, and clients were required to place their positions in the firm's custody. This enabled BMIS to falsify trade confirmations and reports.
- Despite the size and volume of Madoff's fund, **the auditor** that certified the books of BMIS was a three-person firm consisting of two principals, David G. Friehling and Jerome Horowitz, and a part-time secretary.
- The **secrecy and exclusivity** around BCIM hindered normal due diligence activities. Clients were declined or granted only delayed access to offices and the firm's records under the pretext of confidentiality and trade secrets.

+49 6221 6479171
mailbox@forrs.de
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