



Protecting Yourself from the Next Bernie Madoff

Four questions to ask your advisor, plus tools to do your own research

Bernie Madoff, mastermind of the biggest investment fraud in history after he defrauded more than 40,000 people of over \$65 billion, died at the age of 82 in prison on April 14, 2021.

Considered by many to be the archfiend of the financial world, his death will haunt the financial industry for years, despite his 150-year prison sentence that he started more than a decade ago.

Advisors Regaining Trust

The epic Ponzi scheme Madoff ran underscored a harsh reality: many folks don't understand what advisors do or much about finance.

Financial advisors must draw sharp contrasts for clients between how they operate and how Madoff did. For instance, Madoff was custodian for his clients' assets, a big red flag.

Madoff also generated his own statements for clients, which were major works of fiction. Clients need to be told that their money is with a third-party custodian, who can generate independent statements.

And it is vital for advisors to explain this contrast to gain client trust. Most importantly, advisors must lay out what a custodian does and assure clients that we don't hold or take custody of their money.

A crucial way to gain trust is to explain everything that is happening. Not every client understands how

markets work and financial matters are daunting to some.

But advisors must assure clients that investments "won't go Madoff" which is hard to do, especially if we're showing clients that they are giving up liquidity for a better opportunity.

But in today's post-Madoff era, advisors who counsel their clients about bad investments are doing both their clients and themselves a favor. Someone who buys a flaky asset that falls apart will soon be knocking on an advisor's door, begging for help.

Avoiding Another Madoff

So how do you make sure you don't run into the next Bernie Madoff? One way is to assure that your advisor does not oversee every part of your investing.

Here are four questions to ask your advisor:

1. Who is selecting my securities?
2. Who is executing my trades?
3. Who is keeping custody of my assets?
4. Who is verifying my performance?

Madoff controlled the first 3 exclusively. And for the 4th, he was able to find a small outside auditor to help him with his scam and sign off on the phony returns.

Your advisor might be selecting securities for you, but listen carefully to how they answer the next three questions.

Do Your Homework

Further, check to make sure that your advisor has no adverse actions at the Securities and Exchange Commission, the Financial Industry Regulatory Authority (FINRA), state securities departments and state insurance commissioners.

It is tedious because by some estimates, close to 5% of financial advisors will receive a client complaint in their lifetimes. For perspective, consider that the American Bar Association found that 8% of attorneys receive complaints annually. And the American Medical Association says 5% of doctors are sued each year.

For advisors, lawyers and doctors, sometimes these complaints are frivolous. But sometimes they are not.

Madoff Had a Record of Paying Fines

A little research would have told clients that Madoff paid \$15,500 in fines, stemming from a 2005 violation. Details from the Form ADV on the SEC's website are sketchy, but it appears that his firm withheld required information from the Nasdaq exchange.

A Madoff client wanting to buy or sell a stock had filed a limit order, which means that the customer wanted a specific price or better. This information is necessary for bidders to see what the market for the stock is like. And the Madoff client who bid had the right to have that order entered into the market.

Oddly, the SEC still maintained a listing for his firm, Bernard Madoff Investment Securities, even though it is defunct. If you just emerged from a coma after Bernie had been in prison for a few years, you might have thought the Madoff outfit still existed. The reason for the continued listing, according to the SEC, is legalistic. Madoff's firm needs to be registered with the agency so victims can make claims on its assets.

As a practical matter you couldn't invest with the firm if you tried because the firm is out of business and its founder was in prison for 150 years. Now, he's no longer alive.

One More Thing

It has been over 10 years since Madoff went to prison and his recent death will surely resurrect more client concerns with respect to their financial advisors.

But if any financial advisor balks at your 4 questions or doesn't want to provide you with their Form ADV, don't walk away.

Run.