Chapter 1

Good Fences Make Good Neighbors

Fortunately for our friend Jim from the Introduction, the SEC and FBI shut down Big-Time Portfolios almost immediately after his meeting—before his check was even cashed. Now Jim must find someone else to manage his money. He wants someone trustworthy—he was beyond lucky to escape unscathed last time. He won't be fooled again.

A few towns over, he finds Trusty Time LLC. They manage a few billion and have been around a while—so they must be safe. And they're big enough that they do money management and are their own broker-dealer, so Jim can write them a check and deposit his money directly with them. Jim thinks that's convenient! Cuts down on his paperwork.

Jim's headed straight for trouble again. He's considering a decision maker who takes custody of assets—financial fraud sign number one.

Sign #1 Your Adviser Also Has Custody of Your Assets.

In December 2008, a long-standing, well-regarded member of the finance community, former NASDAQ chairman and member of SEC advisory committees, huge charitable contributor, and New York and Palm Beach society pillar admitted to his sons the $65 billion he managed for hedge funds, charities, foundations, Hollywood stars, and Jewish grandmothers was a fraud. A pyramid scheme. The money—gone. Lots of fortunes blown—and minds blown.

Then oddly came Texas-born Antiguan knight "Sir" R. Allen Stanford. A repeat *Forbes* 400 member, the SEC charged that the $8 billion he managed was a Ponzi scheme. As 2009 began more scams surfaced. Indiana hedge fund manager Marcus Schrenker faked his own death—staged a plane crash—to escape authorities closing in on his alleged scam.[1] New Yorker Nicholas Cosmo was charged with making fake bridge loans and swindling $370 million.[2] Philly man Joseph S. Forte was charged with running a $50 million Ponzi.[3]

As more details emerged about all these swindles, folks wanted to know what happened. Who did what and how? How did they avoid detection? Will they be punished? Where did the money go, and will victims get any back? Good questions, but the most important and this book's purpose:

How can I make sure it never, ever happens to me?

An age-old Western saying related to how to keep people from stealing things from your wide open spaces is "good fences make good neighbors." To avoid being victimized by a future Madoff-style Ponzi scheme (because there will be more—count on it), that's the single best advice. I'm going to show you how to easily build a great fence against financial embezzlement of any form. It's the single most important thing you can do. I've studied the recent cases and history's biggest cases, and they all have one thing in common—financial fraud sign number one: *The money manager also had custody of the assets.*

In other words, the money manager or financial adviser also acts as the bank or broker/dealer—holding and supposedly safekeeping the assets he/she/it manages. Clients didn't deposit the money with a third party—they deposited the money directly with the decision maker. Then, it's the decision maker's responsibility not only to decide to buy this stock and not that one, but also to keep and account for the money and all securities that may be owned.

In taking custody, the adviser entity literally has the ability to spend the money in any way it sees fit or take it out the back door and flee to Mexico—any old time he wants. Some set their businesses up this way intentionally to embezzle. Others start honest but later fall to the temptation to exaggerate returns. In my view, the latter happens more often than the former but it's just as devastating to you if it happens. It doesn't matter that your adviser started out with good intent, only that you got embezzled.

Separating the two functions—custody and decision making—is prophylactic. The very, very few instances historically where the money manager didn't have direct access through custody and still embezzled, he could somehow manipulate the custodian (one example I'll describe later). Identify those cases, figure out how to avoid them (using this book's other chapters), and then your success in preventing your money from being Madoff with should be just about 100 percent perfect.

If the manager has custody, he can take money out the back door—any time he wants. Don't give any adviser that opportunity, no matter what. They may start completely honestly, but if they fall to temptation later like Madoff did, you're not protected at all—completely vulnerable.

That doesn't mean there aren't valid reasons to combine custody with decision making at the same firm. There are. But you must confirm a rock-solid, nuclear-proof firewall exists between the two functions. Otherwise, it's simply a disaster waiting to happen.

A Ponzi by Any Other Name

Just because Madoff is safely behind bars, don't assume the world's now safe from his brand of disaster. Though he and Stanford were big news in 2009, this kind of scam is nothing new. History is littered with rats, big and small, who helped themselves to client money—whether the clients had millions or a few thousand. Madoff made headlines because of the scale and scope of his long con, but what he allegedly did—a Ponzi scheme—has been around since long before Charles Ponzi gave this con a name in 1920.

And there will—100 percent certainty—be more future cons; always have, always will. You must remain vigilant to protect yourself. Try as regulators and politicians might, there will always be black-hearted thieves and enough folks to victimize who believe big returns without risk are possible. (More on too-good-to-be-true returns in Chapter 2.) And inflation surely means future cons will be bigger dollar-wise. But no matter the size, they almost all had (and likely will have) the same feature: The rats are decision makers who also have custody of client assets.

Same Scam, Different Scamsters

And just who are these rats? Were it not for the Madoff scandal being uncovered just weeks before, "Sir" Stanford's $8 billion (alleged) swindle would have been history's all-time biggest scam. He almost set the record, but he simply paled in comparison to Madoff. It will be some time, I suspect, before someone out-Madoffs Madoff and makes off with a new all-time record rat attack.

But before them was the infamous 1970s fugitive Robert Vesco. In 1970, this charismatic con artist "rescued" a troubled $400 million

When the Pyramid Became a Ponzi

Why did Ponzi become synonymous with robbing Peter to pay Paul? Though uneducated with a background as a laborer, clerk, fruit peddler, waiter, and smuggler, Ponzi was also handsome, slim, dapper, self-assured, and quick witted—which let him look and sound the part once he shifted to finance.

In 1920, he placed a simple newspaper ad, promising a 50 percent return in just 45 days—or *100* percent in 90—playing currency spreads by trading International Postage Union reply coupons. The money flowed in—which was good for him—because he wasn't investing it. He used new investor money to pay older investors. But it worked! For a while—until the *Boston Post* investigated. Turns out only $75,000 in reply coupons were normally printed in a given year—but six months into his scam, Ponzi had taken in millions! He couldn't possibly have invested it all.

Ponzi responded by offering *doubled* interest payments. You'd think folks would be scared off, but instead money kept flooding in. Finally, the *Boston Post*—not regulators, mind you—revealed Ponzi's firm as virtually penniless. Ponzi had taken in about $10 million, issued notes for $14 million, but his accounts held less than $200,000. Ponzi didn't spend all $10 million, though undoubtedly he spent some. It appeared most went to pay his earliest investors—like any pyramid. This is the very basis of what is now famously called a Ponzi scheme.

His pyramid-based cash flow let him actually buy controlling interest in Hanover Trust Company, where he brazenly made himself president shortly before his scheme was blown apart. Crowds adored him, followed him, chanted to him—until the gig was up. He had a mansion and servants. For a very brief period, he had a charmed life, high on the hog.

But he was clearly a con man from the get-go. You could see from his prior history as a smuggler that he wasn't integrity-constrained. Later, while out on bail pending appeal, he sold underwater swamp lots in Florida, making another small fortune before going to the big house for 12 years. Italian born, when he was released from prison he was immediately deported to Italy and then moved to Rio de Janeiro, where he lived a meager life until his death in 1949 in a Rio charity hospital. At death he had $75.

Source: Matthew Josephson, *The Money Lords*, Weybright and Talley, Inc., 1972, pp. 35–36; Robert Sobel, *The Great Bull Market*, W.W. Norton & Co., Inc., 1968, pp.17–20, 98.

mutual fund from its previous owner—who himself ran afoul of the SEC. Investors hoped Vesco would improve returns. Instead, Vesco carted off $224 million. He then bounced from the Bahamas to Costa Rica to finally Cuba, reportedly keeping his money in numbered Swiss bank accounts and dribbling payments over time to Fidel Castro in exchange for protection from Western world authorities. While I'm sure this was lucrative for Castro, he probably also enjoyed housing Vesco—it created a thorn in the side of the US Department of Justice, who saw Vesco as a top-10 wanted criminal for a very long time. Never brought to justice, Vesco apparently died in Cuba, though many believe he faked his own death—another routine escape-artist act.[4]

But Vesco's wasn't even the biggest swindle up to that time! That distinction for many years went to Ivar Kreuger—the Match King—who swindled $250 million before his pyramid toppled in 1932. Kreuger ran an audacious scam—offering shockingly cheap loans to sovereign nations in return for monopoly distribution of his safety matches. He kept capital flowing in by offering ridiculously high dividends to investors and escaped detection by cooking the books and bribing countries with ever-lower rates. He bamboozled investors with flashy displays and a slick appearance. He, too, lived high. Fancy suits, countless mistresses—at least a dozen documented at one time in different European cities, all on allowance and decked in diamonds and silk—and this after the 1929 crash! (I'm always amazed Kreuger isn't better known now—he was such a huge, famous villain. A bio of him from my 1993 book, *100 Minds That Made the Market*, is excerpted in Appendix C.)

Like all Ponzis, it couldn't last—distributions overwhelmed incoming funds, which is the normal undoing of most Ponzi schemes. In March 1932, he had a nervous breakdown, couldn't sleep, and answered imaginary phone calls and door knocks. Eventually, dressed to the nines, he lay on a bed, unbuttoned his pin-striped suit and silk monogrammed shirt, and hand-gunned himself.[5]

An Unending Rat Pack

History's rat parade is effectively endless. Market volatility in 2008 and 2009 uncovered a whole new rat pack.

- Nicholas Cosmo—the $370 million rat—promised *80 percent returns* by providing private bridge loans to commercial real estate firms. It doesn't appear many—if any—such loans were made.[6]
- Arthur Nadel, a one-time lawyer previously disbarred for investing escrow funds, was charged with a $350 million hedge fund scam. He claimed *12 percent monthly returns* in 2008—actual fund returns were negative. What the market didn't take, he allegedly did. The FBI is still investigating.[7]
- Daren Palmer ran a textbook Ponzi (allegedly, still being investigated) in Idaho Falls. He's charged with swindling $100 million—boasting *40 percent annual returns*. He gave himself a $35,000 salary, a $12 million home, a fleet of snowmobiles, and likely a one-way ticket to federal prison.[8]
- Robert Brown from Hillsborough, California—the town next to where I was raised—was charged with scamming $20 million by promising to double investments in 13 months. He also promised if clients lost money, he'd cover the difference—out of his own pocket![9] He didn't take care of clients. He just took them to the cleaners.

And the theme repeats through history.

- Kirk Wright rocked the NFL—ripping off former and current pros with a $185 million hedge fund scam that crumbled in 2006.[10]

- In 2008, the SEC convicted Alberto Vilar with stealing $5 million from hedge fund investors for personal use and giving away much more to opera houses globally. A fondness for fine arts does not necessarily translate to honesty and good sense.[11]
- After being banned for life by the SEC in 1991 for securities crimes, Martin Frankel was undaunted. He bought small, troubled insurance firms, pillaged their reserves, plundered premiums, and dummied financials to make them look healthier—using them to lever purchases of more firms to rob. Meanwhile, he contacted the Vatican to set up a fake charity—to scam still more! In 1999, he was charged with defrauding investors of $208 million—then he absconded to Germany. He was later brought to justice, serving time both in Germany and America.[12] A globe-trotting rat.
- David Dominelli, outed in 1984, served 20 years in prison for his scam. He swindled about $80 million through his currency trading firm, J. David Company.[13] His victims were largely San Diego's wealthy. He so ingratiated himself, he took down San Diego's then-mayor, Roger Hedgecock, who was charged with taking illegal contributions from the con artist and forced from office.
- Richard Whitney, *president of the New York Stock Exchange* (a lot like Madoff) in the 1930s, ripped off $2 million or more—a princely sum during the Great Depression. Never take an impressive resume at face value.

Just a few examples. And before them all is an unending line of black-hearted thieves and pirates. Rats! They had different ploys to lure marks. Struck different victims—large and small. Some were global; some preferred terrorizing their own small towns. But they all—*all*—had one major thing in common: **They all had access to the till.** They made sure of that. A rat has to have access to the cheese. Take away the access, and they probably do no more damage than a Three-Card Monte street hustler. And if you don't give them that access—refuse to hand over decision making—then you are safe.

What Victims Look Like

Or are you? This book teaches how to spot the rats, but what do victims look like? Like *you*? Maybe! You already know victims come from all walks—with billions or pennies. But what makes someone more likely to be conned?

In my 37-year career managing money, 25 years writing the *Forbes* "Portfolio Strategy" column, writing five other books, and generally touring and speaking with investors—hundreds of speeches—I've interacted with lots of investors—many, many thousands. My firm itself has more than 20,000 clients. Having studied them, profiled them, watched countless focus groups of them, and surveyed them, I consider investors of all sizes and types fit pretty darned tightly into one of six categories. They can all be victims of embezzlement. But understanding who these investor types are and how they generally think helps you see what you have to do to stay safe. You're likely one of the following:

- **Confident Clark**. Professional help? Pah! You're just as good as any of them. No—better! Plus, you enjoy everything about investing. You're a do-it-yourselfer—no one but you is going to make decisions on your money. You love getting reports and stock tips and charting your own course.
- **Hobby Hal**. Investing is a serious pursuit—like a full-time job. You like educating yourself and being active in portfolio decisions and "talking shop." You might use an adviser, but it's definitely a two-way business partnership, with you making the final call. It's your very serious hobby.
- **Expert Ellen**. You enjoy studying and learning about markets—it's fun! You check in regularly on how your investments are doing, but admittedly you're often too busy to keep up as much as you'd like. You like having a professional partner and may even have them make your investment decisions—you appreciate the value a good professional provides. Besides, you really don't have the time to do it yourself—too busy being Chief Executive Something.

- **Daunted Dave**. You don't feel comfortable making investing decisions without professional help. Investing is complex and intimidating—it's not fun, plus you don't have time nor want to make time. You don't read or watch much financial media. Having a professional make decisions for you gives you peace of mind, so you can focus on the parts of life you really enjoy and consider yourself good at.
- **Concerned Carl**. You worry you won't meet your investing goals and don't feel confident making important decisions for yourself. You don't have time to adequately manage your money—you want a professional handling decisions for you. You'll probably ask lots of questions, but to be honest, you aren't entirely sure what to do with the answers.
- **Avoidance Al**. You don't want to deal with investing, ever! (Heck, you're probably not reading this book.) You don't like thinking about it, doing it, or even thinking about hiring someone to do it for you. It's all too overwhelming, and in some ways feels inappropriate to be talked about—maybe a little like sex, it's certainly not dinner conversation. You'll think about it next week (month, year, decade).

We know Clark isn't hiring a con artist—he isn't hiring anyone! Hal might hire an adviser, but a con artist probably doesn't want him either. Hal's way too involved for a con artist to feel comfortable that Hal won't get into the middle of things. Ellen will be less constantly involved—which a con prefers—but she'll likely not be conned by big returns (Chapter 2), and she'll question too hard. Not optimal for fraudsters.

Dave could definitely run into trouble. Dave doesn't have the time or the inclination to learn more than he has to. Worse, Dave probably doesn't do much due diligence. He'll take referrals gladly from his tennis buddy, his neighbor, his dog walker. Dave's too busy to dig—he wants to be told what to do by someone he thinks he can trust, and he'll do it.

I worry about Carl, because Carl is a worrier. He frets he can't hit investing goals without a professional. No way he can do it! He wants

Daunted Dave in Hollywood

The media was amazed that big-name Hollywood stars fell for Madoff. I'm not. Believe it or not, they're daunted, like Dave. So too were Kirk Wright's sports stars. Classic daunted investors. They don't have time. Plus, big-time stars and athletes can be very isolated. Movie stars in particular are sheltered from the real world and most of their financial decisions are made by their managers. They feel isolated and unable to deal with the real world because the real world makes such a fuss over them. Often, they're simply not safe in public. They get very few real-world interactions of the type you take for granted every day. They're daunted and they trust their managers implicitly, which is why they've delegated so many functions to them—including picking asset managers. So, the daunted may rely even more heavily on referrals—which con artists really love (discussed more in Chapter 4).

to hand decision-making over entirely—goes looking for help. Con artists like to be looked for. Con artists also love Carl because complex mumbo-jumbo nonsense (Chapter 3) works on him. (E.g., "We look for beta volumetric opportunities in mid-cap value Pan-Asian tech stocks, and hedge to take full advantage with minimal risk using complex derivatives and mythorian algorithms.") Carl thinks that sounds smart, and that works just great for rats.

Now, Al may avoid hiring a con artist, just because he avoids doing anything at all! But once he decides to hire someone, he never checks back, and likely doesn't find out he's been conned until after the media fanfare, after the trial, and after the villain's been cooling his heels in jail for six years.

Con artists love Dave, Carl, even Al. If you see yourself in one of them, you're more likely to hire a pro, but you're also more likely to be conned. But don't make the mistake of thinking, "I'm like Clark! I'll never be taken in. I never need to worry." This is like being told by your doctor you have a low risk of heart disease, so you don't take care of your health.

You may feel like Clark or Ellen right now. But the same investor can actually morph over time into someone else—happens all the time. The way investors see their needs can easily change. During bull markets, investors are more likely to say they want growth and aren't risk averse. They're not conservative, no! They want zooming stocks. They're confident and tough. Maybe they don't need professional help at all! They want to pick their own investments. Then, they may feel more like Clark, Ellen, or Hal—eager to engage, feeling confident.

But after a bear market knocks their stocks down, those same, confident, tough-guy (or gal) investors may change. Not only do they now want capital preservation, but they often believe that's all they ever wanted! Growth? Who ever wanted growth? Not them! Same investor—and they'll swear they haven't changed. Their long-term goals certainly haven't. But what they say they want has. The bull market made them confident, but the bear market made them daunted. And that's when a con artist strikes.

The Big Swindle

So how can you rat out the rat? By knowing how they operate. No matter what the window dressing, no matter the psychological ploys, the rat's fundamental operation is the same. They sell themselves as chief decision maker. Then they have clients deposit assets in a custodial institution they control or in an account they control—allowing them to plunder at will. An intended con man will set up this way with the intent to embezzle. Others just fall into it. Either way, doesn't matter. Structurally, the possibility exists if there's no division between decision maker and custodian. They can inflate asset values and issue false statements. They can shift money or drain it entirely. Who will stop them? They're in charge of the piggy bank—no one else.

Why would an honest person set up a financial advice or money management firm this way? Because it's simply easier for the operator. How does a seemingly honest person evolve into a swindler? Usually, in my view, they have a personal problem that requires temporary money,

Don't Take Anything for Granted

An important lesson: First, Ponzis are nothing new. Second: Anyone can fall victim.

Former US President Ulysses S. Grant was himself victimized by a pyramid scheme—years before Ponzi thought about hawking postage stamps. Grant was perhaps equally as famous for his battlefield heroics as he was for his financial failings. He was financially made and undone a number of times—falling for a scheme to corner the gold market that failed and getting involved in risky Nevada mining operations.

But his final undoing was a classic pyramid. Grant lent his name to a family friend, Ferdinand Ward, in opening a brokerage business—Grant and Ward. Grant wasn't involved in operations, just a figurehead. His name gave the business respectability—Civil War veterans by the hundreds invested with them.

Unfortunately, Ward not only didn't invest well, he didn't invest at all. He paid out dividends from incoming money. He finally admitted to Grant they were in financial trouble, and Grant, believing in Ward, asked for a $150,000 loan from railroad king and friend William Vanderbilt. Vanderbilt gladly lent the money, but soon that too was gone. And then Ward disappeared.

Grant tried to pay off the loan to Vanderbilt by giving him his home, his horse farm, and all his belongings. Vanderbilt refused to accept. Grant was already destitute; Vanderbilt didn't want him homeless too. Grant spent his final days writing his memoirs to try to earn a little something for his wife to live on.

If a US President can fall prey to a Ponzi, who can't? You can—don't give Ward or anyone else access to your assets.

Source: Lynn Fabian Lasner, "The Rise and Fall of Ulyssess S. Grant," *Humanities*, January/February 2002, 23(1).

and they simultaneously have what they see as a sure-fire investment opportunity. In their mind they're going to "borrow" the money for a while, make the investment in their own name, get a big one-time return, put back the "borrowed" money, and then pocket the profits to cover their personal problem.

Of course, the surefire investment opportunity blows up and they can't return the "borrowed" money. So they falsify statements, use new investors to cover losses for older investors, and borrow more to bet again on another surefire investment opportunity they think will bail them out—and it doesn't either. It goes down too. Soon they give up on anything else but recruiting new investor money to cover older investors, and hope they can keep doing that—which they only can by faking financial statements, claiming very high but very stable and desirable returns, and selling hard.

If there's no division between decision maker and custodian, a rat can inflate asset values, issue false statements, shift money around, or steal it entirely. They're in charge of the piggy bank.

During his arraignment, Madoff claimed he didn't begin misapplying client funds until the early 1990s—in response to a rocky year—in what he hoped would be a short-lived solution that snowballed.[14] It's no excuse, but had he set himself up without access, he simply couldn't have fallen to temptation. He would have had to admit to losses, as many thousands of honest money managers and financial advisers routinely do every year. The very best long-term money managers have had some rocky years. But some folks don't have the stuff to own up to mistakes, learn from them, and move on. Some would rather cover them, maybe fudging the numbers and doubling down to make it up, believing no one will be the wiser. Madoff didn't have the stuff.

It's not just illegal and amoral—it's fundamentally backward. More risk from doubling down can mean bigger potential future losses. When doubled-down bets go awry, you're really in a hole. All the while, the manager is reporting good returns, using incoming assets to cover the tracks of his losses. Eventually, the thing blows up—always.

I have no way of knowing how many fraudsters started fine but later evolved to sliminess, but it doesn't matter. By simply setting it up so they don't have access to client funds, they can't manipulate your returns and misapply your funds.

When the Fox Owns the Henhouse

How did Madoff do it? Madoff's advisory clients deposited assets directly with Madoff Investment Securities. Madoff Securities, on its own, appeared to be a legit, long-standing firm. Founded in 1960, at its height it handled $1 trillion in trades per year, making it one of the top-three market makers in both NYSE and NASDAQ securities globally.[15] That's really pretty impressive. You wouldn't logically think someone who had gotten that far in life would devolve to crime.

But it wasn't the brokerage operation that was the problem for people. There's really nothing there to raise alarm—until the fellow with the name on the piggy bank became an asset manager, running an LLC that took custody of people's money and made investment decisions for them. Then it becomes tactically nothing for him to steal, if he chooses. And Madoff chose, claiming he didn't start out to swindle but fell into it. But he appears to have been an exceptional student of the game.

"Sir" Stanford did the same (allegedly—as of this writing). Though Madoff stole more, Stanford seems to me a particularly loathsome villain. Did he specifically set his business up intentionally to defraud? That's for courts to decide. But as a disinterested onlooker, I'm suspicious he did—he was the fox who owned the henhouse. He set up a bank—Stanford International Bank—based in Antigua. By all accounts, the bank does engage in some normal, non-criminal banking activity. But why Antigua? Because if I were a would-be villain, I'd want to choose a spot where I knew I could easily buy influence—hence better not in America—better in a small, poor place where you could more easily make a big impact on the government.

Note: This isn't to say Antigua was in cahoots. Rather, in a smaller, cash-strapped nation, it's likely easier to pay a regulator or two to wink at peccadilloes. That's why Robert Vesco ended up in Cuba. Further, Stanford was Antigua-Barbuda's second-largest employer, after the government.[16] If you've ever been there, you know it is a tiny little place, with most people living in abject poverty with a heavy dependence on cruise-based tourism. In a small, poor country, Stanford became the biggest fish in the pond. Did he know his hosts wouldn't eagerly question and look into the big employer, who built soccer and cricket stadiums and showered the island with charitable contributions?

Stanford's bank issued certificates of deposit (CDs) with ultra-high interest rates—much higher than you could get from a normal bank (a red flag covered in Chapter 2)—based on the bank's "unique" investment strategy. (Unfortunately, it may have been "unique" like the Tooth Fairy is unique.) The CDs were sold primarily through Stanford's advisory business, Stanford Capital Management, and assets were held at his broker-dealer, Stanford Group Company.

At every turn, Stanford had access. (Vital rule: If it looks suspicious in terms of custody, it is suspicious and should be avoided!) Making matters worse, his businesses were operated by family and friends—a close inner circle—including his father and college roommate. Perhaps Stanford's top executives didn't intend to be fraudsters—again, up to the courts—but it appears he arranged matters, giving him maximum access with minimal outside objection. In fact, the court-appointed receiver, charged with overseeing Stanford's businesses while the SEC continues its investigation, said, "The structure was seemingly designed to obfuscate holdings and transfers of cash and assets."[17](Stanford's response was that the receiver is a "jerk.")[18]

Such an arrangement is the ultimate red flag. Clients believed they were buying safe bank CDs. The outrageous interest rates, much higher than other banks, should have raised alarm. But the biggest mistake was buying a Stanford CD from a Stanford salesperson deposited in a Stanford custodial institution. Insisting on separation would have saved you from victimhood.

Commingling Cons

Some scamsters lack the prestige, resources, or both to set up a custodial institution. Not everyone can start a broker-dealer or a bank—takes time, money, or partners with big pockets (an additional scam layer that's harder to pull off). But this doesn't preclude anyone from thieving. Instead, they can open a brokerage account or series of accounts—wholly under their control—and commingle client assets. Then, it's easy to withdraw at will—there's no clear delineation between what's yours, what's someone else's, and what the fraudster takes.

When you allow your money to be commingled, there's no clear delineation between what's yours, what's someone else's, and what the rat wants to steal. Insist on a separate account in your name at a third-party custodian.

This is easier for small-time scamsters—anyone can open a brokerage account—though perhaps a bit harder to convince folks you're a legit operation. But this is how many hedge funds operate! They commingle assets in a single or several accounts. Amazingly, something as simple as an Ameritrade account can be used to swindle millions. This is just what Kirk Wright did. He ran a $185 million hedge fund fraud lasting from 1996 to 2006—all through a few plain-vanilla Ameritrade accounts.[19] (He has since been convicted of, among other things, securities fraud and money laundering. And, in another dramatic turn, similar to the Match King, he hung himself in his cell in 2008.)[20]

There's nothing wrong with Ameritrade—not at all. Perfectly fine place to custody assets. The problem was Kirk Wright deposited client money in accounts he controlled. He had full access but clients had none. Even if they had gotten some form of access, because assets were commingled, they couldn't tell what was rightly theirs.

What If the Firm Goes Bankrupt?

Another reason to park your assets at a big, major name, non-connected broker-dealer or bank? You are better protected in case the firm becomes insolvent.

Note that when Lehman failed in September 2008—failed completely!—those who had securities custodied there were fine. Yes, stocks were down, market-like, but *clients still owned those securities in their portfolios*. They didn't go "poof" with Lehman. Clients simply moved securities to another custodian.

That's the beauty of owning securities in a separate account at a non-connected, major custodian—you just pick them up and deposit them elsewhere; no one can steal them. There is a complete and hard firewall between that custodial function and the rest of the firm—always. Those securities are yours, no matter what happens to the piggy bank where you've deposited them. And in the age of digital accounting, as opposed to moving physical stock certificates, it's even easier to transport your stocks should the broker-dealer fail, get wobbly, or simply not provide service you care for.

Whether it's major banks like Wells Fargo or JP Morgan Chase; major brokerages like Schwab, Fidelity, Merrill Lynch, Morgan Stanley, Smith Barney, UBS; or smaller but still substantial and publicly traded brokerage firms like Raymond James, at least the custody function leaves your assets whole and embezzle-proof.

Master Manipulators

As stated before, you're almost entirely safe from embezzlers by depositing assets in a big, third-party custodian. There are exceptions—if the decision maker is in some form of collusion with or can otherwise manipulate the custodian, whether the custodian knows it or not. This has become beyond exceedingly tough to do in the Internet age—better for you—but it still isn't completely impossible. This is why you don't just want a third-party custodian—you want a big, deep-pocketed one who can make you whole in the event your decision maker goes rogue.

It happened not too long ago. Frank Gruttadauria (mentioned briefly in my 2008 book *The Ten Roads to Riches*) allegedly stole anywhere from $40 million to $115 million from 50 clients—but it's hard to know exactly how much. He inflated account values, so clients believed when it all blew up that they lost much more.

He was an SG Cowen stock broker, then a Lehman Brothers branch manager in Cleveland. Lehman's gone now, but at the time, both were big, nationally known outfits. Gruttadauria persuaded many clients to give him discretion—so he wasn't just a custodian in his normal function as a broker, he also became the decision maker. (Nowadays, broker-dealers are reluctant to allow in-house brokers to take full discretion, but it still happens—be on alert.)

Still, Lehman was a big outfit with layers of client security. However, as branch manager, Gruttadauria had enough power to manipulate. First, he had oversight of other employees, including the branch compliance officer. Talk about conflict of interest! How likely are you to cast dispersions on the guy who decides how big your bonus is?

Second, Gruttadauria set up post boxes in his clients' names and had the real statements Lehman issued sent there. With help from his assistant (so the SEC charges), he created fake statements on official-looking Lehman letterhead and mailed those to his clients. Meanwhile, Gruttadauria was generating big losses by actively trading. The active trading generated big commissions for him and his firm—which kept his firm happy. To cover his losses—from poor management and outright stealing—he overstated account values, which kept clients docile. Clients were all too happy to "let it ride," but if one requested a distribution, Gruttadauria wrote a check out of another account—classic Ponzi-style.[21]

After Gruttadauria was finally outed by a heads-up granny who wanted online access, Cowen and Lehman together settled with the SEC and the NYSE—paying $7.5 million in fees and restitution.[22] The silver lining: Because Lehman was a big-pocketed firm, they were on the hook for what Gruttadauria stole. Very ironically, the problem comes in identifying exactly how much he stole and from whom in his giant shell game. The lawsuits continue to this day.[23]

But how does finding out your portfolio was an inflated fiction for years make you feel? Imagine a hypothetical scenario: As a client, you deposit $100,000. Statements over 15 years show big growth—you think you have maybe $800,000. Then you discover it's all been one big lie. Big Name Brokerage agrees to cover your losses. But because your broker was a thief and a liar, you never actually had the $800,000 that you believed you had, nor was it even reasonable to expect based on what the strategy purportedly was, so your settlement is for much less! No one wins.

Gruttadauria's scheme is harder to pull off in the Internet age—you can easily check account balances online directly from the custodian. And make sure you do! But no doubt, someone somewhere will figure out a way, yet it's so easy to protect yourself.

Building a Good Fence

How can you protect yourself? Insist on a good fence. If someone is making investment decisions for you, be sure he, she, or it is separate from whoever has custody of your money. That's it. Have your assets held at a major-name custodian—a major bank like Wells Fargo or Bank of America or a major brokerage firm like Schwab, Merrill Lynch, Fidelity, UBS, or the like. There are many, and all are fine and similar in terms of safety—you choose. Have someone else, non-connected, make decisions about what to buy and sell. End of embezzlement story.

No matter how big, how reputable the money manager is, if your assets are deposited in an institution—whether a bank, broker-dealer, or other depository institution—somehow connected to the decision maker, you run the risk he, she, or it will plunder. And if not the chief decision maker, then one of its employees.

Bigger Is Better

Why does the custodian have to be big with a big name? Think it through another way. Joe and Moe set out to swindle you. Joe claims to be the investment guru. He takes you to Moe who runs Moe Money Custody

Inc. as a supposed independent third-party custodian. Joe tells you because Moe is independent, your money will be safe there. You give your money to Moe, then Moe and Joe go and take your money out the back door and off to Antigua, and you can't find them or your money ever again. It isn't sufficient just to have a separate custodian from your decision maker, but to have one you're sure your decision maker can't possibly collude with. The only way to do that with surety is have the custodian be big, big name, and completely independent so the decision maker can't possibly collude to swindle.

But also insist on an account with *your* name on it. Fine, do it jointly with your spouse. Or your trust. But get your own account where you deposit your assets and no one else does—no commingling with the decision maker. No one but you (and/or your spouse) has access to these funds. When you call the custodian, you actually *want* them to put you through a little bit of a wringer, asking for key information so they know you really are "you"—Mr. or Ms. Client—who you say you are, not an impostor. This means you don't just get statements from the money manager's firm in your name—that's fine—but actual, monthly statements from the custodian too, showing assets *held in your name*.

You want an account in your name at a big-name, third-party, non-connected custodian who makes you jump through hoops a little bit to confirm you are who you say you are. That shouldn't annoy you—that should give you confidence others won't be able to get at your money.

Your decision maker can have a limited power of attorney to direct investments. This is normal. But what they absolutely cannot ever do, and what you must never let them do, is request or make distributions or shift assets in or out of the custodian. Not ever. And by setting up your own account in your name at a third-party custodian, that can't happen if you don't let it. You put the money at the custodian.

Your separate money manager or financial adviser gets the right to buy and sell stocks at that custodian for your account but has no authority to take money outside and away from the custodian (unless authorized by you). Your custodian safe keeps you from your decision maker.

Maybe this precaution sounds silly. Of course you'd only open an account in your name, right? Let's hope so. Remember Mr. Wright—he bilked $185 million. This is what Joe Forte, Nicholas Cosmo, and Martin Frankel all did. They used commingled assets in plain vanilla accounts to steal hundreds of millions.

Always a Red Flag?

Separating decision maker and custody and not commingling assets is rock-solid protection against most would-be scamsters. Unfortunately, it precludes investing in many hedge funds, venture capital, private equity investments, and other alternate investments that typically commingle assets. That might mean giving up some potential upside. Bear in mind, hedge funds, private equity, etc., aren't all upside and no downside—these vehicles can also be very risky. Just so happens they often have the additional risk inherent in commingled assets.

This doesn't mean all hedge fund managers are bad or intend to steal. Not at all. I know they don't. But if they really care about clients, they should protect them. Note: Many hedge funds could park assets in a non-connected custodian and not commingle. And some do—this is almost always safer for clients. There are reasons some don't. The entities they invest in will find the accounting costs of tracking all those separate accounts costly and annoying. But, if you're getting paid 2 percent a year and 20 percent of the profits as most hedge funds are, there is plenty of profit to cover these accounting costs.

In some cases, hedge fund managers want to buy securities that are tough to buy with smaller pools of assets or aren't easily accessible to individual investors through a plain-vanilla brokerage fund—like commodities, futures, or some derivatives. Fair enough. As long as you undertake rigorous due diligence this may be an appropriate risk worth taking. Up to you. But you need to know you still have a risk.

What about mutual funds? Say you have an account at Nationally Known Broker-Dealer, and the salesperson pitches Nationally Known brand mutual fund. Isn't that a decision-maker in direct contact with the assets? Maybe, but usually not—but always, *always* check. Most, if not all, of the larger mutual funds deposit client assets in a completely separate bank or trust company. Why? They wisely want to mitigate any potential conflicts of interest. You can see that clearly delineated in the mutual fund's prospectus. (A separate question is whether that salesperson receives a larger fee for selling the "house" mutual fund, and if that's a conflict of interest—but that's a topic for another book and isn't an embezzlement issue.)

Further Reading

There aren't books on all the rats (and alleged ones) we've mentioned, but for further reading on some of history's most notorious, try these.

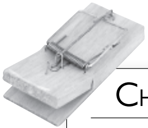
Meet the Embezzlers

- *Ponzi's Scheme: The True Story of a Financial Legend* by Mitchell Zuckoff (Random House 2006).
- *Ponzi: The Incredible True Story of the King of Financial Cons* by Donald Dunn (Broadway 2004).
- *Vesco: From Wall Street to Castro's Cuba The Rise, Fall, and Exile of the King of White Collar Crime* by Arthur Herzog (IUniverse 2003).
- *The Match King: Ivar Kreuger, The Financial Genius Behind a Century of Wall Street Scandals* by Frank Partnoy (Public Affairs 2009).
- *Kreuger's Billion Dollar Bubble* by Earl Sparling (1932).
- *The Pretender: How Martin Frankel Fooled the Financial World and Led the Feds on One of the Most Publicized Manhunts in History* by Ellen Pollock (Free Press 2002).

And if you'd like more general reading on financial fraudsters through history, these are a good start.

FRAUDSTERS THROUGH HISTORY

- *The Founding Finaglers* by Nathan Miller. This excellent 1976 book, not currently in print, can be found easily on eBay, Amazon.com, or in your favorite used bookstore.
- *Once in Golconda: A True Drama of Wall Street 1920–1938* by John Brooks (Wiley 1999).
- *The Big Con: The Story of the Confidence Man*, David Maurer (Anchor 1999).
- *The Embezzler*, Louis Auchincloss (1966). A spot-on work of fiction that's worth buying used.
- *100 Minds That Made the Market* by yours truly. That book isn't just about embezzlers, though I have a hefty section on some of history's biggest financial con artists (part of which is excerpted at the back of this book). This book walks you through 100 cameo biographies of folks who contributed hugely to America's capital markets, some for good and, like the rats, some for bad.



Chapter Recap

How Not to Be a Fraud Victim

In almost all situations, and in almost 100 percent of future scams, you can avoid having your funds "Madoff" with by *separating, entirely, your decision maker and the custody/safekeeping of your assets.*

This means you should:

- Insist your assets be deposited in a third-party, credible, large custodial institution with 24/7 Internet access.
- Insist your assets be held in a separate account in your name alone (or jointly with your spouse, or your trust).
- Never hire a discretionary money manager who holds assets at a broker-dealer he/she/it owns or controls.
- Never allow your assets to be commingled.

How can you make sure your decision maker doesn't have access? Easy. If the firm is registered, they must state whether they have custody on their Form ADV (a standard form all Registered Investment Advisors [RIAs]—which includes almost all forms of money managers and financial advisers—must file and update regularly). You can search for the ADV at www.adviserinfo.sec.gov. (More in Chapter 5.) Look for "Item 9"—you want your adviser to answer "No" to the questions relating to custody.

But if you aren't in front of a computer, here are a few key questions.

Table 1.1 Questions to Ask Your Adviser About Custody

Question	Right Answer	Red Flag Answer
Where do I deposit funds?	With your third-party, big-name, nationally known, big-pocketed custodian.	With us! With my firm's affiliate In my firm's brokerage account.
Can I give my check to you?	No. We never take custody of your assets. Please send it to your custodian.	Yes.
How are you related to this institution?	Other than depositing other client assets there, we're not associated or affiliated at all.	We ***are*** the broker-dealer. They are an affiliate.

Chapter Recap *(continued)*

Do I have online account access?	Yes, you have 24/7 online access through your custodian.	No. Yes, but only through my firm's website.
Can I contact the custodian myself?	Yes, anytime.	You can contact us.
Who sends me statements?	In addition to any account information we send you, you'll also receive normal brokerage statements, monthly, directly from your custodian.	We do.

If you must hire a money manager in some way connected to a custodian (because nothing is absolute, there can be reasons to combine the functions), make sure it's a big-name, big-pocketed firm with online access. Should your money manager go rogue, the odds of recouping losses are better with a big-pocketed firm, particularly if it's SIPC-insured. (My recommendation to RIAs is to always avoid custody—keeps life simpler. Good fences make good neighbors on both sides of the fence.)

Keep in mind, if your adviser "inflates" account values, even at a big SIPC-insured broker, they aren't necessarily responsible for restitution on the faked up amount. You could always sue for that, of course, which is why you want a big-pocketed firm. But it's pretty tough to prove you're entitled to fake portfolio returns, no matter how black-hearted the evil-doer was. To be fair, in the age of 24/7 account access, inflating account values the way Frank Gruttadauria did would be pretty tough—particularly for vigilant clients. But someone may figure out how to do it again. To be safe, keep the decision maker and assets separate—always.