

# Bernie Madoff And the SEC Financial Watchdog That Didn't Bark or Bite

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Perhaps the most incredible aspect of the greatest Wall Street swindle ever was that despite repeated warnings from many different sources the Securities and Exchange Commission (SEC) over a period of 16 years refused to conduct a diligent probe into the operations of fraudster securities broker Bernard Madoff.

The “watchdog” Federal agency, which didn’t bark or bite, not only disregarded the repeated warnings of knowledgeable whistle-blower Harry Markopolos, a fund manager, as well as the two examiners in its own Boston office who said that Markopolos likely had it right; the SEC also disregarded reports in Barron’s and other financial publications that questioned Madoff’s legitimacy; and, perhaps most damning of all, the SEC disregarded letters from an obvious insider who revealed that Madoff was keeping two sets of books and told the SEC to find the evidence on a computer Madoff always carried on his person. Even when, toward the end of Madoff’s Ponzi scheme charade, the SEC discovered Madoff was lying to them, SEC officials didn’t care to ask the elementary questions that would have revealed he was not trading stocks at all. Incredibly, Madoff had also been lying to his investors for years, saying that he was turning a profit on the funds they gave him when he was actually paying them “profits” with monies from new depositors. On one occasion, the Assistant Director of SEC’s Office of Compliance Inspections and Examination(OCIE) asked a financial institution that Madoff claimed he used to clear his trades whether they knew of any trading done by or in behalf of Madoff during a specific time period. Despite a negative reply, the SEC official decided it did not merit any follow-up. Madoff’s career of fraud, which Federal investigators believe may have started in the 1980s, did not collapse until 2008.

Besides Markopolos, there were “plenty of others on Wall Street who went to the SEC, some anonymously or who used their names, so they had more than one warning,” says Erin Arvedlund, the reporter who broke the first Barron’s story in 2000. One inescapable conclusion of the Madoff disaster was that the SEC didn’t know and likely didn’t want to know he was running a Ponzi scheme. In 2006, for example, Madoff actually gave the SEC the number of his Depository Trust Account(DTC 646), yet its probers declined to make the phone call to this record-keeping entity that would have revealed Madoff’s claims of stock trading were a tissue of lies. The call would have revealed Madoff had only \$18 million in his DTC account although Fairfield Greenwich feeder fund said he was handling \$2.5 billion worth of their business. The SEC might also have checked with the National Association of Securities Dealers(NASD) to see if the stocks Madoff claimed to be trading were, in fact, actually being traded by him on the NASDAQ stock market. But Arvedlund said the SEC decided “this would have been too time-consuming for us to go through these records” so the records were never requested. Its reluctance may have had something to do with the

fact that Madoff played a key role in NASDAQ's formation. When Madoff founded his firm in 1960, he made trades using the National Quotation Bureau's Pink Sheets. In order to compete with firms that were New York Stock Exchange members trading directly on the floor, according to Wikipedia, Madoff began using innovative computer information technology to disseminate its quotes—a development that led to the creation of NASDAQ, which swindler Madoff served as Chairman during 1990-91 and in 1993.

The SEC compounded its own malfeasance by issuing a report in 1992 saying that it found Madoff's operations to be on the up-and-up, a finding it publicized only for this favored entity—in short, a veritable endorsement that brought investors flocking to “the lipstick building” (nicknamed for the skyscraper's shape and color) at 885 Third Avenue in New York that was the headquarters of Bernard L. Madoff Investment Securities LLC, only to be systematically parted from their money. Arvedlund said, “He used the SEC's Good Housekeeping seal to market the fund. And I've talked to a lot of investors who said, ‘I knew he'd been investigated and received a clean bill of health from the SEC, and that's why I gave them my money.’” These included Elie Wiesel, the Nobel Peace Prize laureate, who invested on behalf of a charity and Hollywood director Steven Spielberg, who invested for the Wunderkinder Foundation. Other notables taken in were real estate mogul Mortimer Zuckerman; Philadelphia Eagles owner Norman Braman, New York Mets owner Fred Wilpon, and legendary Brooklyn Dodgers pitching great Sandy Koufax. In its 1992 investigation, the SEC learned that New York accounting firm Avellino & Bienes had been raising money from clients and turning it over to Madoff to invest. The SEC ordered the funds returned to the clients and never inquired where Avellino & Bienes got the funds to do so. The SEC may have overlooked Madoff's role as it regarded him as something of a hero for his role in developing NASDAQ in competition with the New York Stock Exchange. It even used him in an advisory capacity.

When accepting Madoff's guilty plea to 11 counts of fraud, perjury, money laundering and theft, Judge Denny Chin termed Madoff “extraordinarily evil” and sentenced him to 150 years in prison. This, however, may have closed the window on the Ponzi scheme by which Madoff looted at least \$20 billion and perhaps as much as \$200 billion from the investing public. The New York Times of March 13, 2009, quoted Madoff as confessing to the packed courtroom, “I knew what I was doing 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 finding an exit “proved difficult, and ultimately impossible. I cannot adequately express how sorry I am for what I have done.”

The Times pointed out that Madoff's guilty plea was crafted to shield his wife, Ruth, who had amassed \$65 million worth of assets she claimed were her own, his brother, Peter, and his sons Mark and Andrew, all of whom denied any knowledge of the fraud. Mrs. Madoff was later required to forfeit all but \$2.5 million of her assets. “As a result, those who thought his guilty plea would shed more light on Wall Street's biggest and longest fraud left the courtroom unsatisfied and uncertain—about where their money had gone and who may have helped Mr. Madoff to steal it. Indeed, the hearing made clear that Mr. Madoff is refusing to help the government build a case against anyone else,” the Times observed.

Although no individual reportedly wrote Judge Chin a letter to mitigate his sentence by relating any good works Madoff performed in his life, the fraudster might not have been entirely unloved. He may have been the illicit love child of the Internal Revenue Service (IRS) which in June, 2004, oddly approved him as a nonbank custodian of investor funds “even

though he was in gross violation of the IRS's own regulations," according to Lawrence Velvel, dean of the Massachusetts School of Law at Andover and a former Justice Department attorney. Velvel raises the possibility that Madoff was favored by the IRS because it collected "billions" of tax dollars on "profits" from investors he swindled when those profits were all lies. Arvedlund said the \$65 billion Madoff claimed to have taken in was not the real number, which may have been closer to \$20 billion, but investors paid taxes on the invented \$45 billion as well, "so the IRS was actually a big winner in the Madoff case." Velvel, who lost funds of his own invested with Madoff, interviewed reporter Arvedlund twice on his Comcast TV show "Books of Our Time," first on her book "Too Good to be True: The Rise and Fall of Bernie Madoff," and again after publication of the SEC Inspector General's 457-page report on Madoff.

Arvedlund said SEC Inspector General David Kotz did "a very thorough job" and "for the most part didn't pull any punches" in his report, which she termed a "very painstaking" examination of "how the agency screwed up." She said the commission "was not used to going to independent third parties for information" but instead went to the source and trusted that person to tell the truth. The result, she explained: "Madoff was feeding them lies for years and they just didn't double check." They caught Madoff lying when he told them he stopped trading options years ago but they found sales literature from one of the big Madoff feeder funds that said he was trading "Standard & Poor 100" options. "Why didn't that bother them enough to probe a little further?" Arvedlund asked.

When reporting for her original article, Arvedlund said "pretty much everyone on Wall Street that I talked to said they'd never done a trade with him: not Merrill Lynch, not Goldman Sachs, not Salomon Smith Barney. So they were all wondering the same thing—where's all the trading volume coming from for this billion-dollar hedge fund? And there wasn't any." She believes that a bunch of very high-ranking portfolio managers may have suspected what Madoff was doing "but they were very fearful of losing their jobs." One of the original sources for her story told her he didn't want his name used because his boss was an investor in Madoff "and if he asked any questions or pulled his clients out, he'd probably get fired." Alone among his peers, Madoff did not charge hedge funds the customary one or two percent annual fee that was the norm. Instead, he rewarded them handsomely for bringing him their business, in effect, a legal "kickback." Arvedlund said Madoff was giving up perhaps \$200 million a year in income—again, a sum that should have raised eyebrows. The financial writer said that Madoff had concocted "a complex (investment) strategy as a cover story, and it prevented most people from asking questions because they thought it's too complicated to understand. They thought "it sounds very professional, so I'll just trust that he's doing it." She added that Madoff would not let people on Wall Street invest with him because "he didn't want financially savvy investors."

The financial writer notes that the average investor also does not have the ability to subpoena or inquire, "'Does Bernie Madoff do trades with you?' That's the regulators' job. That is what we pay taxes for them to do. They are acting on the customer's behalf, or at least that is their stated mission. They are supposed to have that power, and that curiosity, on our behalf, and they didn't." One tell-tale indication that it was more than a lack of curiosity that stopped the SEC from exposing Madoff is the hostility it showed toward Markopolos. True, he had been warning them for more than a decade, asking how, contrary to market fluctuations, in good economic times and in bad Madoff never reported any losses

but only consistent profits ranging from eight to 17 percent. For example, even when the market plunged 40 percent in 2008, taking most mutual funds with it, Madoff miraculously reported that his investments were up more than eight percent for the year. The fact is, Arvedlund believes, “The SEC didn’t like Markopolos personally. He was very smart and was impatient to reveal Madoff for the fraud that he was.” Apart from Ed Manion and Mike Garrity of the SEC’s Boston office, the SEC “took an instant dislike to him. They thought he was arrogant, and they pretty much found any reason they could to dismiss his allegations.” By contrast, the SEC had a high regard for Madoff because he was a pioneer of electronic trading. “The SEC knew Madoff very well,” Arvedlund said. “He was considered kind of a godfather around the SEC, a big advisor to the agency.”

Arvedlund said the SEC never tumbled to the fact that Madoff had two major bank accounts, one for his legitimate brokerage firm with the Bank of New York, the other with JP Morgan Chase (JPMC). This was on the phony hedge fund side, basically his “slush fund” into which he’d have new investors write checks and out of which he paid old investors, “so there was no trading ever taking place.” Yet, Arvedlund says, the examiner sent by the SEC “had no idea how the cash flows worked” and to conceal her own ignorance “didn’t ask the right questions.” If Madoff had been buying and selling stocks and stock options there would have to be wire transfers or checks in and out of the JP Morgan Chase account going to other financial houses. Arvedlund says JPMC is being sued because by 2008 it “should have had a very good idea that Madoff was not all that he seemed to be.” That bank, she said, “had a view of both sides of the House of Madoff” because in 2008 it had taken over Bear Stearns, which had a long trading relationship with Madoff. And when JPMC started asking around, “How does Madoff do it?” Bear Stearns employees replied they had no idea. “Meanwhile, over on the banking side,” Arvedlund said, JPMC “has the old Chase bank account, and they see that in ’08 the bank account’s starting to dwindle to zero, and according to one lawsuit, they pulled their money out before Madoff confessed.” By not blowing the whistle revealing the suspicions they should have had, Velvel pointed out, JPMC “permitted the fraud to continue for many years.” He noted “about \$12 billion” got pulled out in the last six months as the market was collapsing and Madoff’s clients were demanding their money to pay off other people. Indeed, the reason Madoff’s Ponzi scheme collapsed was because his fund simply ran out of money. Madoff was arrested on Dec. 11, 2008; pleaded guilty in March, 2009; and was sentenced in June of that year. His firm was in liquidation as of Dec. 15, 2008.

Stock market investors supposedly are protected by the Securities Investor Protection Corp. (SIPC), which the public has thought of as an insurance policy in the event of a fraud. “In fact,” Arvedlund said, “SIPC is now saying it is not an insurance agency and it’s a big mess. How they’re going to either pay back the Madoff investors, or not pay them back...is what’s at issue right now.” She noted that court-appointed Madoff trustee Irving Picard and the SIPC are arguing that investors cannot use the last statement they received from Madoff as the basis of what Madoff owed them. On the other hand, the investors’ attorneys are responding, “‘Well, if I invest on Wall Street, what else can I rely upon except the statements I get?’” What the SIPC is essentially saying, she adds, “is if you had a brokerage account at Madoff, you’ll be paid back the money that you put in—and that could have been 10 or 20 years ago—not the profits that were accrued.” If Velvel is correct, investors may have trouble getting anything back through SIPC. He’s charged that Picard is not revealing vital information in order to reduce the amount SIPC would otherwise legally have to reimburse the swindled investors. This want of information is apparent at many levels across the Madoff fraud, Velvel said, adding that Judge Chin “did us no favors by letting

Madoff plead guilty instead of forcing a trial at which much would inevitably be revealed.” Velvel concluded, “I do not remember a major crime in which, at the times of plea and sentencing of the lead culprit, the details of what happened and what was done were as little known publicly as in Madoff.”

Madoff’s imprisonment dropped the curtain on his lavish lifestyle. Money swindled from charities was used for his own private pleasure. His assets were said to include a \$21 million home on the Intercoastal Waterway near the Palm Beach, Fla., country club where he played golf; a beachfront home on Montauk, L.I.; as well as his primary residence in an Upper East Side co-op duplex which he purchased in 1990 for over \$3 million. There were also two private planes, one a 2008 Embraer business jet registered to BLM Air Charter at Madoff’s business address and two boats valued at \$11 million, one a 55-foot yacht named “Bull”. According to Kathryn Kroll, writing in a May 13, 2009, article in the Cleveland Plain Dealer, credit card records that surfaced in Manhattan Bankruptcy Court indicate Madoff and his wife ran up eye-popping bills. Just one of the credit card bills, Kroll writes, “provides a window into the lives of the Madoffs and their inner circle. A vacation to Jackson Hole, Wyoming, over the holidays shows what seemed to be a lavish ski trip: They spent thousands at the Jackson Hole Mountain Resort, hundreds more for car rentals, and ate and drank at places like a Mexican restaurant where they rang up at \$2,879 bill. They also ran up a \$254.38 tab at the Nikai Sushi Bar, but they left a tip on the card of only \$15.”

According to newspaper accounts, Madoff was beaten up in the Federal prison in Butner, N.C., last December, and sustained a broken nose and fractured ribs at the hands of an inmate judo expert. The man did so, he claimed, because Madoff owed him money.

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