

volume, over-the-counter (OTC) stocks on the outskirts of traditional markets like the New York Stock Exchange (NYSE) and American Stock Exchange (ASE), and was one of the first to invest heavily in the electronic technology needed to automate the buying and selling of those stocks at reduced trading costs. Then, in the mid-1970s, he purchased a position in the Cincinnati Stock Exchange and invested \$250,000 to help upgrade its computer equipment and improve its software, which enabled the exchange to report running stock quotes. Cincinnati became the first all-electronic computerized stock exchange, and eventually changed its name to the National Association of Securities Dealers Automated Quotations (NASDAQ).

By 1989, Madoff Investment Securities was handling more than 5 percent of the trading volume on the NYSE. This rapid ascent made him an unpopular target of the traditional traders on the floor of that exchange, as did a controversial practice called "payment for order flow," in which his company would pay large firms like Fidelity and Schwab to send their customer orders directly to his electronic trading desk instead of to the NYSE. Congressional hearings ensued after complaints by the floor traders, who were still primarily operating on a manual "shout and signal" system, but Madoff continued the payments and benefited from the attention that the investigation generated, which primarily served to enhance his stature on Wall Street. He became chairman of NASDAQ; was asked to take a leadership role in the Securities Industry and Financial Markets Association, Wall Street's principal lobbying arm in Washington; and served for a period of time as Chairman of the Board of Governors of the National Association of Securities Dealers (NASD).

In short, toward the end of this period of rapid growth, Bernard Madoff had become very well known within financial circles as a successful manager of stock trading operations, a senior participant in stock trading associations, and a wealthy recipient of stock trading profits. Less well known was his activity in an investment-advisory business that he had started as a low-profile adjunct to the trading operations at Madoff Investment Securities during the 1970s. Under his direction, this operation began to actively manage entrusted funds, rather than merely provide financial advice to clients, and it gradually drew in increasing amounts of money from institutional investors, wealthy individuals, private charities, and many middle-income families who invested through third-party companies or "feeder funds." Madoff focused on the internal operations of this investment-management portion of his business, and relied upon his father-in-law, Saul Alpern, for the external marketing.

Saul Alpern developed a recruiting circuit that included stops in the New York Catskills, Palm Beach, and Long Island, calling on prominent Jewish families who were familiar with the success of Alpern's son-in-law. As time passed, Madoff also began to use his personal wealth as a market-building tool, entertaining clients on his large yacht or at his numerous homes and leveraging his influence at charitable organizations to build a network of trust and an aura of integrity.

Madoff never became a household name among the majority of American investors who dealt with more established institutions. Within the Jewish philanthropic community in New York, however, Madoff's growing fortune, burgeoning reputation, generous donations, and quiet confidence made him the money manager of choice for many of the major groups. Enticed by the steady double-digit investment returns those charities reportedly received from Madoff, outsiders began desperately working connections for the opportunity to meet him and get in on the action. Through friends of friends,

Madoff's network reached well beyond New York, picking up new investors through social settings like country clubs and golf courses throughout the country and even abroad. Demand for inclusion in Madoff's fund became global.

As Madoff's profile in the hedge fund community grew, skepticism about his amazingly consistent returns grew. Rivals complained that they could not achieve the same returns when replicating his trading strategy (essentially a hedge fund, with options sold or purchased to protect, or "hedge" against losses on long-held securities), and those complaints prompted a few regulatory investigations that proved inconclusive. Madoff ran the investment management arm of his firm with great secrecy; it was totally separate from the market-making arm. The two divisions were located on different office floors and used separate computer systems, and the traders knew very little about what the hedgers did on the floor below them. The employees who worked on that lower floor remained totally loyal to Madoff and never alleged or even hinted at any improprieties. The necessary audits were performed by a small accounting firm that had worked with Madoff since the start of his company, and they also never reported any problems.

Madoff's personal privacy and constructed secrecy kept him out of the spotlight and allowed him to create a fraudulent investment program that became grotesque in its final size and investor loss. But the operations of that investment program continued without interruption or difficulty until Bernard Madoff confessed to his two sons who ran the trading floor of the firm that the entire investment program was a total sham, that no investments had ever been made, and that the consequential losses were huge. The two sons, as requested by their father, reported this to the Securities and Exchange Commission (SEC), and Bernard Madoff was arrested that afternoon.

Class Assignment

1. Why in your opinion did Bernard Madoff do this? He had been exceedingly successful in the electronic exchange trading that he had started and his firm continued, and he had clearly achieved both wealth and stature. What was it that drove him, again in your view, "off the cliff"? What does this say about human character? What does this say about the nature and/or culture of the investment community?
2. Why was it so easy for Bernard Madoff to raise so much money? The case describes a "network of trust and an aura of probity." How does a person build a network of trust and aura of probity? Give some thought here. It may help you to avoid a similar situation in the future.
3. The *Wall Street Journal* (August 20, 2009, p. B5) published three articles on the lessons that business schools should teach and business students should take away from the financial meltdown that had occurred. The huge Madoff investment losses were part of that meltdown. What are the lessons that you think are important from the Madoff investment fraud as part of that overall meltdown?
4. What would you have done differently had you been (a) an advisor to a charitable organization that was investing substantial funds through Madoff, (b) a member of a well-paid feeder fund that was collecting smaller amounts from middle income investors for transfer to Madoff, or (c) a competitor who had reported to the SEC that the investment model Madoff was using was incapable of generating such large and consistent returns, but seen little happen?