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CHAPTER 1

The Face of War

In such a world of conflict, a world of victims and executioners, it is the job of thinking people, not to be on the side of the executioners.

—Albert Camus

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COST OF DEFEAT

We live in a postwar society. In human capital and monetary value, the decades-long conflict has taken a horrific toll. And as painful as it is to face, by a large and embarrassing margin, we lost.

By any measure, it was a very odd series of battles. Admittedly, our forces were not well trained or outfitted. We relied on outdated resources while our enemy effectively used the latest technology. When we captured a leader of our opponent, the punishment was often a token reprimand. Curiously, when our adversary was struggling for survival, we extended a life line. And most alarming, except for infrequent interludes, our national leadership seldom felt that our struggle was a priority. After choosing the weapons, establishing the rules of engagement, and designing the field of battle, repeatedly we were outflanked, and finally we were soundly defeated in the war against investment fraud. Well-executed evil strategy often triumphs over well-intentioned weak tactics.

Unfortunately, there has yet to be a "war to end all wars," so we must choose. We can accept the defeat and withdraw or commit to a new strategy. This book has been written for those who refuse to submit and who understand that there is really only one choice—win all wars against economic terrorism.

Our losses—"Junk Bond Crisis," "Match King Ivar Kreuger," "Billionaires' Boys Club," "Martin Frankel," "Mortgage Crisis," "Enron,"

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Canada's "Bre-X," "Bank of Credit and Commerce International," "Parmalat," "Hong Kong Accumulators," "WorldCom," "Satyam," "Tyco," and "Bernard L. Madoff Securities"—in many ways were just as destructive and embarrassing as military blunders. Financial services firms have also felt the claws of the serpent. The venerable English bank, Barings, was forced to insolvency by the fraud of a single rogue trader, Nick Leeson. It survived nearly three centuries of European wars and pestilence, but it was no match for a trader with the ability to place enormous leveraged bets on the market. Credit Suisse Bank, after unwittingly serving as the launch pad for the fraud of institutional derivative salesman Eric Butler and his co-conspirator Julian Toslov, has a badly tarnished image. There are many victims—private investors, institutions, employees of financial services firms, and even the complex Rube Goldberg contraption we refer to as the global economy. Without a change of fundamental direction, the struggle will continue to take its toll. Securities fraud is many things, but first and foremost it is democratic. Its destruction is widely distributed and shared by all.

DRAWN AND QUARTERED

There is no shortage of misinformation related to losses through investment fraud. Many unsubstantiated opinions are pronounced by Wall Street and legal commentators, but often lack quantitative insight. In general, all forms of fraud and misconduct are dependent on deception, so estimates of monetary and consequential damages from this activity are exponentially understated. Victims often nurse their wounds in private while potential victims remain largely uninformed of the all too frequent risks of investment fraud—perhaps the most underreported disease on the planet.

On a corporate level, due to the fear of loss of brand confidence and competitive concerns, fraudulent activity is often handled unofficially, off the books and out of the press, something similar to the retirement compensation of some former CEOs.[1] On an individual level, embarrassment or family considerations often cause the fraud to go unreported. Stanford University and Cornerstone Research, using data gathered from class action suits, estimate that the annual losses in the United States associated with securities fraud exceed $400 billion—approximately twice the gross domestic product (GDP) of Chile and up nearly tenfold since 1997.[2] The world's largest antifraud organization, the Association of Certified Fraud Examiners (ACFE), offered the following insight.

Fraud by its very nature, does not lend itself to being scientifically observed or measured in an accurate manner. One of the primary

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characteristics of fraud is that it is clandestine, or hidden; almost all fraud involves the attempted concealment of the crime.[3]

While the metrics of fraud are somewhat debatable, it is fair to say that on an annual basis, monetary losses due to investment misconduct and fraud are significant and in the hundreds of billions, denominated in a myriad of currencies.[4] For the fraudster, it is a richly rewarding career path. Through civil and criminal litigation, very little of those losses is recoverable.[5] Yacht brokers, luxury car distributors, antique dealers, and vacation home agents enjoy the spoils of war while the victims are drawn and quartered.

ART AND FOG OF WAR

It is a sad commentary indeed. With four centuries of historical perspective, the might of statutory privilege, and near limitless regulatory muscle, it is a disappointing defeat. We should have fared much better. Sun Tzu recognized in his *Art of War* that in battle, one must engage the enemy swiftly, drive deep into the heart of their forces, and deliver crippling blows. Our forces ignored this proven strategy and rejoiced in mediocrity by rallying around sporadic minor victories. Instead of moving swiftly, we were reticent. Rather than probing the heart of the issue, we were fringe players. And most importantly, we failed to deliver crippling blows. Occasionally, we negotiated a modest success or captured one of the leaders of the opposition. Nevertheless, these were token wins and the acts of a desperate army. While our forces were lost in the fog of war,[6] for many reasons (not the least of which included a misguided understanding of laissez-faire enterprise), our resilient enemy prevailed.

I expect many to take issue with the opinion that the nation that was once the unchallenged global financial leader actually lost the war on investment fraud. Despite their misguided confidence, it is unlikely that they would claim that we were victorious. The absence of a win against economic terrorism equates to a crushing defeat. But an even greater tragedy would be the failure to recognize our past errors and assume that the Great War on investment fraud has concluded. As Canadian Prime Minister Stephen Harper points out, this is a global conflict that ignores all arbitrary geopolitical borders. Victimization is pervasive.

These [white collar] crimes have real victims. They may not be victims of violence, but they are real victims, suffering real pain, and we should have a justice system that responds accordingly.[7]

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As it relates to the destruction caused by investment misconduct, war is much more than a metaphor. Driven by greed and deception, securities fraud inflicts a staggering toll. Cicero, certainly no stranger to war, noted that "in the face of war, the laws fall silent."[8] More wars are inevitable, and only through the recognition of our previous missteps and committing to a bold new approach will we be prepared. Despite Cicero's caution, in the face of war against investment misconduct and fraud, our securities laws can have substance and empowered advocates.

ORIGINS

Retrospectives are written by survivors and are inherently biased by subjective constraints. This book is no different. Of those whom I trained with at the outset of my career, none remain associated with financial services. Either by personal choice or through actuarial tables, in the jargon of Wall Street, they have gone *"ex-dividend."*[9] Therefore, it is appropriate to note that this book can be considered a minority perspective.

The Best of Times—The Worst of Times

Since 1980, the year Apple Computer completed its initial public offering,[10] I have been directly involved in the financial services industry, and most of that period involved management responsibilities. My career was bracketed by a Dow Jones Industrial Average (DJIA) below 800 while short-term U.S. government bonds had double-digit yields. Later I saw a DJIA rise to 14,000 and interest rates fall to less than 1 percent. Even though this book will be somewhat influenced by my career, it is not my story. Instead, it is dedicated to the many victims of securities fraud.

My "management responsibilities" encompassed a diverse range of duties, many of which were unrelated to providing financial services. Even though it was a questionable use of my time, I once calculated that I reviewed and approved 30,000 new accounts, authorized 2,000 vacations, directly managed 400+ financial brokers, organized and financed 15 holiday parties, kept an eye on roughly $20 billion in investor assets, and attended more than 3,000 meetings.

Since this book will introduce you to a number of new concepts, you might be amused by some of the "Wall Street speak" that I picked up along the way. Those 3,000 meetings introduced me to new terms that are translated for you in Exhibit 1.1.

Most of my days as a manager were much like an early-stage wildfire where only 10 percent of the inferno is contained. For me and many of my

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EXHIBIT 1.1 "Wall Street Speak" and Translations

Wall Street Speak	*Translation*
"Win Win"	"We'll do okay, but we aren't sure about anyone else."
"Commoditized"	"Our competition has caught on and the spreads are narrowing."
"We Like This Space"	"I need to tell someone that I have an MBA."
"Outside the Box"	"We have no clue as to what might happen."
"Window of Opportunity"	"We have discovered someone weaker than us."
"Leveraged Transaction"	"We are going to light this fuse, so you continue to write checks."

fellow managers, most days were chaotic and most nights were restless. It was a challenging career when investors refused to invest in an 800 DJIA with the response that their palm reader observed that the stars were out of alignment.

Recently, with the hope that others may benefit from my experience, I have directed my attention to documenting the world of investment misconduct and fraud, none of it based on the counsel of a clairvoyant. In the overused jargon of Wall Street, I "leveraged" (see Exhibit 1.1) my training and experience. Even though it has been an exciting personal transition, in many ways it is also disturbing. In retrospect, based on my current perspective, I realize that my industry was often a Petri dish for cultivating circus acts. Each day as I entered the big top, I was either the ringmaster or the fellow who cleaned up after the pachyderms. It was a theater of bizarre behavior with a cast of pros and amateurs. I had a hint of it then, but now I am thoroughly convinced that my experience was the Wall Street version of the Charles Dickens observation in *A Tale of Two Cities*:

> *It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to heaven, we were all going direct the other way.*

In light of recent events, many might challenge the "age of wisdom" aspect of this journey, yet there was an interesting synchronicity to my experience.[11] Amid the maddening events, I was fortunate to be mentored

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by both brilliant investment statesmen and hardworking financial journeymen. For many reasons, they were heroic. I wanted to be just like them, gain the respect of my clients, have a long career, and train the next generation of respected advisers. Many had stepped into their careers after serving in World War II. Like one of my greatest friends, Mr. Frank Paddy, diligently caring for his clients' assets well into his 80s, they were disciplined, dedicated, and always seemed to know how to do the right thing. Mr. Paddy, and others like him, made working with the idiots and egomaniacs bearable.

Lords of Chaos

Through media outlets, we are often introduced to rogue firms, rogue brokers, and rogue products. After all, with 1 million individuals licensed to sell some form of investments, there is abundant mischief.[12] Our sources in the media tell us how these wrongdoers decorate their corporate offices, report on the names of their yachts, and expose us to the complexities of financial strategies that rival the *Da Vinci Code*. We become one with the chaos and the Lords directing this evil empire. At least that is what the sound bites lead us to believe. Behind the hyperbole and sensationalism, we seldom discuss the millions of financial services staff and professionals who actually serve a valuable purpose in their craft. Even though I realize that there are many hardworking and effective Wall Street professionals, as you might have guessed, this book is less about the aircraft mechanic and more about the horrific crash.

While I muddled through my fair share of Dickens' darkness, incredulity, and times of insanity, my lasting memories will be those associated with my heroes and teachers. Even though I sense that they would have grimaced at many of the recent developments in financial services, they would also appreciate this modest attempt to set things right.

In the spirit of full disclosure, when comparing the past with the present, all things are certainly not equal. Admittedly, many of the challenges of years past were stormy while current issues often reach tsunami levels. For example, as recently as the early 1980s firms were concerned that the back office operations systems could not manage a 50 million share day on the New York Stock Exchange. Currently, we have 1 to 3 billion share trading days. Additionally, the financial ante has been raised. As recently as the mid-1980s it was common practice to have individual investors place odd-lot (less than 100 shares) orders for stocks. In modern terms, the concept of a round lot is arguably 1,000 shares for individuals and 10,000 shares for institutional accounts. The stakes are high, and thus goes the opportunity for the committed fraudster.

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Predictably Controversial

Despite the staggering impact of several recent cases, securities fraud was not spontaneously created in 2008. It has a long-standing reputation for destruction on both Wall Street and Main Street. It has an enormous footprint, impossible to ignore. The misconduct is as common in Manhattan as it is in Madrid, and just as destructive in Minneapolis as in Melbourne. As devastating as any of these recent events were to thousands of investors and the reputation of the global financial markets, they were at their core another series of benchmarks in a long-running pattern of global economic terrorism. Throughout this book, I will demonstrate that the events of late 2008 and early 2009 were both predictable and thus preventable—a predictably controversial opinion.[13] But instead of laying the blame for neglecting red flags at the feet of the most convenient government agency or enforcement professional, another theory will be offered that tracks the responsibility to a more logical origin.[14] Additionally, even though these recent events are of extraordinary importance, this book will attempt to be forward thinking and not entirely retrospective.

Conventions for Prevention

Rather than focusing on "characters," to a large extent I will focus on the "characteristics" of securities fraud. While we will examine the personality and methods of several colorful fraudsters, more can be learned from enduring trends than from the acts of any single individual. This entails some basic ground rules:

- Know the definitions and descriptors.
- Know the perspectives and products.
- Know the rules and resources.

Even though it is an ambitious objective, it is my hope that at the conclusion of this effort, private investors, institutions, policy makers, and regulatory officials will be better equipped to detect, prevent, and prosecute investment fraud. In other words, I hope to reduce the number of victims. We can accomplish this by learning how we lost the first round of battles, so our past is not a prologue for the future. But the task is daunting.

The Moderately Trained Advising the Moderately Informed

To put the challenge in perspective, after nearly three decades in senior management roles on Wall Street, during my career I had less required

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training in securities fraud than anyone who finishes this book. Nevertheless, my licenses technically permitted me to oversee billions in client assets. The Financial Industry Regulatory Association (FINRA)[15] conducted an investment literacy study that found that 65 percent of investors had inadequate knowledge.[16] The study's other conclusions are even more troublesome:

- 69 percent of those surveyed considered themselves somewhat knowledgeable.
- 21 percent did not understand the concept of a stock.
- 29 percent did not understand the concept of a bond.
- 49 percent failed to understand the concept of a "junk bond."
- 79 percent failed to identify or understand a no-load mutual fund.
- 69 percent of those surveyed either did not know if they were insured or believed that they were insured against losses in the stock market.

In other words, it can be effectively argued that in most cases the modestly trained are supervising the assets of the modestly informed—not a promising situation.

Non Sequitur

Early in my career, I developed a reputation for getting an errant brokerage operation back on track—in other words, cleaning up a mess that someone else had created. That often entailed more gore than glory, but I learned a lot from the gore. It was clear to me that sustainability was a foremost consideration for any career or enterprise, and critical to this was avoiding the errors of others. Yet, in financial services, professional skills development was sometimes another way of discussing sales and marketing initiatives. For some, incremental growth in revenues healed all wounds. There never seemed to be a sufficient budget for full-fledged management training. Firms might have reasoned that it was less expensive to write a settlement check or rebuild a dysfunctional business unit than it was to institute a comprehensive training regimen. I encourage each investor to browse their investment firm's web site. Do you see any mention of specialized training to meet the ever-evolving needs of its clients? In my experience, no training equates to no commitment.

With the rapid pace of expansion in financial services that began in the late 1970s, firms failed to keep pace with the professional development

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of their managers. Satyajit Das's well-documented text on the world of derivatives, *Traders, Guns & Money*, says it well:

> *The problem is that ability to trade or sell does not automatically translate into managerial excellence, and perfectly competent traders and salespeople accept managerial roles that they are not suited to. They can't refuse the promotion as they fear working for someone they can't stand. A management role is the only means of preserving your fiefdom. You hate your new job, you feel insecure in it, you surround yourself with cronies to protect yourself. The feudal kingdoms are perpetuated.*[17]

My situation was unique. I had no interest in a feudal kingdom, but I was very fascinated by the life of a Wall Street gladiator. Tackling the challenges and risks of a runaway brokerage operation was curiously invigorating. Luckily, I had been raised in a household of strategic risk takers and investors. We were farmers, so cleaning up a mess was a common occurrence.

Flawed Logic

The financial services industry has the dangerous philosophy of inbreeding of supervisors. Just as in the animal kingdom, the herd's DNA needs diversification. But Wall Street training has failed to appreciate animal husbandry. The logic is that since an individual is successful in sales and marketing, he or she will be effective in leading others who focus on sales and marketing. As Nassim Taleb points out, this is a fatally flawed premise:

> *My major hobby is teasing people who take themselves and the quality of their knowledge too seriously and those who don't have the courage to sometimes say: I don't know.*
>
> *Banks hire dull people and train them to be even more dull. . . . Once again, recall the story of banks hiding explosive risks in their portfolios. It is not a good idea to trust corporations with matters such as rare events because the performance of these executives is not observable on a short-term basis, and they will game the system by showing good performance so they can get their yearly bonus.*[18]

In Logic 101, the Wall Street theory of "successful sales equates to successful supervision" is known as a non sequitur; it simply does not follow. In financial services a non sequitur is the recipe for a disaster. Many

supervisors trained in the 1980s and 1990s, and likely to this day, have modest pre-brokerage business experience. Most had never met a payroll, took the risk of a start up business, or in extreme cases never had an investment portfolio. In some instances, the extent of their business acumen was limited to a low-balance checking account. While there are exceptions to this observation, in many states professional barbers are required to have more practical experience than financial services supervisors. The military concept of "earning one's stripes" was completely ignored by an industry growing at a meteoric rate. In Chapter 8 we will take a closer look at the supervisory structure in financial services and how it has often fallen short in detecting misconduct.

HUMAN CAPITAL

The global financial network consists of the transition of a variety of assets among a wide assortment of owners. Done legally and absent misconduct, it is a cornerstone of our economic fabric. However, if this exchange is based on greed and deception, it is fraud. Regardless of the device, legitimate or fraudulent, at the heart of the process is a critical element, human capital.

Ordinary People Performing Extraordinary Deeds

For centuries, when enterprise value was first packaged (or securitized in the form of investment securities) and exchanged in the form of stocks, bonds, and futures contracts, there have been repeated examples of effective fraudulent intent and devices.[19] Yet, this begs the question, "If aware, why not forewarned"? After all, at the most granular level, investment fraud is not altogether artful. If the task is to simply lie, grab, and run, little finesse is required. Fraudsters who might be classified as exceptionally bright could fit into a mid-size canoe, while the rest of the not-so-bright club could fill a mid-size ocean liner. However, that is not to underestimate the power of resourcefulness and single-minded dedication of those who commit fraudulent acts. I refer to this as *myoptical singularis*, laser-sharp focus on a single issue.[20]

No doubt, my "not altogether artful" and "not so bright" representations are strongly worded and beg for examples. In my opinion, even though he was never convicted of securities fraud, Robert Vesco was a very bright fraudster. In Chapter 5, I will describe his intriguing career, but at this point it should be noted that he demonstrated the enduring ability to strategize on a multidimensional basis. He targeted the assets of an international mutual fund but realized that the path to these riches was not a straight line. Vesco

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was unrelenting in his pursuits, a poster child for greed and deception. He was dripping with *myoptical singularis*.

It may surprise many that while I would describe Bernard L. Madoff as incredibly manipulative and singularly charismatic, in terms of creative ability, he was less than astute. In Chapter 5, when we explore the topic of a securities fraud psychopath (SFP), the profile of the financial criminal will come into focus. At this point we can all agree that his well-documented global monetary damages top the charts. If investment fraudsters sponsored a talent show, Madoff would surely be their version of *American Idol*. Through his guile and bravado, over several decades he managed to misappropriate billions. In the Hopi culture, he would be Kokopelli, the god of the tricksters. Madoff described his crimes as "all just one big lie." I would go one step further and offer a subtitle, "All Just One Big Lie: Actually, That's Also a Lie—It Was More Than Just One!" The core of his operation relied upon a highly orchestrated system of bogus account statements, fabricated asset values, and near-perfect market conditions. For decades, the system was bulletproof.

Despite the vast damage, his actions were not subtle, more like a street brawl than pugilism. It was only a matter of time before his bluff was called. It is obvious from the Securities and Exchange Commission (SEC) Inspector General's Report on Madoff's operations that he was no more than a two-minute phone call away from being discovered. Certainly, this raises the challenge, "If he wasn't so smart, how did he get by with his massive fraud for decades?" The answer has two elements. For many of those who profited from his deeds, his methods were never challenged. They were well compensated for their silence through hush money. They cashed the enormous checks and kept their mouths shut. And for those who were charged with monitoring his actions, he was the smartest guy in the room.

In many respects, I consider Madoff fortunate. In China, business fraud can be classified as "a crime against the state" and is punishable by death. No one has yet to propose that a new form of ping pong diplomacy would be the transfer of those convicted of securities fraud in the United States to China for sentencing. However, with pending reforms being discussed, all options are on the table. There is also a thoroughly grotesque case of a Minnesota broker who defrauded several members of his local Russian community and when detected was promptly processed through a sausage grinder. This grisly story should be required reading for every financial consultant.[21]

Fraudster—Not the Typical Job Applicant

Despite the maelstrom of criticism targeting regulatory and enforcement agencies charged with the supervision of fraudsters such as Bernard Madoff,

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before rushing to judgment, there are many more issues to consider. While investigative officers are often involved in several concurrent cases, a securities fraudster can dedicate inordinate energy and resources to their ultimate goal—maximizing their *myoptical singularis*. Lacking the specialized skills and access to capital or influential patrons, many fraudsters have less than promising career opportunities. By their past deeds or current demons, their career options may be limited.

For those who choose this lifestyle, every waking moment can be dedicated to the illegal change of the ownership of assets—theft. They are driven to achieve their single-minded goal and often they are desperate in their methods. Their logic or rationalization is that somebody will be a victim, and they refuse to accept the notion that they will be cast in that role. Typically nimble and intense, they are very important to this story.

Heroes and Villains

Once again, breaking with tradition, this book will not simply showcase the central characters of securities fraud as neatly categorized "heroes" or "villains."[22] In fact, you will find that the line between the two extremes is often blurred or a moving target. All too often, investment fraud has been packaged into sound bites for around-the-clock business reporting and not for useful insight. While investing your time in better understanding the nature of investment fraud and its victims, in this and other accounts, ask if you are being offered what you need or what someone else wants you to know. It is an important distinction that I will respect.

New Notions for Old Issues

Another important goal of this text is to encourage the reader to challenge many assumptions related to investment misconduct. In doing so, you will become both informed and incensed. I will also attempt to bridge the artificially crafted abyss between private investors and the institutional market. If I achieve my objective, the following pages are just as valuable for Mr. and Ms. Investor as they are for Investor Incorporated. To reengineer a Washington catch phrase, there should be "no investor left behind."

Fair warning: During this process, you are likely to run an emotional gauntlet; one consisting of anger, intellectual curiosity, bewilderment, humor, uncompromising disbelief, and most importantly, total discomfort. If that is the result of this work, then much has been achieved. Reversing the trend of decades of neglect and misinformation can be unsettling, but by any measure, a worthy goal. Attempts to simplify complex issues and the creation of artificial bottom lines linked to dated theories have created an

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atmosphere of analytical dishonesty and regulatory inefficiencies. These are less than effective resources for waging a successful campaign against investment misconduct. So we are going to take a very different path. Sun Tzu provided valuable guidance. Drive deep into the heart of the enemy.

A Collarless World

As you will soon discover, you are about to enter a “collarless” world where the classic definitions of “blue-collar” violent crime and “white-collar” nonviolent acts must be reconsidered and possibly revised. Breaking with tradition, white collar crime can indeed be violent and blue collar crime can be a funding mechanism for large scale acts of economic terrorism. And the collarless, t-shirt-clad computer programmer in Budapest has an important role in our story.

Additionally, the essence of this narrative is not captured on 8.5 × 11 inch, two-dimensional paper. I maintain that the world of securities fraud is multidimensional, memorialized on 8.5 × 11 inch × .02 mm stock. Cressey’s widely accepted two-dimensional fraud triangle, I also contend, must be expanded to three dimensions. In fact, the three insightful elements attributed to Cressey’s model, particularly as they relate to securities fraud, are overshadowed by a fourth attribute, a self-appointed sense of entitlement (as shown in Exhibit 1.2).

While I recognize the importance of the groundbreaking work of the pioneers who attempted to make sense of the motivations, misconduct and minds of the fraudster, I believe that they would be the first to suggest that new challenges demand fresh and innovative dialogue.[23] Despite this important mandate, it is reckless to challenge respected theories without a thorough analysis of the topic. Thus, I plan to offer you concepts consistent with an underlying theme of this book, the anatomy of greed and deception—anatomically explicit, but hopefully much more.

The limited scope of this effort does not permit a subatomic perspective, but I trust that at least we will be able to accurately chart the DNA of securities fraud. With DNA chart in hand, exciting accomplishments are possible. Be assured that I am cognizant of the inherent danger in being too graphic and thus producing a “How To” guide for fraudsters. In other words, since I want to avoid tutoring the fraudster, I will discuss the exotic ingredients and the dining experience without providing recipes.

No doubt, much of what you are about to read will have its well-reasoned detractors. Just a few years ago, I would have likely been an agent for *status quo*. My opinion was partially based on the theory that few policy makers understood the financial services industry—an opinion, as it relates to policy makers, that I still maintain. However, after digging around in

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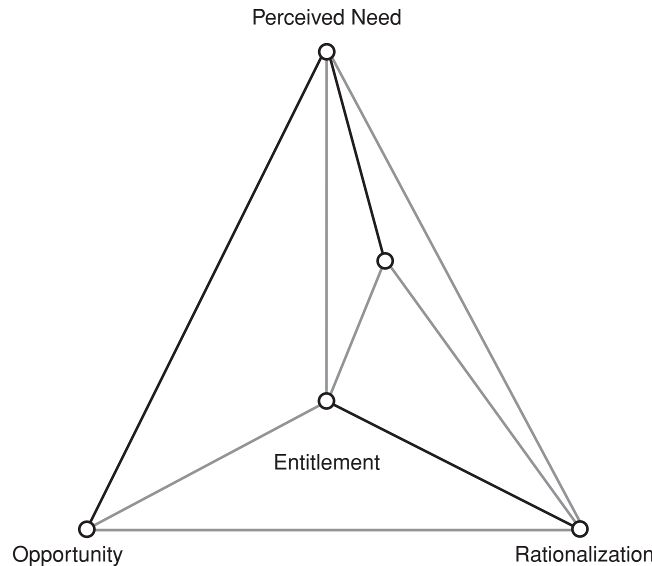

EXHIBIT 1.2 The Fraud Triangle—Reconsidered

the dark caverns of investment misconduct and fraud, I realize that the evolutionary process of reform and self-regulatory custodianship has failed miserably.

Greed and deception, for the most part, are winning. At this stage, they have few worthy challengers so they remain unchecked in their growth. By the modest acceptance that there is a chance, as remote as it may seem, that this trend can be reversed, progress is possible. Nevertheless, progress often rides on the shoulders of controversy and unsettling opinions. With that sobering premise, our journey begins.

Definitions: Securities, Investment, Fraud

As odd as it may seem, even though I had extensive training and professional licenses during my thirty year career in financial services, the differences between an "investment" and a "security" were never explained to me. To make matters worse, the financial services industry never quite figured out what their professionals did and what they should be called.[24] In other words, the financial services industry struggles with an undefined goal championed by undefined professionals. We will explore this topic later and demonstrate how indistinct titles and corporate directives can contribute to

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confusion and misconduct. The quirky characteristics of investments and securities are more than a subtle use of jargon or convention.

In general, almost all securities are investments but not all investments are securities. For example, common stock in Dell Computer is a security and an investment. However, if I were to open a Dell kiosk at my local airport, that would be an investment through a franchise agreement and not a security. Seems simple enough, but there is more to the story. If there is an allegation of fraud, then the distinction between the two is not as well defined. For the purposes of this book, we will focus on securities fraud but do so with the understanding that generally speaking when there are allegations of fraudulent activity, the securities statutes and regulations apply to investments and recognized securities. For example, in recent years, viatical[25] contracts are often associated with securities fraud. By structure, these contracts are investments and generally fall under the jurisdiction of individual states. However, many of these contracts were marketed as securitized investments[26] through FINRA registered securities representatives. Investigative and enforcement actions associated with viatical contracts focused on securities fraud as opposed to the less serious world of investment misconduct. At this point, that may be less than clear but it will sort itself out as we move forward. For foundation purposes, and as working definitions throughout this book, the following will serve as practical definitions and examples:

Investment: Participation in an enterprise that infers a long-term goal of profit. The investment may permit or require personal efforts and is often represented by a contract or legal agreement. Franchise ownership is an example.

Security: Typically involves the ownership of an equity (such as a stock), creditor status (such as ownership of a bond), or a future right (such as an option or futures contract). A security has no implicit profile as a long-term investment or a short-term speculation. Ownership of common stock is an example of a security.

With the adjectives out of the way, that brings us around to the noun, the sinister part of the issue—fraud. In civil and criminal statutes there are complex definitions of fraud. The securities approach is similar. For the most part, Rule 10(b)-5 of the 1934 Securities Exchange Act spells things out, but certainly not succinctly. As with the adjectives, our approach will be to establish a working definition of fraud which will consist of something practical that will cover most issues. In Chapter 4 there will be a detailed discussion of the statutory and regulatory foundation for a

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more technical definition of fraud, but at this stage a general understanding should suffice.

Fraud: The intentional misrepresentation or omission of material information with the intent to induce someone to act against their best interests; or in some cases, actions related to the theft or attempted theft of property.

By linking our adjective to our noun, we have a working definition.

Securities Fraud: Generally speaking, it is the intentional use or attempt to use securities (stocks, bonds, or future rights) through omission of material facts, or misrepresentations for the purpose of inducing someone to act in a manner that is not in their best interest. Even though it is not always the case, securities fraud usually entails monetary damages.[27]

Bad Advice, Bad Luck, Bad Service—But Not Fraud

Under the broadly defined category of securities fraud, there are subcategories of specialized areas such as; accounting fraud, stock manipulation, reporting fraud, insider trading, misappropriation, and various forms of money laundering. But to complicate matters, securities regulation often lacks a unified field theory. For example, manipulation is central to stock and bond fraud, while the issue is far less troublesome for the futures markets. Much to the surprise of many, the futures markets depend on trading contracts based on your unique (many times nonpublic) understanding of underlying dynamics.

A simple comparison will illustrate this point. Under securities regulations and federal law, it is fraudulent to take advantage of nonpublic information such as a decline in theme park revenues, by trading a security such as Walt Disney. However, if you are a large grain processor such as ConAgra, knowing that your distributor demand for soybean oil is softening, it is perfectly within your rights to take advantage of that proprietary knowledge. While there are several forms of fraudulent activity that fall under securities fraud, there are some misconceptions that should be clarified.

Bad advice, even very bad advice, is not securities fraud. If all material[28] facts are disclosed to an investor, even when the strategy is flawed and causes massive monetary damages, it does not necessarily rise to the level of fraud. Financial consults must listen to your objectives, and risk tolerance but they are not required to be insightful. For example, if an adviser were to suggest that the technology sector is oversold and is likely to recover, even if this

opinion is less than well founded and the investor suffered monetary damages by acting on this recommendation, the adviser did not commit securities fraud. But when we add the act of deliberate deception to the story we have very different results. Take the very same recommendation with the knowledge that the adviser concealed the fact from his or her clients that these investment recommendations were low-priced, highly speculative securities, having no objective research coverage, with most of the trading volume created by his or her firm. This description is a classic "pump and dump"[29] scheme and will be discussed later. With the addition of these new variables, the bad advice has morphed into fraudulent activity, subject to a wide range of prosecution including imprisonment, sanctions and restitution.

In the fast-paced world of securities trading, honest mistakes happen and if unintentional, do not constitute fraud. For example, if an investor places an order to purchase a specific number of shares at the limit price of $50.00 per share and receives a verbal confirmation that the trade was executed at $49.50, there could have been a reporting error that results in the trade being corrected to $50.00. It should not be concluded that there was some deceptive act that permitted the firm to intercept the more profitable trade. It was often my experience that in a fast market, reporting errors occur.[30] On some occasions I would use a process that requested "time and sales" and I would match the sales to the time of my order entry. Had I found an error by an exchange floor trader or specialist, I could have disputed the "fill" and made the investor whole. However, that was seldom the case. I found exchange trading to be an efficient process.

Even though a nuisance, operational and administrative errors or miscommunications occur and should not be interpreted as being fraudulent. An example that was commonplace prior to having securities issued and transferred in electronic format was lost, stolen, or delayed delivery of securities. The sequence would involve a client requesting delivery of physical certificates. Records may have indicated that the assigned transfer agent had initiated delivery, but the client never received the registered certificates. To some, it might be claimed that their certificates were stolen or that the purchase never took place. Operationally, there is a remedy. A lost certificate affidavit is signed, the certificates are canceled, and new certificates are issued. Prior to the 1990s, when there was a delay in the communication of lost certificate numbers to the transfer agent, there were reported instances where certificates had been stolen, quickly sold, and then cashed out under a false identity. While that is still possible, nearly instantaneous communications with transfer agents, make certificate scams far less likely.

Finally, even though there are requirements for disclosures of activity and account status, for a number of reasons that disclosure may not be received by the investor. But once again, if unintentional and not part of

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overt concealment, it is not fraud. For example, an investor is required to receive official account statements at least quarterly even if there has been no activity and more often if activity has occurred. Non-receipt of a trade confirmation or official statement is not necessarily indicative of fraudulent activity. However, as it will be discussed later, the sporadic receipt of reports, which are not official client statements,[31] is a very different matter. Bogus official statements, which have been constructed with after-the-fact transactional data, as was the case with Madoff Securities, will be discussed later at length.

Methodology

Since current cases and future developments can only be fully appreciated in the context of past events, this text will lay the foundation for a broad-based understanding of the key issues related to investment fraud. When an important new concept or challenge is introduced it will be done so with a historical perspective. Victimization is an ancient art.

An example of this is first addressing the question, "Why and how did the securitization of assets take place?" It stands to reason that without securities, securities fraud is impossible. By understanding the concept of *shared interests,* you will begin to develop a sense of the exchange of risk for consideration (money, debt, or a future right). Shared interest for securities works something like this: "OK, I'll be your friend, but it's going to cost you." With this as background, you will understand how fraudulent acts are used to manipulate the elements of this transaction. At this point, this may seem somewhat esoteric but once you get to visit the merchants of seventeenth-century Amsterdam, you will see the richness of the origins of securities.

Once a historical perspective is established, we will take a century of federal statutory mandates, and roll them into a manageable group of benchmark guidelines. As aggressive as it may sound, you will discover that acts that required hundreds of legislative pages can be summarized in a few succinct paragraphs. Even though every attempt will be made to avoid making this a legal treatise, select precedent-setting case law must be referenced.

After identifying a historical context for securitization and discovering that most securities guidelines can be understood through eleven statutes or concepts, we will explore the investigative and enforcement organizations that are charged with maintaining a fair and orderly (but not necessarily productive) financial system. You will soon learn that in our quest to examine all perspectives, there is another often overlooked responsible party in this process. Once this foundation is established, we will turn our attention to the cornerstone of understanding securities fraud—the four distinct

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categories of victims. All too often, reports of securities fraud are so vague that the allegations or charges fail to identify the most important element of the case—the alchemy of the victimization. Merely stating that someone violated a securities statute fails to personalize the damages. With financial fraud, more than laws or regulations are broken. Lives are damaged as well. Understanding the prosecutorial process is of little value to someone trying to avoid being a victim of securities fraud.

What You Need to Know versus What Someone Wants You to Know

In most cases associated with securities fraud, there are references to wire fraud and mail fraud, but with no explanation. What does that mean? What did the fraudster "wire"? What did he "mail"? Who received the "wires" and "mails"? Did I get one? Why not? How did that happen? How can I avoid this happening to me? What are the red flags? Unless selected as a lead story, most media reports of securities fraud are an exercise in third grade plot outlines. As mentioned earlier, they often focus on what the writer wants you to know rather than what you need to know. Throughout this book, I hope to demonstrate what plot content you should demand.

Dismantling Silos

The importance of the four distinct perspectives of investment fraud analysis cannot be overstated. Only with this knowledge firmly in place, will we be able to conduct our anatomical study of greed and deception. Each of the perspectives of securities fraud will first be described then forensically examined. Some illustrations will encompass well-known cases. Other examples may introduce you to new situations. I anticipate that you will find the resolution of some of the cases very puzzling and restitution uneven. I do. Unfortunately, due to the imbalance in fines and sentencing, confusion is unavoidable.

We will conclude with a very important chapter. Chapter 10 involves dismantling informational silos that are constructed to conceal fraudulent activity. While at first glance this chapter may appear to be more appropriate for fraud investigators or policy makers, the analysis is invaluable to the private investor as well, possibly more so. For all investors, the construction and management of informational silos often conceals misconduct. Essential transactional data can be deceptively pushed into hard-to-reach areas in these silos. However, there are techniques that pierce the insulated walls of these systems. You will learn many of these methods. Once you complete the chapter on identifying and dismantling silos of misconduct you may

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conclude that those 30 pages of content would have prevented many of the recent high profile cases of fraud.[32] If you draw that conclusion, you will be correct.

Magician's Curtain

Finally, you will get an opportunity to see behind the magician's curtain—a doorway leading to the source of mysteries that defy logic but are impossible to ignore. In Chapter 8, you will learn that the linchpin for securities fraud rests with the change of asset ownership. Was this change authorized? Was it fully disclosed? Was it understood by all parties? Was it appropriate? The importance of these questions will be found behind the magician's curtain and you have an "All Access" backstage pass.

For both private investors and experienced institutional investment managers, there are a number of warning signs of misconduct that should be understood and monitored. These warning signs are not intended to be a collection of obscure theories. Instead, they will be offered as a practical defense against victimization. Tempted to jump ahead and read that chapter first? That is not a wise decision since you will omit vital background information. Throughout this text, there are essential concepts that must be understood before you will be properly equipped to detect these warning signs. An example is to understand how the eastern European term *vig*, or *vigorish*, plays a critical role in the development of investor situational awareness.[33]

Before we begin our review of the background of shared interests, settlement of accounts and securitization, it is appropriate to emphasize that this text is designed to bring heightened awareness to a wide audience. From the early-stage investor to the most experienced professional, in the next few chapters there are issues to consider. At the conclusion of this work, I am confident that you will be a better informed investor or angry to the point that you decide to be an agent of change. In either case, I will have succeeded.

NOTES

1. Estimates vary, but it is generally agreed that approximately 50 percent of corporate crime goes unreported.
2. Stanford Law School—Securities Class Action Clearinghouse in Cooperation with Cornerstone Research, news release, January 3, 2008.
3. Association of Certified Fraud Examiners, 2008, *Report to the Nation on Occupational Fraud and Abuse.*

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4. One of the common errors made in the quantification of damages related to investment fraud is an approach based solely on the market decline of the subject security. For example, if a company has a market capitalization of $3 billion and files for bankruptcy, then the losses are often linked to the market value. However, I suggest expanding this damage estimate to account for consequential damages associated with terms such as "market retracement," "sector entrenchment," and "reversal of gains." These directly related losses magnify the full spectrum losses to a more representative level. Additionally, as with the Enron and WorldCom accounting scandals and fraud, the losses of community value and employee wages are very real and should be incorporated into the total impact of the fraudulent acts.
5. In a 2008 research project including 850 FINRA arbitration hearings, a source of possible recovery for investor disputes with their financial services firm, I found that monetary awards for investors averaged less than 40 percent of their initial claims. Large recoveries in excess of $250,000 were rare and an alarming high percentage received nothing. A respected study by the U.S. General Accounting Office indicated that in many cases when there is an arbitration award, the investor is unable to collect from the brokerage firm. Louis L. Straney, "Rethinking Self-Regulatory Arbitration Awards," *Public Investors Arbitration Bar Association Law Journal*, November 2008.
6. The concept of disorientation in the "fog of war" is originally attributed to the eighteenth century Prussian military historian and theorist, Carl von Clausewitz, in his treatise, *On War*.
7. Daniel Leblanc, "Tories Promise Action on White-Collar Crime," *The Globe and Mail,* August 1, 2009, www.theglobeandmail.com.
8. Marcus Tullius Cicero, "Silent enim leges inter arma," *Pro Milone*, 52 B.C.
9. *Ex-dividend* refers to the date when the value of the dividend is deducted from the market value of the security and is payable to the owner of record on that date.
10. The IPO for Apple Computer was historically significant since it marked the popular introduction of a company that broke with the American tradition of heavy industrial manufacturing. For Apple Computer, the enterprise depended on the vision of what was to be, not what had been.
11. *Synchronicity,* first formulated by Swiss psychologist Carl Gustav Jung, is defined as a subtle coherent pattern of activity based on seemingly unrelated events.
12. This total is based on registered professionals associated with the securities, futures, and insurance industries.
13. However, it should be noted that the SEC Inspector General's report on the Madoff operation highlighted a long series of regulatory inefficiencies noting that had it not been for poorly trained inspectors and jurisdictional confusion, Madoff's misdeeds should have been uncovered more than a decade earlier.
14. The government oversight of the SEC rests with the House Committee on Financial Services. A review of the Committee's web site on August 29, 2009, noted that the site's "Key Issues" section made no mention whatsoever of

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investor protection. It listed one somewhat related issue, "Financial Regulatory Reform." http://financial services.house.gov.

15. In 2007, FINRA became the successor organization to the National Association of Securities Dealers (NASD).
16. NASD Investor Literacy Research—Executive Summary, Applied Research & Consulting LLC, 2003.
17. Satyajit Das, *Traders Guns & Money: Knowns and Unknowns in the Dazzling World of Derivatives* (New York: Prentice Hall, 2006). In *House of Cards* (New York: Doubleday, 2009), author/former banker, William D. Cohan suggests that Jimmy Cayne, who as CEO of Bear Stearns presided over its demise, got his job because of his skills at bridge.
18. Nassim Taleb's personal web site, www.fooledbyrandomness.com, and his best-selling book, *The Black Swan* (written 2003–2006 and published by Random House well before the recent crisis in financial services).
19. While there is ample evidence that there were active securities exchanges in sixteenth-century Europe, an early form of shared interest and securitization was used to finance the Roman Legions. See endnote 26 for a working definition of securitization.
20. I first used this term in the ACFE self-study module on Securities Fraud, June 2009.
21. Jeffrey Taylor's *Rogue Broker: The Pru-Bache Murder* (New York: Harper Collins, 1994), describes the murder of Russian émigré Michael Prozumenshikov.
22. Researchers enjoy profiling fraudsters by such factors as ethnicity, age, gender, and other easy-to-grasp characteristics. However, the financial services industry has a well-deserved reputation for a homogeneous work force. Any profiling must consider that the data points are skewed and it stands to reason that any trend must be measured against an obvious bias.
23. The pioneering work for analyzing criminal behavior can be found in Edwin H. Sutherland and Donald Cressey, *Principles of Criminology,* 11th edition (Lanham, MD: AltaMira Press, 1992).
24. In the very early period of financial services, brokers were referred to as "customers' men." That evolved into "registered representatives." Currently, the universe of monikers has expanded to include; financial associate, account executive, financial consultant, financial adviser, and investment executive. For the most part, the only title that requires a distinct license is Registered Investment Adviser which mandates a FINRA Series-65. Commodity firms often use a simplified approach with fewer titles. Consumers are often confused by status titles such as the many iterations of Vice President. For the most part, these are marketing and sales titles that indicate revenue production and have limited correlation to training or overall product knowledge. Additionally, individuals with sales and marketing titles have no corporate signatory power.
25. Wall Street is famous for creating unique jargon, some of which will be used throughout this text. Viatical is an excellent example since it is highlighted as a misspelled word in Microsoft Spellcheck but well known to securities enforcement officials.

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26. The term *securitized* refers to an asset that has been adapted to a method of shared ownership and is represented by a security such as a stock, bond, option, or contract.
27. The difficult-to-litigate "fraud on the market" is an example of securities fraud that impacts the performance of securities but may not create easily detailed monetary damages.
28. The legal community enjoys grappling with the issue of materiality. The problem, as I see it, is that no one has ever bothered to ask the investors' opinion on what they believe to be material facts related to an investment. However, the investment community has a remedy for any dispute related to misrepresentations or omissions of material information—they often provide language in official documents and prospectuses that they maintain absolves them of liability for the things that investors believe advisers are responsible for. Obviously, for the data reflected in the NASD Literacy Study referenced in endnote 16, there is an obvious problem of investors and the industry speaking the same language.
29. Various investment schemes will be discussed in a later chapter, however it should be noted that "pump and dump" refers to the coordinated effort to run up the price of a security through tightly controlled sales to the public followed by highly orchestrated mass sales by the perpetrators. Often, the scheme is launched through bogus Internet promotions or blogs. It should also be noted that the term "scheme" has a very different connotation in the United Kingdom. There, it refers to a legitimate investment strategy, while in the United States, it is inherently derisive.
30. Trading errors often accompany relatively high exchange volume. However, as will be discussed later, while the concept of "volume" is straightforward on physical exchanges such as the NYSE, that is not the case with the over-the-counter markets such as the NASDAQ and much of the trading in derivatives.
31. Official statements typically have distinct physical characteristics, such as: They are printed on high quality stock, they often display marketing banners or service offers, they have several disclaimers including the directive that all errors should be immediately reported, and official statements are mailed from the corporate headquarters and arrive on a regular schedule usually on the same day of each month.
32. The SEC Inspector General's report on the Madoff investigation used the term "siloed" in describing their unsuccessful investigations.
33. One of the advantages of any lengthy professional career is a large collection of metaphors and analogies. I am very drawn to the term *situational awareness,* which is used by most pilots. As it relates to investments, situational awareness has an interesting implication, "know what's unnecessarily risky, and avoid it"—in either case, it is essential to land safely.