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Bennett's Refco Scheme Exposed by Late-Night Hunch: 'It Hit Me'

Oct. 27 (Bloomberg) -- Phillip Bennett had a lot to celebrate at a dinner with clients last December. The futures broker he led, Refco Group Ltd., had sold a majority stake, netting Bennett hundreds of millions of dollars.

An initial public offering of Refco stock would raise tens of millions more for Bennett and the new majority owner, Boston-based Thomas H. Lee Partners LP.

Still, Bennett told his guests he was reluctant to transform Refco into a public company, according to one participant, who asked to remain anonymous because that person remains a Refco customer.

Bennett, 57, had good reason to avoid the regulatory and investor scrutiny that a public offering would bring New York-based Refco, the biggest independent U.S. futures broker. Since 1998, he had presided over two Refcos. The visible one reported a 33 percent average annual gain in earnings over four years. That record helped send Refco shares soaring 25 percent on opening day of the IPO last Aug. 11.

A second, secret Refco hid hundreds of millions of dollars of debt owed by Bennett. Much of it consisted of losses amassed by Refco customers, according to a person familiar with the company's accounts. That led U.S. prosecutors to arrest Bennett on Oct. 12 and charge him with securities fraud.

Now, the company's former chief financial officer, Robert Trosten, also faces government scrutiny, according to people with direct knowledge of the investigations. Trosten left Refco a year ago with a \$45 million payout.

'It Hit Me'

Bennett's deception -- missed by regulators, Refco's auditors, Thomas Lee Partners and IPO investors -- was discovered at the beginning of October by Peter James, the company's new controller.

"I was working late one night and it hit me," says James, who started work at Refco on Aug. 3 as the company approached its IPO. "I was a fresh pair of eyes."

According to prosecutors, Bennett's scam worked like this: Bennett accumulated \$430 million of debt by borrowing from Refco through a related company he controlled, Refco Group Holdings. Before the end of each quarter, when Refco prepared its financial statements, Bennett would temporarily pay the money back.

He did so by arranging for a Refco subsidiary to lend money to a hedge fund -- Summit, New Jersey-based Liberty Corner Capital Strategies LLC -- which then lent the money to Refco Group Holdings. Bennett's company in turn pumped the money back to Refco, leaving Liberty recorded as the debtor.

By the time each quarterly accounting occurred, the loan to Bennett was no longer on the books.

'His Undoing'

This past quarter, as the IPO progressed, something different happened, according to the person familiar with the company's accounts: Bennett didn't repay the debt. Instead, for reasons that aren't clear, he left it on Refco's accounts, where James spotted it. The controller declines to say exactly

what drew his attention to the transaction or to Bennett.

`` The heightened scrutiny that goes on in an IPO could well have been his undoing," says James Cox, a securities law professor at Duke University School of Law in Durham, North Carolina, and author of the textbook ``Financial Information Accounting and the Law" (Little Brown & Co., 1980). `` Maybe he thought he would be lucky."

Bennett's lawyer, Gary Naftalis of Kramer Levin Naftalis & Frankel LLP in New York, didn't return a phone message seeking comment.

Santo Maggio

Santo ``Sandy" Maggio, the former head of Refco's capital markets unit, also faces government scrutiny, in addition to Bennett and former CFO Trosten, according to the people with direct knowledge of the Refco probes, who said they didn't want to be identified because the inquiries aren't public.

The Financial Times, citing two unidentified people familiar with the process, said yesterday that Maggio is cooperating with prosecutors investigating the scandal.

Paul Shechtman, a lawyer representing Maggio at Stillman & Friedman in New York, declined to comment. Trosten's attorney, Robert Morvillo, a partner at the New York firm Morvillo Abramowitz, didn't respond to three requests for comment left with his secretary.

Investigations are being conducted by the U.S. Attorney in Manhattan and regulators including the U.S. Securities and Exchange Commission in Washington and the Commodity Futures Trading Commission, the Washington-based regulator of futures brokers.

Trosten, then 35, left Refco on Oct. 12, 2004, after two years as CFO. Neither Refco's statement, which said he was leaving ``to pursue other opportunities," nor the IPO prospectus released six months later disclosed his \$45 million payout.

Revealed at Hearing

That only became public after hearings in July and August for a National Association of Securities Dealers arbitration case, brought by a former Refco consultant over a finder's fee. Trosten disclosed the amount of the payment under cross-examination, says Sean O'Shea, a New York attorney who represented the consultant, Edward McElwreath.

In fiscal 2005, when he worked a partial year, Trosten was paid a salary and bonus totaling \$2.2 million, according to Refco's IPO prospectus. That made him Refco's third-highest-paid executive, after Bennett and Executive Vice President Joseph Murphy, the head of Refco's futures unit.

In 2004, Trosten was paid \$3.1 million, and in 2003 he was paid \$2.8 million, making him the second-highest-paid executive in both those years.

``The real question is, how could that stuff be going on without this guy being in the know?" says Brian Foley, an executive pay consultant in White Plains, New York. ``And if he wasn't in the know, how could this guy be worth so much money?"

Trosten hasn't been accused of wrongdoing.

\$53.1 Million Pay

Including the buyout, his compensation totaled \$53.1 million from 2003 to 2005. By contrast, the chief financial officer of Goldman Sachs Group Inc., David Viniar, made \$38.2 million during the same period, according to proxy statements. Goldman, the world's third-largest securities firm by market value, had sales of \$29.8 billion in its most recent fiscal year, about 30 times those of Refco.

``One wondered why some people were compensated the way they were," says Brad Reifler, an 18-

year Refco veteran who was head of institutional sales and trading when he left the company in 2000. ``One never knew anything specific."

Refco spokesman Rob Solomon declined to comment.

If Bennett felt reluctant about the IPO, he didn't let employees know, says Reifler, 46, who is helping an investor group backed by the government of Dubai in bidding for Refco assets.

'Phil's Perspective'

``People were concerned about going public -- what that may do in terms of the culture, not knowing Thomas Lee and that group," Reifler says. ``But Phil tried to reassure everybody that it was business as usual. One just didn't understand what that business was from Phil's perspective."

James, Refco's controller, says he became suspicious ``about a week and a half before Bennett was let go," on Oct. 10. ``It took me a long time to put this together," he says. He declines to be more specific.

Around the same time, accountants for Refco's outside auditor, Chicago-based Grant Thornton LLP, were reviewing Refco books for the preceding quarter. They noticed that the amount of interest on a loan to Liberty Corner was higher than in the past and that the loan hadn't been paid off as usual, the person familiar with the company's accounts said.

Grant Thornton contacted James to get answers, said the person, who declined to be identified because neither Refco nor its auditor authorized public comments on the issue.

Refco Tells Auditors

Refco never provided the answers to the auditors, the person said. Instead, on Oct. 7, Refco informed the auditors that the loan was questionable, the person said.

Then, on Oct. 10, Refco's board announced it had discovered a \$430 million debt owed by Bennett's company and said he'd been suspended. Two days later, U.S. authorities charged him with one count of securities fraud for using the U.S. mail, interstate commerce and securities exchanges to lie to investors ahead of the IPO.

Bennett's lawyer, Naftalis, responding Oct. 12 in federal court in Manhattan, said the government arrested Bennett without a full investigation of the case. ``They jumped the gun," Naftalis said. ``He received no personal profits from this indebtedness." No further court dates have been set in the case.

``Our auditors raised issues in the course of a regular quarterly review," says Grant Thornton General Counsel Peggy Zagel. ``We're cooperating with various investigations." She declined to be more specific.

'Significant Deficiencies'

Grant Thornton found two ``significant deficiencies" in Refco's internal controls, according to the IPO prospectus filed April 8 with the SEC. They included a shortage of people to prepare its financial statements and a lack of formalized procedures for closing the company's books each quarter.

Refco collapsed just two months after its IPO, seeking bankruptcy protection on Oct. 17, a week after announcing it had uncovered Bennett's unpaid debt. The company's fall erased about \$3.6 billion in shareholder value. Refco stock, which peaked at \$30.12 on Sept. 7, traded yesterday at \$1.09. Refco's 9 percent bond maturing in 2012 has fallen to as low as 40 cents on the dollar, from 110 cents.

At least seven groups are bidding for Refco's assets in bankruptcy court in New York. Bennett, after his arrest, was released on a \$55 million bond and is awaiting trial.

Pain on Wall Street

The Refco flameout scalded some of the biggest names on Wall Street. Thomas H. Lee Partners lost more than \$275 million as Refco's biggest shareholder. The firm faces investor class-action lawsuits, along with Refco and auditor Grant Thornton, the fifth-largest U.S. accounting firm by sales.

The three banks that arranged the IPO -- Credit Suisse First Boston Inc. and Goldman Sachs, both based in New York, and Charlotte, North Carolina-based Bank of America Corp. -- also face investor suits. Others hurt in the scandal include investors in a commodities fund run by Jim Rogers, the New York-based former partner of billionaire investor George Soros. Rogers's investment fund said it had 63 percent of its assets tied up with Refco Capital Markets. Two of Rogers's funds sued Refco Oct. 24.

The hedge fund Liberty Corner said Oct. 20 that it had been informed by the U.S. attorney's office in New York that it wasn't a target of investigations.

Bennett's arrest clouds a career that had placed him among Wall Street's elite. He and his wife, Valerie, split their time among a 21-acre horse farm in Bedminster, New Jersey; a Park Avenue apartment; and a house with a spa in Aspen, Colorado, according to property records. To stay out of jail, Bennett pledged the horse farm and the apartment.

Graduate of Cambridge

A British citizen who once played rugby at Cambridge University in Cambridge, England, Bennett worked for a decade at Chase Manhattan Bank, now part of New York-based J.P. Morgan Chase & Co.

He joined Refco in 1981, rising to become CFO in 1983 and CEO in 1998 upon the retirement of Thomas Dittmer, a stepson of the company founder.

Refco began in 1969 as Ray E. Friedman & Co., taking its name from the Sioux City, Iowa-based meat and grain dealer who founded it. Friedman sold the business in 1974 to Dittmer.

Bennett's polished demeanor contrasted with the reputation of his two predecessors, both known for making huge leveraged bets on trades, says Martin Mayer, who interviewed Refco executives for his book "Markets: Who Plays, Who Risks, Who Gains, Who Loses" (Norton, 1988).

'Rough and Tumble'

"Friedman and Dittmer were the guys who came from the rough and tumble of the pits," says Mayer, now a guest scholar at the Brookings Institution, a Washington research group. "The company was the great speculator of the modern-day commodity exchanges."

Bennett, by contrast, was a workaholic who devoted himself to making acquisitions once he became CEO.

"He spent most of his time in his office," says Reifler. "He was very private -- not a lot of interaction in terms of letting people know what his ideas for growing the business were."

As a futures broker, Refco made its money by collecting commissions from customers who paid it to execute trades on their behalf on exchanges. Futures are agreements to buy or sell a specific amount of a commodity or security at a specific price and time. They are often used by financial institutions to hedge exposure to risk.

As the clearing agent in futures contracts, Refco essentially acts as an insurance company. It receives commissions in return for taking on the risk of ending up with a significant loss if a client cannot pay.

'The Big Dog'

With 200,000 customer accounts and 2,400 employees, Refco was the largest broker on the Chicago Mercantile Exchange. Refco processed 654 million contracts worldwide in the fiscal year ended Feb. 28, 2005, more than the number traded on entire individual exchanges, including the Chicago Board

of Trade, the Chicago Board Options Exchange or the New York Mercantile Exchange during the same period.

``They were the big dog," says Tod McElhaney, president of LaSalle Futures Group Inc. in Chicago. ``At one point, Refco had over 50 percent of all futures accounts in the U.S."

Refco had repeated run-ins with the industry's regulators, the Commodity Futures Trading Commission and the National Futures Association in Chicago. The two agencies took action against Refco and its units more than 100 times since 1970, making it among the most cited brokers in the business, according to data provided by the NFA.

In 2001, the NFA ordered Refco to pay \$43 million to 13 investors who said they were defrauded by a scheme in which their broker used bogus order tickets to clear trades, then the largest arbitration award in the regulator's history. The New York Supreme Court upheld the judgment in August 2002.

Hedge Funds

Investigators believe Bennett's debts may have started as a way to deal with losses amassed by several clients, including hedge funds, according to the people with direct knowledge of the investigations. By accounting for them as receivables instead of losses, they wouldn't flow to the company's income statement and thus wouldn't affect profit.

``This was about hiding losses, losses from customers on the edge," says James Bianco, 43, president of bond research firm Bianco Research LLC in Chicago.

Refco, after its own investigation, appeared to draw a similar conclusion. In a statement released Oct. 11, the company said that most of Bennett's debt was ``uncollectible historical obligations owed by unrelated third parties to the Company, that arose as far back as at least 1998."

Victor Niederhoffer

Refco was exposed to trading losses by customers such as Victor Niederhoffer, a Weston, Connecticut-based trader who shut his investment fund in 1997 after a wrong-way bet on futures options.

The Dow Jones Industrial Average dropped 550 points on Oct. 27, 1997, a 7.2 percent plunge that forced the exchange to shut early. Niederhoffer had been betting on a market rise.

Traders at the time said Refco may have been responsible for as much as \$35 million of Niederhoffer's losses. In a lawsuit Niederhoffer later filed in the U.S. District Court for the Northern District of Illinois against the Chicago Mercantile Exchange, where he traded the options, Niederhoffer said Refco ``liquidated at a huge loss the funds' options contracts."

In a statement on Oct. 29, 1997, Tone Grant, then Refco's president, denied that the losses would affect Refco's own liquidity. The company ``has had no problem in satisfying any margin obligations and is in full and complete compliance with all the applicable requirements of exchange and clearing organizations of which it is a member," Grant said.

Minimal Losses

Niederhoffer didn't return a call seeking comment. This month, he wrote on his Web site, Daily Speculations, that his funds' losses exceeded his equity with Refco. To settle, he agreed that Refco would take over all of the funds' assets and liabilities. He also agreed to pay back \$2 million, which he did within a year, Niederhoffer wrote.

``I am not privy to whether Refco lost or made money, on balance, when the proceeds of the assets received from me were netted against the trading losses or profits on the positions that they ultimately traded out of," Niederhoffer wrote. ``Any net loss that Refco had on the transaction, if any, was minimal relative to the amounts that have been disclosed about receivables improperly accounted for on their books."

Refco spokesman Solomon didn't return calls seeking comment.

Market turmoil continued through 1998 and many futures traders were reeling after the devaluation of the Thai baht and Russia's default on its bond obligations. Long-Term Capital Management LP, the hedge fund founded by John Meriwether, considered one of the brightest minds on Wall Street, lost \$4 billion and had to be bailed out by 14 securities firms.

Regulator's Rule

The CFTC in August 1998 passed a new rule that ordered futures brokers to immediately report when their funds had dropped too low to meet trading obligations.

The next month, Bennett, then Refco's chief financial officer, took charge as president, chief executive officer and chairman.

Within eight months, in May 1999, Vienna-based Bawag Bank P.S.K. took a 10 percent stake in Refco.

The bank, whose full name is Bank fuer Arbeit und Wirtschaft und Oesterreichische Postsparkasse, might seem an unlikely investor. It is owned by Austrian trade unions and focuses on retail banking, not the futures contracts that were Refco's specialty.

Hedge Fund Link

Bennett got to know the bank through Wolfgang Flottl, who ran Bermuda-based Ross Capital Markets, a hedge fund that had traded through Refco since at least 1994, according to two former Refco employees who asked not to be identified because they didn't want to be embroiled in regulatory probes. At the time, Wolfgang's father, Walter Flottl, was chairman of Bawag.

In a press release announcing Bawag's investment, Bennett welcomed the "significant infusion of capital," saying it "positions us well to achieve our strategic goals as we move into the 21st century."

Those goals, as stated by Bennett when he became CEO, included turning Refco into a more professional firm and the world's leading clearinghouse.

"They became Pac-man and gobbled up all these other firms," says McElhaney of LaSalle Futures.

Refco bought Chicago-based futures rivals Lind-Waldock and LFG LLC in 2000, and in 2003 acquired London-based Trafalgar Commodities Ltd. to expand its energy broking business.

\$1 Billion in Sales

Sales grew to \$1 billion in fiscal year 2004 from \$461 million in fiscal 2000, a compound annual growth rate of 22 percent, according to the prospectus for the stock sale. Reported operating income more than tripled to \$189.5 million from \$61 million in the same period. Refco cleared 461 million transactions on exchanges in fiscal 2004, up from less than 80 million when Bennett took over.

In June 2004, when Thomas H. Lee Partners agreed to buy its controlling stake in Refco, the deal valued the firm at \$2.25 billion. When Refco went public a little over a year later, the sale raised \$670 million and netted Bennett himself \$145 million.

In the year before the IPO, Bennett and his associates took more than \$2 billion out of the company in the form of cash distributions and asset transfers in conjunction with the Thomas H. Lee investment, according to company SEC filings.

In August 2004, Bennett and Grant, the former Refco president, received cash payments of \$550 million and \$507 million and equity valued at \$231 million, the documents show. A "former shareholder" in Refco, whom the filings don't name, received almost \$862 million in cash.

At the time, Refco was 90 percent owned by Bennett and Grant through Refco Group Holdings. The remaining 10 percent was held by Bawag P.S.K. bank.

Refco disintegrated quickly after the IPO.

Under Arrest

By Thursday, Oct. 6, Refco's board had been informed of controller James's suspicions. Bennett met with the board that day, according to his lawyer, Naftalis. He spent the weekend huddled with lawyers and other Refco executives at the law firm representing Refco.

On Sunday, Oct. 9, Bennett got Bawag to agree to lend him 425 million euros (\$513 million) to repay the debt to Refco, with instructions to wire the money before noon, Vienna time, or 6 a.m. New York time.

Refco made its surprise announcement Monday morning that it had uncovered Bennett's debt. Bawag bankers saw the news story and scrambled to stop the payment. They were two or three hours too late.

'Wasn't Possible'

"That wasn't possible anymore," Supervisory Board Chairman Guenter Weninger said Oct. 20 at a Vienna press conference.

On Tuesday, Oct. 12, prosecutors arrested Bennett at his Park Avenue townhouse after overhearing him on a wiretap telling a colleague he planned to go to Europe within 48 hours. His destination, prosecutors said: Vienna.

Naftalis, Bennett's defense lawyer, told a federal judge the next day that it was a long-planned wine-tasting trip.

After pledging a \$50 million bond, his Park Avenue apartment and New Jersey farmhouse, Bennett was released on bail to the apartment, where he wears an electronic monitoring bracelet.

To contact the reporter on this story: Peter Robison in Seattle on robison@bloomberg.net.

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