

Whistleblowers key to outing future Madoffs

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FULL TEXT

Almost five years to the day that Bernard Madoff was arrested at his Manhattan penthouse for running a \$65bn Ponzi scheme, Martin Scorsese's *The Wolf of Wall Street* - a film about a fraudulent New York stockbroker - went on general release in the US.

Although Jordan Belfort, the wolf in question in Mr Scorsese's December film, defrauded investors of a comparatively meagre \$100m, the film flagged up eerie similarities between Mr Belfort's crimes and those of Madoff, which took place a decade apart.

Madoff, who is five years into a 150-year prison sentence, has since told reporters he has learnt his lessons and is "ashamed" of his actions. But what lessons, if any, have investors and the investment management market learnt since Madoff's arrest? And could a scandal of such magnitude - the largest in US history - take place again?

According to a poll of a handful of fund management experts, the answer is yes. The feeling is another scandal lies just around the corner.

Amin Rajan, chief executive of Create Research, a fund management consultancy, says that after every financial scandal since tulip mania in 1637, when the price of single tulip bulbs reached extraordinary highs, investors learnt a lot in the short term, something in the medium term and nothing in the long term.

"Like alchemy, dodgy investment ideas will continue to thrive on investors' desire to believe in the impossible," he says. "When there is so much money involved, unscrupulous fund managers will always be tempted to fleece the unsuspecting public."

Ron Weekes, chief executive of ACA Compliance in Europe, the regulatory advisory company, agrees. "The possibility of another Madoff Ponzi scheme or similar fraud remains," he says. "While operational and investor due diligence has come a long way, the likelihood of fund management fraud or another scandal has not been entirely removed."

In the past few months, however, regulators have waged an aggressive battle against would-be financial villains by enlisting the help of whistleblowers.

In February, the European Commission approved a pan-European whistleblowing hotline for fund managers. The US has experienced a recent surge in the popularity of its whistleblower protection programme, which entitles individuals to a bounty worth 10-30 per cent of any sanction made by the Securities and Exchange Commission, the regulator.

The biggest whistleblower reward to date was made last September when the SEC paid an individual \$14m for helping "recover substantial investor funds" within six months of receiving the tip-off.

Jordan Thomas, chairman of the whistleblower representation practice at Labaton Sucharow, a US law firm, believes these measures will make a big difference. "Can whistleblowing prevent or detect large-scale misconduct? The answer is absolutely yes," he says. "The genius of the SEC whistleblower programme is that it recognises that law enforcement authorities cannot effectively and efficiently police the market without the assistance of individuals."

Last month the SEC charged Paradigm Capital Management, a New York-based hedge fund advisory firm, with engaging in prohibited principal transactions and then retaliating against the employee who reported it. Paradigm and its owner, Candace King Weir, paid \$2.2m to settle the charges.

Andrew Ceresney, director of the SEC enforcement division, says: "Those who might consider punishing whistleblowers should realise that such retaliation, in any form, is unacceptable."

In the UK, a supreme court ruling in May meant that senior partners at companies structured as limited liability partnerships, such as hedge funds, also became protected under whistleblowing laws for the first time.

Stephen Kohn, director of the National Whistleblowers Center, says simply: "The improved whistleblower laws will stop new Madoff scandals."

Sean Tuffy, senior vice-president of investor services at Brown Brothers Harriman, the investment group, agrees. "If properly crafted, the whistleblower provisions can be an important weapon. While whistleblower provisions may not stop fraud from happening, they could ensure they don't become Madoff-style events."

Indeed, one of the most worrying aspects of the Madoff fraud was the complicit silence of the many external parties involved. In January, JPMorgan, the US bank, agreed to pay more than \$2bn to settle charges that it failed to act on doubts it had about the 76-year-old, some of which arose more than a decade before the Ponzi scheme came to light.

Madoff himself predicted JPMorgan would one day face such a fine. In a 2011 interview with the Financial Times he said: "JPMorgan doesn't have a chance in hell of not coming up with a big settlement. There were people at the bank who knew what was going on."

Authorities said that had JPMorgan alerted regulators to its suspicions - at the same time the bank took \$250m of its own money out of Madoff investments - it could have saved other victims from losses.

The hope is the whistleblower rules will do that job for investors and put an end to such costly silences.

"At least in the US, the whistleblower does not need to be an employee of the firm [committing the fraud] but just needs to have original information, which means that competitors, disgruntled employees and any number of other people who may be privy to information surrounding securities laws violations are now incentivised to tip off the SEC," says Lynne Carreiro, managing director at ACA Compliance.

"Where previously a person may have been fearful of losing their job, their livelihood, and potentially being blackballed from the industry, they now stand to make 30 per cent of any money recovered."

Mr Thomas says: "Because people can report anonymously and for significant monetary gain, people are breaking their silence. I think it is far less likely a Madoff-style fraud would occur today."

This article is based on a comment piece that previously appeared in FTfm

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