



Deception Unveiled - Investors Flee

January 2, 2009

The U.S. securities market provided a great venue for honest wagering from the post-World War II period until the late 1990's. While brokers still owned the largest yachts, investors stood far more than an even chance to earn a reasonable return.

In the mid-1990's, investors saw their world begin to shift. The Clinton Administration began tearing down the Glass-Seagall Act of 1933, which had been enacted to rescue a banking system that had collapsed during the Great Depression. By the late 90's, all barriers to the aggregation of financial institutions had been removed. The result was an increasing degree of monopolization in the financial industry, and weaker protection for investors.

As an investor, I have lived the last ten years suffering the consequences of these rounds of deregulation and the resulting exploitation by irresponsible brokers, banks, fund managers, and others. Let's take a brief trip down Memory Lane:

- 1999 – Dot-com IPO's are available to favored clients in return for kick-backs to the brokers, but not accessible to the average investor. Analysts grow their transaction fees by recommending worthless stocks ("lipstick on a pig..."). Most of the dot-coms fizzle as soon as their capital is spent.
- 2002 – The Enron and WorldCom accounting frauds decimate the pension funds of their employees and send the market down. Despite these earth-shaking events, public companies continue to deceive their shareholders, masking significant risk and compensating their executives millions of dollars based on the transitory appearance of profitability. The *New York Times* calculates that waste, fraud and abuse in the financial sector probably exceeded \$400 billion a year.¹ In spite of this, 'the average salary of employees in 'securities, commodity contracts, and investments' was more than

four times the average salary in the rest of the economy....Incomes of \$20 million or more were fairly common."²

- 2003 – Mutual Funds allow their hedge fund clients to trade illegally after hours.
- 2007 – Subprime mortgages implode, carrying with them \$65 trillion in unbacked Credit Default Swaps and plunging the entire world into recession. The biggest banks and brokerage houses in the U.S. fail or are forced to merge, creating even bigger entities. U.S. regulatory agencies step up to the plate with empty hands.
- 2008 – Even before Bernie Madoff proves that America is indeed the Land of Opportunity, a \$3 billion hedge fund Ponzi scheme by Gregory Bell and Thomas Petters of Lancelot Investors is uncovered. As reported by Forbes:

"Until the grand scheme collapsed in the fall, Bell looked like a genius, posting healthy paper returns since 2003 and taking his cut – 2% of assets and 20% of Lancelot's 'profit,' which totaled \$57 million, court documents show. But according to the feds the great returns and the electronic gizmos never existed. What's real, they say, is a long trail of bogus purchase orders and fake invoices. Petters, they allege, had been running a \$3 billion Ponzi scheme, using new investor money to pay off old debts and, it seems, to finance the purchase of the once valuable brand name Polaroid, a small airline and who knows what else.

"Petters was arrested in October after one of his deputies tipped off the feds and before Petters

¹ "The Madoff Economy," *The New York Times*, December 19, 2008

² Ibid.

could flee the country. By then \$12 billion-plus had flowed through his companies, which relied on capital from hedge funds now out \$3.3 billion, according to claims in bankruptcy proceedings involving various Petters entities.

*"The hedge funds all claim they were duped, but a closer look shows there was plenty of evidence Petters was up to no good... Now there are new lawsuits being filed against Bell and Lancelot by investors like Royal Bank of Scotland, which lent \$50 million to Lancelot and says 'at a bare minimum it is clear that the Lancelot funds... failed entirely to confirm the accuracy and authenticity of the purchase orders and the existence of the underlying inventory.'"*³

The Madoff Affair

While many facts still remain to be uncovered, the Madoff affair stands out to date as the most outrageous testament to the disintegrating financial marketplace. The irony is that Madoff actually shafted his partners in crime, the very same financial experts who have been shafting pensioners, 401(k) investors, and others who continued to believe the deregulated "fairy tale."

What have we uncovered so far? The fraud appears to be massive. The SEC, de-fanged by the current Administration and led by a *laissez-faire* Commissioner, turned a blind eye. Banks lent substantial sums of money to funds without doing due diligence. Feeder funds invested all or a substantial portion of their assets with Madoff, with an apparent lack of due diligence and, in my opinion, a total lack of fiduciary responsibility.

Here is what I know so far from reading the papers, most of which is very frightening.

A recent *Financial Times* article points out that some of the world's largest banks were conned.

"HSBC, Royal Bank of Scotland, Nomura and BNP Paribas lent the money without spotting a fraud, and in at least one case without due diligence teams visiting Mr. Madoff's brokerage, which held the assets..."

"Bankers said they had done everything they could, including checking the auditor and regulatory reports, and could not have been expected to spot a fraud..."

*"Lending by all the banks was secured on the assets, making it appear to be a low-risk loan. Even so, RBS and HSBC limited lending to twice the level of assets, while Nomura was willing to go to three times, according to documents and people familiar with their practices."*⁴

The *Wall Street Journal* reports that Tremont, a hedge fund owned by MassMutual, disclosed that its clients lost \$3.3 billion – more than half of all assets overseen by Tremont.

*"Spokesmen for MassMutual and its Oppenheimer subsidiary declined to discuss what due diligence the firms did on Tremont's business. Mass Mutual said its exposure to Madoff-related losses is 'very limited....' Tremont spokesman Montieth Ilingworth also declined to discuss Tremont's due-diligence process. Tremont's Web site says it uses 'effective investment strategies and oversight, thorough manager research [and] careful due diligence.' Neither Tremont, OppenheimerFunds nor MassMutual has been accused of wrongdoing as part of investigations into Mr. Madoff."*⁵

Meanwhile, a *Financial Times* article reports that UBS sought to absolve itself from any duty to safeguard investor assets in a \$1.5 billion fund that channeled money to Madoff's fund.

³ "A Plague on All Their Houses," *Forbes*, December 8, 2008

⁴ "Banks Lent Billions to Madoff Feeder Funds," *The Financial Times*, December 18, 2008

⁵ "MassMutual Burned by Madoff," *The Wall Street Journal*, December 22, 2008

“The Swiss Bank used an agreement that denied it was responsible for the assets, even though its marketing documents claimed it would be.”⁶

In an article entitled “Madoff Misled SEC in ‘06, Got Off,” The Wall Street Journal describes an SEC investigation of Madoff’s firm.

“Among other things, the SEC found that Mr. Madoff personally ‘misled the examination staff about the nature of the strategy’ used by the Fairfield funds and other hedge fund accounts, and also ‘withheld from the examination staff information about certain of these customers’ accounts,’ the SEC documents say.”⁷

On November 21, 2007 the examination staff, having found no evidence of fraud, recommended the case be closed.

On December 17, 2008, Reuters quoted SEC Chairman Christopher Cox as saying “he was deeply concerned” by the Agency’s apparent multiple failures to thoroughly investigate almost a decade of credible allegations of wrongdoing at Madoff’s brokerage firm.

FinancialTimes.com commented:

“Hedge funds and investors who lost money in the alleged \$50 billion Madoff scam have begun defending their decision to invest with Bernard Madoff, in some cases trying to shift the blame to U.S. regulators.”⁸

Bloomberg News reports:

“The options trading strategy Bernard Madoff said he used to help produce profits for 17 straight years would have required at least 10 times

the contracts that trade on U.S. exchanges....

“‘It was never done,’ Michael Schwartz, chief options strategist at Oppenheimer & Co. in New York and a trader since 1965, said of the strategy. ‘If he did it on an exchange, we would have heard about it, and if he did it over the counter, the person he bought it from would have hedged it on an exchange.’...

“Madoff’s firm ‘was not a significant player in the options industry,’ says Jim Binder, a spokesman for Chicago-based Options Clearing Corp., which settles all trading of exchange-listed contracts.”⁹

In concert with a trading strategy that would be impossible to execute, two other items of note should have raised alarms. First, the accounting firm that audited Madoff’s results consisted of three employees, and has not been subjected to a professional review during the past 15 years. Second, Madoff executed transactions through his own trading firm – hence no information could be gathered from an independent third party.

What can we glean from reading these reports?

1. If any involved party -- bank lenders, hedge funds, feeder funds, or the SEC – had done any reasonable due diligence, they would not have been able to justify investing in Madoff or his funds
2. No professional investor has admitted a lack of due diligence, and in fact, they all claim to have exercised thorough analysis despite evidence to the contrary.
3. In addition to claiming appropriate due diligence was taken, investment firms are denying any liability to their stakeholders, and in some instances are blaming the SEC for their due diligence failure.

⁶ “UBS Seeks to Deny Duty over Madoff Funds,” *The Financial Times*, December 19, 2008

⁷ *The Wall Street Journal*, December 18, 2008

⁸ “Funds Blame U.S. Regulators for Madoff Debacle,” *FinancialTimes.com*, December 18, 2008

⁹ “Madoff Strategy Dwarfed Market in Trades ‘Never Done,’” *Bloomberg.com*, December 19, 2008

The very vocal claims of those parties involved, ring hollow to my ears. The alleged Madoff fraud is the direct result of events that found their roots in the deregulation of the 1990's. Financial markets received just what they asked for: the aggregation of financial entities (each with unique risks) coupled with a dramatic weakening of direct regulatory control. Along with financial deregulation, the current Administration "gutted" the Securities & Exchange Commission and appointed an SEC Commissioner who cares little about the investor and a lot about business (quite contrary to the SEC's stated mission). In fact, SEC fraud cases dropped from 513 in 2002 (the Enron era) to a mere 133 prosecutions in the first 11 months of this fiscal year.¹⁰

What's the lesson? "Be careful what you wish for." The *Wall Street Journal* article, "Stock Investors Lose Faith, Pull Out Record Amounts" (December 22, 2008) pretty much sums it up. With mounting evidence of failure on the part of investment advisors, rank-and-file investors have lost faith in the system. According to Birinyi Associates, individuals account for half or more than half of all U.S. stock holdings. From 2002 to 2006, investors added an average of \$62 billion per year into U.S. stock mutual funds. Since 2006, they have *withdrawn* \$40 billion per year, and this past October alone, investors withdrew \$72 billion dollars from stock funds. The financial community's wish has come true: they stacked the deck to collect high fees without providing reliable service to their investors, and it worked, but now their investors are pulling out.

The Future

I do believe that this process has proven, and will prove, so damaging that the entire system will have to be rebuilt – not only through better regulation and enforcement, but with more discerning, self-reliant investors who will not pay professional managers unless they do their job. This rebuilding will take years, and restoring faith in the system will require healthy skepticism on the part of investors and transparency and accountability from the financial community, as well as corporations.

Clearly, we will see increased regulation by the financial regulators and the SEC. However, during

the next few years the financial industry will shrink dramatically, and hedge funds will melt away (I forecast over 2,000 hedge funds will close over the next year, or use "toxic options" to eliminate shareholder redemptions for years to come).

Financial service providers should no longer be able to sell product without substantiating the facts, including both risk and return assumptions. Risk Management tools should be utilized to temper expectations, creating a more realistic set of valuations.

Regardless of how quickly re-regulation comes, it is ever more apparent that the market will be more discriminating between those professional investors who actually do due diligence, and those who don't.

"The (financial) system is now plagued by a lack of independent or critical thinking, and the role this absence has played in the global financial crisis is becoming clearer by the day. The idea that professional investors apply rigorous independent analysis to everything they do has already taken a harsh beating this year. Some do, but many do not."¹¹

James A. Kaplan
CHAIRMAN

¹⁰ "Federal Stock Fraud Cases Fall Sharply," *New York Times News Service*, December 25, 2008

¹¹ "Who's afraid of thinking for themselves on investments?," *Ft.com*, December 19, 2008



Audit Integrity Client Services
Phone: (877) 880-8820
Email: support@auditintegrity.com
Website: www.auditintegrity.com

Audit Integrity, Inc. and its affiliates, Directors and Officers of the company may own stock or options to purchase or sell stock in the companies mentioned on our website and in our publications and may elect to increase or decrease the size of these positions at any time. Audit Integrity, Inc. however, is not directly or indirectly compensated for the specific views, opinions or recommendations expressed in its research reports. This document is for information purposes only and is not to be considered a solicitation to buy or sell any security. Neither Audit Integrity nor any other party guarantees its accuracy nor makes any warranties regarding its usage. Modification or reproduction of this report is forbidden without explicit permission. Copyright © 2009 Audit Integrity, Inc.