FINANCIAL PREPAREDNESS

"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen

Issue #107
February 24, 2023

Madoff: The Monster of Wall Street

I recently watched the four-part documentary series Madoff: The Monster of Wall Street on Netflix. It was excellent, and I highly recommend it.

For decades, I've been fascinated by the theory of overcompensation: most people spend their adult lives trying to overcompensate for the deficiencies of their childhood or their parents. I think it has great explanatory power.

Apparently, Madoff was overcompensating for his parents' financial failure. As this website says, "After struggling financially for many years, [his parents] became involved in finance. Records of Madoff's financial dealings show they were less than successful with the trade. His mother registered as a broker-dealer in the 1960s, listing the Madoffs' home address in Queens as the office for a company called Gibraltar Securities. The SEC forced the closure of the business for failing to report its financial condition. The couple's house also had a tax lien of more than $13,000, which went unpaid from 1956 until 1965. Many suggested that the company and the loans were all a front for [Madoff's father's] underhanded dealings." As one of his employees said, "He could live with himself as a liar much more easily than he could live with himself as a failure."

Here's what I found most shocking in the documentary:

Madoff defrauded and stole billions of dollars from his own tribe. Apparently, the vast majority of his investors were Jewish. They trusted him because he was one of them. According to Wikipedia, "Madoff targeted wealthy American Jewish communities, using his in-group status to obtain investments from Jewish individuals and institutions. Affected Jewish charitable organizations considered victims of this affinity fraud include Hadassah, the Women's Zionist Organization of America, the Elie Wiesel Foundation and Steven Spielberg's Wunderkinder Foundation. Jewish federations and hospitals lost millions of dollars, forcing some organizations to close."

His Ponzi scheme began sometime between 1960 and the early 1970s, and apparently, he never actually invested *any* of his investors' money.

Below his legitimate market making business in the iconic Lipstick Building in Manhattan, he leased another floor where he secretly ran his Ponzi scheme using crooked but loyal high school graduates and obsolete technology. Apparently, many of his employees were unaware of the operations there, and virtually none of them were allowed to go there. He used proceeds from the Ponzi scheme to subsidize his legitimate business after it became unprofitable.

Harry Markopolos, a financial analyst at a competing firm, believed that the claimed investment returns of Madoff's hedge fund were mathematically impossible, and sent detailed memos to the SEC warning of dozens of red flags. The SEC did nothing, perhaps because they were too busy viewing porn.

Despite supposedly managing tens of billions of dollars, Madoff never registered as an investment advisor with the SEC. One time an SEC official called him and said, "We'd like to know more about your hedge fund." Madoff replied, I'm not running a hedge fund." SEC: "Oh, OK. Goodbye."

Another time the SEC sent two newbie examiners to his office to look into his operation. He wowed them by meeting with them himself and regaling them with stories from Wall Street. One day when they were at lunch, he rifled through their briefcases and found out that they were really trying to find out more about his hedge fund.

Around this same time, I had to register with the SEC (instead of with my state) as an investment advisor, either due to an increase in assets under management or changes in SEC regulations (I don't remember which). At the time, the SEC had a policy of conducting an initial exam of all newly registered investment advisors. I was managing around $50 million at the time. Unlike with Madoff, the examiners they sent to my office were not newbies. One was an attorney and the other was a CPA. They had budgeted five full days to examine my practice, even though I was fee-only and had a fiduciary relationship with my clients, I ran a clean, simple practice (e.g., no conflicts of interest, referral fees, soft dollar benefits, no custody of client assets, etc.), and I had a clean record (no complaints, lawsuits, etc.). They spent about three and a half days digging deep into my practice before ending the examination early after concluding that nothing was amiss. Meanwhile, Madoff was getting away with stealing tens of billions of dollars.

Then the SEC got more serious with Madoff, and told him they were launching a formal investigation. He boldly marched over to their offices himself and asked them what they wanted to know. They asked him for his hedge fund's bank account number (which was with J.P. Morgan Chase, which according to Wikipedia, earned as much as $483 million from it), but they never looked into it. After their investigation, they required his primary feeder fund to register, but if I recall correctly, Madoff still did not register as an investment advisor. He used the apparent clean bill of health that the SEC provided to reassure investors, which allowed him to steal billions more.

The high and steady returns (which Markopolos argued were mathematically impossible) led investors to become incurious. For example, why did so few people ask him why he didn't charge a management fee? How did they think he made money? And why did he try to keep his fund a secret? Why was Madoff not registered with the SEC as an investment advisor? Why was his fund never audited? Asking questions would have caused cognitive dissonance and might kill the golden goose. Madoff said they were greedy.

One of Madoff's investors who happened to meet him in person picked up on something interesting. He said Madoff never looked you in the eye. That should have told him everything he needed to know. Humans communicate primarily through body language.

Some other interesting facts from Madoff's Wikipedia entry:

He ran his business as a sole proprietorship for *41 years* before finally incorporating in 2001. That means my business was incorporated about five years before Madoff's.

"Madoff was the first prominent practitioner of payment for order flow, in which a dealer pays a broker for the right to execute a customer's order. This has been called a 'legal kickback'. Some academics have questioned the ethics of these payments." This really screwed up the stock market, transforming it from a de facto public utility that simply matched orders to profit-seeking businesses that cater to its best customers (high frequency traders and hedge funds) on scattered exchanges, most of them "unlit."

Madoff served as chairman of the NASDAQ stock exchange, chairman of the board of directors of the NASD and was a member of its board of governors. He "served on the board of directors of the Securities Industry Association...and was chairman of its trading committee. He was a founding board member of the Depository Trust & Clearing Corporation subsidiary in London, the International Securities Clearing Corporation." He was once on the short list to become the chairman of the SEC. Several of Madoff's relatives also held positions with various self-regulatory agencies.

"From 1991 to 2008, Bernie and Ruth Madoff contributed about $240,000 to federal candidates, parties, and committees, including $25,000 a year from 2005 through 2008 to the Democratic Senatorial Campaign Committee. The committee returned $100,000 of the Madoffs' contributions to...the bankruptcy trustee...and Senator Charles E. Schumer returned almost $30,000 received from Madoff and his relatives." Maybe some politicians

told the SEC to go back to viewing porn.

“In 2004, Genevievette Walker-Lightfoot, a lawyer in the SEC's Office of Compliance Inspections and Examinations (OCIE), informed her supervisor branch chief Mark Donohue that her review of Madoff found numerous inconsistencies, and recommended further questioning. However, she was told by Donohue and his boss Eric Swanson to stop work on the Madoff investigation, send them her work results, and instead investigate the mutual fund industry. Swanson, assistant director of the SEC's OCIE, had met Shana Madoff in 2003 while investigating her uncle Bernie Madoff and his firm. The investigation was concluded in 2005. In 2006, Swanson left the SEC and became engaged to Shana Madoff, and in 2007 the two married.” Sounds like a happy couple!

“Madoff said he could have been caught in 2003, but that bumbling investigators had acted like 'Lt. Columbo' and never asked the right questions: 'I was astonished. They never even looked at my stock records. If investigators had checked with The Depository Trust Company, a central securities depository, it would've been easy for them to see. If you're looking at a Ponzi scheme, it's the first thing you do.”

“The SEC's inspector general...found that since 1992, there had been six investigations of Madoff by the SEC, which were botched either through incompetent staff work or by neglecting allegations of financial experts and whistle-blowers. At least some of the SEC investigators doubted whether Madoff was even trading.” Nothing to see here, move along!

“Although Madoff's wealth management business ultimately grew into a multibillion-dollar operation, none of the major derivatives firms traded with him because they did not believe his numbers were real. None of the major Wall Street firms invested with him, and several high-ranking executives at those firms suspected his operations and claims were not legitimate. Others contended it was inconceivable that the growing volume of Madoff's accounts could be competently and legitimately serviced by his documented accounting/auditing firm, a three-person firm with only one active accountant.”

In conclusion, the fact that all of the above could happen and that Madoff could get away with it for so long was just unbelievable to me. The lesson here is that things are not always as they appear, and where there's smoke, there's fire. You cannot rely on the federal government to protect you. You must remain vigilant, be a critical thinker and ask questions, especially when things seem too good to be true.

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