

A CASE STUDY

Opportunity Lost: The Story of Bernie Madoff and the Securities and Exchange Commission

Independent regulatory agencies may not be in the everyday thoughts of most Americans, but when such agencies fail to do their job, they can quickly draw the ire of an angry public. Such was the scenario in 2008 when the nation was introduced to Bernie Madoff and his elaborate multibillion-dollar scheme to defraud thousands of investors.

As is always the case, Madoff's fall was preceded by his ascendancy. For decades, he was considered a star in the investment world. He regularly provided his clients with returns on their investments that surpassed market averages, and he was known throughout New York City as a philanthropist and community leader. What wasn't well known was that Madoff was conducting one of the largest Ponzi schemes in the history of the United States. In other words, Madoff was using money from new investors to pay old investors, a process that gives the appearance of providing high rates of return

(continued)

when, in fact, the schemer isn't investing any money at all. Like any Ponzi scheme, Madoff's scam was eventually exposed when it became impossible for him to pay all the investors he owed. However, before his scheme was found out, Madoff had defrauded investors of an estimated \$65 billion. Among those defrauded by Madoff were many charities, colleges, and non-profit organizations—many of which lost their entire investment portfolios.

At this point, you may be asking, "Wasn't anybody from government watching Madoff as he perpetrated this elaborate scheme?" The answer, unfortunately, is no. The investment activities of Madoff were under the regulatory jurisdiction of the Securities and Exchange Commission (SEC). The SEC is charged with ensuring that investments are legitimate through enforcing the regulations that govern markets in the United States. In essence, the SEC is designed to make sure that fund managers such as Madoff are playing by the rules of the game. The Madoff case, therefore, exposed the many weaknesses in how the SEC oversees and manages the investment world. These weaknesses became all too apparent during 2009 congressional hearings that examined the conditions that allowed Madoff to perpetrate his crime.

During the February 2009 hearings before the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, witnesses brought forth strong evidence that the SEC was tipped off about Madoff's activities on numerous occasions, but for various reasons failed to act on the information. Harry Markopolis, an independent financial fraud investigator, told the subcommittee that he "gift wrapped and delivered the largest Ponzi scheme in history to them and somehow they couldn't be bothered to conduct a thorough and proper investigation because they were too busy on matters of higher priority." Indeed, Markopolis had sent detailed letters to the SEC listing numerous red flags in Madoff's actions and establishing a route by which the agency could completely expose Madoff's scam. So, why didn't the SEC act on this information?

The answer is multifaceted and demonstrates the importance of organizational design and personnel. First, the SEC's relationship with the firms that it is supposed to regulate has proven problematic. During the subcommittee hearings, claims were made that the SEC is too "chummy" with prominent Wall Street investment houses and that the agency was reluctant to take on the well-known players in the financial world. This phenomenon is commonly referred to as *agency capture*. Under agency capture, regulators are hesitant to challenge some of the "celebrity" names in the financial world. Individuals such as Bernie Madoff, with their incredible wealth and social prominence, are imposing figures for agency officials who may have to bring charges against these "stars."

Consider, for example, Meghan Cheung, the branch chief of the SEC's enforcement division in New York City. Cheung was the SEC official who signed the commission's 2006 investigation that cleared Madoff to continue doing business. In 2006, she was a 34-year-old public administrator who had

to decide whether she wanted to challenge one of the most well-known and powerful names in New York's financial community. Despite the compelling evidence provided by Markopolis, Cheung never brought charges against Madoff and effectively allowed him to continue his Ponzi scheme. While Cheung claimed that Madoff's stature did not affect her decision in the case, her comments on the matter suggest this may not be the case. In 2009, she asked a *New York Post* reporter who was interviewing her, "Why are you taking a mid-level staff person and making me responsible for the failure of the American economy?" Cheung's description of herself as a mere "mid-level staff person" demonstrates some of the disadvantages that the SEC faces when it decides whether or not to take on investment "giants" such as Madoff. In Cheung's case, it's reasonable to believe that a mid-level bureaucrat didn't relish going head to head with one of the biggest players in the game.

In addition to issues of agency capture, the SEC's failure to stop Madoff appears to be the product of interagency rivalries. During Markopolis's testimony to Congress regarding the Madoff scandal, he noted that when he first approached the SEC's Boston office with his allegations against Madoff, he received a warm reception from the Bureau Chief, Edward Manion. However, the SEC's New York City office, which supervises the Boston branch, made the decision to block further investigation into the matter. Why didn't the New York branch take the lead from Boston and vigorously pursue Madoff? One answer to this question is that the Boston and New York branches don't like each other. According to Markopolis, Manion felt the relationship between the New York and Boston regional offices "was about as warm and friendly as the Yankees-Red Sox rivalry and that New York does not like to receive tips from Boston."

Finally, the failure of the SEC to stop Madoff raised questions about the agency's personnel. It's often said that you need a fox to catch a fox: In other words, if you're trying to discover fraud on Wall Street, you need the assistance of individuals who've spent many years in the investment game. Seasoned Wall Street veterans should be able to recognize scandals because they know how things work. Unfortunately, the SEC hasn't brought experienced Wall Street players into its ranks. Instead, the SEC has relied more on a group of young attorneys and lifelong government employees to do its business. This situation becomes even worse when some of its best employees are hired away by the very investment houses the agency is monitoring.

Under most circumstances, the work of the SEC may not interest the average American. But after Bernie Madoff stole millions from many average citizens, most citizens were outraged by the agency's failure to do its job. The outrage brought increased public pressure on Congress to make changes in the SEC to prevent this type of crime from occurring again. If such changes aren't made, Bernie Madoff may someday have a rival for the unofficial title as America's most notorious con artist.

On a positive note, however, the American legal system has forced some changes in Bernie Madoff's lifestyle. He's been ordered to repay billions, yes

(continued)

A CASE STUDY | *Continued*

billions—to investors and to spend 150 years in prison. He will probably not be able to repay the billions he owes; but he is currently spending the rest of his life in prison.

For Discussion: *Why did the SEC respond so slowly to tips about Bernie Madoff's Ponzi scheme? Will the failure to stop Bernie Madoff lead to major changes in the way SEC officials do their job? ▲*