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## Madoff: A Riot of Red Flags

# Bernard Madoff Investment Securities (BMIS) and its Business Lines

- BMIS, founded in 1960, was initially a brokerage business.
- Madoff was early adopter of technology and used the ailing Cincinnati Stock Exchange (CSE) to exploit Rule 390. The rule allowed for trading of NYSE stocks away from the exchange. He upgraded the computer systems, and the CSE became the first electronic trading exchange.
- Due to increased competition in brokerage business, Madoff started an investment advisory business which lasted for 17 years. By 2008, the business was managing \$17 billion in assets.
- Madoff was a key figure in developing the NASDAQ stock market and was at one point chairman of the NASDAQ board of directors.

# Split-strike Conversion Strategy

Madoff referred his investment strategy as a split strike conversion strategy. The strategy involved the following:-

- To take a long position in portfolio of stocks. The portfolio must be highly correlated with S&P 100.
- Write out of money call options on the S&P 100. The notional principal of the calls must be close to the value of the equity portfolio.
- Buy out of the money put options on the S&P 100. The notional principal of the puts must be close to the value of the equity portfolio.

## Returns Reported on Madoff's Feeder Funds

- Madoff claimed that the portfolio was in cash most of the time and the split strike conversion strategy was implemented over short period of time, usually less than 30 days.
- Feeder funds reported extremely consistent positive returns ranging between 8% and 12%, year after year.
- Negative returns were returns in a mere 5% of the months.
- Returns were not that far off from the S&P 100 on average but volatility was marked lower.

## Securities Fraud at BMIS was Caught

- As the market downturn got accelerated, investors started withdrawing their funds and BMIS could not keep up with the rate of withdrawal.
- Madoff tried to raise additional capital but could not do it fast enough.
- In December 2008, Madoff confessed to family members that his investment advisory business was "a giant ponzi scheme".
- Regulators, who had been warned off the problems and red flags at BMIS, did not discover earlier that the scheme was a ponzi scheme.