CASE 1.12

Madoff Securities

Bernie wanted to be rich; he dedicated his life to it.

John Maccabee, longtime friend of Bernie Madoff

Bernard Lawrence Madoff was born on April 29, 1938, in New York City. Madoff spent his childhood in a lower middle-class neighborhood in the borough of Queens. After graduating from high school, Madoff enrolled in the University of Alabama but transferred to Hofstra College, now known as Hofstra University, on Long Island at the beginning of his sophomore year. Three years later in 1960, he graduated with a political science degree from Hofstra.

According to a longtime friend, the driving force in Madoff's life since childhood was becoming wealthy. "Bernie wanted to be rich; he dedicated his life to it."[1] That compelling force no doubt accounted for Madoff's lifelong fascination with the stock market. As a teenager, Madoff frequently visited Wall Street and dreamed of becoming a "major player" in the world of high finance. Because he did not have the educational training or personal connections to land a prime job on Wall Street after he graduated from college, Madoff decided that he would set up his own one-man brokerage firm.

While in college, Madoff had accumulated a $5,000 nest egg by installing sprinkler systems during the summer months for wealthy New Yorkers living in the city's exclusive suburbs. In the summer of 1960, Madoff used those funds to establish Bernard L. Madoff Investment Securities LLC, which was typically referred to as Madoff Securities. Madoff operated the new business from office space that was provided to him by his father-in-law, who was a partner in a small accounting firm. For nearly five decades, Madoff served as the senior executive of Madoff Securities. During that time, the shy New Yorker, who had an occasional stammer and several nervous tics, would accumulate a fortune estimated at more than one billion dollars.

Taking on Wall Street

Initially, Madoff's brokerage firm traded only securities of small over-the-counter companies, securities commonly referred to as "penny stocks." At the time, the securities of most large companies were traded on the New York Stock Exchange (NYSE). The rules of that exchange made it extremely difficult for small brokerage firms such as Madoff's to compete with the cartel of large brokerage firms that effectively controlled Wall Street. Madoff and many other small brokers insisted that the NYSE's rules were anticompetitive and inconsistent with a free market economy. Madoff was also convinced that the major brokerage firms kept securities transaction costs artificially high to produce windfall profits for themselves to the detriment of investors, particularly small investors.

Because of Madoff's resentment of the major Wall Street brokerage firms he made it his mission to "democratize" the securities markets in the United States while at the same time reducing the transaction costs of trading securities. "Bernie was the king of democratization. He was messianic about this. He pushed to automate the [securities trading] system, listing buyers and sellers on a computer that anyone could access."[2]

---

1. J. Maccabee, "Mom and Dad and Ruth and Bernie," *New York Magazine* (nymag.com), 22 February 2009.
2. S. Fishman, "The Monster Mensch," *New York Magazine* (nymag.com), 22 February 2009.

In fact, Madoff Securities was one of the first brokerage firms to utilize computers to expedite the processing of securities transactions. Bernie Madoff is also credited as one of the founders of the NASDAQ stock exchange that was organized in 1971. The NASDAQ was destined to become the world's largest electronic stock exchange and the largest global stock exchange in terms of trading volume. In the late 1980s and early 1990s, Madoff served three one-year terms as the chairman of the NASDAQ.

Madoff's leadership role in the development of electronic securities trading contributed significantly to his firm's impressive growth throughout the latter decades of the 20th century. By the early years of the 21st century, Madoff Securities was the largest "market maker" on the NASDAQ, meaning that the firm accounted for more daily transaction volume on that exchange than any other brokerage.[3] By that time, the firm was also among the largest market makers for the New York Stock Exchange, accounting for as much as five percent of its daily transaction volume. This market-making service was lucrative and low risk for Madoff Securities and reportedly earned the firm, which was privately owned throughout its existence, annual profits measured in the tens of millions of dollars.

In 1962, Madoff had expanded his firm to include investment advisory services. For several years, most of the individuals who set up investment accounts with Madoff Securities were referred to him by his father-in-law. Although the firm was a pioneer in electronic trading and made sizable profits from its brokerage operations, investment advisory services would prove to be its most important line of business. By late 2008, the total value of customer accounts that Madoff Securities managed had reached $65 billion.

The key factor that accounted for the incredible growth in the amount of money entrusted to Madoff's firm by investors worldwide was the impressive rates of return that the firm earned annually on the funds that it managed. For decades, those funds earned an average annual rate of return generally ranging from 10 to 15 percent. Although impressive, those rates of return were not spectacular. What *was* spectacular was the consistency of the returns. In 2001, *Barron's* reported that some of the Madoff firm's largest investment funds had never experienced a losing year despite significant stock market declines in several individual years.[4] Even when the stock market collapsed in late 2008, individual Madoff funds continued to report net gains for the year-to-date period.

Although Madoff would eventually serve as an investment adviser to dozens of celebrities, professional athletes, and other wealthy individuals, most of the money he managed came from so-called "feeder firms," which were large hedge funds, banks, and other investment companies. The individuals who had committed their funds to these feeder firms were typically unaware that those funds had been turned over to Madoff.

The reclusive Madoff and his subordinates disclosed as little as possible about the investment strategy responsible for their firm's success in the stock market. On one occasion, Madoff told an executive of a feeder firm, "It's no one's business what goes on here."[5] The *Wall Street Journal* reported that Madoff commonly "brushed off" skeptics

---

3. *Investopedia,* an online encyclopedia of business terms, provides the following description of a "market maker": "Broker-dealer firm that accepts the risk of holding a certain number of shares of a particular security in order to facilitate trading in that security. Each market maker competes for customer order flow by displaying buy and sell quotations for a guaranteed number of shares. Once an order is received, the market maker immediately sells from its own inventory or seeks an offsetting order."

4. *Barron's* (online), "What We Wrote About Madoff," 12 December 2008.

5. *Ibid.*

who questioned his firm's investment results by pointing out that those results had been audited and by insisting that his investment strategy "was too complicated for outsiders to understand."[6]

The only substantive information Madoff Securities provided regarding its investment policies was that it employed a "split-strike conversion" investment model. In simple terms, this strategy involved purchasing several dozen blue-chip stocks and then simultaneously selling both put options and call options on those securities. Supposedly, this strategy ensured a positive rate of return on those investments whether the stock market went up or down.

Competitors, financial analysts, and academics repeatedly attempted to replicate the success of Madoff Securities' investment strategy. None of those attempts were successful, which only added to Bernie Madoff's stature and mystique on Wall Street. As one industry insider noted in 2001, "[e]ven knowledgeable people can't really tell you what he's doing."[7] A CNN reporter observed that by the turn of the century Madoff was widely regarded as a stock market wizard and that "everyone" on Wall Street, including his closest competitors, was "in awe of him."[8]

The Bubble Bursts

On December 10, 2008, Bernie Madoff told his two sons who worked at Madoff Securities to meet him at his apartment that evening. In this meeting, Madoff reportedly told his sons that the impressive returns earned for clients of his firm's investment advisory division over the previous several decades had been fraudulent. Those returns had been produced by an elaborate Ponzi scheme engineered and overseen by Madoff without the knowledge of any of his employees or family members.[9] The following day, an attorney representing Madoff's sons notified the SEC of their father's confession. That evening, FBI agents came to Madoff's apartment. One of the agents asked Madoff "if there was an innocent explanation" for the information relayed to the SEC from his sons.[10] Madoff replied, "There is no innocent explanation."[11] The agents then placed Madoff under arrest and within hours filed securities fraud charges against him.

The public announcement of Madoff's fraudulent scheme in December 2008 stunned investors worldwide. That announcement further undercut the stability of global stock markets that were already reeling from the subprime mortgage crisis in the United States, which had "frozen" the world's credit markets, caused stock prices to drop precipitously, and threatened to plunge the global economy into a deep depression. Politicians, journalists, and everyday citizens were shocked to learn that a massive investment fraud, apparently the largest in history, could go undetected for decades within the capital markets of the world's largest economic power. Even more disconcerting was the fact that the Madoff fraud went undetected for several years

6. G. Zuckerman, "Fees, Even Returns and Auditor All Raised Flags," *Wall Street Journal* (online), 13 December 2008.

7. *Ibid.*

8. A. Chernoff, "What Drove Bernie Madoff," *CNNMoney.com*, 5 January 2009.

9. *Investopedia* provides the following description of a "Ponzi scheme": "A fraudulent investing scam promising high rates of return with little risk to investors. The Ponzi scheme generates returns for older investors by acquiring new investors. This scam actually yields the promised returns to earlier investors, as long as there are more new investors. These schemes usually collapse on themselves when the new investments stop."

10. Fishman, "The Monster Mensch."

11. *Ibid.*

after the implementation of the far-reaching regulatory reforms mandated by the U.S. Congress in the wake of the Enron and WorldCom debacles.

News of the Madoff fraud caused a wide range of parties to angrily demand that the federal government and law enforcement authorities determine why the nation's "watchdog" system for the capital markets had failed once again. The accounting profession was among the first targets of the public's anger. On the day that Madoff's fraud was publicly reported, Floyd Norris, a *New York Times* reporter acquainted with Madoff, asked a simple question that was on the minds of many people, namely, "[w]ho were the auditors?"[12]

"Rubber-stamped" Financial Statements

Business journalists quickly determined that the auditor of Madoff Securities was Friehling & Horowitz, an accounting firm located in the small New York City suburb of New City. Friehling & Horowitz had issued unqualified opinions on the financial statements of Madoff's firm since at least the early 1990s. Madoff had paid Friehling & Hororwitz nearly $200,000 in annual audit fees.

Further investigation revealed that Friehling & Horowitz had only one active accountant, one non-professional employee (a secretary), and operated from a tiny office occupying approximately two hundred square feet. The active accountant was David Friehling, who had performed the annual audits of Madoff's firm and signed off on the firm's unqualified audit opinions. Accounting and auditing experts interviewed by the Associated Press insisted that it was "preposterous" to conceive that any one individual could complete an audit of a company the size of Madoff Securities by himself.[13]

Friehling and his firm were members of the American Institute of Certified Public Accountants (AICPA). A spokesperson for that organization revealed that Friehling had reported to the AICPA each year that he did not perform any audits. As a result, Friehling's firm was not required to submit to the AICPA's peer review program for CPA firms. Friehling's firm was also not required to have a periodic peer review at the state level. At the time, New York was one of six states that did not have a mandatory peer review program for accounting firms.

In March 2009, *The New York Times* reported that Friehling had maintained dozens of investment accounts with Madoff Securities, according to documents obtained by the court-appointed trustee for that firm. Those same documents indicated that Friehling & Horowitz had another 17 investment accounts with Madoff's firm. In total, Friehling, his accounting firm, and his family members had nearly $15 million invested in funds managed by Madoff. Federal prosecutors noted that these investments had "flouted" the accounting profession's auditor independence rules and "disqualified" Friehling from serving as the auditor of Madoff Securities.[14]

David Friehling would be the second person arrested by federal law enforcement authorities investigating Madoff's fraud. On March 17, 2009, federal prosecutors charged Friehling with securities fraud and with aiding and abetting an investment fraud. The prosecutors did not allege that Friehling was aware of Madoff's fraudulent scheme but rather that he had conducted "sham audits" of Madoff Securities that had "helped foster the illusion that Mr. Madoff legitimately invested his clients' money."[15]

---

12. F. Norris, "Bernie Madoff," *New York Times* (online), 12 December 2008.

13. Associated Press (online), "Questions Surround Madoff Auditor," 17 December 2008.

14. New York State Society of Certified Public Accountants, "Madoff Auditor Charged for Role in Massive Fraud," 19 March 2009 (www.nysscpa.org/ezine/ETPArticles/ML31909a.htm).

15. L. Neumeister, "Federal Appeals Court to Hear Madoff Jail Argument," Associated Press (online), 19 March 2009.

News reports of Friehling's alleged sham audits caused him to be berated in the business press. A top FBI official observed that Friehling's "job was not to merely rubber-stamp statements that he didn't verify" and that Friehling had betrayed his "fiduciary duty to investors and his legal obligation to regulators."[16] An SEC official maintained that Friehling had "essentially sold his [CPA] license for more than 17 years while Madoff's Ponzi scheme went undetected."[17] Many parties found this and other denigrating remarks made by SEC officials concerning Friehling ironic since the federal agency was itself the target of scornful criticism for its role in the Madoff fiasco.

Sir Galahad and the SEC

On at least eight occasions, the SEC investigated alleged violations of securities laws by Madoff Securities during the two decades prior to Bernie Madoff's startling confession. In each case, however, the investigation concluded without the SEC charging Madoff with any serious infractions of those laws. Most of these investigations resulted from a series of complaints filed with the SEC by one individual, Harry Markopolos.

On the March 1, 2009, edition of the CBS news program *60 Minutes*, investigative reporter Steve Croft observed that until a few months earlier Harry Markopolos had been an "obscure financial analyst and mildly eccentric fraud investigator from Boston." Beginning in 1999, Markopolos had repeatedly told the SEC that Bernie Madoff was operating what he referred to as the "world's largest Ponzi scheme." Between May 2000 and April 2008, Markopolos mailed or hand delivered documents and other evidence to the SEC that purportedly proved that assertion. Although SEC officials politely listened to Markopolos's accusations, they failed to vigorously investigate them.

One lengthy report that Markopolos sent to the SEC in 2005 identified 29 specific "red flags" suggesting that Madoff was perpetrating a massive fraud on his clients. Among these red flags was Madoff's alleged refusal to allow the Big Four auditor of an investment syndicate to review his financial records. Another red flag was the fact that Madoff Securities was audited by a one-man accounting firm, namely, Friehling & Horowitz. Also suspicious was the fact that Madoff, despite his firm's leadership role in electronic securities trading, refused to provide his clients with online access to their accounts, providing them instead with monthly account statements by mail.

Among the most credible and impressive evidence Markopolos gave to the SEC were mathematical analyses and simulations allegedly proving that Madoff's split-strike conversion investment strategy could not consistently produce the investment results that his firm reported. Markopolos noted that if such an investment strategy existed, it would be the "Holy Grail" of investing and eventually be replicated by other Wall Street investment advisors. Even if Madoff had discovered this Holy Grail of investing, Markopolos demonstrated there was not sufficient transaction volume in the options market to account for the huge number of options that his investment model would have required him to buy and sell for his customers' accounts.

In the months following the public disclosure of Madoff's fraud, Harry Markopolos reached cult hero status within the business press. Markopolos was repeatedly asked

16. W. K. Rashbaum and D. B. Henriques, "Accountant for Madoff Is Arrested and Charged With Securities Fraud," *New York Times* (online), 18 March 2009.

17. *Ibid.*

to comment on and explain the scope and nature of Madoff's scheme. Markopolos's dissection of Madoff's fraud suggested that three key factors accounted for it continuing unchecked for decades.

First, Madoff targeted investors who were unlikely to question his investment strategy. According to Markopolos, a large number of "smart" investors had refused to invest with Madoff despite his sterling record. "Smart investors would stick to their investment discipline and walk away, refusing to invest in a black-box strategy they did not understand. Greedy investors would fall over themselves to hand Madoff money."[18]

The second factor that allowed Madoff's fraud to continue for decades was his impeccable credentials. Even if his impressive investment results were ignored, Madoff easily qualified as a Wall Street icon. He was a pioneer of electronic securities trading and throughout his career held numerous leadership positions within the securities industry, including his three stints as NASDAQ chairman. Madoff's stature on Wall Street was also enhanced by his well-publicized philanthropy. He regularly contributed large sums to several charities.

The final and most important factor that allowed Madoff to sustain his fraudulent scheme was the failure of the regulatory oversight function for the stock market. In testimony before Congress and media interviews, Harry Markopolos has insisted that the Madoff debacle could have been avoided or at least mitigated significantly if federal regulators, particularly the SEC, had been more diligent in fulfilling their responsibilities. According to Markopolos, Madoff knew that the SEC's accountants, attorneys, and stock market specialists were "incapable of understanding a derivatives-based Ponzi scheme" such as the one he masterminded. [19] That knowledge apparently emboldened Madoff and encouraged him to continually expand the scope of his fraud.

Even after Markopolos explained the nature of Madoff's fraud to SEC officials, they apparently did not understand it. "I gift-wrapped and delivered the largest Ponzi scheme in history to them . . . [but the SEC] did not understand the 29 red flags that I handed them."[20] The outspoken SEC critic went on to predict that "[i]f the SEC does not improve soon, they risk being merged out of existence in the upcoming rewrite of the nation's regulatory scheme."[21]

Markopolos's pointed criticism of the SEC and additional harsh criticism by several other parties forced the agency's top officials to respond. An embarrassed SEC Chairman Christopher Cox admitted that he was "gravely concerned" by the SEC's failure to uncover the fraud. [22]

> *In an extraordinary admission that the SEC was aware of numerous red flags raised about Bernard L. Madoff Investment Securities LLC, but failed to take them seriously enough, SEC Chairman Christopher Cox ordered a review of the agency's oversight of the New York securities-trading and investment management firm.*[23]

---

18. D. Carrozza, "Chasing Madoff," *Fraud Magazine*, May/June 2009, 39.

19. *Ibid.*, 57.

20. J. Chung and B. Masters, "SEC 'Illiteracy' to Blame for Madoff Affair," *Financial Times* (online), 4 February 2009.

21. Carozza, "Chasing Madoff," 58.

22. A. Lucchetti, K. Scannell, and A. Efrati, "SEC to Probe Its Ties to Madoffs," *Wall Street Journal* (online), 17 December 2008.

23. *Ibid.*

EPILOGUE

On March 12, 2009, Bernie Madoff appeared before Judge Denny Chin in a federal courthouse in New York City. After Judge Chin read the eleven counts of fraud, money laundering, perjury and theft pending against Madoff, he asked the well-dressed defendant how he pled. "Guilty," was Madoff's barely audible one-word reply. Judge Chin then told Madoff to explain what he had done. "Your honor, for many years up until my arrest on December 11, 2008, I operated a Ponzi scheme through the investment advisory side of my business."[24] Madoff then added, "I knew what I did was wrong, indeed criminal. When I began the Ponzi scheme, I believed it would end shortly and I would be able to extricate myself and my clients . . . [but a] s the years went by I realized this day, and my arrest, would inevitably come."[25]

Despite allegations that his two sons, his brother, and his wife were at least knowledgeable of his fraud and possibly complicit in it, Madoff refused to implicate any of them or any of his other subordinates. Madoff claimed that he alone had been responsible for the fraud and that the brokerage arm of his business, which had been overseen by his brother and his two sons, had not been affected by his Ponzi scheme. On June 29, 2009, Madoff appeared once more in federal court. After reprimanding Madoff for his actions, Judge Chin sentenced him to 150 years in federal prison, meaning that the 71-year-old felon would spend the rest of his life incarcerated.[26]

In November 2009, David Friehling, Madoff's longtime auditor, pleaded guilty to numerous charges in a Manhattan federal court. These charges included securities fraud, obstructing or impeding the administration of federal tax laws, and submitting false filings to the SEC. Friehling, who was to be sentenced in 2010, faced a prison sentence of more than 100 years. In March 2009, the AICPA announced that it had expelled Friehling for not cooperating with its investigation of his audits of Madoff Securities. The controversy over the failure of Friehling's firm to undergo any peer reviews prompted the New York state legislature to pass legislation in December 2008 requiring New York accounting firms that provide attest services to be peer reviewed every three years.[27]

Although none of the Big Four accounting firms were directly linked to Madoff Securities, legal experts speculated that those firms might face civil lawsuits in the wake of Madoff's fraud. This potential liability stems from the Big Four's audits of the large "feeder firms" that entrusted billions of dollars to Madoff. Lynn Turner, a former chief accountant of the SEC, contends that the auditors of the feeder firms had a responsibility to check out Madoff's auditor. "If they didn't, then investors will have to hold the auditors [of the feeder firms] accountable."[28]

In February 2009, KPMG became the first of the Big Four firms to be named as a defendant in a civil lawsuit triggered by the Madoff fraud. A California charity sued the prominent accounting firm to recover the millions of dollars it lost due to Madoff's scheme. KPMG had served as the independent auditor of a large hedge fund that had hired Madoff to invest the charity's

24. D. B. Henriques and J. Healy, "Madoff Goes to Jail After Guilty Plea," *New York Times* (online), 13 March 2009.

25. *Ibid.*

26. In August 2009, Frank DiPascali, Madoff Securities' former chief financial officer, pleaded guilty to complicity in Madoff's fraudulent scheme. During an appearance in federal court, DiPascali testified that, "It was all fake; it was all fictitious. It was wrong and I knew it at the time" (C. Bray and T. Lauricella, "'All Fake': Key Madoff Executive Admits Guilt," *Wall Street Journal* (online), 11 August 2009.)

27. Ironically, the New York law exempts accounting firms that have fewer than three professional accountants, meaning that Friehling & Horowitz would not have been required to undergo a peer review if the law had been in place during the time span covered by Madoff's fraud.

28. I. J. Dugan and D. Crawford, "Accounting Firms That Missed Fraud at Madoff May Be Liable," *Wall Street Journal* (online), 18 February 2009.

funds. A legal expert commented on the allegations pending against KPMG:

> *[t]he suit alleges that the [hedge] fund's auditor, KPMG, missed numerous red flags that should have alerted the auditor to Madoff's scheme. From financial returns that were too good to be true, to the fact that Madoff's multi-billion dollar operation was utilizing bookkeepers headquartered in an upstate strip mall, KPMG truly missed the elephant in the room.*[29]

In early 2009, President Obama appointed Mary Schapiro to replace Christopher Cox as SEC Chairman. In the aftermath of the Madoff fraud, Schapiro reported that her agency would revamp its oversight policies and procedures for investment advisers having physical custody of customer assets. Among the proposals announced by Schapiro were annual "surprise audits" of such firms to ensure that customer funds were being properly safeguarded. Schapiro also recommended that those firms be required to have internal control audits by independent accounting firms to determine whether they have "the proper controls in place."[30] Finally, Chairman Schapiro pledged that the SEC would implement specific measures to ensure that credible whistle-blowing allegations, such as those made by Harry Markopolos regarding Madoff's firm, would be investigated on a thorough and timely basis.

Regulatory and law enforcement authorities predict that it will be years before the total losses suffered by Madoff investors are known. Most estimates put those losses in the tens of billions of dollars. The large asset management firm Fairfield Greenwich Advisers alone had more than one-half of its investment portfolio of $14 billion invested with Madoff. Other companies and organizations that had significant funds in the custody of Madoff Securities include the large Dutch bank Fortis Bank, the large British bank HSBC, the International Olympic Committee, Massachusetts Mutual Life Insurance Company, New York University, Oppenheimer Funds, and Yeshiva University.

One media outlet reported that the list of individuals who had investments with Madoff reads like a lineup from "Lifestyles of the Rich and Famous," a popular television program of the 1980s. Those individuals include award-winning actors and actresses, Hollywood directors and screenwriters, media executives, prominent journalists, professional athletes, a Nobel Prize winner, and high-profile politicians. Among these individuals are Kevin Bacon, Zsa Zsa Gabor, Jeffrey Katzenberg, Henry Kaufman, Larry King, Sandy Koufax, Senator Frank Lautenberg, John Malkovich, Stephen Spielberg, Elie Wiesel, and Mort Zuckerman. To date, several suicides have been attributed to Madoff's massive fraud.

Questions

1. Research recent developments involving this case. Summarize these developments in a bullet format.
2. Suppose that a large investment firm had approximately 10 percent of its total assets invested in funds managed by Madoff Securities. What audit procedures should the investment firm's independent auditors have applied to those assets?
3. Describe the nature and purpose of a "peer review." Would peer reviews of Friehling & Horowitz have likely resulted in the discovery of the Madoff fraud? Why or why not?

---

29. *USLaw.com*, "The Madoff Saga Continues as Pomerantz Files the First Derivative Suit Against an Auditor," 11 February 2009.

30. S. N. Lynch, "SEC to Consider Surprise Audits of Advisers," *Wall Street Journal* (online), 14 May 2009.

4. Professional auditing standards discuss the three key "conditions" that are typically present when a financial fraud occurs and identify a lengthy list of "fraud risk factors." Briefly explain the difference between a fraud "condition" and a "fraud risk factor" and provide examples of each.
5. In addition to the reforms mentioned in this case, recommend other financial reporting and auditing-related reforms that would likely be effective in preventing or detecting frauds similar to that perpetrated by Madoff.