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OPINION

LEADERS

The Madoff affair

Dumb money and dull diligence

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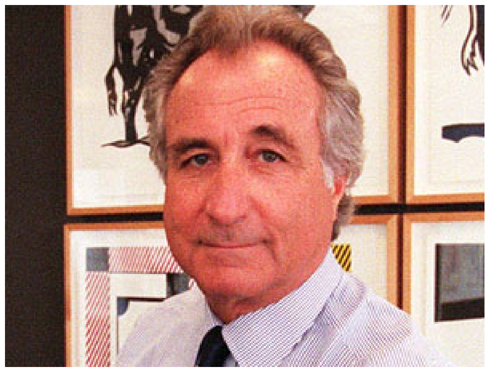
Like mould, Madoffs flourish in the darkness

eyevine New York Times



WRITING about one of the great swindles of the 1930s, J.K. Galbraith pointed to three traits of any financial community that he believed put it at risk of fraud. There was the tendency, he wrote in 1961, to confuse good manners and good tailoring with integrity and intelligence. There was the sometimes "disastrous interdependence" between the honest man and the crook. And there was the "dangerous cliché that in the financial world everything depends on confidence. One could better argue the importance of unremitting suspicion."

The case of Bernard Madoff, a New York financier who has allegedly confessed to running a pyramid scheme that destroyed up to $50 billion of his clients' money, has all three traits (see article). The former chairman of NASDAQ was as well known to insiders on Wall Street as he was in the posh Palm Beach Country Club in Florida, where he was a pillar of Jewish philanthropy. His clients were fiercely loyal; they had to be or he would cut them out of his hallowed investment circle and month-after-month returns of metronomic regularity. And he thrived in an era of cheap credit, when greed and gullibility became far more powerful than fear and suspicion.

What marks Mr Madoff's case out, however, is the calibre of investor he suckered. It is not the first time that wealthy people have been swindled out of huge sums of money, nor will it be the last. But never have so many big financial institutions—the oxymoronic "smart money"—been so bilked by an individual. It is here that investors, as well as the authorities, should tighten the thumbscrews and demand more transparency.

Oxymorons

Tragicomically, a handful of global banks that had fared well during the financial meltdown of the past 18 months are on the list of those caught out. HSBC, a British bank, Santander of Spain, and BNP Paribas of France: all bear a share of losses that add up to $33 billion, according to a Bloomberg tally. So were the suave private bankers of Switzerland and Singapore.

It is, however, the reputation of the big funds of hedge funds—some belonging to the banks, others at firms like Britain's Man Group and America's Tremont Capital Management—that have been most damaged. They charge whopping fees, say 1.5% of assets, largely on the basis of their ability to pick out clever people to manage their clients' money. Their business has flourished partly because the hedge-fund industry is so opaque: if investors could dig out more information for themselves, they would not have to pay others to penetrate the veil for them. They are also the largest investors in hedge funds, accounting for about half the investment in the industry, or $800 billion at the end of last year.

Yet for all their insights and access, some of them missed red flags billowing over Mr Madoff's business, such as the way he kept custody over his clients' accounts, handled the trades himself and employed an obscure accounting firm. They ignored warnings from lesser mortals, such as one in 2001 from *MAR/Hedge*, a diligent trade journal. They never wondered why, though the sums he managed were vast, he rarely caused a ripple in the markets. Their argument that enlightened self-interest is a reason to leave the hedge-fund industry largely unscrutinised and unregulated looks ever harder to sustain.

The investors were not the only dullards. The regulators, too, were taken for a ride. The Securities and Exchange Commission (SEC), Wall Street's regulator in chief, overlooked Mr Madoff's investment-advisory business, even though it had assets under management of $17.1 billion at the start of 2008. The outgoing head of the SEC has admitted the commission made a hash of the Madoff case, failing to act on warnings made nearly a decade ago.

Not even the best of regulators (and the SEC is not that) can be sure of stopping a determined fraudster. The authorities can, however, help investors make better judgments by requiring more disclosure from hedge funds and other high-fee asset managers. It would have been particularly useful to know how much of their clients' money they were investing in inscrutable people and illiquid assets—even if, at the time, few investors may have cared.

The industry has made a fetish of keeping its clients—and competitors—in the dark about its holdings. But the credit crunch has revealed how few original ideas most of them held. Like sheep, many of them flocked to borrow money to enhance returns, parlaying this as genius. Some also turned to money managers like Mr Madoff, where they were mercilessly fleeced. Let the light shine in.