

The Madoff Double Bluff

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At first sight it was extremely refreshing. A white-collar financial crook raising his hands and pleading guilty to his financial crime. This has to be almost a first. Usually financial criminals when caught in the most obvious of wrong-doing plead 'not guilty'. The criminal can be caught boarding the plane, with a suitcase containing US\$100mn of someone else's cash, with his mistress holding on to his arm, he will look into the camera with his most genuine 'Tony Blair look of sincerity' and say "What we have here is a misunderstanding.... " You make up the rest of the excuse, there is a million of them.

So yes, an outright confession, "It was me, I chopped down the apple tree" is so against the current socio-political culture it was almost too good to be true. Especially given the pedigree of this perp, the CEO of one of the busiest and most prominent financial exchanges in the world. After his confession the world goes into shock, especially the Jewish world, since affluent members of this community had previously flocked to his door, seeking his world famous high returns. Since his arrest the press is full of people extolling his virtues as a decent human-being and "who would ever have believed it?". It would be so easy for this man to deny any wrongdoing because he could bring out an army of good character witnesses and he could just point at some suspect-looking guy in his hedge fund organisation to lay the blame on.

So a truly heartwarming confession. And it was apparently made to his 2 sons, both of whom who worked for the fund and who had absolutely no idea that this fraud was being perpetrated, until such time as this astounding confession.

But then I started to look more closely at the mix of investors who have lost money. About half of them are professional investing institutions. Look at this quote from the UK's Daily Mail newspaper (online <http://www.dailymail.co.uk/money/art...-lawsuits.html> <<http://www.dailymail.co.uk/money/article-1096228/Lloyds-London-braced-claims-Madoff-meltdown-makes-directors-targets-lawsuits.html>>)

"Full details of the exact losses are yet to emerge. Hedge funds and banks have so far admitted to having around £16 billion with Madoff - only half of the total that is reckoned to have been lost. Some of the biggest casualties are Swiss private banks, which have taken hits amounting to about £2.5 billion. Spanish bank Santander had £2.1 billion of client money with Madoff. HSBC has admitted to lending about £600 million to funds who wanted to use debt to gear up their positions with Madoff. RAB capital, the hedge fund that lost huge sums on investing in Northern Rock, has revealed that it is exposed to Madoff to the tune of around £6 million."

Now the confession does not look right at all.

It is possible to accept the idea of a Ponzi scheme be played on members of the public, who are ignorant of how such schemes are worked, in fact the schemes are targeted specifically at such people. Yet Madoff would have us believe that he managed to convince professional investment companies to put their funds with him without any due diligence being performed. This is clearly nonsense.

I have acted as a professional consultant to major EC and US financial institutions on corporate and institutional credit risk and the idea that anyone in HSBC or Santander could authorise large investment without the internal checks and controls being employed is almost impossible. To try and believe that EVERY institution that invested in Madoff circumvented their internal control procedures IS impossible.

Why is this important? Simple. If someone approaches the HSBC credit risk team, for instance, with a view to making a loan or investing a sum as large as £600m to what is ultimately a single institution (therefore a single counterparty credit exposure) a significant number hoops would have to be jumped through. Firstly there is the credit officer competence limit, which is the maximum amount that a single credit officer may be allowed to authorise. More than his/her limit must be referred up the credit approval food chain. In an institution like HSBC or Santander etc, £600bn or US\$1bn will have been referred to the very top of the food chain, the banks' credit committees at the board level. This is an enormous sum and no lucky is going to be able to approve this by themselves, ever.

When the credit committee are called together to review an application, everything is ready prepared for them, so they can cut to the chase . The lower levels of the credit approval process will have prepared a summary of all the application documentation, included in the meeting bundle, with the strengths, weaknesses, and other important credit risk points. This application will usually contain a set of audited accounts going back a minimum of 3 years and most likely 5 years. There will be a full credit breakdown of the investment profile of the business, Madoff's hedge fund, looking at how the fund obtains its returns; investment assets and investment methodology. After the committee is satisfied that all the issues and concerns have been addressed they will vote on the approval or otherwise.

So there is no way that Madoff could have been pulling a scam. It would have stood out as clear as day to professional financial analysts, whose only job in life is to examine the management of companies and their reports and accounts, to make sure that all is in order. Its their job, its what they do. They are the world experts in spotting anomalies. The idea that all these professionals in all these companies were all duped is absolute nonsense. It is highly improbable that one such evaluation process could have been fooled, but all of them, never. A Ponzi scheme is easy to spot when you have the audited accounts and the full range of investment assets and investment methodologies employed.

Also, this scam avoided the attention of all the funds employees; accountants, traders, auditors and the US regulators, all of whom are also financial professionals.

This again is absolute nonsense. A ny company that I have ever worked for would have known internally that such business was being done, because they are all involved. For instance, a trader goes on buying equities from the worlds stock exchanges that go down in price for 5 continuous years, but the company just keeps giving him more money to top up the trading, continues paying his salary and even annual bonus. Absolute rubbish. But assuming this actually did happen, the market risk team would have been watching these

losses, as would have the accountants. It is not possible to hide things like this internally for very long, months at the most; 20+ years, NEVER.

So why plead guilty? The answer is simple. Look on the net and you will see that because this case is being labelled a fraud, it would appear that investors are going to be able to claim their investment back under the US government's financial fraud protection scheme. A judge has already given his approval in principle for compensation, without any evidence having been presented and financial fraud being demonstrated in a court of law. And it would appear that there will never be such a demonstration in a court of law. Why? It would appear that all the funds financial records are mostly "missing" (rather like Dov Zakheim's US\$1.4tn) and those few records that do survive are in a terrible mess.

However, since the guy has pleaded guilty we do not need to demonstrate the fraud, because he says he is guilty.

And look further on the net and you will see that these "victims" have also been told by the US tax authorities that they will probably also be entitled to claim back some taxes on these defrauded sums.

Rather than saying this hedge fund has gone bust, due to its choice of investment assets and investment methodologies, a scenario which is highly probable in the current financial paradigm, since all the professionals are predicting that at least 30% of all hedge funds are about to fail, more than 700 of them, the CEO chooses to fess up to fraud. If the CEO admits the fund has gone bust, then all those wealthy members of the Jewish community get nothing, but if the CEO admits to fraud they get their money back as compensation from the US tax payer, just as they are also drawing money back from the tax payers with the other hand.

And, as can be seen at the Daily Mail link above, the investors in this fund only get to litigate the fund directors against Lloyds insurers in London for even more compensation. Done properly the compensation could end up paying out far more than the original fund returns (yes this is sarcasm, it was bound to creep in eventually in yet another swindle like this).

Would that I could believe that Madoff were a good guy who slipped and then became repentant. But given the facts, this simply cannot be true.

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