Q&A: How To Spot The Next Bernie Madoff

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L. Burke Files

The recent raft of Ponzi schemes may seem like a new sort of epidemic to the investors they victimize and the regulators they all too frequently skirt. To **L. Burke Files**, it's just another day at the office.

As practice leader for due diligence and asset location investigations at New York-based investigative and protective services firm The Lubrinco Group, Files has seen frauds from the very small to the very large. And he has successfully steered clients away from such high-profile hedge fund frauds as those led by Bernard Madoff and R. Allen Stanford.

In addition to dealing with investment fraud, Files is also a specialist on intellectual property investigations. And, he tells *FINalternatives*, there are ways to avoid situations like those currently facing Goldman Sachs and Citadel Investment Group before it's too late.

FINalternatives: *It seems that every week a new Ponzi scheme is uncovered. Is that the most common kind of fraud you're seeing or are Ponzi schemes just the most high-profile? Is there anything new about these particular frauds?*

Files: No, not really. Charles Ponzi was an amazing man. I'd love to have dinner with him. I'd just have to figure out some way to get him to pay for dinner. The crowning achievement as an investigator is to get the fraudster to buy dinner.

FINalternatives: *So what explains the recent proliferation of Ponzi schemes?*

Files: There are five or six ways a hedge fund fails. One is, quite frankly, that the managers don't understand the risk of positions they're taking. The quantitative method using Bayesian mathematics to analyze the market is a failure. Market numbers are not Bayesian for socioeconomics. It works 95% of the time, but when it doesn't work, it doesn't work really bad. That's one problem that certainly has surfaced again and again.

The second is investment drift. They set up trading peaches. The next thing you know they're slipping into apricots and plums and then you never know. And they're saying, "Those are peaches, aren't they?" That, quite frankly, is a failure both of the manager and the administrator.

Third are the conflicts of interest between manager, administrator and custodian. There's nothing there; the good old boy, good old girl, good old whatever network. They say, "Well, he's a good boy. He's not gonna do anything bad."

***FINalternatives:** What about the banks?*

Files: There were a lot of fund managers that I know, both domestic and international, that were running really boring portfolios. They were making 8% on the hedged portfolios with $100 million in and they borrowed $500 million. So let's say they're making about $48 million minus the cost of the money, $20 million, so making 38% gross before fees. All of a sudden, the lending institutions go, "We need our money back, we've gotta pay for all the bad loans." And now you have a hedge fund that's making 8%.

***FINalternatives:** Then what?*

Files: The first person we lie to is ourselves. We lie to ourselves in a couple of different ways. One of them is we've encountered something we just don't understand. I've been making 5% per quarter for my entire life. I drop 10%. So I'll just tell my clients I made 3% or 4% and I'm certain after a couple of quarters we'll be back to even and no one will know the difference. Can you see how slippery a slope that is?

I don't want to call that something evil. I call that an absolute tragedy of the individual, but what happens then in each and every one of these cases: They continue to split the funds so now new money coming in is going to pay old investors and we have a Ponzi scheme. Most of these things evolve into a Ponzi scheme; they're not set up as a Ponzi scheme.

***FINalternatives:** And the investors want to believe it's true.*

Files: We're idiots, me included, and we all want to have that secret key to wealth and riches. Take a look at how many lottery tickets are sold. You'd have more success over-insuring your uncle and sending him out to play golf in a rainstorm than with lottery tickets. That is statistically true.

***FINalternatives:** What do you make of current cross-border regulatory efforts?*

Files: There's going to be more hedge funds operating, more jurisdictions, more diverse assets in more diverse areas…Is regulation going to increase or decrease the quality of a hedge fund? And the answer is no.

Whose fault is this financial crisis? "It's the hedge funds." So the media goes, "Okay, let's look at the hedge funds."

In actuality, hedge funds did better than mutual funds on average. Hedge funds did better than the market on average. Why? Because typically—not always—the people who set up hedge funds are a little smarter and they realize that there's more opportunity out there under a hedge fund banner than under the incredibly restrictive banner of the mutual fund.

It is wonderful it is to have a heavily regulated institution, isn't it? The regulations are there to save the investor. And let's see: General Motors, Lehman Brothers, Washington Mutual, Enron, WorldCom, Global Crossings, Adelphia, K-Mart, United Air Lines and Delta, all heavily regulated businesses that the investors were saved from by the regulations.

Additional regulations, in fact, are going make it worse. The regulators are creating rules while many of the failed managers still do not understand what happened to them and what happened in the background to cause it. Increased regulation is not a substitute for the knowledge and wisdom that is required. I also have a nagging fear that the wealthy but unsophisticated investors finding themselves in this future wonderfully regulated hedge fund world will assume it is safe.

The floor is wet, so we mop it up. Soon the floor is wetter and wetter and we have to mop more often, so what do we do? We'd invent better mops.

The regulator or legislator would make wet floors illegal, when in reality, someone needs to go over to the tap and turn it off and uncork the sink. And that's often how I see the regulations promulgated.

***FINalternatives:** Is it possible that American and European regulators could eliminate*

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Guest Contributor

Hedge Funds And High-Performance Computing

By the Essvale Corporation -- High-performance computing (HPC) can be described as the use of (parallel) supercomputers and computer clusters; that is, computing systems comprising multiple (usually mass-produced) processors linked together in a single system with commercially available interconnects. More...

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the threat of having these companies flee to friendlier jurisdictions?

Files: No. Hedge funds are leaving the U.S. in buckets right now. They're not leaving because of taxes. That's what the legislators don't get. It's not a tax issue anymore. The taxes in the United States, though higher than some place, are reasonable.

They're leaving because their attorneys are saying, "There is so much regulation here in the United States and so much of it is conflicting that there is no way that you can do your business without breaking the law somewhere."

The cost of doing business is incredible in the United States. Take a look at how much the law firms make and realize that that is a tax on our productivity.

FINalternatives: *What did you see in Stanford that raised your eyebrows? What should we be looking at to avoid getting stuck in a Stanford or in a Madoff, or, more importantly, in less spectacular frauds?*

Files: First of all, throw out your due diligence checklist. There's no amount of checklists that will ever get you to understand what the risks are in an investment. And I wrote a book called Due Diligence for the Financial Professional. A new edition should be out this fall. I still hate checklists, they're a substitute for thinking.

FINalternatives: *Is it as simple as just using common sense?*

Files: Common sense isn't common. First of all, in Madoff the size of his operation was such that it was almost impossible for him to run counter-current to the market. It put him out—some ridiculous calculation someone in my office made was somewhere between 30th or 50th standard deviation of probability. About three years ago we were asked also should someone make an investment with Madoff's fund. [We said] that given what we know about markets and mathematics makes the size of his fund and his reported return incongruent with one another. That's one of my favorite words.

FINalternatives: *It's a great way of calling someone a liar.*

Files: Now for Allen Stanford—I'm sorry, Sir Allen. It was quite easy. Having watched fraud over the years and if you look back at the people with Enron or WorldCom or Adelphia or even Bernie Madoff, they all had some of these problems. Sir Allen has all of them.

One, he bought a knighthood; he's an egomaniac.

Second, he made two of the worst investments you can possibly make. He invested in an airline and he invested in sports, which I've called, time and time again, the jock-sniffer syndrome. That is a term of economic art. Jock-sniffer syndrome is one of those big red lights. Any intelligent person would not be putting their money into sports.

Third, he owned a castle. Buying a castle is an additional indicator that there's some island-bound auditor with four people in his firm that just doesn't cut it for the size he was at. Would that auditor work fine for $5 million or $10 million a month? Absolutely. Would he work for international banks and complex investments? No.

FINalternatives: *That's a big one, then. It's the same with Madoff: If your fund is claiming to manage, you know, $17 billion, make sure he's not using a one-man storefront auditing firm.*

Files: Yeah. If you're manufacturing the product, should one man be in charge of all the design, building and implementation? Of course not. There's no possible way he can understand the electrical system, the engines, braking, metallurgy, paint. It's just not there. Lots of people in the automotive business have spent 20 years studying nothing but paint.

Going back to some of the problems with the funds, in most cases it's not that the traders didn't trade. They did trade; they just didn't win. And when they didn't win, they played butt-cover with lies, stories and statements putting off recognition of losses.

FINalternatives: *That is a very diplomatic way of putting it.*

Files: Well, it's true. As an investigator, I'm supposed to be hard. Quite honestly, it's the opposite. I believe that everyone has the best intentions.

FINalternatives: *What are some of the more bizarre cases that you've come across?*

Files: A fellow had a $30 million fund that he used to do nothing but exactly what the fund was set up for, which was to gamble, was to bet on horses, to do what are called burns between different bookie operations. So when the point spread is different between two booking operations he would middle them. So he'd bet $10,000 on the Jets to win, and $10,000 on the Giants to win. If the Jets win, he makes $11,000. If the Giants win, he makes $13,000. It doesn't matter who wins. He makes it.

And he had a model that he stuck to assiduously and returned 10% to 20% per season or better. The problem was that in his private life he was a gambler. He was running the fund like an actuarial time clock, but in his private life he was such a horrific gambler and risk-taker that he ended up bankrupting himself and having to liquidate the successful fund and send it out to his investors.

***FINalternatives:** With talent hopping from firm to firm, how do the Goldman Sachs and Citadel Investment Groups of the world protect themselves from situations like the alleged Teza Technologies theft?*

Let me split the topic and let's call it intellectual property and critical information. Intellectual property is things like patents, trademarks, copyrights, trade secrets, things that have a use and an expiration. Critical information is that information you don't want your competitors to have.

We drop stuff as we go. I was having a similar conversation with a friend of mine and I was trying to describe what I do, and I said, "Okay, you come with me. We're going to go to this particular bar." And it's a bar where I know the accounting department of a particular company hangs out.

I started chatting up with them, and they say, "We're in the chair business." I say, "Gosh, your margins must be down to 7%." He said, "No, we've got about a 12% margin." So here you've approached someone who is hell-bent on being accurate. You tell them that they've got bad numbers, and he goes, "No, my numbers are good. It's 12."

What we need to do is we need to put together an intellectual property-critical information asset element list: What are our pieces of intellectual property and critical information and identify them clearly. Once they've been identified, we then can assess the threats against them. Once we've identified the threats, we can then begin protecting them and part of that goes into comprehensive employment agreements, identifying everything on the IPCI asset element list as something you cannot disclose while you work for us or when you leave.

But intellectual property and critical information is the heart of the competitive advantage we have over the companies that compete with us for customers, and in the United States we've been leaking intellectual property and critical information at such a rate: It's something like $600 billion representing 2.5% of our gross domestic product. Our response to the loss of intellectual property and critical information has been to out-innovate faster than we are losing, which is really difficult. It results in products that are rushed to market faster without thoroughly testing.

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