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**Madoff Swindle Was Aided and Abetted by Lack of Due Diligence**

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AS INVESTIGATORS SORT THROUGH the sordid details of Bernard Madoff's global investment scam, victims of the massive \$50 billion securities fraud must be wondering how they can ever trust the financial services industry again.

It's understandable that Madoff, a 50-year Wall Street veteran, was able to pull the wool over the eyes of less-sophisticated investors that he met through his memberships in exclusive golf and country clubs in Long Island and Westchester, N.Y.; and Palm Beach. But the fact that Madoff was able to dupe scores of sophisticated wealth managers, fund-of-funds and elite European banking institutions as well as various nonprofit organizations and charities with his Ponzi scheme is troubling and raises questions about their due diligence methods. After all, fund-of-fund managers are hired to investigate managers, diversify risk and monitor the authenticity of performance.

Did any fund-of-funds monitor Madoff's trading? Did they visit the 17th floor of his New York headquarters where he ran the shadowy investment advisory business on separate computer systems and ask to meet his operations staff? Did they question his use of a tiny accounting firm in Rockland County, N.Y., rather than a brand-name auditor to monitor the \$17 billion in assets his firm managed?

By now we know that Madoff kept multiple sets of books and records, ran his opaque and highly secretive business on a separate floor from his regulated market-making and brokerage operation, and refused to share any information about his black-box trading strategy with investors. He also generated trading confirmations that didn't match the footprint of his trading in the market.

Nonetheless, with his record of consistent returns, he established a network of fund-of-fund managers and "feeder funds" that marketed his investment services to other hedge funds and banks, and clients kept giving him assets. These feeder funds, which earned 20 percent commissions on Madoff's bogus returns, reportedly included Greenwich Sentry Fund, Optimal Investment Services (owned by Santander), Bank Medici and Rye Investment Group (a unit of Mass Mutual Insurance Co.'s Tremont Group Holdings).

Given the scope of the fraud, many are wondering how Madoff's scheme could go undetected for as long as 30 years. "It's absolutely amazing that someone that is investing hundreds of millions of dollars in a hedge fund or an investment vehicle or even a mutual fund would not do the due diligence to see how the operations are run or the controls that are in place," comments Andy Nybo, senior analyst at TABB Group in New York.

Part of Madoff's mystique, however, was his proprietary trading model, which he wouldn't disclose. After Madoff reportedly confessed to his sons that his business "was a big lie," victims came forward with their customer statements. An analysis by The Wall Street Journal revealed that the large-cap stock and options trading activity in which Madoff claimed to be buying and selling puts and calls on Standard & Poor's 100 index contracts did not match up with the open interest of index options contracts.

"The options liquidity could not support his scale of trading if his strategy was replicated across all the accounts,"

observes Nybo. If large institutional investors had examined their statements, they would have noticed a discrepancy in the trading activity in their accounts compared with the volume in the marketplace, he contends.

Now the SEC is under fire for repeatedly ignoring credible red flags even though it audited Madoff's firm three times, in 1992, 2006 and 2007. (The SEC admittedly found only technical violations.) It even ignored a whistleblower in 2007 who warned the SEC that Madoff was running a Ponzi scheme.

While the complete lack of due diligence and monitoring by the fund-of-fund community propelled Madoff's rise to stardom, the failure of regulators to follow up on any of the clues is even more shocking. Clearly there was a breakdown of the regulatory system, which is intended to police the industry and prevent fraud. And clearly changes are needed. After all, investor trust in our industry is at stake.



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