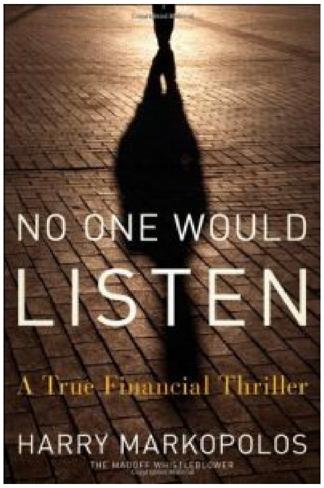


# Book No One Would Listen

## A True Financial Thriller

Harry Markopolos
Wiley, 2010
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## Recommendation

When Harry Markopolos began his career in the securities industry, he applied his mathematical skills to the design of investment products. In particular, his bosses wanted him to create investment instruments that competed with those offered by financier Bernie Madoff. When Markopolos found that Madoff's results were impossible to match, he suspected that Madoff was running a Ponzi scheme – not investing money, but paying each investor with cash from other investors. His suspicion led to an investigative odyssey. Markopolos and his team uncovered not only the largest financial fraud in history, but also a dangerously dysfunctional U.S. regulatory system. In this book, Markopolos recounts his frustrating, thwarted efforts to warn the Securities and Exchange Commission (SEC) about the threat Madoff posed to unwary investors. The SEC failed to respond to his detailed written evidence, though Markopolos submitted it five times, starting in 2000, long before Madoff finally confessed in 2008 (he is now serving 150 years in jail). *BooksInShort* recommends this engrossing book to readers who want to learn more about this epic scandal and its implications for financial industry regulation.

## Take-Aways

- Bernard Madoff ran the largest financial fraud ever, stealing $65 billion from investors.
- Harry Markopolos first tried to compete with Madoff and then tried to stop the scam.
- When Markopolos could not create an investment product that rivaled Madoff's profits, he suspected fraud.
- Madoff ran a Ponzi scheme, paying phony returns to existing investors with cash from new investors, so it was impossible to vie with his supposed results.
- Markopolos warned the Securities and Exchange Commission (SEC) about Madoff for years.
- Securities marketer Frank Casey, quantitative analyst Neil Chelo, financial journalist Michael Ocrant and other experts joined Markopolos' investigative team.
- Markopolos submitted written evidence compiled by his team to the SEC five times.
- The financial panic of 2008 led Madoff's investors to demand more cash than he had.
- In 2009, Madoff began a 150-year prison sentence after confessing his crimes.
- The U.S. government should enact regulatory reforms to prevent similar frauds, and the SEC should improve its practices and hire more expert investigators.

## Summary

### The Biggest Financial Crime Ever

In December 2008, as Harry Markopolos prepared to bring his kids home from karate practice, he noticed several voice messages on his cellular phone. All his callers had the same shocking news: Wall Street legend Bernard Madoff, former chairman of Nasdaq, was under arrest for running a fake investment fund. His Ponzi scheme had collapsed in the wake of the global financial panic. The arrest vindicated years of Markopolos' efforts to end Madoff's financial ruse and to prevent investors from handing him more money.

> "Madoff's subtle – but unspoken – message was that he had access to trade flow information because clients were buying and selling through his brokerage."

By the time his crime spree ended, Madoff had attracted investors around the world, from major financial institutions and charitable organizations to families in the New York and Florida Jewish communities to descendants of European nobility.

His investors responded to the 2008 economic meltdown by rushing to redeem their investments with Madoff, and before long, his fake fund was empty. In the end, he stole an estimated $65 billion from investors – the largest financial fraud in history.

> "Bernie Madoff...didn't have to be a genius; he just had to be smarter than the SEC."

The Securities and Exchange Commission's lack of response and its dismissive treatment of Markopolos were as shocking as the breadth of the fraud. Markopolos submitted written evidence of Madoff's crimes to the SEC five times and received virtually no response. Many investment industry professionals doubted the veracity of the evidence against Madoff, an avuncular philanthropist with a genteel demeanor. But he fooled neither Markopolos nor his investigators, who were determined to develop and disseminate proof that Madoff was a financial criminal on an unprecedented scale.

## A Knack for Finding Fraud

From a young age, Markopolos demonstrated a talent for solving mathematical problems and a gift for spotting fraud. He once worked as the assistant controller of his family's group of 12 fish-and-chips restaurants. He identified a staffer who was stealing food at one restaurant by carefully analyzing changes in the inventory at all 12 locations. Instead of firing him, Markopolos reduced the thief's working hours until he quit. This tactic steadily pared the losses and kept the ex-worker from filing claims for unemployment compensation at the family's expense. By the early 1990s, Markopolos was on a career path in the securities industry. After working at other investment firms, he joined Rampart Investment Management in Boston. At Rampart, he began his long-running investigation of Madoff and his discouraging struggle to convince the SEC that the venerable Wall Street leader was not what he appeared to be.

> "Madoff practically swore his investors to secrecy. He threatened to give them back their money if they talked about him."

Everyone knew Madoff as a financial industry veteran with a respectable securities broker-dealer business. Not everyone knew that, on the side, Madoff was running what he called a hedge fund. He told his victims that he conducted automated securities trades by using a secret "black box" computer program that was based on his years of experience. Theoretically, he switched the composition of the fund regularly, moving back and forth from the safety of Treasury securities to hedged investments in stocks. In truth, Madoff simply amassed cash, never invested in stocks and distributed fake investment returns by moving money from new investors to existing ones. Markopolos did not suspect fraud in 1999, when he first learned about Madoff and his hedge fund. He initially saw Madoff as a competitor to copy, not a criminal to capture.

## Unsuccessful Imitation Leads to Investigation

While at Rampart, Markopolos assembled part of the core team of professionals who later worked with him to investigate Madoff. Quantitative analyst Neil Chelo, who had joined Rampart as an unpaid intern while still in college, later became a permanent member of the staff. Like Markopolos, Chelo had a gift for understanding complex mathematics. The team also worked with Markopolos' attorney, Dr. Gaytri Kachroo.

> "Probably what surprised me most was how many people knew Madoff was a fraud."

Rampart securities marketer Frank Casey, who also joined the investigative team, was the first person to tell Markopolos about Madoff's hedge fund. Casey encouraged Markopolos to design a hedged investment product that could produce consistently solid returns and compete with Madoff's offering. The attempt to do so was revelatory. The more Markopolos analyzed Madoff's investment claims, the more he doubted them. Madoff was making money in almost every imaginable investment climate, whether the prices of stocks, bonds and other securities rose, fell or stagnated. His track record suggested that Madoff had perfect market timing, or the ability to enter and exit markets at precisely the most profitable moments. Markopolos dismissed that as a practical impossibility. Markopolos waved another "red flag": Elite firms on Wall Street evidenced a lack of faith in the Madoff fund. Such major institutions as Goldman Sachs, Citigroup and Morgan Stanley were not feeding investment dollars to Madoff. A Goldman manager told Markopolos that "they didn't believe Madoff's returns were legitimate."

> "When he surrendered in 2008, it was estimated that he was running $65 billion. You do the sad math."

Rampart executives and clients implored Markopolos to keep trying to design a solid investment product that could compete with Madoff's. One client, an affable Frenchman named Thierry de la Villehuchet, ran a large investment firm for the wealthy. Since he had invested very heavily in the Madoff fund, he wanted an alternative product to diversify his clients' risk.

> "Madoff's operation was too big to be believed. Once I stated how many billions he purportedly was managing, people stopped listening."

Markopolos worked closely with Chelo and Casey to figure out exactly how Madoff was doing what he claimed. Since they were trying to improve the quality and variety of Rampart's investment products, finding a way to compete with Madoff was part of their job. They were unable to do so. As the Rampart squad intensified its investigation of Madoff, Markopolos decided to report the findings to the Securities and Exchange Commission. He submitted written evidence for the first time in 2000. He told the Boston office of the SEC that Madoff was operating a Ponzi scheme. The agency took no action. In 2001, Markopolos again submitted evidence of Madoff's wrongdoing to the Boston SEC office. This time it forwarded the information to the agency's New York office, but again the SEC did not act.

## Madoff and Media Scrutiny

The SEC's inaction frustrated Markopolos. He tried to think of alternative ways to stop Madoff from taking more money from investors. He considered sharing damning evidence with the news media, but decided that giving Madoff publicity could have served to solidify his Ponzi scheme. Then, at a conference in Spain in 2001, Casey met financial journalist Michael Ocrant, editor in chief of *MARHedge*, a monthly hedge fund industry magazine. He had written an award-winning article in 1994 explaining how a corrupt broker helped Hillary Clinton earn $100,000 in a year on a $1,000 investment in cattle futures contracts. Ocrant, who later joined Markopolos' investigative team, asked his sources in the hedge fund industry about Madoff. Amid other information, he learned that Madoff's fund was surprisingly large, maybe one of the world's biggest. Madoff attracted so much money because his fund almost never reported a loss. Many of his best customers managed so-called feeder funds. Madoff paid fees to hundreds of funds for bringing him new investors and the ever-increasing sums he needed to sustain his Ponzi scheme.

> "In a nutshell, the SEC staff was not capable of finding ice cream in a Dairy Queen."

One day, Ocrant called Madoff directly and, to his surprise, quickly got Madoff on the telephone. When he requested an interview, Madoff invited him to come to his office later that day. Instead of acting like a criminal with something to hide, Madoff was calm and cordial. He never ducked a question. He gave plausible responses to every query about his hedge fund. When asked for more details about the "black box" computer program that guided his investing, Madoff claimed the details were proprietary and releasing them would give his competitors an edge. Ocrant's article on Madoff appeared in the May 1, 2001, issue of *MARHedge*. A similar article appeared in *Barron's*, a major weekly financial newspaper, later that month. While neither story charged Madoff with fraud, they presented strong evidence of a possible Ponzi scheme and other misdeeds. Markopolos thought the articles would stir regulators to action. He was wrong. The public response was negligible. Markopolos said the pieces had the impact of "a single snowflake."

## Danger Abroad

Money kept rolling into Madoff's hands, not only from domestic investors, but also from Thierry de la Villehuchet (though Casey warned him about Madoff) and other European asset managers. Markopolos gradually realized that Madoff received money from many foreign feeder funds in Europe and other parts of the world, not just from U.S. investors. In 2002, Markopolos traveled to Europe and met with managers of 14 feeder funds that had handed their clients' money to Madoff. He found that they were drawn to Madoff "like moths to a flame." Some of the funds were operating in offshore havens for those who wanted to avoid paying taxes on their income. Markopolos strongly suspected that people involved in organized crime were investing with Madoff through certain feeder funds. After his trip to Europe, Markopolos first began to worry about the possible consequences of exposing Madoff as a fraud and inflicting huge losses on investors, including, he feared, the Russian Mafia. He wondered how much danger Madoff himself was facing. Markopolos began to take precautions to protect himself and his family. He routinely looked under his car for a bomb before turning on the ignition and started sleeping with a handgun nearby.

## The Delayed Destruction of the Madoff Scam

In 2004, Markopolos quit his job at Rampart after almost 13 years and switched to full-time work as an investigator of potentially fraudulent companies, including Madoff's firm. Casey and Chelo also went to other firms, but they continued to participate in Markopolos' investigation. Ocrant left journalism to work for an investment firm, but he kept sharing his discoveries about Madoff with Markopolos and the investigative team.

> "Everybody deserves full transparency when they are dealing with investments, and it's up to the government to provide it."

In June 2005, the team got its initial sign that Madoff was having problems. Over lunch, Casey learned from an Italian investment manager that Madoff was seeking banks that would lend money to his investors, so they could give him their money plus funds they borrowed. Casey also learned that two large banks, the Royal Bank of Canada and France's Société Générale, had stopped lending money to investors who wanted to use it to enlarge their positions in Madoff's fund. Yet the SEC did little to hasten the demise of the Madoff scam. In 2005, Markopolos again submitted written warnings about Madoff to the SEC. The agency did a shallow investigation of Madoff and ordered him to register as an investment adviser because he claimed to run a hedge fund. Madoff was still cheating investors, but instead of shutting him down, the SEC allowed his Ponzi scheme to keep growing for three more years.

> "The damage done by Madoff was reverberating throughout the financial markets of the world, as well as in millions of homes. In an instant, thousands of people had been financially devastated."

In 2008, a surge in foreclosures slashed the value of mortgage-backed bonds and derivative securities, deepening the U.S. recession. Lehman Brothers, the doomed investment banking firm, filed for bankruptcy in September 2008, triggering a global credit shortage. Worried about their liquidity, many Madoff investors suddenly demanded their cash to offset their losses on legitimate investments. But the money was gone.

> "There were a few people we warned away from Madoff, but we saved very few people. The best way to make up for that, I felt strongly, was to make sure the SEC became the agency it should be."

On December 11, 2008, law enforcement authorities arrested Madoff. Within a year, the SEC's inspector general published an embarrassing critique of its lack of response to warnings about Madoff from Markopolos and other sources. Markopolos testified before two congressional committees about Madoff and the SEC's ineptitude. The agency's repeated failures to stop Madoff much earlier exposed its structural weaknesses. The SEC should take remedial actions such as hiring more finance experts and fewer lawyers to examine financial firms, offering incentive pay to staffers who uncover large-scale financial fraud, and encouraging investment professionals to submit evidence of potential illegal actions by their employers or their competitors. And the U.S. should enact regulatory reforms to stop future Madoffs.

> "People kill to protect their money, and if my team was successful, a lot of people were going to lose a lot of money."

On December 23, 2008, when Thierry de la Villehuchet learned that no chance existed of getting back any money he invested with Madoff, he committed suicide. He lost $1.4 billion belonging to his family and investors, including Europe's rich and royal. The investigation had long since stopped being "an intellectual pursuit" for Markopolos: He wept for Thierry for days, furious at Madoff and the SEC on behalf of his friend and the other Madoff investors who lost so much.

# About the Author

**Harry Markopolos** is a financial fraud investigator and former securities industry executive.