The Madoff **Era**

Surviving Today's Collusive Capitalism.

By Larry Bakerjian, CFP®

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Former financier Bernie Madoff created what may be the largest Ponzi scheme of all time. Other schemes have occurred besides his, and likely more can be expected. Here's what you can do about it.

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In February 2012, a day after the Academy Awards, a public service announcement featuring the movie actor Michael Douglas appeared on television. I watched with interest as Douglas took on a new role — corruption crusader.

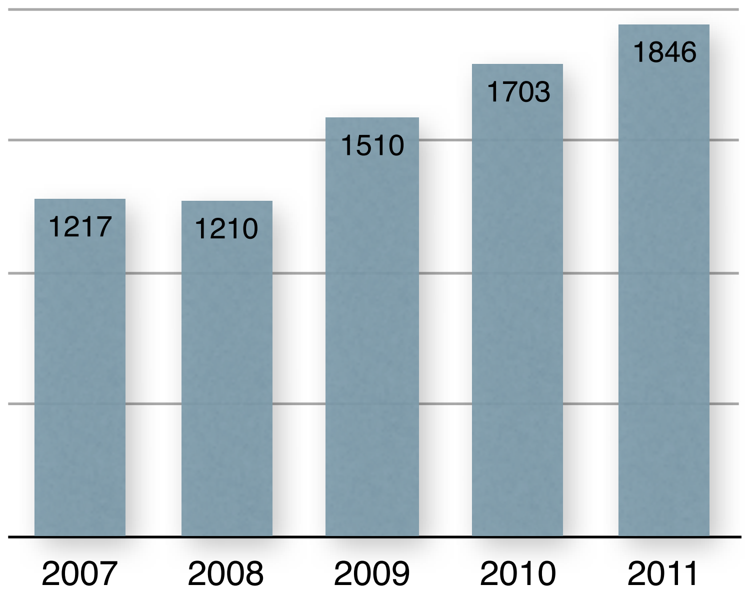
Douglas won an Oscar for the role he played in the 1987 movie, *Wall Street* — a Best Actor performance as the fictional character Gordon Gekko. In the movie, Gekko is a ruthless, criminal corporate raider, known for cheating innocent investors and uttering the now famous line, "Greed, for lack of a better word, is good."

Of course, greed is not good. FBI figures show that securities and commodities fraud cases have jumped by 52% since 2008. Billions of dollars have been lost and more than 1,800 criminal fraud cases are pending[1].

An FBI New York Field Office release says the Douglas' PSA is part of FBI efforts "to root out criminal behavior in the marketplace."[2] ABC News interviewed an assistant director of the FBI who said that Douglas participated in the PSA because he "wanted the world to know that Gekko was a crook."[3]

Why is unethical behavior burgeoning on Wall Street lately? What happened to honest prosperity? Can we do anything to avoid becoming the victim of a swindle, living as we do in The Madoff Era — the most pronounced financial-crime period of all time, in my opinion?

Securities and Commodities Fraud Pending Cases



Source: FBI, *Financial Crimes Report 2010-2011*

Purpose of This Paper

Unlike Gordon Gekko, who is a work of fiction, Bernard L. "Bernie" Madoff is a real person who orchestrated an enormous Ponzi scheme.[4] It was the largest such scheme in history, "wiping out $65 billion in paper wealth and shattering lives around the globe."[5]

In December 2008, the SEC charged Madoff and his investment firm, Bernard L. Madoff Investment Securities, LLC, with securities fraud. Madoff pleaded guilty to the securities fraud charge and was sentenced to serve 150 years in the federal penitentiary in North Carolina. Madoff said that his securities crimes began in the early 1990s. Some government officials who worked on his case and those charged with locating the lost money believe that the scheme started in the early 1970s.[6]

Madoff is a fitting symbol of the financial fraud that tarnishes our times. In our modern era, billions of dollars have been pilfered from individual investors and institutions in schemes devised by Madoff and others. At a point in time when wealth creation and prosperity have never been greater, investment fraud has come with a vengeance and at great price.

The purpose of this paper is not to rail on Bernie Madoff. I do not have any special knowledge of him as a person, nor do I have any facts or pieces of evidence to offer anyone beyond what was brought to bear against him during his criminal investigation, the details of which have been published widely. Other individuals and companies are named in this paper and, again, my purpose in naming them is not personal or vindictive, but to illustrate points. My goal is merely to help readers to be prepared during a time when financial swindling is common.

> "Executives and insiders ... may tend to favor their own interests."

All investments involve taking risks. And trust is involved when other people help oversee your money or provide investment products that you can purchase. It's just part of the process. I believe, however, that it's possible to understand the current climate surrounding Wall Street, and that this knowledge can lead to making smart choices regarding your wealth. Later in the paper, I'll raise questions that you can use as a barometer for assessing the integrity of your investment program.

But first, let's take a look at our times.

Why So Much Swindling?

In *The Wall Street Journal* article entitled, "Why Capitalism Has an Image Problem,"[7] author and scholar Charles Murray discusses what he calls "the rise of collusive capitalism." Let me elaborate on this point and develop it to fit the purpose of this paper.

1. Colluding controllers.

The idea of "collusive capitalism" is that top executives and insiders in any given industry may tend to favor their own interests, protecting one another more so than those below them, such as shareholders. Murray says such colluding controllers can include members of government, who through legislation and bureaucracy set the regulatory rules (or the lack of them). In Murray's view, government controllers can lead to "corruption on a massive scale."

"Sometimes the corruption is wholesale, creating an industry wide potential for profit that would not exist in the absence of government subsidies or regulations," he says.[8]

Murray cites ethanol used to fuel cars and low-interest mortgages to high-risk borrowers as examples of industry-level collusion in action.[9] In my opinion, the entire financial system, and not just the mortgage lenders, has the potential to succumb to "collusive capitalism."

I'm not saying that our financial system is absolutely flawed, shady and unworthy of investment support. That's not my point at all. I'm merely agreeing with Murray who notes the *potential* for high-level controllers to throw their weight around. I agree with him because we have seen it happen:

The Libor scandal. Libor is a collection of interest rates set daily by an association of bankers in London.[10] It represents the rate one bank charges another bank to borrow money for a given period of time. It's an important benchmark, and it affects borrowers of all kinds including individual consumers, municipalities and states amongst others. CNN reports that $10 trillion in credit card rates, car loans, student loans and adjustable-rate mortgages are tied to Libor.[11] So then, if Libor goes up, consumers pay more to borrow money.

- A problem occurred between 2005 and 2008 when traders at Barclays Capital, a leading UK bank, asked their contacts in the banking association to set the Libor rates — likely so as to benefit their trading positions. Suspicion has now turned to other large banks as having participated in fixing Libor rates. At the time of this writing, these other banks were also being investigated.

- The collusion was huge and has affected many. Lawsuits have been filed by individuals, companies and municipalities. The governors of some powerful central banks, notably, the Bank of England and the New York Federal Reserve Bank, appear to have known about the Libor problem as far back as 2008.[12] The scandal is so big that one professor at the Massachusetts Institute of Technology reportedly said that it "dwarfs by orders of magnitude any financial scams in the history of markets."[13]

Clearly, Libor rate-setting involves a few at the top looking out for one another, despite harm coming to innocent traders, mortgage holders and investors. The very structure of the system allowed for it, since the Libor rate schedules are set based on what the banks report that they charge, not the *actual* rates that they charge.[14] This system of bank rate *estimates* relies on honest reporting of rates which, clearly, can be manipulated through collusion. Observers now cry for more regulation.[15] In fact, incidents such as the Libor scandal bring the lie to the argument that business can regulate itself and government regulation is not needed. We see in case after case that that is simply not what happens.

Many have been seeking "alternative investment opportunities."

Collusive capitalism is just one reason why we see more financial scandals and schemes these days. Here is another reason:

2. Climate of uncertainty.

The FBI's *Financial Crimes Report to the Public 2010-2011* correlates "the continued uncertainty and volatility of today's financial markets" with "a steady rise in securities and commodities frauds."[16] Spooked by today's volatile stock market, many investors, the FBI concludes, have been seeking "alternative investment opportunities." This has lead to the "development of new schemes and the continued rise of Ponzi schemes," states *Financial Crimes Report*.

I think the problem is two-fold:

- **Large amounts of money to invest.** "The creation of complex investment vehicles and the tremendous increase in the amount of money being invested have created greater opportunities for individuals and businesses to perpetrate fraudulent investment schemes," states *Financial Crimes Report*.[17]

- **Lots of worries.** "The number of investment frauds continues to grow as investors remain susceptible in the current uncertainty of the global economy," states *Financial Crimes Report*.[18] "The securities and commodities frauds being investigated include market manipulation, investment frauds, and miscellaneous matters such as broker embezzlement."

When you have uncertainty in the markets and the rise of unscrupulous individuals focused on selling a tight network of associates, you have a problem. That's what happened in the Bernie Madoff case. His Ponzi scheme, which wiped out the life savings of hundreds of investors and caused losses at funds and banks all over the world, made use of a technique called **affinity fraud**.[19]

"Madoff presented himself as a trusted member of communities at the same time he was trying to separate them from their money," states financial writer Christine Benz.[20] According to Benz, Madoff pitched his services particularly to various Jewish organizations and institutions, as well as Jewish individuals.

A court-appointed trustee has estimated that Madoff's client losses total $17.3 billion. This trustee has accused Bernie Madoff, his brother, Peter, and others of running the Madoff investment business as a "family piggy bank."[21]

Here is another reason for why I believe we live in one of the most pronounced periods of financial swindling of any time:

3. Regulators can't keep up with the criminals.

Initially, what's amazing about securities fraud is how close regulators and enforcers come to catching the crooks but often fail to make the nab before years and even decades pass. For example:

R. Allen Stanford. Convicted Ponzi schemer R. Allen Stanford was sentenced in June 2012 to 110 years in federal prison for his $7 billion fraud. He had lived a lavish lifestyle, which included private jets, yachts, island vacation homes and even ownership of a professional cricket team.[22]

- Stanford fooled nearly 30,000 investors in 113 countries. His pitch: Certificates of deposit issued by the Stanford International Bank based on the Caribbean island of Antigua **promising sky-high interest rates**.[23]

- Why hadn't regulators caught on to Stanford's act? They did. According to *The Wall Street Journal*, the SEC's own examiners "raised red flags as early as the 1990s."[24] For some reason, regulators never *acted*.

So, then, we live in a time of collusive capitalism, where a few at the top can sometimes gain an advantage over others. We also see that many individuals with wealth to invest are chasing returns. They are often looking for big return payouts and may be willing to try new investment opportunities. Finally, we have seen that regulators have their hands full and can't always provide proper governance. This isn't a surprise in this era of budget cuts and reduced government services. The fact is that in many cases the folks perpetrating fraud have greater resources than the folks trying to catch them.

An investment plan can help you to balance goals with your risk tolerance.

What Can You Do?

I would like to offer a number of suggestions. In addition to those, I will raise some important questions. These questions, shown below in bold, colored type, can serve together as a barometer of how well protected you are from criminal investment schemes. If your answer to any question is Yes, then consider that a good reading on the barometer.

1. Don't panic about living in the Madoff Era. Over the years, many traditional investment opportunities have performed just fine. There will always be cycles of highs and lows in stocks, bonds, real estate and other markets, and nobody can predict their direction. Having an investment plan can help you to balance your long-term goals with your tolerance for risk.

Do you have an investment plan?

What's most effective, in my opinion, is to develop an asset allocation strategy that suits your objectives. By being diversified, your investment allocation will generally be able to tolerate the normal ups and downs that come with investing.

Sure, times may come when you need to make changes to your asset allocation. But, generally speaking, short term reactions often cost you in the longer run. Making hasty investments in products and services you don't understand should be avoided, too.

Are you sticking to your investment plan by avoiding hasty investment decisions?

2. Work closely with a qualified advisor. It's generally good to know your income needs and financial goals and have these reflected in an overall investment plan. I typically recommend that clients stay with their investment plans rather than make hasty decisions.

Do you have a qualified investment advisor helping you with your wealth management?

- *If a new investment opportunity presents itself, then discuss it with your advisor.* I have a strong opinion here. I am not too game on my clients pursuing unusual and different private placements and other poorly vetted investment scenarios.

- *Don't let your emotions fool you.* When a new fangled investment product or program comes around and you become all excited about its prospects, it's time to stop, research and properly evaluate the new product or program. I take the lead in reviewing my clients' situations and the investment opportunities before them. I believe that you should do the same.

- *Be reasonable with regard to your investment return expectations.* Meet with your advisor to review your total investment program. As you evaluate new investment opportunities, weigh the expenses and the risks associated with the opportunities and assess their tax implications *before* reallocating any large investment stakes.

Are your investment choices being made with restraint and with reasonable expectations of performance?

Please remember that all investments involve the risk of a potential loss. Investors may receive less upon selling than the original amount. Before investing, my clients are advised to consider their investment objectives, risk tolerance and the expenses associated with a particular investment.

3. Beware of common investment red flags. Here are some practical pointers adapted from *"A Guide for Seniors — Protecting Yourself Against Investment Fraud,"* published by the SEC[25]:

- *If an investment opportunity's promised rates of return and growth prospects sound too good to be true, then they are.* Any investment that claims it can generate returns higher than well-known stock indices[26], for example, could be highly risky. You might lose money.
- *Don't believe in promises of "guaranteed returns."* All investments carry a degree of risk. Generally, the higher the risk taken the greater the returns expected. Low risk generally means low yields. Fraudsters frequently play to investors' hopes for high yields with little or no risk. So, if someone tells you that the product is "guaranteed" or "can't miss," I say you should walk away.

Fraudsters frequently play to investors' hopes for high yields.

- *Don't send money.* Scam artists like to pressure individuals to "send money now." They often suggest that it's a "once in a lifetime opportunity" and that it will be "gone tomorrow." As stated above, having a qualified financial advisor can be your fail-safe, because they can help you evaluate the investment opportunity in light of your goals and current life situation. My clients have heard me say many times that if it's a good idea today it'll be a good idea a week or a month from now after you've thought it over completely.

Are you being asked to invest in something that's raising one or more red flags?

Conclusion

Michael Douglas' public service announcement has raised the stakes in the efforts to fight financial crimes in this country.

"Integrity and fairness are paramount to the success of our markets," says Janice K. Fedarcyk, FBI Assistant Director in Charge. "The FBI will continue to pursue those who cheat the system."[27]

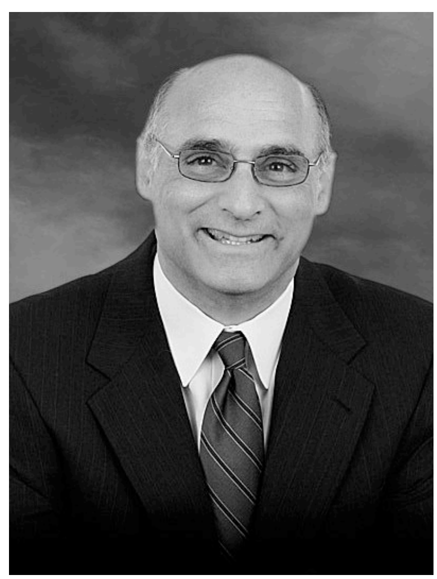
I believe that the FBI's efforts will continue to be helpful. But I also believe that it's wise to have a smart financial plan in place, given this backdrop of crime.

In summary, here are the questions I'd like you to raise before making any investment decision:

- **Do you have an investment plan?**
- **Are you sticking to your investment plan by avoiding hasty investment decisions?**
- **Do you have a qualified investment advisor helping you with your wealth management?**
- **Are your investment choices being made with restraint and with reasonable expectations of performance?**
- **Are you being asked to invest in something that's raising one or more red flags?**

There are likely more “Gordon Gekkos” out there. Let’s just hope that the amount of the losses attributed to Bernie Madoff’s Ponzi scheme is never exceeded by anyone else’s orchestrated racket. ■

ABOUT THE AUTHOR



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[9] Murray, Charles (2012, Jul.). Ibid.

[10] Libor stands for London Interbank Offered Rate. Libor rates are the interest rates at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The rates are fixed on a daily basis by the British Bankers' Association. Each rate is derived from a filtered average of the world's most creditworthy banks' interbank deposit rates for larger loans with maturities between overnight and one full year. Libor rates establish the rates at which the world's most preferred borrowers are able to borrow money. Source: Investopedia.com.

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[19] Perpetrators of affinity fraud take advantage of the tendency of people to trust others with whom they share similarities—such as religion or ethnic identity—to gain their trust and money. Source: The Federal Bureau of Investigation's "Financial Crimes Report to the Public 2010-2011."

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[26] Common stock indexes include The Dow (Dow Jones Industrial Average), a price-weighted index of 30 actively traded blue-chip stocks, the S&P 500 (Standard & Poor's 500), an unmanaged group of securities considered to be representative of the stock market in general, and the NASDAQ Composite Index, an unmanaged, market-weighted index of all over-the-counter common stocks traded on the National Association of Securities Dealers Automated Quotation System. Indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

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