Ponzi mastermind Bernie Madoff is portrayed as the Joker on the cover of *New York* magazine

Image: Getty Images

FINANCIAL CRIMES

Behind the smoke and mirrors

By examining the most notorious financial frauds in history, what can we learn about how to better protect our money today?

BY OLIVER PICKUP

In 2009, American financier Bernie Madoff began a 150-year sentence for defrauding clients of almost $65 billion in the largest Ponzi scheme in history. In January this year, Netflix released a documentary series called *Madoff: The Monster of Wall Street*, which explored the motives and modus operandi of the 'financial serial killer'.

His atrocity ranks alongside other infamous financial crimes: the collapse of energy firm Enron; the $15 million fraud of Charles Ponzi; and American financier Allen Stanford's $7 billion operation, which was toppled the same year as Madoff.

These notorious cases captured the public imagination partly because of the extraordinary sums involved and the flagrant deception. At the heart of this fascination, though, lies the nagging question for potential investors: how can I ensure something like that never happens to me?

1. BEWARE OF YOUR EMOTIONS

Common threads run through these headline-grabbing cases, points out Paul Davies, an Oxford-based behavioural psychologist. "Criminals often create situations that excite or frighten our emotional control centre, then use mechanisms to ensure we decide before we calm down," he says.

Greed and need are weaknesses of the human condition, says Paul, and they create the perfect environment for making emotional decisions. "Greed is the 'I want more' mentality – so situations where you can double your money quickly and take advantage of some suggested loophole," he explains. "Need is the 'I need more' mentality, where people's situations are desperate and they feel justified in taking an extreme position to try and overcome their predicament.

"In the case of pyramid schemes, you'll find elements of greed and need leading people to ignore their rational control centre and take a chance on what their emotional brain is telling them."

2. FIGHT THE FEAR (OF MISSING OUT)

The explosion of cryptocurrencies has fuelled headlines in the past decade, with numerous enticing tales of investors making eye-watering sums in a short space of time. These types of stories can spark our fear of missing out, says Paul.

"When your friend is basking in their financial glory, having tripled their money in months by buying Bitcoin, it's tough to ignore the emotional pull of missing out," he says. "You start to feel stupid for not doing something when the pressure comes from people close to you, even though you don't fully understand it."

How to counteract this urge? "The only way to overcome this instinct would be to consciously attempt to become a purely rational decision-maker," Paul says. He urges investors to stop and look for other clues that could help give you a complete picture.

3. DON'T TRUST CULTISH ENTREPRENEURS

Fraudsters such as Madoff are often charming, smart and persuasive. Allen Stanford made himself a popular resident of Antigua, where his fraudulent bank was based, by investing money in infrastructure, including a hospital; he was the largest private employer on the island by the time of his arrest.

Alastair Hazell, founder of The Calculator Site among other businesses, says investors must be careful not to let such characters influence their decision-making. "It's important for investors to be aware of the potential for hype and bold claims to cloud their judgement and to be cautious of investing in companies or individuals based solely on their promises or charismatic personalities," he explains.

It was the promise of a revolutionary innovation that won Theranos, a now-defunct health firm, around $1.4 billion in funding. In November 2022, Elizabeth Holmes, the company's founder and CEO, was sentenced to 11

FOUR NOTORIOUS FINANCIAL FRAUDS

years in prison for defrauding investors after it was revealed that Theranos's blood-testing technology didn't work.

The same month she was sentenced, Sam Bankman-Fried's cryptocurrency exchange FTX was declared bankrupt. He was arrested in December 2022 and charged with fraud and money laundering.

Scott Galloway, Professor of Marketing at New York University's Leonard N Stern School of Business, argues that many influential people took the declarations of "these cultish entrepreneurs at face value".

Chris Thomas, Financial Crime Executive at St. James's Place, notes that former President Bill Clinton, among others, publicly endorsed Theranos. "These people come across as very confident and are typically charismatic," he says. "They know what they're doing is wrong, but their outward persona is compelling to many people. So you have to keep an independent mind."

4. OVERCOME THE GROUPTHINK

Sometimes it's hard to ignore the hype. And fraudsters often rely on a herd mentality, whereby people can be influenced by the majority. However, Paul advises anyone considering putting their money into a venture to look deeper and, if possible, ignore the herd.

"Sharing your thoughts with someone outside the group is an effective way to protect yourself when you feel the crowd jostling your decision," he says. "Often, simply attempting to explain your choice to a third party is enough for you to question your judgement. If you pick the right person, they may offer an alternative viewpoint that promotes greater rational thought."

In the case of FTX and Bankman-Fried, for example, there were "red flags everywhere", according to Scott. FTX was incorporated in the tax haven of the Bahamas; it had no executive board and no audited financial records. And yet, Scott argues, the richer Bankman-Fried became, the more trustworthy he seemed – a self-perpetuating cycle.

1. Bernie Madoff

3. Elizabeth Holmes

2. Enron Corporation

1. Who: Bernie Madoff

What happened: The American financier and former Chairman of the Nasdaq stock exchange infamously ran the largest Ponzi scheme in history. After his fraud was eventually uncovered, in 2009 he was sentenced to 150 years in prison, where he died, aged 82, in 2021.

2. Who: Enron Corporation

What happened: Enron Corporation, founded in 1985, was once one of the largest energy companies in the world. In the late 1990s, the firm's accountants began using complex financial transactions to hide debt and inflate profits. In 2001, the company, which held more than $60 billion in assets, filed for bankruptcy. Enron's 20,000 employees plus many investors lost significant personal savings.

3. Who: Elizabeth Holmes

What happened: In 2003, Holmes founded Theranos, claiming to have developed a new type of blood-testing technology. Some $1.4 billion was raised in funding, including venture capital and private equity, before the technology was revealed to be flawed and unreliable. Holmes and Ramesh 'Sunny' Balwani, Theranos's former President, were each found guilty of fraud.

3. Who: Sam Bankman-Fried

What happened: Sam Bankman-Fried founded cryptocurrency exchange FTX in 2019. Often dubbed a poster boy for the crypto industry, his net worth peaked at $26 billion. FTX was declared bankrupt in November 2022, owing $3.1 billion to its top 50 creditors. He has been charged with eight counts of fraud, money laundering and campaign finance offences; his trial is scheduled for October.

Images: Getty Images

How SJP protects and educates clients to reduce fraud

Gavin Welch, Deputy Money Laundering Reporting Officer, St. James's Place

Of course we want to keep clients' money safe and take steps to ensure we stay well away from Madoff-type schemes. Much of our focus is on preventing clients from losing money on particular products. We do a lot of horizon scanning, regularly reviewing relevant regulator and industry sites to identify new or incoming financial-crime-prevention regulations. Although regulation around fraud is tightening up, we're as proactive as possible.

We're always looking at new ways to communicate with our clients securely. For example, Partners are trained to verify individual clients' requests to withdraw money or change bank details. In time, we hope our clients will become less reliant on email, as phishing messages and email account takeover remain a significant threat.

Additionally, we've recently invested £1.5 million in technology to boost our financial-crime systems. We've also partnered with a third-party company to help with client validation through our app. And we work with another firm that takes down bogus websites that are trying to mimic either SJP or Partner platforms.

Due diligence is critical. We often talk about due diligence from an anti-money-laundering perspective, and this also throws into question the credibility of any potential clients. Our partners are trained to spot and flag when the circumstances don't add up for would-be clients and investment prospects. So we have a robust way of weeding these elements out.

Finally, we're increasing fraud awareness and educating clients directly via our social-media channels. And we're continually educating our Partners so that they can, in turn, guide clients.

4. Sam Bankman-Fried

5. ASK QUESTIONS – THEN ASK MORE

In *Madoff: The Monster of Wall Street*, a source says: "If people are making good returns, they know not to ask too many questions." But turning a blind eye is especially dangerous for investors.

"If something looks too good to be true, then it probably is," says SJP's Chris. "It's simple advice, but it generally works."

It's interesting to consider how the hype around and dissemination of supposedly winning investments has evolved. "Madoff's scheme was spread through word of mouth, where people shared their investment secret with friends in country clubs, golf courses and across dinner tables," says Paul. "When something comes from a trusted source, we're less likely to question it."

In a warning that investors need to remain alert, Paul says that because our "decision-making engine hasn't changed for thousands of years", there are likely to be "many more Madoffs" in future.