MADOFF SCANDAL

How to Hold Money Managers Accountable

By Web Master, 1-09-09

As the list of wealthy individuals, institutions, and charities that have lost millions, even billions of dollars in the Bernard Madoff fraud case continues to grow, other investors have been asking an important question: Why was there no independent custodian holding the securities and other assets Madoff's firm was said to be investing?

In a legitimate arrangement between an individual investor and a money management firm or financial planner, the money manager may buy and sell stocks, bonds, mutual funds, and other investments on behalf of the client. These trades are often, but not always, made after consulting with the client.

But the money manager does not – in fact, experts say, should not – have access to the client's money. Rather, it is held in a separate "custodial account." Several large firms, including Charles Schwab, Fidelity Investments, and T.D. Waterhouse, provide custodial services.

Checks from the client should be made out to one of these firms, not to the planner or adviser. Every month, both the client and the adviser receive a statement from the custodial firm showing the current value of the account, as well as a list of any trades. If the client wants, he can even go online every day to check his balance. This arrangement isn't much different from if an investor made trades through Schwab or Fidelity himself; he's just giving the adviser authority to use those firms to make trades on his behalf.

The importance of independent custodians is likely to grow as more investors turn to professionals to manage their money. Many recent retirees, for instance, may have several hundred thousand dollars or more in 401(k) or 403(b) plans that they want to roll over into IRAs, and they're looking for professional money management. In general, a planner's service costs about 1 to 1.5 percent of client assets per year.

In the Madoff case, there was no independent custodian. All client statements and checks came from his office. But, as long as clients could take out money when they wanted to, they apparently didn't ask questions. Of course, this meant they didn't know that the money they were getting was coming from new investors, which made Madoff's operation a classic Ponzi scheme, and at some $50 billion, the nation's largest.

Another red flag, experts say, should have been the consistently positive returns his firm provided, even in the face of severe market turbulence. For instance, Madoff claimed an average return of more than 10 percent a year, with very little price volatility, in both up and down markets.

That may have been one reason investors didn't ask questions, says Michael Martin, a financial planner and president of Financial Advantage, a planning firm in Columbia, Md. "They may say 'I've got something here that other people don't know about, so I'll keep my mouth shut.' "

In addition, he notes, the financial business is filled with many smart people with good social skills that they use to gain the trust of potential clients. That may be fine, Martin says, but, quoting former President Ronald Reagan, he adds: "Trust, but verify."

"Madoff ingratiated himself to his community," agrees Jeanne Sullivan, a financial planner with Back Bay Financial Group in Boston. She points out that in addition to being a former chairman of Nasdaq, Madoff spent many years cultivating clients in Boston, New York, and Florida. "Many of them were people he had known for 20 or 30 years," Sullivan says. Also, she notes, Madoff would sometimes refuse to take on new clients the first time they asked, "so it increased their desire to be part of his operation." It's also been reported that if current clients asked Madoff too many questions about how he invested, he kicked them out.

But experts stress that there was no financial or legal reason why even these wealthy people and large institutions could not have insisted on having their money held by an independent custodian – except that Madoff would not have let them into his

"club."

As difficult as the Madoff case has been, avoiding this problem isn't difficult. Just ask the money manager or financial planner plenty of questions, Sullivan says. Of course, one of the first should be: Do you use an independent custodian, and do my statements and any checks come from you or the custodian? (They should come from the custodian.) "Make sure that the custodian is a well-known independent firm," such as Fidelity, Schwab, or T.D. Waterhouse, Sullivan adds. Several large banks also provide custodial services.

Other important questions to ask any financial adviser:

• Are you registered with the Securities and Exchange Commission?

• Can I see the ADV (adviser) form that you filed with the SEC? This form is also used for state registration and includes information on the adviser's education, type of business, as well as any disciplinary actions within the past 10 years. It also covers the adviser's services, fees, and investment strategies. (It's not foolproof; Madoff was registered with the SEC and had an ADV form.)

• What kind of investment returns have you provided over the past several years? While many managers do "beat the market," their returns should not be wildly out of line. Some managers have legitimately been able to lose far less than the market this year by constructing portfolios that include a fair amount of bond and money-market investments, as well as stocks. But even some of these portfolios fell 20 percent this year, while the S&P 500 is down about 40 percent. **[End of article]**