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Madoff Misled SEC in '06, Got Off

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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.

Harry Markopolos

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.

Markopolos's Documents

- [Documents Harry Markopolos submitted to the SEC in fall 2005](#), making a case that Bernard Madoff's business was a Ponzi scheme.
- [The response Mr. Markopolos received from an SEC official](#) in response to his case against Mr. Madoff.
- [An email Mr. Markopolos sent to a SEC official in April 2008.](#)
- [See the SEC's case opening and closing recommendations.](#)

The Madoff Fraud Case

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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."

Mr. Markopolos says his suspicions started in late 1999, after a colleague returned from New York with tales of Mr. Madoff's trading prowess. Whether the markets were up, or down, Mr. Madoff managed to clock in with steady gains of 12% or so a year, reportedly achieving that by trading a mix of stocks and stock-index options.

Liked the Look

Mr. Markopolos says his bosses liked the look of those returns — and asked him why he couldn't do the same thing.

Under pressure to deliver, Mr. Markopolos and a colleague at their Boston investment outfit tried to reconstruct Mr. Madoff's purported strategy. Their results paled in comparison, and Mr. Markopolos began suspecting possible fraud.

His bosses told him to go back and check the math, given Mr. Madoff's renown as a trader.

So Mr. Markopolos turned to Daniel DiBartolomeo, a top financial mathematician in Boston. Mr. DiBartolomeo says he spent hours poring through Mr. Markopolos's data, and ultimately agreed: The strategy Mr. Madoff said he used couldn't have achieved the returns he boasted of.

'Sounds Serious'

In early 2000, Mr. Markopolos shared his explosive concerns with Edward Manion, a staff examiner at the SEC's Boston office.

In his documents, Mr. Markopolos said that there's a chance "I'm an idiot for wasting your time." But he argued forcefully that "I believe an SEC visit is warranted" to look into Mr. Madoff's practices.

"This sounds serious," Mr. Manion told him, inviting Mr. Markopolos in for a meeting.

In May 2000, Mr. Markopolos says he sat down with Mr. Manion and an SEC attorney.

Mr. Markopolos argued his case: A key part of Mr. Madoff's strategy relied on buying and selling options on the Standard & Poor's 100-stock index. But Mr. Markopolos said his research showed there weren't enough S&P-100 options in existence at the time to support Mr. Madoff's stated strategy, given all the money he seemed to be managing. So something else must be going on.



Bernard Madoff, accused of running a massive investment fraud, was placed under house arrest Wednesday after a New York court hearing.

Mr. Markopolos, a native of Erie, Pa., who had trained in "unconventional warfare," including intelligence gathering, as a reservist in the Army, says he came to "consider Madoff a domestic enemy."

Outsized Gains

In the months after the initial meeting with the SEC, Mr. Markopolos kept hearing about Madoff's outsized gains, and how the firm was growing — sparking frequent calls to Mr. Manion to discuss the case.

Over a year passed. Then, in late 2001, Mr. Manion told Mr. Markopolos the case appeared to have fallen through the cracks. He asked Mr. Markopolos to resubmit his documents and arguments, so they could be passed on to the SEC's New York office.

Mr. Markopolos sent the documents, adding three pages arguing that the fraud was growing in size as Madoff's assets under management grew beyond \$12 billion.

Mr. Markopolos also diagrammed how he believed the Madoff organization seemed to work, using a Byzantine flow chart with circles, squares, rectangles and arrows.

Mr. Markopolos continued to receive sympathetic calls from Mr. Manion. "He's the one that kept me going, I would have stopped long ago," Mr. Markopolos says.

But Mr. Manion pointed out that any investigation would have to be conducted by the New York office, where Mr. Madoff's firm was based.

Mr. Markopolos says that worried him. "I was told that the relationship between the SEC's Boston and New York offices is about as warm and cordial as the Yankees-Red Sox rivalry," Mr. Markopolos says.

Mr. Markopolos left his firm in 2004, and started a fraud-investigation practice. Mr. Markopolos's old colleagues, prodding him not to give up, spoke by phone for hours at a time about Mr. Madoff.

"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.

Rules Violations

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?"

Funds Pulled

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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