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A Madoff Whistle-Blower Tells His Story

By Robert Chew

Harry Markopolos, the man who knew too much about Bernie Madoff, appeared in public on Wednesday, and this time the Securities and Exchange Commission (SEC) was listening.

In front of the House Financial Services Committee hearing, the former investment manager told how his nine years of repeated warnings to SEC enforcement officials went ignored and how they dismissed his detailed "red flag" reports. Markopolos also told the committee that tomorrow he will be turning over evidence to the SEC of another major Ponzi scheme, a \$1 billion "mini-Madoff." It's expected that the SEC will pay closer attention to him this time. ([Read "Bernie Madoff's Victims: Why Some Have No Recourse."](#))

The whistle-blower said in written and oral testimony that he and his associates did their best "to stop the most complex and sinister fraud in American history," but that no one at the SEC cared.

With SEC's top enforcement brass in the back of the hearing room, House committee members, including Pennsylvania Representative Paul E. Kanjorski, chairman of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, listened to by far the most damning explanation of how the government missed Madoff's crime for decades.

The hearing was the committee's second in a series to help guide the most substantial rewrite of the laws governing the U.S. financial markets since the Great Depression. Ultimately, Markopolos asked the committee to "restructure" the SEC, calling it "nonfunctional" and "harmful to our nation's reputation as a financial leader."

Markopolos, who said that he feared for the safety of his family's life prior to Madoff's arrest, read parts from his nearly 60-page written description of the SEC's "investigative ineptitude" and "financial illiteracy." At the start of his oral statement, Markopolos injected a bit of metaphorical humor into his charge, describing the SEC as a regulatory agency that "roars like a mouse and fights like a flea." With the sober, academic look of an accountant, the former investment manager for Rampart Investment

Management in Boston (he is currently an independent certified fraud examiner) detailed Madoff's phony split-strike conversion strategies and oddly "unsophisticated portfolio management." Markopolos said Madoff's "math never made sense" and his "return stream never resembled any known financial instrument or strategy."

Markopolos said Madoff was earning 82% of the S&P 500's return with less than 22% of the risk, but his returns only had a 6% correlation when Markopolos expected "something like a 50%" correlation. "If your returns are coming from the S&P 100 stock index, you better at least resemble that stock's performance," he said. He also compiled statistics from S&P 100 index options and from the Chicago Board Options Exchange as reported in financial media. "There were not enough index options in existence for Madoff to be managing the split strike conversion strategy he purported to be running," he said. But the biggest tip-off of a fraud was that Madoff reported his fund was down only three months out of 87, whereas the S&P 500 was down 28 months during the same period.

Markopolos described the crooked returns as "the equivalent of Major League Baseball player batting .966 and no one suspecting a cheat." In the hearing, he used his arm to show the straight upward growth of Madoff's funds, up 45 degrees without any down ticks. "This was the first sign that this was a fraud," Markopolos said.

The independent investigator said Madoff's fraudulent fund was in the \$3 billion to \$7 billion range in 2000, then a year later grew to near \$20 billion, and then eventually to its reported \$50 billion in late 2008. He said there were at least 14 feeder funds.

Madoff's greatest talent, the witness indicated, was his use of a "hook" or lure to play "hard to get" and the false security of exclusivity, a hallmark of a Ponzi scheme.

In a story that seemed part financial doctoral thesis and part financial thriller, Markopolos told of his years of toil on the Madoff case, with often "disastrous meetings" with SEC enforcement chiefs. It was in 2005 when Markopolos wrote his now famous and lengthy report detailing Madoff's giant Ponzi scheme and pointing out 29 red flags. He sent it to the SEC, and nothing happened. But when he finally met the SEC's Boston branch chief, Mike Garrity, who had a willingness to "think outside the box," he felt some hope.

Garrity, he said, understood Madoff's impossible returns, but the problem was location: Madoff was not in the New England region. Were jurisdiction not a problem, "he would have had an inspection team inside Madoff's operation the very next day," Markopolos said. Ed Manion, a 15-year SEC-certified financial analyst, also urged Markopolos to continue his investigation. Manion, he said, was the "only one who understood [Madoff's] threat to the public."

Unfortunately, Markopolos said, his report was sent down to the SEC's New York branch chief Meaghan Cheung, whom he said "never grasped" the concepts "nor was the slightest bit interested in asking questions."

At that point, Markopolos decided to go to the press. He told the committee he went to a reporter at the *Wall Street Journal*, John Wilke, but the editors never approved an investigative piece, so things went back to the SEC's Cheung, and there it stopped. "It is a sickening thought," but if the SEC or the *Wall Street Journal* "would have picked up the phone and spent one hour contacting the leads" provided, Markopolos said, Madoff would have been stopped in 2006, and "untold billions" would have been saved.

Interestingly, Markopolos said he never went to the Financial Industry Regulatory Authority (FINRA), a nongovernmental regulator that oversees 5,000 brokerages, out of fear for his safety: "Bernie Madoff was chairman of their predecessor organization and his brother Peter was former vice chairman." Those links to Madoff, he felt, could have exposed him to harm, especially since a lot of feeder fund money "was coming from Russia and South America."

FINRA was created in July 2007 through the consolidation of NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange. The former chairman of FINRA, Mary Schapiro, is now the new head of the SEC, selected by President Obama and approved by the Senate Banking Committee last month.

In the second half of his testimony, both oral and written, Markopolos outlined his recommendations for fixing the SEC. Markopolos said that "right now investors are afraid." He cited investor fears of banks, insurance companies, brokerage firms, credit rating agencies, investment manager, and the country's regulatory agencies, including the Federal Reserve and the Treasury. In a backhanded compliment, Markopolos said the SEC is a "bad regulator, but the best of a very sorry lot," though at one point he also suggested that it might be better to disband it or merge it with another agency. The bigger fix, he said, was to create one "super regulatory agency" and one national banking regulator, thereby filling regulatory gaps and duplication.

Robert Chew is a former investor with Madoff via a feeder fund. He lives in Colorado.

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