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The Madoff story reveals more faults

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What are the lessons of the Madoff scandal? The more that comes out about this incredible story, the more complex and intriguing it becomes. Harry Markopolos, the whistleblower who tried unavailingly to get the Securities and Exchange Commission to investigate Bernie Madoff over more than 15 years, sub-titles his book about the affair "a true financial thriller". And so it is, with the twist that the book is a story not of triumph, but of heroic failure to persuade anyone to take seriously his well-founded allegations that Mr Madoff was a fraudster on a grand scale.

Taken together with the SEC inspector general's damning report into the SEC's failings published last year, it provides more disturbing evidence that the real world can often be crazier than the way it is portrayed in drama or fiction.

Small wonder that the first people to queue up to watch Enron, the play, or Wall Street, the movie, are professionals, or that the books Liar's Poker and Barbarians At The Gate remain essential reading for anyone wanting to understand the extremes to which unfettered capitalism can be taken.

Some of the details in No One Would Listen, Mr Markopolos' highly readable book, are beyond invention. For example, having failed to get the SEC interested in his original allegations, he turns to the media for help and eventually prompts MARHedge, a specialist hedge fund publication, to run a story raising questions about Mr Madoff's performance.

A similar story appears shortly afterwards in Barron's. He and the informal team of former colleagues who pursue their futile crusade against Mr Madoff wait triumphantly for the SEC to take action, convinced that it cannot ignore such public exposure.

But what happens? Nothing. According to Mr Markopolos, the SEC does not even subscribe to specialist industry publications. Staff members have to pay for their own media subscriptions, even for the Wall Street Journal. A specialist publication such as MARHedge costing more than $1,000 (£657, €741) is simply not on anyone's reading list.

Why was the SEC so reluctant to investigate the allegations that the split strike options strategy Mr Madoff claimed to be running was too implausible to be genuine? Too many lawyers is the first item on Mr Markopolos' lengthy charge list.

All the key people in charge of the potential investigation, he points out, were lawyers rather than financial experts. Ignorance, turf wars and lack of resources also played a part. When staff needed to research what derivatives were, in the absence of an investment library they had to rely on Google and Wikipedia.

The agency was also too quick, it appears, to dismiss Mr Markopolos as a bounty hunter with a grievance rather than as a serious investigator. Mr Madoff himself had few fears of the SEC, which he derided as useless. As the owner of one of the largest broker-dealers in New York, he was already such a big fish in the securities industry that only the bravest of regulators would be willing to take him on. (Since the crisis, as always happens, the incentives for regulators to seek big scalps have dramatically changed, as recent events have demonstrated).

The MARHedge article on Mr Madoff appeared in 2001, by which time he was already running what was effectively the largest hedge fund in the world, with more assets than George Soros or any other much better known names. Yet because of the secrecy requirements that Madoff imposed on anyone who put money into his bogus strategy, and his refusal to charge fees, his name did not even feature in the MARHedge database at the time.

Mr Markopolos is right to say that the scale and durability of Mr Madoff's scam raises troubling issues for the financial services industry. By the time he turned himself in, Mr Madoff was taking money from more than 330 feeder funds of funds in over 40 countries; yet many of them continued to believe they had exclusive or preferential access to his impressive but non-existent winning strategy. Their claims to have carried out exhaustive due diligence were risible.

At the same time there were many on Wall Street who knew there was something not right about what Mr Madoff was doing, and steered well clear. Some invested anyway, believing that whether it was front-running or some other improper activity, they would rather not know as long as the returns kept racking up. The irony is that Mr Markopolos himself only first took an interest in Madoff because his employer kept badgering him to try to replicate what Mr Madoff was doing. Yet nobody else felt it worth their while to expose him.

The Madoff story is ultimately a story about breach of trust. Investors were naïve to trust Mr Madoff, naïve to trust the intermediaries who channelled money to him in such prodigious amounts, and naïve to believe that regulators could or would stop such an accomplished liar and conman.

In Mr Markopolos' view, although the majority of individuals in the financial services industry are honest, incentives to cut corners and breach both client trust and regulations are hard-wired into the system they work in.

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