Bernard L. Madoff was no evil genius. He was a pretty bad liar every step of the way – and the investigators knew it.

By James B. Stewart, Fortune

FORTUNE – *Pulitzer Prize-winning journalist James B. Stewart has written for years about business and politics, but as the scandals of the last decade mounted — Enron, WorldCom, Adelphia, Tyco, culminating in the shocking Bernie Madoff Ponzi scheme — it occurred to him that they all shared a common thread: lying. In his new book Stewart explores how and why instances of perjury and false statements are on the rise at the highest levels of business, politics, sports, and culture. Perhaps no case illustrates it better than that of Madoff. Judged by the duration and magnitude of his fraud, Madoff would seem to be the most cunning and skilled of liars. But as the following excerpt from his book,* Tangled Webs, *shows, Madoff repeatedly changed his story, he contradicted himself at every turn, and written records flatly disproved many of his assertions, had anyone bothered to check. Worst of all, the SEC knew he was lying and was one phone call away from catching him.*

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. "I have kept this note to a restricted circulation," read the reply. 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.

Some of the most mysterious of the funds were the so-called quantitative, or "black box," funds, which used complex computer programs. Renaissance Technologies had soared to the top of this secretive world. 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. He hired theoretical physicists, philosophers, statisticians, mathematicians like himself — but no MBAs. His was the ultimate black-box trading operation. Renaissance had several funds; its best known, the Medallion fund, was largely restricted to Simons himself and other Renaissance employees. Medallion 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, which had asked it for numerous documents and records, including internal e-mails. 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 didn't simply invest directly in other hedge funds, like most funds-of-funds. It 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. So far it looked as if it had been a very profitable investment for Meritage, since the fund it had swapped into had delivered extraordinarily consistent and quite high returns. It looked as if it had never had a down quarter, even after the

technology bubble, and only a handful of down months.

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. Given Simons's reputation and track record, most funds would have been thrilled to have Meritage among its investors. But when Meritage tried to invest, the fund's manager, Bernard L. Madoff, had turned Simons down.

The name Madoff meant nothing to Thanasules. But 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. Since they were only indirect investors in the Madoff fund, they didn't get account statements or have direct contact with Madoff, relying instead on what they could learn from HCH and other sources. They didn't really know what strategies Madoff used, or how he earned such consistent returns — more consistent than even their Medallion fund. On Nov. 13, 2003, Nat Simons wrote an e-mail to his father and other investment committee members:

We at Meritage are concerned about our HCH investment. First of all, we spoke to an ex-Madoff trader (who was applying for a position at Meritage) and he said that Madoff cherry-picks trades and "takes them for the hedge fund."

This alone was a red flag, since cherry-picking is illegal unless the practice is fully disclosed to investors. Cherry-picking consists of executing many trades, and then allocating the most profitable ones to favored investors, inflating the returns at the expense of others.

The e-mail continued:

He said that Madoff is pretty tight-lipped and therefore he didn't know much about it, but he really didn't know how they made money. Another person heard a similar story from a large hedge fund consultant who also interviewed an ex-trader. The head of this group told us in confidence that he believes Madoff will have a serious problem within a year … Another point to make here is that not only are we unsure as to how HCH makes money for us, we are even more unsure how HCH makes money from us; i.e., why does [Madoff, who charged minimal commissions] let us make so much money?

Simons suggested pulling out of the HCH position entirely.

To Thanasules, the e-mails raised a host of troubling questions and carried extra weight because they came from Renaissance. If Renaissance executives couldn't figure out what Madoff was doing, who could? He called the compliance officer at RenTec, who said that Meritage had reduced its exposure to Madoff, though not because of the concerns expressed in the e-mails. Still, Simons later said that "we were very worried about the position" and cut it in half because of the concerns expressed in the e-mails. He added that they would have eliminated it entirely except for one reason: They understood that the SEC had examined Madoff and given him a clean bill of health. But eventually they got rid of it entirely.

Armed with copies of the e-mails, 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.

Sollazzo especially wanted Lamore, since he was one of the few examiners who had firsthand experience working for a hedge fund and trading options, and had waited to begin the examination until Lamore was available. Lamore was stocky, with neatly clipped brown hair. He had the upright demeanor of a military man, and he’d spent five years in the U.S. Coast Guard after graduating from the Coast Guard Academy. Ostrow had more experience, having been at the SEC for five years. He joined the agency right after graduating from the New York Institute of Technology with a degree in finance. The name Madoff meant little to either Lamore or Ostrow, although both knew that his firm was a large market maker.

Madoff snows the novices

PHOTO: RUBY WASHINGTON/THE NEW YORK TIMES/REDUX

When Lamore and Ostrow arrived at Bernard L. Madoff Securities on April 11, 2005, Madoff himself came into the lobby to greet them. The examiners were impressed that Madoff — the head of the firm — was handling their examination. Usually it was the compliance officer, or someone else designated to act as a liaison with the SEC. Madoff didn’t know why they were there, and they hadn’t wanted to tip their hand. Lamore and Ostrow may have been a little unsure themselves. Contrary to policy, no branch chief was assigned to supervise them. They’d never been given any formal instructions, nor had they drafted any planning memorandum.

After two days of gathering documents and reconciling account statements, they had their first official interview with Madoff. They hadn’t seen anything that suggested he was running or advising any hedge funds, so Ostrow asked a basic question: “Do you do a retail business?” “No,” Madoff answered, “I don’t manage money.” Madoff insisted that his firm was simply a market maker and traded for its own accounts. It didn’t generate investment advice or execute strategies. 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 (including Renaissance) 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. Afterward, Lamore e-mailed a colleague to report that the interview lasted more than two hours and ended after 6 p.m. But he made no mention of Madoff’s startling claim, and seemed in a

lighthearted mood. “Was there a storytelling class when you attended Hofstra because this guy has a story about everything? … Does everyone miss me in the office yet?” he wrote.

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. Madoff continued to regale them with stories about the evolution of Wall Street, which Lamore found simultaneously “captivating” and “distracting,” and impressed Lamore with his “incredible background of knowledge.” Madoff dropped names of SEC officials he knew and mentioned that he was on the “short list” to be the next SEC chairman.

But Madoff was also becoming impatient with the investigators’ presence. 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.” At first he said there were just four hedge funds using the model, and named Fairfield Sentry, Thema, Tremont, and Kingate Global. But then he said there were actually 15 clients, including two corporate accounts, but all of them were foreign.

Lamore and Ostrow asked Madoff how the model worked. 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 used a computer server separate from the firm’s market-making activities. He called the strategy incorporated in the model a split-strike conversion strategy, but described something quite different: a “basket” of about 50 stocks used to replicate the S&P 100, but said it was a “long only” position with no options trading or selling short. He said the model had stopped using options about a year before.

Lamore and Ostrow were flabbergasted that all this information was only now being volunteered, after Madoff had repeatedly and flatly denied that he had any outside clients. At this juncture, Madoff effectively pulled the rug out from under them. 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.) Ostrow and Lamore were embarrassed that this was the first they had heard of it. Madoff sensed he had them at a disadvantage and adopted a “condescending” tone, as Lamore later put it. Ostrow and Lamore were reduced to asking whom Madoff had dealt with besides Richards so they could follow up. 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.

Ostrow noted that “I don’t know who said it — someone from OCIE basically: ‘He’s a very powerful person, Bernie, and you know, just remember that.’ But basically just ‘He is a very well-connected, powerful person.’ “

Ostrow was eager to continue the investigation, and was planning visits to Fairfield Sentry and other Madoff feeder funds. He was especially eager to see how the split-strike conversion strategy could be executed without Madoff trading options. But on June 16, Nee met with Ostrow and Lamore and directed them not to visit or contact any of Madoff’s feeder funds. Ostrow recalled that Nee warned them that Fairfield “is a $7 billion customer and if you go and raise red flags there and they go ahead and pull all of their money from Bernie and we’re wrong, then we’ll be sued personally or the SEC itself.” (Nee denied that fear of lawsuits was a factor, but acknowledged, “We’d have to be very careful about going to a hedge fund client.”) Nee told them it was time to end the examination and move on to their next assignment.

Ostrow and Lamore completed their report on Madoff on Sept. 8, 2005. It cited three minor technical violations they’d discovered in Madoff’s market-making operation.

Madoff breezes past more red flags

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. Suh did some Internet research on Markopolos, which she forwarded to Cheung, including a quote from Markopolos: “I can teach you how to spot fraud and what to do about it, so you aren’t in the hot seat.”

“I have some qualms about a self-identified independent fraud analyst, but who knows,” Cheung responded, betraying an almost immediate skepticism of Markopolos.

Now that the Madoff case had been designated an informal investigation, it was finally entered into the SEC database, and the staff could issue subpoenas and take sworn testimony. 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 leave his home turf in Midtown, and to testify under oath. As he had before with Lamore and Ostrow, Madoff recounted at length his humble origins, his rise on Wall Street, the history of trading commissions, and how the firm came to “execute” trades for hedge funds. He rarely missed an opportunity to digress on an irrelevant topic, such as the intrusion of television screens onto trading floors.

“Let’s get back to the point,” Suh said. “If you could, please explain what makes you the trader?”

“Forty-some-odd years of experience,” Madoff answered. “To me that’s the best answer I can give you … I have a relationship with the regulators and the firms in general in the Street, and I have never, ever — I know the rules and regulations better than most people because I drafted most of them.” He continued: “It’s experience and using what tools are available to me which are perfectly open, legal tools to use,” he said. “The advantage I have and the reason I don’t need to be represented by lawyers is I’m not doing anything wrong.”

Madoff seemed eager to discuss the split-strike conversion strategy and proprietary model that was

uniquely his creation. He likened it to cooking using a blender: “So I’m saying that you’re cooking a meal. You put in carrots and oranges and a whole bunch of stuff. You put it into a blender. If you let it run for two minutes, it’s going to have one consistency. If you let it run for three seconds, it’s going to be a different consistency and so on and so forth. Depending on what you’re looking for, everybody is looking for different things, so people design their systems to say, ‘I don’t care about this stuff, I care about that.’ Again, I don’t attach too much importance to the information that flows out of that stuff. It’s available to anybody. It’s not unique data … Some people ‘feel’ the market.”

The rest of Madoff’s testimony was replete with contradictions. He said he maintained segregated accounts with the Depository Trust Co., or DTC; previously he’d said there was just one account. He said he traded options over-the-counter through the New York office, not in London, as he’d told Lamore. He said he had electronic records of the options contracts; earlier he’d said no documentation existed. And with a firsthand witness who could contradict him sitting at the table, he baldly denied he had told Lamore that he’d stopped trading options. Just about the only consistency was his assertion that “some people can just feel the market.”

Lamore was furious at Madoff’s testimony, which implied that Lamore had either lied about or misstated his previous accounts of Madoff’s answers. “I just remember sitting there in the testimony thinking, ‘He’s lying,’ ” Lamore later said. “It was just remarkable to me.” According to Ostrow, Lamore “was jumping up and down at the attorneys and letting them know about all the discrepancies.”

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. As Lamore put it, “So I’m sitting there thinking, You got to be kidding me. I mean, this is huge. This guy just lied on the record to your face.” But the enforcement lawyers, especially Cheung and her superior, didn’t seriously entertain the possibility. As Ostrow put it, “Peter [Lamore] was extremely upset that the [enforcement lawyers] weren’t taking seriously the fact that everything was a lie. There were so many contradictions to what Bernie said in testimony or [Madoff lieutenant Frank DiPascali] said to what we were told on our exam.” 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.” Lamore was assigned to other matters and had no further involvement in the Madoff investigation.

Madoff “astonished” that the SEC had blown it

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 was expansive and seemed almost eager to unburden himself of the secrets he had held so long.

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”: during the on-site exam by Lamore and Ostrow, because he thought they’d check with third parties, and when Suh asked him for his DTC account number, and he assumed the SEC would go to the DTC. “I thought it was the endgame, over,” he said. Madoff indulged his disdain for Lamore and Ostrow, referring to them

dismissively as “two young fellows” who “didn’t understand what they were looking for.” He was especially annoyed by Ostrow, who “came in here like Columbo” and wasted his time looking at canceled checks. He said he was “astonished” they didn’t go to either the DTC, as Madoff had offered to let them do, or his purported trading counterparties. “It would’ve been easy for them to see,” he said. “If you’re looking at a Ponzi scheme, it’s the first thing you do.”

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. They narrowed the investigations to minor technical issues rather than confront the possibility of massive fraud. They didn’t reach out to the Renaissance officials and treated Harry Markopolos as a meddlesome fortune-seeker who was making their lives more difficult. They seemed more interested in proving him wrong than in catching criminals.

Still, for all the missteps by the SEC, it came amazingly close to catching Madoff. Thomas Thanasules deserves a promotion and recognition for spotting the Madoff issues in the Renaissance e-mails and bringing them to the attention of his superiors. Michael Garrity and others in the SEC’s Boston office [who were eager to pursue Markopolos's claims] also showed genuine enthusiasm and an investigative bent. Would that their instincts had extended further into the agency.

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. Madoff had the temerity to lie about what he said to Lamore to Lamore’s face. “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.