

## **Governance softness and financial predation: First steps in solving the problem**

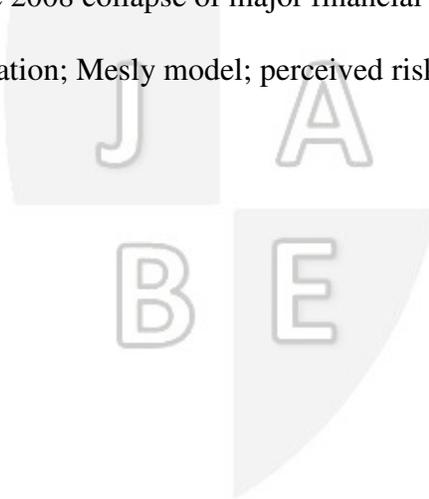
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### **ABSTRACT**

This paper posits that key financiers have a hidden financial motivation which is to maximize their own gains regardless of the harm they cause others by catching them by surprise. As such, it appears most appropriate to consider tougher regulatory measures and better controlled governance systems to minimize, if not eradicate, such predatory behaviors.

The theory of predation is anchored in the concepts of predatory pricing (first legally discussed in the Sherman Act at the turn of the 20<sup>th</sup> century) and predatory mortgages (which form the base of the 2008 collapse of major financial institutions in the USA).

Key words: perceived predation; Mesly model; perceived risk; financial predation; fraud.



## INTRODUCTION

Bernard Madoff was a political strategist of his kind, being well-connected in the higher levels of finance (NASDAQ) and education (Yeshiva University) as examples. But as it became known to the general public in 2008, he turned out to be the best of the best in terms of financial predation, having mounted a Ponzi scheme worth 50 billions of dollars in which close friends and strangers alike lost their life savings (see Gregoriou and Lhabitant, 2009).

On April 16, 2010 Goldman Sachs Group, Inc. was accused of fraud by the U.S. Securities and Exchange Commission (SEC) following its alleged involvement in so-called predatory mortgages. As soon as July 2009 Matt Taibbi had commented in the Rolling Stone magazine that Goldman Sachs, today's world largest investment bank, had been involved in most if not all major crises that had affected the US (and consequently the world) since its creation in early 1900: he cites, among others, the Great depression of 1929, the technology of the 1990's and the mortgage crises of 2008.

Prior to the 2008 meltdown of key financial institutions, predatory mortgages were guaranteed by the thousands without verifying that the borrowers could pay off their debt. Goldman Sachs created hundreds of mortgage instruments called "Collateralized Debt Obligations" (CDO) betting they wouldn't fail, but then betting the opposite later on. Laissez-faire and the willingness of companies such as AIG to accept the coverage of dubious, high-risks loans eventually led to the fall of organizations such as Lehman Brothers and to the rescue efforts of numerous financial institutions by the average American tax payer under the Paulson plan.

Soft rules do not appear to be the mere fact of politicians whose concerns were for these average tax payers. Rather, many citizens have assumed that they were put in place by people who had vested interests in diverting money from them to powerful financial institutions. After all, Goldman Sachs paid millions of dollars in bonuses to his star traders a day after it was being partly bailed out by the public. Salary and bonuses at Goldman Sachs hover over US\$ 600 millions per year.

This paper is organised as follows: section 2 describes the theory of predation (Mesly, 2009, 2010, 2010a, 2011 and 2012). Section 3 then takes a look at Mr. Madoff and the Quebec financier Vincent Lacroix to show how this theory can be put to work. Finally, section 4 concludes by pointing out avenues of research and by proposing some solutions to the problem of financial predation.

### **The theory of financial predation**

This section explains the theory of predation as put forth by the various works of Mesly (2009, 2010, 2011, and 2012). Because of its relative novelty, it is deemed appropriate to go into some of the major elements of the theory as they relate to the present paper.

## A definition

Perceived predation consists of the perception any market agent may have of another agent thinking he wants to take advantage of him to serve his own interests, thereby causing him harm (such as a financial loss), by surprise (Mesly, 2010). Market agents are considered to fall into four categories: consumers (e.g. buyers of options and company shares), producers (e.g. a bank), regulators (e.g. Security Exchange Commission – SEC, in the USA) and outsiders (e.g. those operating black and grey markets). The focus is placed on perception: it is what a market agent sees or interprets that count, not what is really happening. Perceived predation is the interactional equivalent of perceived risk which applies to goods and services.

A Montréal (Québec, Canada) financier called Vincent Lacroix was perceived as a sound businessman in a society where people have had historical disdain for money, being of strong French Catholic heritage. He did this by directly or indirectly gaining support from key financial institutions that Quebecers felt they could trust (Caisse de Dépôt et de Placement du Québec and the Caisses Desjardins, with assets in 2010 of 152 and 172 billions of dollars respectively). Bernard Madoff used exactly the same strategy: he built his reputation by working closely with the financial markets and by entertaining benevolent relationships with clients, for example by calling them up during stressful events such as death in the family so as to show support and care.

Perceived predation does not equate with opportunism (Williamson, 1975, 1981 and 1985) as this concept is based on contractual agreements; perceived predation develops in the context of trust. It is active at the interpersonal level, not the transactional level.

There is a well-known negative association between the perception of a salesperson and perceived risk (Bergeron and Laroche, 2009) so that the financier would have a keen interest in generating a positive image in order to minimize the perception of risk towards his products.

## Predation in action – the predatory web

According to the theory of predation, a predator (which can be any one of market agents) necessarily displays four features: he is sneaky, calculative, cold, and self-centered. He has an arsenal of subterfuges such as complex financial instruments aimed at cognitively confounding or else emotionally weakening his preys. He targets first and foremost his prey's weaknesses, such as a lack of understanding of financial markets.

Predation is best described by the predatory web as follows (See Figure 1 in Appendix)

The elements of this web are divided in two under the terminology used in the theory of predation: on the left are the structural variables and on the right are the functional variables. These variables are explained below<sup>1</sup>.

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<sup>1</sup> The *structural* and *functional* variables are part of the theory of predation and its methodology, called data percolation (Mesly, 2011, 2012). They are inspired by statistical modeling (formative and reflective variables). They do not refer to endogenous and exogenous variables found in structural equation modeling.

### **The structural elements of predation**

In order to conclude that there is indeed predation (from a structural point of view) five elements must be present: a predator (e.g. a financial broker); a prey (e.g. a greedy multiple-home buyer); a tool (e.g. easy mortgage access); a loss (e.g. an investment); and finally a surprise effect. In essence, the prey has been hypnotized by the various subterfuges the predator has used and has been caught by surprise. There is no predation if one or more of these five are missing. These are called structural variables (similar to formative variables in statistics; they present low co-linearity; see Jarvis, MacKenzie, and Podsakoff, 2003) by the theory of predation. Predation is composed of these five elements just like a bicycle is formed of two wheels, a seat, etc. Take away one wheel and it is no longer a bicycle. A structural variable is a sine qua non condition to the existence of the construct it forms.

### **The functional elements of predation**

The above five static components of predation must be put into action. The theory of predation recognizes that a predator performs five strategic steps. He first targets his victims' vulnerabilities. He then instils trust and encourages cooperative efforts as well as promoting a sense of win-win so the preys let their guard down. Trust can be defined as the willingness to accept to be vulnerable towards another person with the hope that he will act with positive intentions (Mayer, Davis, Schoorman, 1995, p. 712; Lewicki, McAllister and Bies, 1998). Hence, a predator's strategy is to foster blind trust (the Madoff case is a perfect example: he managed to generate blind trust, not hesitating to "borrow" from his friend of 25 years Mr. Shapiro some 250 millions of dollars prior to his downfall). He does this by choosing among a series of twelve subterfuges<sup>2</sup>, including diversion, presenting false documents, pretending to be what he is not and offering a sense of exclusivity (Madoff is again a perfect example: his clients had to pay a hefty price to have the privilege to put their money in his care). The fact that financial predators are capable of convincing their preys to the level they have shown in 2008 helps explaining the fact that nowadays 71% of current customers distrust the financial industry (Mattila, Hanks and Kim, 2010).

Thirdly, a predator encourages that a decision be taken by the prey under time constraints and information asymmetry. A prey will likely opt for a non-optimal choice so that the predator thereby gains a definite advantage. In the case of Madoff, the aura of secrecy and exclusivity he built around him helped somehow convince potential clients he was someone very special who could be trusted without investigating further on his real achievements). All predators aim for the highest point on the battle field: Madoff has been at the helm of financial institutions such as NASDAQ, which helped him experience the rules of the market in their most profound details (thus knowing its vulnerable points). The fourth strategic step is to force the preys into action (e.g. signature of a contract) whereby the preys are locked in (e.g. contractually at last assuming a mortgage too big to carry but

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<sup>2</sup> Faking, camouflage, chaos/panic, rerouting/distraction, false identity/ mask, mimicry, promess, skirting, obnubilation, screams, seduction, secrecy/exclusivity.

hard to get out of without stiff penalties). Finally, a transaction whereby a transfer of ownership or a movement of property titles is accomplished serves the benefit of the predator to the detriment of the preys, by surprise.

In order to conclude that there is predation, all structural variables must be present and at least three functional variables must be active. Functional variables, under the theory of predation, are not sine qua non conditions.

### **The predatory web in the context of financial predation**

Predatory mortgages are one example of a financial act of predation. Typically, predators want to maximize the damage on their preys by aiming for the three components that form their identity: their assets, their activity and their mobility. Financial predators, however, have a unique feature: they are only interested in their prey's assets. By opposition, a judge would go after a criminal's mobility by jailing him (mobility).

Financial predation occurs when all of the structural and at least three of the functional variables of the predatory web are proven to be present and active with a focus on the prey's assets, but not necessarily on its activities or mobility.

### **The financial predation ecosystem**

The exact mechanism of perceived predation is represented in Figure 2 in Appendix. This model, called the Mesly model, reads as follows: the financial predator does all he can to reduce the negative perception the targeted prey may have of him. He associates himself with a large financial firm, dresses properly, drives a nice car, participates in social functions and so forth. This lowers the defence mechanisms of the prey, which starts believing that the agent is trustworthy. The financial expert appears to share common interests with the prey, is benevolent, seems very capable and appears honest. Trust immediately leads to some cooperative efforts, which immediately help raising the level of trust (from suspicion towards blind trust). The predator cooperates with the prey: he adapts to the prey's needs, shares some information, helps the prey solve problems and demonstrate a high consumer-orientation. Add to this a sense of win-win and a perfect working atmosphere is created, which in turn helps annihilate any apprehensions the prey may have had initially.

To achieve this feat, the financial predator cannot act alone; unlike the sexual predator, the financial predator is always part of an ecosystem into which he is constantly trying to rise to the highest position.

Four key characteristics define the financial predator's actions: first, he only goes after his prey's assets. Second, he is an integral part of an ecosystem (he prefers to be at the helm of such close-knit network of key partners and influential people). Third, financial predators track their victims in geographical areas where they feel comfortable, unlike sexual predators who often act at random. The latter are so impulsive they'll take wild risks in operating areas they don't necessarily know well (See Eigner, 2008). Financial predators act in areas where the necessary resources are at their disposal: knowledge, connections and ability to perform. Finally, financial predators feed on complexity: to baffle their preys is a

primary tactic. Sexual predators operate differently: they target their preys and go to them as directly as possible.

### **SOME RELEVANT NORTH AMERICAN CASES**

Madoff rose from a somewhat obscure childhood in Queens (NYC) to being labelled the ultimate “crook” in the history of finance. The worst part of this was that there were plenty of warning signals that were kept aside, ignored or denied by the authorities that should have spotted his Ponzi-scheme long before it imploded (see among others Markopolos, 2005). His actions probably resulted in at least two suicides: one by his own son and one by a foreign investor. Some of the major losses incurred by corporate clients (including banks such as HSBC) vary between one and nearly eight 8 billions of dollars. While Madoff claimed he was the sole operator of his massive scheme, investigative reports eventually showed that he was actually assisted by a number of insiders and outsiders in mounting securities fraud and in creating falsified documents.

Vincent Lacroix, founder of a Québec financial company called Norbourg, was pronounced guilty in 2008 of having planned the re-routing of some 130 millions of dollars to the detriment of 9 200 private investors. The charges include fraud, recycling of criminal products and falsification of documents. He faced both civil and criminal accusations.<sup>3</sup>

Some 6 millions of dollars were spent by the financial regulators (the Autorité des marchés financiers or AMF) and another 4 millions of dollars were drained to build the criminal case against Lacroix. The structural variables of financial predation are present: 1) a predator, 2) a prey or more factually, many preys: the investors, the general public which had to foot the bill of the lawsuits and the regulators themselves who suffered by drop in the credibility; 3) a tool (falsification of documents among other mischief); 4) a loss (financial and emotional – some investors have been affected for generations: savings put aside by average investors for grand-children were promptly spent by Lacroix to nurture his lavish lifestyle); and 5) a surprise-effect (most people believe he was the emblem of financial success in Québec without raising an eyebrow on Norbourg web of companies’ seemingly exceptional performances). The only thing Lacroix was after was his client’s money (assets) and he spent most of it in a matter of less than a year. Also, he acted on a territory he knew extremely well from exposure, education and past work experience: Québec and its financial sector.

Suspicious are that Vincent Lacroix has hidden some 35 millions of dollars in two foreign banks where that money is waiting for his release from jail: one in the Cayman Island (the Butterfield Bank) and potentially another one in the Bahamas.

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<sup>3</sup> Sources : Lacroix c. Autorités des marchés financiers, 2008 QCCS 2998 (CanLII);Date: 2008-07-08  
Dossier : 500-36-004600-089; [2008] R.J.Q. 1884 • 59 C.R. (6e) 61; URL:  
<http://www.canlii.org/fr/qc/qccs/doc/2008/2008qccs2998/2008qccs2998.html>

Judge<sup>4</sup> Claude Leblond from the Cour du Québec (Québec Court) explains<sup>5</sup>: Vincent Lacroix acted in a deliberate and premeditated manner. He did so by creating or acquiring various companies, by falsifying documents thus misleading investors and the AMF (the Quebec equivalent of the SEC in the USA), by operating no less than 10 000 transactions so as to make the traceability of money nearly impossible, and by using the money for his own benefit. He then minimized the consequences of his actions, blaming the financial regulators and claiming to be a victim himself. He showed a complete lack of remorse for his actions and their consequences. In essence, Vincent Lacroix refused all responsibility for his actions while most investors face the possibility of never seeing their money again.

This mere analysis by judge Leblanc points to the four fundamental characteristics that all people perpetrating financial predation share, as identified in the theory of predation<sup>6</sup>: they are cold, calculating, selfish and sneaky. It points also to the functional variables of predation: Lacroix identified the weaknesses of his preys: 1) for the investors, their lack of knowledge of the financial market and promptness to trust blindly (much like most of Bernard Madoff's clients did); 2) for the AMF, which seemed to have relied on the fact that Lacroix had been building a reputation based on his deals with the powerful Caisse de Dépôt et de Placement du Québec and Caisses Desjardins.

Lacroix then proceeded exposed himself as a successful businessman, making sure he was seen in the trendy financial venues and living the lifestyle of well-to-be financiers, with the goal of convincing naïve investors he knew how to handle money.

Thirdly, Lacroix limited the amount of information (most notably by falsifying documents) so that investors took decisions based on a detrimental asymmetry of information. A remarkable symmetry exists between Lacroix and Madoff: both used obscure and remotely-located accounting individuals that did not fit the profile of a respectful institution matching the growth exhibited by these two financiers (Lacroix's secret accounting system was handled out of a house on the Montreal South Shore whereas his main office building was downtown Montreal, and Madoff used a two-person accounting firm based in New York)<sup>7</sup>.

Fourth, Lacroix knew those investors that became weary would be reluctant to withdraw their invested money because of the fear to loose their initial application fees (Some investors lost thousands of dollars because they did not want to forego the \$ 300 that it cost to get out of the financial plans, even though news were circulating in the Québec media of potential fraud).

Finally, Lacroix "constrained" his preys (taking away any fear they would still have) by trying to operating a seemingly well-rounded operation, giving the image of an

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<sup>4</sup> Source : Lacroix c. Autorités des marchés financiers (AMF), 2008 QCCS 2998 (CanLII) Date : 2008-07-08 File : 500-36-004600-089 [2008] R.J.Q. 1884 • 59 C.R. (6e) 61 URL : <http://www.canlii.org/fr/qc/qccs/doc/2008/2008qccs2998/2008qccs2998.html>

<sup>5</sup> Our translation.

<sup>6</sup> In fact, all predators (sexual, etc.) share these four characteristics.

<sup>7</sup> Both were subject to previous critics that were kept ignored until after their downfall: in 2001 by *Barron's*, in 2005 by Harry Markopolos (29 questions on Madoff's methods); the French business magazine *Finance et Investissement* in 2004 respectively.

articulated man. Lacroix's strategy was a not a Ponzi scheme contrary to Madoff's ingenious operations, but both men operated in remarkable similar ways, although at different levels (Lacroix at \$ 130 millions; Madoff at \$ 50 billions).

All in all, the structural variables are present and at least three functional variables are active (the theory of predation requires at least three functional variables to be active). The Norbourg case can be deemed a case of an active financial predatory web.

The theory of predation also stipulates that the researcher or investigator must be able to observe all relevant constructs, and to observe them back and forth in time (see Mesly, 2011). An observable is something that can be detected and measured, like a behavior (or a change in brain activity detected by an fMRI- magnetic resonance image for example) or an annual report. Anyone looking at Vincent Lacroix prior to his fall but not knowing what company he operated would have concluded that his lifestyle (trips with many colleagues and clients to fancy Caribbean's resorts and Europe) pertained to a very, very wealthy individual, which he was not. In other words, the present state of affairs (his lifestyle) was not in hindsight a logical consequence of his past activities: thus, this was a clear indication that some other variable had to be taken into account. That other variable was financial predation.

The theory of financial predation identifies the use of complexity as one of the main tactics used during financial acts of predation (e.g. overly complex transactions in the case of Leeson-Barings; 30000 transactions by Mr. Iguchi at Daiwa; 3000 Special Purpose Entities at Enron). As mentioned, Lacroix recorded no less than 10,000 transactions in a very short amount of time (essentially a couple of years) for a 130 millions dollars budget.

## CONCLUSION

In this paper demonstrates how the theory of predation can be used to analyse some of the American and Canadian known financiers' behaviors.

Going back to the Mesly model, it can be seen that Lacroix acted to annihilate any possible image of him being a financial predator – rather, he positioned himself as a successful businessman. He gained trust from some key financial institutions and from the average citizen investors, which led them to believe they could safely cooperate with him, notably in managing their hard-earned money. Financial reports led the investors to believe that interest earned justified their decision: they won acceptable rates of return and fairly enough, in their mind, Lacroix earned his commission. The same line of thought applied in the Madoff's case: the outstanding regularity of his returns, year after year and despite market troubles put investors at ease rather than warning them of imminent danger. This generated a business atmosphere that encouraged growth; as returns kept coming, the spending of Lacroix and his associates and that of Madoff kept going. As long as the system could be maintained, there were no reasons to activate the antennas of financial predation: perceived predation was kept at a minimum until one of Lacroix's key employees went to federal police (and Madoff's two sons did the same).

This analysis was presented for the purpose of outlying some key components of the theory of predation with the objective that corporate governance will come to consider measures to deal with financial predation. Whilst the theory of financial predation is still in its infancy, practical applications can be anticipated: to generate tougher regulations in

order to stabilize the markets and protect investors of all walks of life. It is only through a better understanding of financial predatory behaviors that the financial sector will restore its social image, damaged by the likes of Lacroix in Canada and Madoff in the USA.

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APPENDIX

Figure 1 – The predatory web

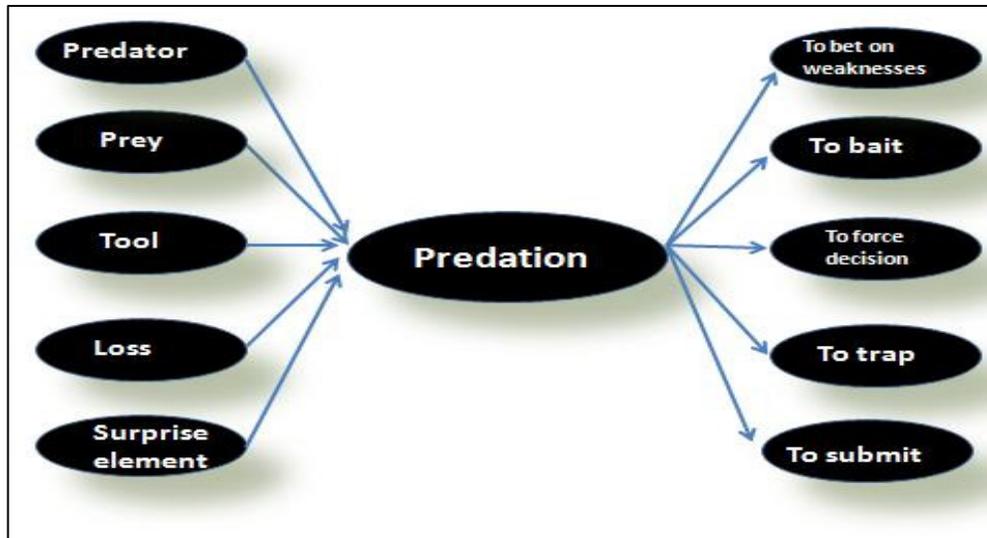
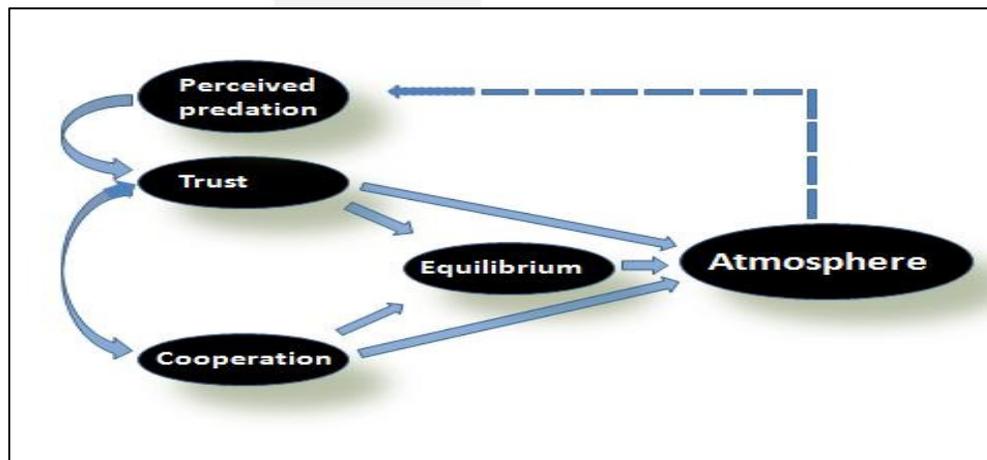


Figure 2 – Perceived predation (Mesly model)



**Author Biography**

Olivier Mesly is professor of marketing at the University of Quebec in Outaouais (Canada). He holds a post-doctorate degree from HEC Montreal, a doctorate degree in marketing from the University of Sherbrooke (completed in a record time of two and a half years with high honours), as well as an MBA and a Bachelor in East Asian studies from McGill University (with Distinction). He teaches in French, English and Spanish in various countries around the world. His main research theme is that of predation, particularly financial and marketing predation.