

HOW HE DID IT

DECEMBER 2008

Investigators from the Securities and Exchange Commission rushing to uncover Bernard Madoff's alleged fraud last week found records from what appear to be thousands of clients. Federal authorities have been combing the offices and books of Bernard L. Madoff Investment Securities LLC for days trying to unravel the extent of the investment fraud and trace where the money has flowed. Mr. Madoff maintained records on thousands of securities positions for clients of his investment-advisory business in seven binders. The positions were stated as being with "clearing banks" but the SEC stated that it was unable to identify any such clearing banks.

The discovery of the binders supports that Mr. Madoff held at least held two sets of books, a fake set to be used as the basis for statements sent to customers and another set that showed the assets Mr. Madoff actually held.

The SEC stated, *"We are concerned that many or possibly all of these positions do not exist."*

Everyone enjoys being proven right.

When locked in a debate, or when trying to prove a point, the moment when the facts are laid out on the table and you can say those five triumphant words, **"See I told you so!"** For example: **"I told you A-Rod would strike out with the bases loaded again!"** Or **"I told you that new Indiana Jones movie with space aliens would stink!"**

However when it comes to my warnings and calls for action, it often deals with somewhat more important issues like investment fraud, pyramid schemes, annuity fraud, and conflicts of interest, the big bad investment houses and confidence men disguised as financial advisors. Therefore my "See I told you so moments" are not appropriate times to gloat, it's time to help. Only a real jerk could gloat over the financial pain of someone else.

The media is calling it the **"Scam of the Century!"** Bernard Madoff and his \$50 billion pyramid scheme. As the subscribers of this newsletter and audience of my radio show already know, the only difference between Madoff and the other con-artists that we expose regularly is size and scope.

The billion dollar questions are: **How? How did so many sophisticated investors get duped? How did this scam go on for decades? How did authorities miss this? and Why?**

I can answer all but one.

Scarcity Sale: Give the illusion of exclusivity. **"Not just anyone can be a part of this deal."** Good marketers understand that, by utilizing the illusion of scarcity, they can hasten demand. This false scarcity encourages us to buy sooner and perhaps to buy more than normal. When this strategy is applied to investment products it also gives the illusion of above-average return. Big brokerage firms and boiler room operators used this tactic during the 1990's to drive up the prices of IPO's. They simply cut back on investors IPO allocation and forced them to buy after-market, thereby driving the stock price to ridiculous

levels. In Madoff's case along with many other hedge funds, being chosen is akin to being a member of the in-crowd in high school and carries with it similar clique-like behavior.

The Wall Street Journal quotes one investor, ***"If you were eating lunch at the club or golfing, everyone was talking about how Madoff was making them all this money."*** One of the largest clusters of Madoff victims was in Florida. Madoff relied on a network of friends, family and business colleagues to attract his investors. According to investors and agents, some of these agents were paid commissions for harvesting investors. Others had separate, lucrative business relationships with Mr. Madoff. The marketing often was in the hands of what one *Wall Street Journal* source described as a ***"macher"*** (the Yiddish term for a big shot). ***"I've got my money invested with Madoff and he's doing really well."*** When the listener expressed interest, the ***macher*** would reply, ***"You can't get in unless you're invited...but I can probably get you in."*** If you were lucky enough to become one of the anointed ones, and a clique member went out of his or her way to aid you in getting access, it would be social faux pas or insult to decline.

The Brilliance Con: To be a great investment con-artist you must be brilliant at making people believe you are brilliant. *The Wall Street Journal* stated that among his clients, Mr. Madoff was considered a money-management legend; clients would joke that if Mr. Madoff was a fraud, he'd take down half the world with him. Robert Cialdini, a psychology professor at Arizona State University calls this the ***"inherent domain of people who know more than we do."*** The aura of brilliance often can placate regulators, an analogy might be a health department inspector looking over the domain of a four star chef.

Affinity Fraud: The pitch is simple, ***"Since I am like you and, and believe like you, you can believe in me and what I say."*** Madoff swam in many influential circles, especially within the Jewish community. He was a huge contributor to many Jewish charities and served on the board of directors of many as well. These are the same circles that his clients came from, politicians come from, and the people whom are supposed to be policing him come from.

Political Cover: Make ample donations to the right (most connected) politicians, attend the fundraisers and get your clients to do so as well. The Securities and Exchange Commission is a part of the executive branch of government and very much the subject of the Wall Street/Washington D.C. power play and subjected often to the whims of power politicians. For example former SEC chairman Harvey Pitt, was forced to resign, with one of the main reasons being he was too gruff with Washington D.C. politicians. They didn't like the way he addressed them or should I say, dressed them down. Bernard Madoff was a big player in Democratic politics being a major contributor to both Senators Charles Schumer and Frank Lautenberg.

Madoff was a master at these four cons. Combining the four, most certainly bought him some lackadaisical oversight, if not complete cover.

Harry Markopolos, a former money manager, made it his personal mission to expose Madoff as a fraud and tried repeatedly to alert the SEC as far back as 2000. *The Wall Street Journal* got a hold of all the documents that Markopolos shared with the SEC over the past eight years. Markopolos actually utilized a financial mathematician to prove that Madoff's strategy was impossible. The closest the SEC came to unearthing the scheme was an investigation they conducted in 2006 where they found Madoff and one of his major hedge fund investors, Fairfield Greenwich, ***misleading***. Madoff and Fairfield were not forthright in many of their statements regarding the nature of the strategy used by the Fairfield funds and other

hedge-fund accounts that were customers. Madoff also **“withheld from the examination staff information about certain customer accounts.”**

Unfortunately, rather than digging their claws in, the SEC recommended closing the investigation because Madoff agreed to register his investment-advisory business with the SEC. Madoff was now subject to inspections and examinations. (Whoopee! A lot of help that did.) The SEC stated that they closed the case **“because those violations were not so serious as to warrant an enforcement action.”** Everyone is now asking the question, **“How, and why, could the SEC miss this?”** The same way that the great masses of **“sophisticated investors”** missed the four reasons I have listed above.

Every Thursday morning I leave my home at around 3 AM, to get to Orlando for my weekly appearances on the **Daily Buzz** morning program. Listening to **CNBC World** on the satellite radio is a bit of a safety hazard at that time of day due to many of their sleep inducing hosts. On the early morning jaunt I often tune to the comedy station in order to help keep the eyelids from getting heavy. On a recent trip I heard an old George Carlin skit called **Wurdz**, where he highlights oxymoron’s and makes fun of our use of language. For example: mandatory option, resident alien, hot water heater, wireless cable, near miss, holy war and business ethics. I would like to add one...**sophisticated investor**.

The definition of **sophisticated investor** is **“someone who has the sufficient experience and knowledge of the financial markets, and is able to evaluate a particular investment on its merit.”** That legal grey area, large enough to drive a dump truck through, has been used by boiler room operators, private placement hustlers, hedge fund frauds and other confidence men for decades.

The sad reality, and one that I repeat often, is that **get-rich-quick cons are the world’s second oldest profession**. Madoff was just a more evolved version of a boiler-room operator, crooked televangelist, or some South Florida insurance salesman specializing in elder fraud. The SEC’s budget has increased by almost two thirds since the collapse of Enron and even if we doubled it again, I doubt they would have nailed Madoff. The SEC basically is tasked with mission impossible, trying to enforce securities laws that are written in grey, rather than black or white, fighting off political pressure, and battling an age old part of human nature, greed. The best defense against sociopath’s like Madoff is to engrain in one’s mind that financial guru’s are nothing more than modern day snake-oil salesman and everything in life that has meaning, value, or worth involves work, time and effort. I don’t make the rules, I just follow them.

As for **why**...Why did Madoff, like many others before him, and most certainly after him, knowingly and willfully destroy, take advantage and use their power and influence to harm others?

That I cannot answer.

SOURCE MATERIAL

Scannell Kara [Thousands Appear to Be on Client List](#) *Wall Street Journal* December 19, 2008
Frank Robert, Lattman Peter, Searcey Dionne, Lucchetti Aaron [Fund Fraud Hits Big Names](#) *Wall Street Journal* December 13, 2008
Luccetti Aaron, Scannell Kara, Efrati Amir [SEC to Probe Its Ties to Madoffs](#) *Wall Street Journal* December 17, 2008
Caruso David [For Madoff Investors, Big Returns Trumped Concerns](#) *Associated Press* December 12, 2008
Zuckerman Gregory, Scannell Kara [Madoff Misled SEC in 06 Got Off](#) *Wall Street Journal* December 18, 2008