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Madoff gets 150 years for multi-billion fraud

A private invitation to ruin
Bernard Madoff has taken the secrets of his Ponzi scheme to his relatively comfortable new jail accommodation where he will spend the rest of his life. No one knows, and he isn't telling, how long his fraud lasted, how much it netted and who was in it with him

by Ibrahim Warde

The economic crisis has uncovered all sorts of financial scams. After ultra-sophisticated products that promised the earth before dragging down the whole financial sector, we have what seems to be the most primitive kind of fraud: pyramids. To avoid the risk of making bad investments, the promoters of such operations don't bother with placing the money they take. They simply plunder deposits, using sums deposited by the most recent investors to pay back the earlier ones, and pocket the rest.

We thought we knew all there was to know about Ponzi schemes (see box). They seemed confined to rudimentary financial systems and to investors who stayed on the margins of modern banking. Their perpetrators were usually crooks who came out of nowhere and relieved innocent punters of their cash by making extravagant promises. Pyramids seldom last long; as they reach a certain size they are no longer sustainable. They need more suckers to keep going, and as the numbers dwindle, the scheme is unmasked. But, with the Bernard Madoff affair – "the biggest sting of all time" – everything we thought we knew about Ponzi schemes was upended.

Madoff, a respected member of the establishment, at the very heart of the world financial system, succeeded for at least 20 years in swindling victims, including some of the big names of global finance. Well-known international banks – UBS, Banco Santander, HSBC, BNP-Paribas, Union Bancaire Privée, Royal Bank of Scotland, Nomura – were taken, along with prestigious hedge funds and billionaires (1).The affair burst on the world on 11 December 2008 when the New York-based financier admitted he had never invested one cent of the sums entrusted to his company, Bernard L Madoff Investment Securities (BLMIS). According to the court documents, he had told his wife, his brother and his two sons (all employees of his firm) the day before that he had "absolutely nothing", that "it's all just one big lie," and that he had been running "a giant Ponzi scheme". His sons contacted their attorneys who advised them to inform the FBI. The following day, the Securities and Exchange Commission (SEC) filed charges and Madoff was arrested. He was released against $10m bail, and remained in his luxurious Manhattan apartment until 12 March 2009 when he pleaded guilty to 11 major charges including fraud, perjury, money laundering and theft, and was sent to jail.

On 29 June Madoff, at the age of 71, was sentenced to the maximum available term demanded by the public prosecutor: 150 years in prison. In the words of Prosecutor Lev Dassin: "The scope, duration and nature of Madoff's crimes render him exceptionally deserving of the maximum punishment allowed by law." Judge Denny Chin spoke of "an extraordinarily diabolical crime" committed by an “evil man” and of a “massive breach of trust” that “took a staggering human toll” (2). Before his fall, Madoff had epitomised the American dream: the young man from Queens, a one-time lifeguard, who started his business aged 22 with $5,000; the faithful husband and companion of his wife Ruth, his childhood sweetheart; the head of a family business that employed – besides his wife – his brother, his two sons and niece. After almost half a century of hard work he controlled a little empire and had reached the apex of financial respectability.

Bernard Madoff, chairman of Nasdaq from 1990-3, was involved in all the major professional associations. As a member of the Securities Industry Association (SIA) he lobbied tirelessly for the democratisation and modernisation of the securities market. This man above suspicion made himself the champion of ethics, working for the small shareholder and arguing in favour of lowering the cost of transactions. Beyond market circles, Madoff was known as a philanthropist who contributed generously to humanitarian causes and sat on the boards of prestigious charitable and cultural institutions (3).

‘We thought he was God’

Madoff inspired confidence and charities were among his prize targets (4). The words credit, creed and credibility all share a common Latin root: credere, to believe. Elie Wiesel, who lost $22m of his personal fortune as well as $15m from the Elie Wiesel Foundation for Humanity, lamented: “We gave him everything, we thought he was God.” The Nobel Peace Prize winner met the financier just twice, and they talked about education and ethics. Many philanthropists (including film-director Steven Spielberg and the billionaires Mortimer Zuckerman and Carl Shapiro) saw Madoff’s “method”, with its high and stable yields, as perfectly suited to the charitable environment. As Wiesel explained: “Everyone we know in the field of finance told us... you can do much more, more projects because of Mr Madoff the saviour” (5).

He built a reputation as a financial genius capable of generating profits of between 10-15% in good times and bad, even higher for some privileged investors looking for better returns in exchange for larger deposits. Madoff appeared conservative: he made it clear that he did not seek the stratospheric returns of hedge funds, which came at the price of too much risk. Rather, he boasted of stable returns, and above all the security of investments. Despite the ups and downs of markets, he could deliver, metronome-like, predictable returns. The sentencing judge quoted his words to a widow who had just entrusted him with all her savings. As he hugged her, he said: “Your money is safe with me” (6).

Promoters of pyramid schemes always claim to have a secret formula for success. Charles Ponzi claimed that international response coupons enabled him to make lucrative swaps. Madoff’s secret weapon was supposed to be “split-strike conversion” (7), which allowed him, recession or not, to beat the market.

When he was asked for precise information he hid behind a barrier of professional secrecy. Harry Markopolos, a competitor of Madoff’s firm, attempted unsuccessfully to reverse-engineer the “technique” to obtain comparable results. Convinced that the financial genius was a swindler, he launched a crusade to warn the SEC of his suspicions. Between 1999 and 2005 he sent three reports (the last of which was called “The world’s largest hedge fund is a fraud”) pointing out the red flags that should have alerted investors and regulators. Markopolos had two hypotheses: the first, and more likely, was that the profits were imaginary, and that the operation was a gigantic Ponzi scheme; the second was that the profits were real but were the results of massive insider trading.

In fact, Madoff ran two businesses: a legitimate brokerage and a fraudulent investment company. The first, well established and law-abiding, served as cover for the second. This explains the keenness of some to invest with Madoff. Rumour had it among finance professionals that the real secret of his impeccable timing and golden touch lay in his mastery of “front running” – which is illegal – through which he kept himself, via his brokerage activities, ahead of buying and selling trades likely to impact the market. He invested based on that insider knowledge. It’s understandable that some clients who suspected large-scale insider trading but believed themselves to be benefiting indirectly, chose not to ask too many questions about the miraculous results.

Greatest possible discretion

Ponzi schemes require savoir-faire. They often flourish in certain communities, religious or ethnic, in “affinity groups”. This was the case at the start, when Madoff set his sights on personal acquaintances in New York’s Jewish community. The chain then extended to Palm Beach, Florida, and to Boston before reaching communities, first in the US and then around the world. In contrast to the usual loud publicity of pyramid promoters, Madoff preferred word of mouth and subtle marketing ploys, since he knew the attraction of rareness and exclusivity. Like Groucho Marx, who said he would not join any club that accepted him as a member, the lure of a deal from which one is excluded proved irresistible.

Madoff’s touts, whose hunting grounds were the most exclusive country and golf clubs, made it clear upfront to the customer that Madoff’s funds were closed and not accepting new investors. Then, a few days later, the same touts held out the vague possibility of admission, even of a meeting with Madoff, all the while insisting that nothing was certain. As to what followed, all the witnesses agree. Saying very little, Madoff at first would be unenthusiastic and then agree to make a little room for a new investor. Delighted to belong to such a select club, the client lowered his guard, asked few questions and accepted the rule not to say a word about the deal, under threat of eviction. In Madoff’s words: “If you invest with me, you must never tell anyone that you’re invested with me. It’s no one’s business what goes on here” (8). Most investors believed they were part of a privileged inner circle and were unaware of Madoff’s huge reach.

Ponzi schemes normally collapse quickly. The longevity of Madoff’s system was explained by its continuous geographical expansion and by systematic recourse, driven by the touts, to a worldwide network of feeder funds and mainstream banks offering highly lucrative investments, often with no reference to Madoff. This way, with the greatest possible discretion, he harnessed savings from around the world, generating the cash flow needed to sustain the fraud. In practice, most investors didn’t place their money directly with the financier but via funds like Fairfield Greenwich Advisors ($7.5bn), Ascot Partners ($1.8bn) or Access International Advisors

($1.5bn). Many banks sold their customers shares in funds invested principally or totally with Madoff: Banco Santander ($2.87bn), Bank Medici ($2.1 bn), Fortis ($1.35bn), HSBC ($1bn), Union Bancaire Privée ($700m), ?Natixis ($554m), Royal Bank of Scotland ($493m) (9).

According to the first estimates of the Autorité des marchés financiers (AMF), the amount of French savings sunk into Madoff funds is likely to total $650m and involve 3-5,000 investors. Some had direct contact with Madoff, who owned a villa at Antibes and often visited France, but most of the investment was through a company called Access International Advisors, run by Thierry Magon de la Villehuchet, a former Paribas and Crédit Lyonnais executive who, unluckily, was charmed by Madoff and placed all his clients' cash with him. The chief of these was the Luxembourg fund LuxAlpha, with a sales force including Prince Michel of Yugoslavia and Philippe Junot, a former husband of Princess Caroline of Monaco. The couturier Daniel Hechter lost most of his fortune; Liliane Bettencourt, the L'Oréal heiress, lost some $39m while the industrialist Bernard Arnault narrowly escaped by cashing most of his shares in the summer of 2008.

Besides aristocrats and industrialists, many of the victims were small investors who had never heard of Madoff and thought their money was safe in funds managed by banks and other investment advisers. Magon de la Villehuchet, devastated by the losses he had caused these investors, and financially ruined himself, committed suicide on 23 December 2008 in his New York office.

The rush of large financial institutions to buy into Madoff, often without their clients' knowledge, is explained by the high rates of return and by a very advantageous system of commissions and discounts. Ezra Merkin – the former boss of GMAC, the financial subsidiary of General Motors, and a specialist in not-for-profit organisations – personally took $470m from a total of $2.4bn placed with Madoff over the years via his Ascot Partners hedge fund.

Motives unrevealed

The financial crisis of 2008 called Madoff's bluff. Investments in Bernard L Madoff Investment Securities were, on the face of it, more profitable than ever, a haven in the storm. The more markets collapsed, the more Madoff's fictional profits seemed exceptional. But too many investors, under pressure elsewhere as the crisis deepened, reluctantly decided to withdraw their investments. Madoff made one last effort to save his business: the man who had been so discreet and inaccessible went in person to the banks and institutional investors asking them to provide him with supplementary funds. He attempted, without success, to launch even more lucrative products, and pressured feeder funds to limit their withdrawals. At the start of December he faced withdrawal demands for $7bn while he had less than $1bn in the bank.

Because Madoff pleaded guilty there was no trial. That meant there could be no major official revelations about the sting. As Judge Denny Chin noted when pronouncing his verdict, the crook had revealed almost nothing about his methods. We still don't know when or why he began his fraud. "At the start of the 1990s," said a cryptic Madoff, although investigators suspect that the fraud began at least 10 years earlier, and perhaps much more than that.

We don’t know what his motives were. Was he looking to cover losses suffered in the course of legitimate activities or from bad investments, or did he plan this monumental scam from the start? Who were his accomplices? He claimed to have worked on his own, which is hard to believe. Only one other person has been charged, his accountant David Friehling, BMIS’s auditor. What about the role of his wife Ruth? They were inseparable. Shortly before his arrest she withdrew $15m from the company account. What about his brother, his son and his niece, all of them on the company payroll?

Grey areas remain

Tracing the cash will be an accounting and legal nightmare. In the absence of hard evidence, rumours and fantasies abound. What was the total amount of the fraud? Any calculation that mixes actual losses and fictional profits is tough to unscramble. The court mentioned $65bn, the financier talked of $50bn, but investigators have been unable to pinpoint anything like these sums. Victims want to know what remains, for investigators have recovered just $1.2bn.

In such a convoluted system of fund-feeding there are grey areas. Not all the victims have stepped forward, particularly those who, out of embarrassment or discretion, prefer to avoid being associated with Madoff’s name. Other questions complicate the investigation: did the fraud serve as a cover for tax evasion and capital flight? Were tax havens used to launder money?

In all, 15,400 legal actions have been taken out against Madoff (10). Charges name the many funds and institutions directly or indirectly implicated. Levels of responsibility vary, from active complicity to gross negligence. What’s for sure is that the intermediaries did not meet their fiduciary obligations: their remuneration was both excessive and unjustified, they failed to perform adequate due diligence, and they ignored danger signs (11).

Problems of repayment and indemnity calculations are another huge headache. The “three million” victims of the crime are not all in the same boat. They include billionaires and small savers, hedge funds that were hardly touched and families who have lost everything, and charitable organisations with their invisible victims. A distinction has already been drawn between direct investors with Madoff’s company, who could be indemnified up to a maximum of $500,000 by the Securities Investor Protection Corporation (SIPC), and indirect investors who have no such claims.

Irving Picard, who acts as trustee, has yet to take a position on the issue of investors who profited (those who withdrew more than they invested, making them involuntary accomplices) and on the issue of privileged investors who had the right, because of special deals with Madoff, to higher interest levels than the others.

Since the scandal broke, there has been a wave of revelations about Ponzi schemes and similar frauds (12). The best-known case is that of the Texan billionaire Allen Stanford, who is alleged to have stolen $9bn from clients of his Stanford International Bank based in Antigua. Because the border between the real and the virtual is blurring, fictitious profits can seem true. The political, ideological and practical implications of financial deregulation have created new power relations between the public and private sectors. Nothing was simpler than evading the public watchdogs. The incompetence and inefficiency of the SEC is clear, given its record of three investigations into Madoff's activities without discovering anything. The "war on terror" and the belief in self-regulation of markets no doubt put the fight against white-collar crime on the back burner.

Soothing words on the paradise of financial globalisation and on the pure perfection of regulation regimes quelled fears and reassured investors. Madoff said in October 2007: "In today's regulatory environment, it is virtually impossible to violate rules."

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(1) Bernie Madoff's Clients: The Official List, The Business insider, 5 February 2009.

(2) Tom McElroy, Boston Globe, 26 June 2009, and Diana B Henriques, New York Times, 29 June 2009.

(3) Julie Creswell and Landon Thomas Jr, New York Times, 24 January 2009.

(4) Ross Kerber and Hinda Mandell, Boston Globe, 21 December 2008.

(5) Wiesel lost everything to Madoff, Portfolio.com, 26 February 2009.

(6) Robert Frank and Amir Efrati, Wall Street Journal, 30 June 2009.

(7) The technique involves buying shares in large companies listed on the S&P 100 while simultaneously trading options on these shares with the aim of limiting the portfolio's volatility.

(8) Erin E Arvedlund, Barron's, New York, 7 May 2001.

(9) Madoff's Victims, The Wall street journal, 6 March 2009.

(10) Larry Neuemeister, Boston Globe, 10 July 2009.

(11) An example of dubious practice: BMIS sent fictional and created after-the-event statements to clients, but only by fax or post. Why should a company that boasted of state-of-the-art technology decline to put client statements online?

(12) See Jeremy Grant and Joanna Chung, Financial Times, London, 19 January and 29 June 2009.