THE WALL STREET JOURNAL.

Madoff Misled SEC in '06, Got Off
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1955 words
18 December 2008
The Wall Street Journal
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English

Securities and Exchange Commission investigators discovered in 2006 that Bernard **Madoff** had **misled** the agency about how he managed customer money, according to documents, yet the **SEC** missed an opportunity to uncover an alleged Ponzi scheme.

The documents indicate the agency had Mr. **Madoff** in its sights amid multiple violations that, if pursued, could have blown open his alleged multibillion-dollar scam. Instead, his firm registered as an investment adviser, at the agency's request, and the public got no word of the violations.

Harry Markopolos -- who once worked for a **Madoff** rival -- sparked the probe with his nearly decadelong campaign to persuade the **SEC** that Mr. **Madoff**'s returns were too good to be true. In recent days, The Wall Street Journal reviewed emails, letters and other documents that Mr. Markopolos shared with the **SEC** over the years.

When he first began studying Mr. **Madoff**'s investment performance a decade ago, Mr. Markopolos told a colleague at the time, "It doesn't make any damn sense," he and the colleague recall. "This has to be a Ponzi scheme."

For Mr. Markopolos, the arrest last week of Mr. **Madoff** was something of a vindication after his long campaign. At a certain point, he says, "I was just the boy who cried wolf."

A lawyer for Mr. **Madoff** declined to comment on Mr. Markopolos's allegations.

On Jan. 4, 2006, the **SEC**'s enforcement staff in New York opened an investigation, based on Mr. Markopolos's allegations, into whether Mr. **Madoff** was, in fact, running a Ponzi scheme. The **SEC** staff received documents from Mr. **Madoff** and Fairfield Greenwich, a hedge fund that placed money with Mr. **Madoff** on behalf of its clients. The **SEC** also interviewed Mr. **Madoff**, his assistant, an official from Fairfield Greenwich and another employee.

Among other things, the **SEC** found that Mr. **Madoff** personally "**misled** the examination staff about the nature of the strategy" used by the Fairfield funds and other hedge-fund accounts, and also "withheld from the examination staff information about certain of these customers' accounts," the **SEC** documents say.

The **SEC** report said that neither Mr. **Madoff** nor the Fairfield funds disclosed to investors in the Fairfield funds that Mr. **Madoff** was the investment adviser.

A lawyer for Fairfield couldn't be reached for comment.

The **SEC** report also said Mr. **Madoff** had violated rules requiring investment advisers to register with the **SEC**, which makes them subject to inspections and examinations. Investment advisers must register if they have more than 15 clients.

The staff recommended closing the investigation because Mr. **Madoff** agreed to register his investment-advisory business and Fairfield agreed to disclose information about Mr. **Madoff** to investors. The **SEC** report said the staff closed the case "because those violations were not so serious as to warrant an enforcement action."

"Some people play fantasy sports, that was how it was with us -- **Madoff** was our fantasy sport," Mr. Markopolos recalls. "We wanted him nailed."

In 2005, an **SEC** official in Boston called to say the agency was again looking into the case, and told Mr. Markopolos to contact Meaghan Cheung, a supervisor in **SEC**'s New York office, Mr. Markopolos recalls.

In November 2005, Mr. Markopolos sent Ms. Cheung a 21-page report outlining his concerns.

He presented a series of 29 "red flags," ranging from in-depth mathematical calculations that purported to show the **Madoff** investment strategy couldn't work, to little more than rumor or innuendo -- such as claims that a group of Arab investors were barred from using a major accounting firm to examine Mr. **Madoff**'s books.

He also questioned the fact that Mr. **Madoff**, unlike most money managers of his stripe, didn't charge his investors a fee for handling their money. Instead, he seemed to make profits on commissions generated by the trades on investors' behalf.

"Bernie **Madoff**'s returns aren't real," Mr. Markopolos said. "And if they are real," it's because Mr. **Madoff** might be engaging in "front running," or buying shares for his investors' accounts just before filling orders for other clients that have the potential to send the price higher, an illegal practice.

Mr. Markopolos's allegations against Mr. **Madoff** were far from bulletproof. Mr. Markopolos provided no definitive evidence of a crime. His reports were laden with frothy opinions.

In his lists of "red flags," he occasionally got things wrong. Sometimes he even misstated the starting date of his own campaign against Mr. **Madoff**.

Ms. Cheung was a respected attorney known for quickly bringing high-profile charges against executives of cable-television company Adelphia Communications several years earlier, after that company issued a questionable earnings report.

Mr. Markopolos thought he had a chance for his campaign to succeed.

"I had my hopes up, I thought it was a good enough package that they would go and shut this man down," Mr. Markopolos recalls.

He sent an email adding more evidence -- noting that he might be eligible for the **SEC**'s bounty program if it turned out that Mr. **Madoff** was, in fact, front running.

An **SEC** spokesman wouldn't comment on the agency's communication with Mr. Markopolos.

In its resulting investigation, the **SEC** searched for evidence of "front running" but found no indications that was happening, according to an individual familiar with the matter.

Investigators also checked out Mr. Markopolos's claim that Mr. **Madoff** was running a Ponzi scheme. But the billions of dollars of assets held by Mr. **Madoff**'s asset-management unit appeared to match those that various investment firms said they had placed with **Madoff**, suggesting that there weren't problems.

Today, it is now known that that Mr. **Madoff** had many more investors -- such as individuals and charities -- which weren't disclosed in regulatory filings, making it harder for investigators at that time to ascertain precisely how much money he was managing.

On Tuesday, **SEC** Chairman Christopher Cox also said that **Madoff** kept several sets of books and false documents. That, too, could have thrown off investigators a few years ago.

As part of the inquiry, the **SEC** did find that the firm had violated technical rules about executing trades.

Early this year, Mr. Markopolos made one last major effort after receiving an email from Jonathan Sokobin, an official in the **SEC**'s Washington, D.C., office whose job was to search for big market risks. Mr. Sokobin had heard about Mr. Markopolos and asked him to give him a call, according to an email exchange between them.

With low expectations, Mr. Markopolos got in touch. "The way I figured it," he says, "if they didn't believe you at $5 billion, and not at $10 billion, they didn't believe you at $30 billion, then why would they believe you at $50 billion?"

Mr. Markopolos also sent Mr. Sokobin an email -- with the stark subject line "$30 billion Equity Derivative Hedge Fund Fraud in New York" -- saying an unnamed Wall Street pro recently pulled money from Mr. **Madoff**'s firm after trying to confirm trades supposedly done in his account, but discovering that no such trades had been made.

It was his last try. He never heard back about his allegations regarding Mr. **Madoff**.

"I felt pretty low," Mr. Markopolos recalls.

Mr. Sokobin, through an **SEC** spokesman, declined to comment.

Last Thursday, as Mr. Markopolos watched his children take a karate lesson near his home in Whitman, Mass., 20 miles outside Boston, he checked his voice mail, trying to ignore the noise from the children. Walking out to the foyer, Mr. Markopolos returned one of the calls, and heard an old friend tell him that Mr. **Madoff** had been arrested.

"I kept firing bigger and bigger bullets" at Mr. **Madoff**, "but I couldn't stop him," Mr. Markopolos says. With the **SEC**'s mea culpa and Mr. **Madoff**'s arrest, "I finally felt relief."

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