

HOW THEY FAILED TO CATCH MADOFF

Thomas Thanasules paused as he sifted through a pile of e-mails he'd gotten from Renaissance Technologies, arguably the most successful hedge fund in the world. "Please keep this confidential," one said. ...

What was so secret? It was April 2004, and as a young compliance examiner for the Securities and Exchange Commission in New York, Thanasules was struggling to keep up with the burgeoning number of new investment vehicles known as hedge funds. ...

RenTec, as it was known to traders, was founded in 1982 by James Simons, an MIT- and Berkeley-trained mathematician who used sophisticated mathematical models to invest in markets. ... Renaissance had several funds; its best known, the Medallion fund ... had racked up astounding average returns of over 30% a year. Given its prominence, size, and remarkable returns, RenTec had naturally attracted the interest of the SEC... So far, Thanasules hadn't found anything suspicious, but as he sifted through the assets of Meritage, Medallion's sister fund run out of San Francisco by Simons's son Nat, he discovered that Meritage ... had entered into a so-called total return swap with another fund-of-funds, HCH Capital, effectively paying HCH for the returns and risk associated with one of its investments. ...

Meritage had to gain access to the fund using a swap because the fund was so sought-after that only the chosen few were allowed to invest, handpicked by the fund's manager. ... When Meritage tried to invest, the fund's manager, Bernard L. Madoff, had turned Simons down. ... From the RenTec e-mails, he could tell that Madoff was a subject of concern to the people there, who were, after all, some of the most sophisticated in the hedge fund world. ...

They didn't really know what strategies Madoff used, or how he earned such consistent returns -- more consistent than even their Medallion fund.

... If Renaissance executives couldn't figure out what Madoff was doing, who could? ...

Thanasules went to his supervisor, branch chief Diane Rodriguez. The facts they alleged -- a nonindependent auditor, incomprehensibly consistent returns with near-perfect timing, and, most of all, the inability of Paul Broder, RenTec's risk manager, to identify any trading volume or counterparties essential to execute the strategy -- led Thanasules to wonder "whether Madoff is doing these trades at all," as he described his thinking.

On April 20, he sent an e-mail to Rodriguez. Eight months later Robert Sollazzo, co-head of the SEC's broker-dealer examination program, referred the Madoff case to John Nee, the compliance division's assistant director. Sollazzo also recruited two young examiners, Peter Lamore and William Ostrow. ...

When Lamore and Ostrow arrived at Bernard L. Madoff Securities on April 11, 2005, Madoff himself came into the lobby to greet them. ... Ostrow asked a basic question: "Do you do a retail business?" "No," Madoff answered.... As Ostrow later put it, "According to Bernie, there was no investment advisory business." This was an astounding proposition, since the premise of the Renaissance e-mails was that Madoff was managing money for hedge funds ... and generating returns that seemed impossible to explain. And what about all the feeder funds that the published reports said were funneling money to Madoff? If Madoff was simply a market maker, there was no reason for Ostrow and Lamore to be there. Neither believed him, but Madoff managed to divert them from this line of inquiry, regaling them with stories about Wall Street trading and the evolution of the business. ...

By late May, Lamore and Ostrow had been on the Madoff premises for nearly two months. They spent the entire time in a conference room, and neither ever ventured onto the 17th floor, which is where Madoff indicated that routine back-office tasks were conducted. ... On May 25, Ostrow and Lamore scheduled a meeting to confront Madoff about his assertions that he didn't manage money. They laid two articles on the table and pointed out that both flatly contradicted his repeated claim that he didn't advise any hedge funds or manage their money. With the articles in front of him, Madoff abruptly reversed himself. "We do execute trades on behalf of brokerage firms and institutions, which include a number of hedge funds," he now acknowledged. "They use a model -- algorithm -- that we developed." ...

Madoff said he had developed it eight years earlier and that he was the only person allowed to execute trades using it. ... He said he had already disclosed all of this trading to the SEC about a year and a half earlier, when the SEC's Office of Compliance Inspections and Examinations (OCIE), a separate, Washington-based operation whose primary mission is to detect fraud, examined him. "Lori Richards has a whole file I sent her with this info," Madoff said. "They have it." (Richards was a compliance official with the OCIE.) ...

Despite the bombshells Madoff had lobbed, Ostrow and Lamore, as well as their superiors, were diverted by the embarrassing disclosure that, as one put it, "the left hand didn't know what the right hand was doing" at the SEC.

In a conference call five days later, OCIE officials confirmed that they had indeed investigated Madoff, and although it was still an open investigation, "for all intents and purposes it was finished." They hadn't reached any conclusions or issued a final report, which Lamore thought was strange. It also struck him that the Washington officials kept stressing how important Madoff was. ...

A few months later, in October 2005, after Harry Markopolos came forward with his now famous report alleging Madoff was running a Ponzi scheme, the SEC launched another investigation out of New York. Markopolos's report was assigned to Meaghan Cheung, a branch chief in the enforcement division, and Simona Suh, a staff attorney. ... On Friday, May 19, 2006, Madoff arrived at the SEC's New York office for his testimony with Cheung and Suh.

It was the first time Madoff had been required ... to testify under oath. Madoff seemed eager to discuss the split-strike conversion strategy and proprietary model that was uniquely his creation. "I just remember sitting there in the testimony thinking, 'He's lying,' " Lamore later said. ... Lamore thought there was enough to refer the case to the Justice Department immediately. At the least, Madoff was lying under oath, which raised the question why. ... Suh later explained, "Meaghan [Cheung] did not think that this was likely to lead to an enforcement action or this was likely to lead to anything." ...

On Dec. 16, 2008, five days after Madoff confessed to FBI officials, chairman Christopher Cox announced an internal investigation into the SEC's failure to detect the Madoff fraud, and referred the matter to David Kotz, the SEC's inspector general. After months of negotiations with Madoff's lawyers, Madoff agreed to be interviewed, and on the afternoon of June 17, 2009, Kotz and a colleague arrived at the Metropolitan Correctional Center. ...

Madoff said he was "astonished" that the SEC's enforcement investigation hadn't exposed his fraud, and added there were two times when he "thought the jig was up"... Kotz issued a detailed and unsparing 457-page report in August 2009. It should be required reading for every current and future staff member of the agency. Kotz concluded that there was no "misconduct" or inappropriate influence exerted on any individual staff member. Rather, the staff "never took the necessary and basic steps to determine if Madoff was misrepresenting his trading," and "there were systematic breakdowns" in the investigation, which, if anything, seems an understatement. ...

Judged by the duration and magnitude of his fraud, Madoff would seem the most cunning and skilled of liars. That's what David Kotz assumed when he began his investigation. "I assumed Madoff was a genius, a master, that nobody would have had a prayer of figuring him out," Kotz said. But in fact, Madoff was no better than average, if that. Written records flatly contradicted his lies, had anyone bothered to check them. He repeatedly changed his story on numerous points: whether he did or didn't trade options; whether he did or didn't manage money for individuals; who did or didn't handle his trading; how many clients he had; and how much money he managed. ...

"He wasn't a good liar," Kotz concluded. "He couldn't keep his story straight. He was no evil genius." As of late 2010, two years after the Madoff scandal broke, the SEC had taken no disciplinary or other measure against anyone involved in the various Madoff investigations. The SEC officials' collective failure is, as Madoff himself put it, astonishing. It will surely rank as one of the greatest regulatory failures ever, not just because of the size of the fraud, but because it was staring them in the face.

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