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## The Madoff affair

### Con of the century

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**There are no heroes in the Madoff story; only villains and suckers**



AFP

BERNARD MADOFF worked as a lifeguard to earn enough money to start his own securities firm. Almost half a century later, the colossal Ponzi scheme into which it mutated has proved impossible to keep afloat—unlike Mr Madoff's 55-foot fishing boat, "Bull".

The \$17.1 billion that Mr Madoff claimed to have under management earlier this year is all but gone. His alleged confession that the fraud could top \$50 billion looks increasingly plausible: clients have admitted to exposures amounting to more than half that. On December 16th the head of the Securities Investor Protection Corporation, which is recovering what it can for investors, said the multiple sets of accounts kept by the 70-year-old were in "complete disarray" and could take six months to sort out. It is hard to imagine a more apt end to Wall Street's worst year in decades.

The known list of victims grows longer and more star-studded by the day. Among them are prominent billionaires, including Steven Spielberg; the owner of the New York Mets baseball team; Carl Shapiro, a nonagenarian clothing magnate who may have lost \$545m; thousands of wealthy retirees; and a cluster of mostly Jewish charities, some of which face closure. Dozens of supposedly sophisticated financial firms were caught out too, including banks such as Santander and HSBC, and Fairfield Greenwich, an alternative-investment specialist that had funnelled no less than \$7.5 billion to Mr Madoff.

Though his operation resembled a hedge-fund shop, he was in fact managing client money in brokerage accounts within his firm, seemingly as Merrill Lynch or Smith Barney would. A lot of this came from funds of funds, which invest in pools of hedge funds, and was channelled to Mr Madoff via "feeder funds" with which he had special relationships. Some banks, such as the Dutch arm of Fortis, lent heavily to funds of funds that wanted to invest.

On the face of it, the attractions were clear. Mr Madoff's pedigree was top-notch: a pioneering marketmaker, he had chaired NASDAQ, had advised the government on market issues and was a noted philanthropist. Turning away some investors and telling those he accepted not to talk to outsiders produced a sense of exclusivity. He generated returns to match: in the vicinity of 10% a year, through thick and thin.

### Charming, but far too smooth

That last attraction should also have served as a warning; the results were suspiciously smooth. Mr Madoff barely ever suffered a down month, even in choppy markets (he was up in November, as the S&P index tumbled 7.5%). He allegedly has now confessed that this was achieved by creating a pyramid scheme in which existing clients' returns were topped up, as needed, with money from new investors.

He claimed to be employing an investment strategy known as "split-strike conversion". This is a fairly common approach that

entails buying and selling different sorts of options to reduce volatility. But those who bothered to look closely had doubts. Aksia, an advisory firm, concluded that the S&P 100 options market that Mr Madoff claimed to trade was far too small to handle a portfolio of his size. It advised its clients not to invest. So did MPI, a quantitative-research firm, after an analysis in 2006 failed to find a legitimate strategy that matched his returns—though they were closely correlated with those of Bayou, a fraudulent hedge fund that had collapsed a year earlier.

This was not the only danger signal. Stock holdings were liquidated every quarter, presumably to avoid reporting big positions. For a godfather of electronic trading, Mr Madoff ran the business along antediluvian lines: clients and feeder-fund managers were denied online access to their accounts. Even more worryingly, he cleared his own trades, with no external custodian. They were audited, of course, but by a tiny firm with three employees, one of whom was a secretary and another an 80-year-old based in Florida.

Perhaps the biggest warning sign was the secrecy with which the investment business was conducted. It was a black box, run by a tiny team at a very long arm's length from the group's much bigger broker-dealer. Clients too were kept in the dark. They seemed not to mind as long as the returns remained strong, accepting that to ask Bernie to reveal his strategy would be as crass as demanding to see Coca-Cola's magic formula. Mr Madoff reinforced the message by occasionally ejecting a client who asked awkward questions.

The trading business was hardly pristine either. It had been probed for front-running (trading for its own account before filling client orders) and separately found guilty of technical violations. Some clients reportedly suspected that Mr Madoff was engaged in wrongdoing, but not the sort that would endanger their money. They thought he might be trading illegally for their benefit on information gleaned by his marketmaking arm.

This failure of due diligence by so many funds of funds will deal the industry a blow. They are paid to screen managers, to pick the best and to diversify clients' holdings—none of which they did properly in this case. Some investors are understandably irate that their funds—including one run by the chairman of GMAC, a troubled car-loan firm—charged above-average fees, only to plunk the bulk of their cash in Mr Madoff's lap. This is the last thing hedge funds need, plagued as they are by a wave of redemption requests.

Financial firms that dealt with Mr Madoff are bracing themselves for a wave of litigation as individual victims go after those with deep pockets. Hedge funds will also face pressure to accept further oversight. But the affair shows the need for the government to enforce its rules better, rather than write new ones, argues Robert Van Grover of Seward & Kissel, a law firm.

Mr Madoff's investment business was overseen by the Securities and Exchange Commission (SEC), but it failed to carry out any examinations despite receiving complaints from investors and rivals since as long ago as the late 1990s. As a Wall Street fixture, Mr Madoff was close to several SEC officials. His niece, the firm's compliance lawyer, even married a former member of the team that had inspected the marketmaking division's books in 2003—though there is no evidence of impropriety.

In a rare *mea culpa*, Christopher Cox, the SEC's chairman, has called its handling of the case "deeply troubling" and promised an investigation of its "multiple failures". Having already been lambasted for fiddling while investment banks burned, the commission is now likelier than ever to be restructured, or perhaps even dismantled, in the regulatory overhaul expected under Barack Obama. As *The Economist* went to press Mr Obama was expected to name Mary Schapiro, an experienced brokerage regulator, to replace Mr Cox.

The rules themselves will need changing, too. All investment managers, not just mutual funds, could now be forced to use external clearing agents to ensure third-party scrutiny, says Larry Harris of the University of Southern California's Marshall School of Business. Regulation of financial firms' accountants may also need tightening. And more could be done to encourage whistleblowing. Mr Madoff claims to have acted alone. But given the huge amount of paperwork required to keep his scam going, it seems unlikely that no one else knew about it.

Above all, however, investors need to help themselves. This pyramid scheme may have been unprecedented, but the lessons are old ones: spread your eggs around and, as Mr Harris puts it, "investigate your good stories as well as your bad ones." This is particularly true of money managers who work deep in the shadows or seem beyond reproach—even more so during booms, when the temptation to swindle grows along with the propensity to speculate. There will always be "sheep to be shorn", as Charles Kindleberger memorably wrote in "Manias, Panics and Crashes". Let us hope they never again line up in such numbers.