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Description of document:	Presentation by Harry Markopolos of his detection of the Bernie Madoff Ponzi scheme and the failure of The Securities and Exchange Commission (SEC) to take action, at the March 13, 2014 Council of Inspectors General on Financial Oversight (CIGFO) meeting
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From: "Delmar, Richard K."
Date: Jun 6, 2016 3:22:28 PM
Subject: your FOIA request to Treasury 2016-05-055

This responds to your FOIA request for the presentation made at the March 13, 2014 CIGFO meeting by Mr. Harry Markopolos.

A copy of his presentation is attached.

I believe this is a full production of all records responsive to your request. Please advise if you disagree.

Rich Delmar
Counsel to the Inspector General
Department of the Treasury

Bernie Madoff
"The case that should never have happened"

FSOC OIG
13 March 2014

Harry Markopolos, CFA, CFE
Chartered Financial Analyst
Certified Fraud Examiner

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Whistleblower's Biography

- 9+ years as a Full-time fraud investigator (2004 – Present)
- 4 years as a Part-time fraud investigator (2000-2004)
- Former NASDAQ O-T-C Market-Maker & Registered Options Principal)
- Former Portfolio manager, then Chief Investment Officer for a $ multi-billion equity derivatives asset manager in Boston (1991 – 2004)
- Certified Fraud Examiner
- Chartered Financial Analyst
- M.S. in Finance; Boston College
- B.A. in Business Administration; Loyola University of Maryland
- 17 Years of Army Reserve Component Service; Infantry, Logistics, Civil Affairs (1978-1995)

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Detection Method by Companies > 100 employees

- 46.6% Whistleblower Tip
- 16.5% Internal Audit
- 15.1% Management Review
- 4.7% Account Reconciliation
- 3.2% Document Exam
- 2.3% External Audit
- 2.3% Notified by Police
- 2.0% Surveillance/Monitoring
- 1.4% IT Controls
- 1.0% Confession
- 1.0% Other
- Source: 2012 ACFE Report to the Nations www.acfe.com

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Source of Tips

- 50.9% Employee
- 22.1% Customer
- 12.4% Anonymous
- 11.6% Other
- 9.0% Vendor
- 2.3% Shareholder/Owner
- 1.5% Competitor
- Source: 2012 ACFE Report to the Nations www.acfe.com

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Whistleblower Programs

- DOJ – False Claims Act; 15-30% rewards
- IRS – Section 7623; 15% - 30% rewards
- SEC – Dodd-Frank Section 923; 10-30% rewards
- State False Claims Acts in 30 states but some are Medicaid only
- Whistleblowers put law enforcement on a level playing field with white-collar criminals & are a force-multiplier
- Whistleblower tips provide intelligence & insight into control weaknesses, regulatory gaps, and current fraud schemes
- Resource: www.TAF.org is the whistleblower bar association's website and contains lots of reading references on cases, case law, and offers a weekly e-newsletter

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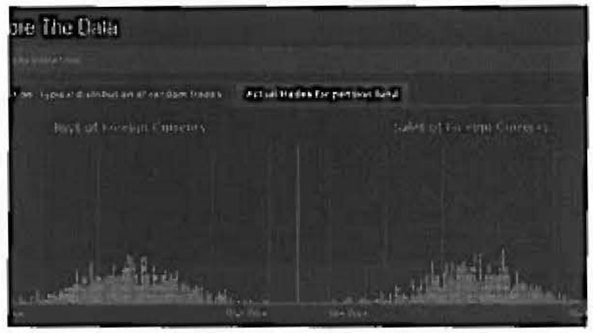
An Honest FX Price Distribution
Source: WSJ 5/23/2011 Page A-1 Cover Story



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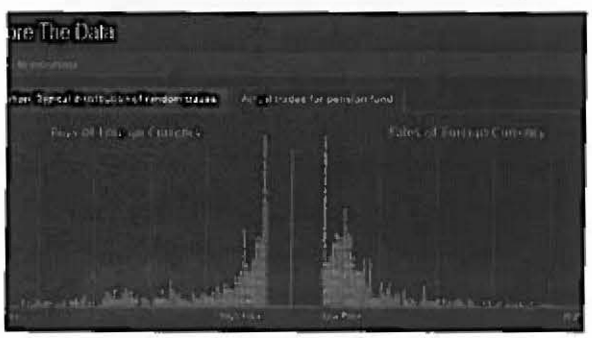
Bi-Modal Fraud Distribution
Source: WSJ 5/23/2011 Page A-1 Cover Story



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How did we get involved?

- I'm not smart
- I misjudged the risks the entire time – 4 guys aren't supposed to tackle multi-billion dollar Ponzi schemes & make those kind of enemies
- I was Portfolio Manager then Chief Investment Officer for a $ multi-billion derivatives asset management firm in Boston, MA
- I knew derivatives math but I didn't know the SEC was non-functional
- BM was a competitor whom no legitimate manager could compete with
- I recruited a team and we went after the case quietly
- 8 ½ year investigation across 2 Continents
- Self-financed but we used employer sponsored travel

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The Investigative Team

- Frank Casey, Former North American CEO, London based Fortune Asset Management (Boston)
- Neil Chelo, CFA, FRM, CAIA; Director of Research, Benchmark Plus (Tacoma)
- Harry Markopolos, CFA, CFE (Boston)
- Michael Ocrant; Director of Conferences Group, Institutional Investor (New York)

3 Places where the $65 Billion went

1. Most went to pay off Old Investors who were receiving 12% / year on average
2. ≈4% went to luring in new victims: Feeder Funds, Fund of Funds & Private Client Banks
3. Way less than 1% / year went to Madoff

Capital Markets Red Flags I

Unrealistically High Performance

- Stocks can go in 3 directions – up, down or sideways
- BM only picked stocks that went up or stayed the same
- BM's performance chart was upward 45 degree straight line up until the 2000 – 2003 killer bear market
- 45 degree performance lines don't exist in finance!!
- > 96% of months were positive
- BM said he was replicating the OEX S&P 100 stock index
- 100% correlation meant he replicated perfectly
- BM's actual 6% correlation meant his portfolios looked nothing like the index he said he was trying to replicate.

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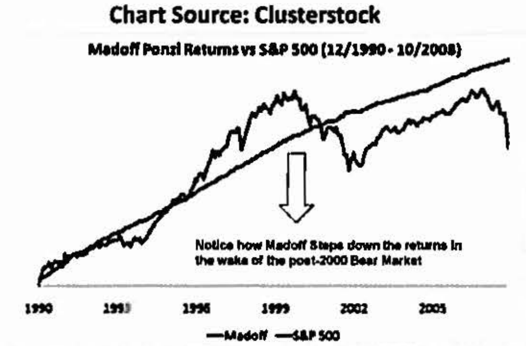
45° Line until 2000 Bear Market

Chart Source: Clusterstock



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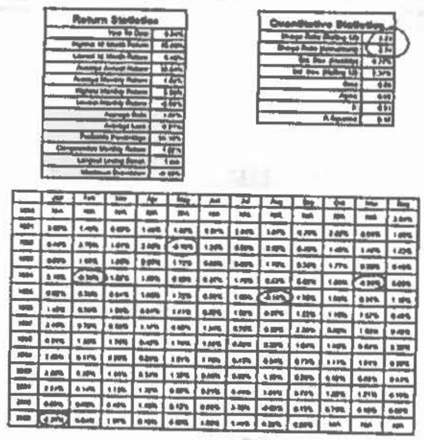

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Capital Markets Red Flags II
Not Enough Options Existed

- There were about $1 billion in near-month (less than 30 day) at-the-money put options on the OEX S&P 100 Stock Index in existence
- BM needed to trade $7 - $65 billion of these options as his size increased
- Every trade leaves a footprint but BM' s footprints were never seen by anyone during our 8½ year investigation
- My firm had trading relationships with most of the largest equity derivatives brokers and none of them ever did an options trade with BM
- BM would tell FOF' s he traded with certain brokers but those firms said they never traded with him
- BM said he traded O-T-C options in Europe on US Stocks which is nonsense because there is no liquidity there
- O-T-C options are more expensive than exchange-traded options

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Capital Markets Red Flags III
Investment Strategy Didn't Make Sense

- BM couldn' t afford the Put options he said he bought because they would have cost him too much $
- BM stock picks would have had to be > 30% per year
- Feeder Funds said BM subsidized down months but this would have been illegal
- Feeder Funds said BM "benefited from his broker-dealer arm' s trading volume" which was code for illegal front-running
- Feeder Funds said that BM had perfect market-timing ability thanks to his access to his B/D' s order flow of 5 – 10% of daily US stock volume
- Reality: BM did know what the other 90 – 95% of trading volume was doing so there was no way he could predict stock prices in advance!

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Capital Markets Red Flags IV
16% US T-bills didn't exist

- BM said he was only in the market for 3 days to 3 weeks and then only 6 to 8 times per year
- Not in the market 4 to 6 months per year
- Therefore he needed to buy US Treasury Bills that yielded 16% for those 4 to 6 months per year he wasn't invested in the market in order to earn those steady 1% monthly net returns after fees. T-Bills haven' t yielded 16% since the early 1980' s
- A fraud investigator looks at "what is" and then figures out "what isn't"

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Capital Markets Red Flags V

Fee Structure & Secrecy

- Typical industry marketing arrangements pay 20% - 50% of the fees to those who bring in client assets
- BM allowed the Feeder Funds, Fund of Funds & Banks to earn the 1% & 20% Hedge Fund fees
- In effect, the marketers were receiving > 90% of the fees which was way too high
- All of the above accepted his excuse that he didn't want to be bothered running a hedge fund and dealing with clients
- BM did all of the hard work yet earned "only commissions" and he allowed everyone else to earn the lion's share of the fees
- Feeders, Fund of Funds, and Banks were not allowed to tell the clients who was managing their money
- BM was the world's largest hedge fund but no one was allowed to know

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Fund of Funds

- Source: "Who Invested with Madoff?" by George A. Martin; Journal of Alternative Investments; Summer 2009
- > 339 Fund of Funds via 59 Management Co's invested
- > 40 countries
- USA: 79 of 740 (10.7%)
- Switzerland: 77 of 267 (28.8%)
- UK: 52 of 546 (9.5%)
- Italy: 27 of 77 (35.1%)
- Brazil: 25 of 68 (36.8%)
- Germany: 24 of 145 (16.6%)

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Feeder Funds = Pure Evil

- Madoff's accomplices were the Feeders
- Madoff was the octopuses' body & head
- The Feeders were Madoff's tentacles & they spanned the globe
- Without the Feeders Madoff would have collapsed long ago
- All pretended to conduct due diligence
- They lied to clients about who was managing their money
- Some pretended to be multi-strategy but were 100% Madoff
- They received 3% - 4% per year in fees to not ask questions
- None asked tough questions or even questioned the obvious
- Now we're finding out that some received out-sized returns
- Lessons Learned:

  Ask Fund of Funds how much they spend on due-diligence in dollars and as a % of revenues. INSPECT their audit work papers FOR QUALITY.

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Don't Blame the Victims

- 30 – 35 Blue Chip companies that you would be proud to own
- GM, Citigroup, Bank America, AIG, Fannie Mae, Freddie Mac, Merrill Lynch, Lehman, Bear Stearns, Wachovia....
- BM said he held "OEX stock index put options" to protect against market crashes
- Earned "only about 1% a month"
- Most individual investors were not finance people and did not know these sorts of risk to returns ratios did not exist
- Lessons Re-Learned:
  1. 0 – 25% is the proper allocation to hedge funds
  2. Never put all of your eggs in one basket
  3. If you don't understand an investment strategy don't invest in it

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AICPA's Section 50 – Principles of Professional Conduct:

- *"By accepting membership, a certified public accountant assumes an obligation of self-discipline above and beyond the requirements of laws and regulations.*
- The Principles call for an unswerving commitment to honorable behavior...
- A distinguishing mark of a profession is acceptance of its responsibility to the public.
- The accounting profession's public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of certified public accountants to maintain the orderly functioning of commerce.
- ....with concern for the best interest of those for whom the services are performed and consistent with the profession's responsibility to the public."

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Accounting's 2 Key Weaknesses

1. 80% - 90% of Big 4 audit contact hours are with CPA's between 21 – 28 years old

Who wins this battle?

Twenty-somethings vs. White Collar Fraudsters

2. CPA's do not have a mandatory duty to report fraud. They should but need a "safe harbor" to prevent being sued. The current standard is only "Noisy Withdrawal" which is not helpful to investors or law enforcement.

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Accounting Red Flags I

Bank Account Numbers too Similar

Bank of America Account # 1-FRO10-3-0 FBO Tremont

Banco Santander Account # 1-FRO62-3-0 FBO Tremont

How Likely is it that 2 custody banks in 2 different nations would assign such similar account numbers?

Source: SEC OIG Exhibits 23 & 237 (we never saw this until the SEC posted it)

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Accounting Red Flags II

Undecipherable Account Statements

- "No Balance Forward" for each beginning month
- No commas to denote thousands of shares bought & sold
- No dollars signs used
- Use of "green bar" paper & a dot matrix printer in the new millennium
- Account numbers used different font sizes
- Account statements in non-standard portrait mode not landscape mode
- Madoff listed opening transactions first, then closing transactions down the page which is not the industry standard
- Only goes out 3 decimal places but that last decimal is a zero!
- Madoff trades were so big he needed to go out 8 decimal places to allocate them properly!
- No positions were carried over a month-end, quarter-end or year-end because companies report who their largest shareholders are

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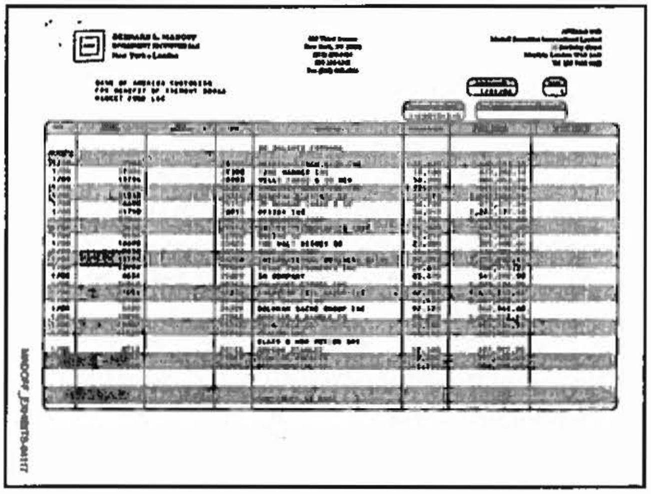

Accounting Red Flags III

Beware "Auditor Shopping"

- In 2007 Neil Chelo offers to invest $50 million thru a Sub-Feeder Fund & obtains the following
- Fairfield Greenwich year-end financial statements for 2004, 2005, & 2006
- 2004 - Regional Accounting firm (Stamford, CT)
- 2005 - Price Waterhouse Coopers (Netherlands)
- 2006 - Price Waterhouse Coopers (Toronto, Canada)
- 3 different auditors from 3 different nations is "Auditor Shopping"
- Big accounting firms are like individual country franchises when being sued but they're global firms when marketing to multi-national clients
- Rationale # 1: Auditors asked too many questions & were replaced
- Rationale # 2: Auditors spotted something & made a "noisy withdrawal"

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Accounting Red Flags IV

Third Party Administrators

- TPA's "supposed to offer" independent arms-length oversight
- Often located in Bank Secrecy Havens
- TPA's verified assets
- TPA's confirmed trades
- TPA's verified performance
- But BM never traded & he stole every dime as soon as it came in
- TPA's have no obligation to report fraud
- TPA's may resign accounts if fraud is present but tell no one
- TPA's are currently defending civil lawsuits
- TPA's rarely understand derivatives trading strategies
- Lesson Learned: Challenge TPA's & query them on the strategies used by investment managers to determine if they really know what they're doing

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Accounting Red Flags V

The Fake Brother-in-Law

- One Man Accounting firm of Friehling & Horowitz (New City, NY)
- BM would tell Feeder Funds that only David G. Friehling allowed to audit in order to protect his secret trading algorithms
- Middle Eastern Investment Office out of London wanted to send in a (then) Big Six Accounting firm to conduct due-diligence
- BM told them only his "brother-in-law" is allowed in to conduct audits
- They invested $200 million anyway
- Lessons Re-Learned:
- Is it a real accounting firm? Does anyone talk to auditors in person?
- Does the size & specialty of the accounting firm match the size & specialty of the company being audited?
- CPA's don't understand the capital markets so don't have blind faith in their audits – they're CPA's not CFA's or CAIA's

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Accounting Red Flags VI
Custody Banks

- BM self-custodied & had full control of the assets
- Several European Banks pretended to custody for BM
- They presumably received checks from investors, consolidated them and passed them along to BM
- Unbeknownst to investors BM was acting as sub-custodian and had full control of their assets
- European Banks had "rented their good names" to Madoff
- **Lesson Learned**: Verify custody bank relationships in writing; always demand a letter from the bank disclosing or denying the existence of sub-custodial arrangements

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Accounting Red Flags VII
Gaming the Audit Team Part I

- BM kept asking the SEC's exam team, "When is this exam scheduled to end?"
- The SEC exam team wisely never told him the exam's time limit
- BM then proceeded to spend hours at a time telling the exam team Wall Street "war stories" to keep them from asking *him* questions.
- The SEC measured the # of exams conducted which is a flawed and meaningless statistic.
- The SEC should be measuring only the $ amounts of fraud caught

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Accounting Red Flags VIII
Gaming the Audit Team Part II

- BM, a Wall Street CEO, was the Single Point of Contact for that SEC exam team (it is industry practice for the Chief Compliance Officer (CCO) to be the SPOC on exams never the CEO).
- BM did not allow employees to meet the examiners!
- Use proper exam techniques: start at the bottom of the organization chart and work your way up to the target (BM) last, looking for things that don't add up along the way
- BM would name-drop to awe the examiners (intimidation)
- BM occasionally would yell at the examiners (intimidation)
- SEC mid-level staff never backed up the examiners after these intimidation tactics were employed
- Lesson Learned: The audit team must control the audit.

  Intimidation is a red flag that fraud is likely present.

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Accounting Red Flags IX
Gaming the Audit Team Part III

- Exam team catches BM lying to them and doesn't expand the scope of the audit and call in high-level re-enforcements
- Exam team should also have made a criminal referral to the DOJ for making false statements
- Exam team asks for documents required to be on site for 2 years and to be available from off-site storage within 24 hours for 3 additional years
- BM takes days to provide documents that should be on-site and available within minutes (a sign that he's manufacturing documents)
- Lessons Learned:

  1. Documents required to be on-site need to be in audit team hands that day

  2. If you are lied to, expand the audit's scope and call in the cavalry!

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Accounting Red Flags X

No Tax Information & Abusive Client Service

- Source: Local CPA firm CEO's I've met
- At the bottom of individual monthly statements, Madoff printed, "Not to be used for Tax Reporting Purposes"
- Madoff clients would hand these to CPA firms to compute year-end personal income taxes and call Madoff's back office for information
- Madoff staff would then start yelling at these CPA's telling them, "Hey pal, if you don't like these very attractive returns we've been generating for your client then just tell us and we'll be happy to refund your client's money because we don't do taxes here."
- Shocked CPA would then call the client who would invariably tell the CPA to back off so as not to offend the Madoff staff because his fund was very hard to get into and they didn't want to get redeemed out of the fund.
- CPA firms never understood the Madoff statements so they did the best they could to compute tax liabilities on their own

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Ponzi Schemes

Characteristics

- Victims typically have not saved enough for retirement so they're desperate to believe
- Victims typically don't understand the capital markets
- Ponzi schemes are usually, but not always, complex and involve strategies that few investors would grasp
- Many schemes involve privately traded investments with no transparency
- Black-Box strategies are common where no one is allowed to peer inside the magic box and see the secret formula
- Returns are usually steady but often not home runs, more like a steady string of doubles
- They need to appear safe so that victims will willingly invest 100% of their assets
- Ridiculously High Sharpe Ratios!

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Quickest Way to Solve Ponzi Cases

Fully Utilize Industry Contacts!!

- ***There are other ways – this is just one quick way***
- Obtain the marketing materials
- Determine which asset class is being invested in
- Analyze the performance – "is it too good to be true?"
- Devise questions to ask and identify documents to request
- Question the lower level staff first to identify inconsistencies
- Ask to be taken to the trading desk & question traders
- Ask to see the trade confirmations & question operations staff
- Call the trade counter-parties to verify trades
- Check DTC or Exchanges for trading activity
- Call the custody banks to verify assets
- Question the top-level executives last

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Sharpe Ratio Analysis

A Good "Ponzi Detector"

- Definition: Ratio of Return compared to how much risk was taken to generate that return
- ★ Formula = $\dfrac{\text{Return of the Portfolio} - \text{Risk Free Rate}}{\text{Standard Deviation of the Portfolio}}$
- The Stock Index BM said he was replicating had a Sharpe Ratio of .43
- BM's Sharpe Ratio was always > 2.1 to a lot higher than that
- BM was > 4.8 times better than the Stocks he was managing against for 18 years which is impossible
- Ponzi operators will usually have unrealistically high Sharpe Ratios
- Compare your target's Sharpe Ratio to the asset class's Sharpe Ratio and ask industry professionals does this make any sense to you?
- Legitimate money managers can't compete with Ponzi operators because markets go haywire and honest managers lose money when they do

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SEC Investigative Errors I

Wrong Staff Not Mission-Focused

- ★ SEC Mission is to protect investors yet almost none of the staff were Certified Fraud Examiners or trained in investigations
- ★ The junior most examiner sat on an options trading desk for a while but didn't have much experience in industry or at the SEC
- ★ None of the senior examiners or enforcement attorneys had any asset management or trading experience
- ★ SEC staff did not know how to use the Wall Street Journal, Bloomberg's or Option Price Reporting Authority (OPRA) tapes to track trading volumes
- ★ SEC staff did not know that Over-the-Counter (OTC) derivatives are more expensive to trade and that the hedging takes place in the listed markets

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SEC Investigative Errors II

Unwillingness to obtain 3rd party verification

1. New York SEC never questioned me or the other BM whistleblowers
2. SEC never phoned any of my witnesses
3. SEC afraid to call reporters for background information
4. SEC never verified BM's bank account's really existed
5. BM told them he custodied assets at Barclays & HSBC but they never checked but once to verify accounts
6. BM says he traded thru Barclays, SEC gets docs back from Barclays that say BM had no trades with them & doesn't think this suspicious
7. SEC never verified time & sales volume of his trades with DTC or OCC
8. SEC asked who BM's counter-parties were but never followed up & asked them if they traded with BM
9. SEC never traveled to BM's accountant Friehling & Horowitz
10. SEC never contacted UK's FSA for assistance

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SEC Investigative Errors III

19 May 2006 SEC's Madoff Deposition

- ★ BM says executions happen electronically but then describes picking up the phone and negotiating the price which is not electronic trading
- ★ BM says he shops stock trade packages to 50 European stock brokers and options trade packages to 12 European options brokers because there isn't enough liquidity in the USA. *Reality: Can't do this because you'd be front-run to death! Plus there aren't 50 capable brokers in Europe.*
- ★ BM says he trades stocks at different times & prices, then calculates an average price for clients but he trades the options all at once so he can deliver one average price for his clients. *Reality: these are functionally equivalent so it's an obvious lie if you can count.*
- ★ BM says he pays 4 cents per share on this stock trades but only 1 cent per share equivalent for his options contracts (i.e. $1 per contract) because there's no value added for his options trading. *Reality: He doesn't know options lingo or options commission math.*

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SEC Investigative Errors IV

19 May 2006 SEC's Madoff Deposition

- ★ BM says he trades the stocks first in London, then trades the options in London between 8 am – 9 am (US Eastern Time) before the US markets are open. *Reality: Too much price risk if stocks drop before he buys his puts. Plus these size trades can't be done overseas.*
- ★ BM says his returns are not high enough to justify setting up a hedge fund. *Reality: 339 FOF's are set up to market BM's chart-topping Sharpe Ratios which beat all hedge funds.*
- SEC asks BM a series of questions about his Depository Trust Clearing Corp account and even obtain his DTC Number. However, they fail to follow up and ask DTC for his trades (there weren't any!). If they had spent an hour going to DTC they would have caught him...
- SEC attorneys only allowed 1 Examiner in the room
- Examiner & Enforcement Attorneys knew BM was lying but did not challenge him

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SEC Investigative Errors V
White Collar CEO's are Cunning & Manipulative

- BM knew SEC operational methods, skill level & weaknesses
- BM knew SEC measured # of exams and budgeted time for each
- ★ BM kept asking *"How long are you going to be here?"*
- BM told junior examiners "war stories" for hours on end so they couldn't get their work done & would eventually run out of time
- BM dropped influential names to impress examiners
- ★ BM would falsify documents - Examiners would ask for documents but were never suspicious that they took a few days to be handed over (docs required to be on-site for 3 years and available off-site up to 6 years)
- ★ BM would yell at examiners and try to intimidate them – Senior Staff did not back up the exam team in the field
- ★ Examiners would catch BM lying but never referred it to DOJ for criminal prosecution

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SEC Post-Madoff

- OIG Report 509"the Madoff Report" led to major changes
- SEC may be the best white-collar law enforcement agency in the world bar none but they have yet to prove they can bring large cases successfully
- New senior leadership of exceptionally high quality
- New National Task Forces of subject matter experts to attack major cases
- Hires industry experts who know finance, complex math, derivatives trading & global accounting standards
- Aggressively seeking large dollar value cases against large companies who are "hard targets which ruin your statistics"
- Whistleblower Program is the best source of current intelligence into the schemes being used to defraud investors
- FBI keeps close tabs on the SEC WB intake and reviews for good cases they'd like to investigate criminally

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Every Check & Balance Failed
Nobody did their jobs!

- Several Banks marketed BM & some offered 3:1 leverage
- Custody Banks "rented" their good names & then sub-custodied to BM
- Accounting firms "audited" Feeder Funds and verified the assets were there (they weren't)
- BM's auditor never conducted an audit
- Third Party Plan Administrators "verified" BM's performance
- Feeder Funds & FOF's never did proper due-diligence
- Consulting firms okayed BM or let their clients remain with BM
- Pension Fund, Endowment & Charity boards invested
- BM's compliance staff were his brother and niece
- FINRA exams did not detect the scheme
- SEC exams did not detect the scheme

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