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Finance

PONZI SCHEME

The Case of Bernard Madoff

Ponzi scheme is an illegal fraudulent investing scam promising high rates of return with little risk to investors. The Ponzi scheme generates returns for older investors by acquiring new investors. This scam actually yields the promised returns to earlier investors, as long as there are more new investors. There is no actual profit or business going on. These schemes usually collapse on themselves when the new investments stop (Investopedia, n.d.).

This scheme is named after Charles Ponzi, who is believed to be the first one to organize such fraud in 1919 in Boston. He promised clients a 50% profit within 45 days, or 100% profit within 90 days, by buying discounted postal reply coupons in other countries. In fact, he was just using money to pay early investors from the money of latter investors. This practice is also known as "robbing Peter to pay Paul".

HOW DOES IT WORK?

As mentioned before, this investment fraud lures people, the investors, usually with an unrealistic promotion of "zero risk", "incredible returns" using "obscure secret trading strategy". Simply it all sounds too good to be true (Investopedia, n.d.). Such scheme is doomed to failure because there is no infinite amount of investors coming in or legal authorities find out and shut it down. If lucky, the head of such scheme usually runs away with all the money left.

MADOFF INVESTMENT SCANDAL

Former *NASDAQ* president of the board of directors and founder of the Wall Street firm *Bernard L. Madoff Investment Securities LLC*, **Bernard Madoff** is responsible for the biggest fraud in history which turned out to be an elaborate Ponzi scheme.

He started off in the 60s´ by setting a company with his wife called *Bernard L. Madoff Investment Securities LLC* also thanks to his father-in-law who borrowed him money. This firm grew successfully thanks to its reliable 10 % annual returns (bio, n.d.). Later, his whole family (wife, 2 sons and a daughter) were employed in this firm. The firm was known as being the hedge fund – legal investment opportunity for wealthy people. *Hedge funds* are most often set up as private investment limited partnerships that are open to a limited number of accredited investors and require a large initial minimum investment (Investopedia, n.d.).

As Madoff wealth grew, in the early stages, there were little suspicions about his firm because of the stable 10% annual returns. (Ponzi schemes usually pay 20% of returns). Anyway, it was all marketed as "too complicated for outsiders to understand" and he kept all his business secrets tightly.

In later stages, there were red flags pointing on Madoff suggesting that whatever he is doing is fraudulent and impossible such as too little losses in a quite a large time span and many more. Harry Markopolos, financial analyst at that time was given "homework" from his bosses to try to replicate the success of Madoff´s fund. Based on information he got, it was mathematically impossible to have returns as Madoff claimed. He reported his findings to the Securities and Exchange Commission (SEC). It took authorities around 7 years to start acting and finally to unravel the whole scheme. Investors started to pull out and Madoff was running out of money.

FBI arrested Madoff on December 11, 2008 on a criminal charge of securities fraud. Initially, SEC estimated this fraud to be worth between 10 and 17 billion dollars. After the family paid 10 million dollars bail, Madoff and his wife were in home prison and monitored by FBI. However, they still tried to save as much money as possible by sending jewellery to relatives by mail etc.

Finally, March 10, 2009 Madoff was accused of 11 federal crimes: securities fraud, investment adviser fraud, mail fraud, wire fraud, money laundering, false statements, perjury, making false filings with the SEC, and theft from an employee benefit plan Madoff had around 4800 investment clients that he defrauded and in total their accounts held a balance of around 65 billion dollars. Therefore this is the largest Ponzi scheme and investor fraud in history committed by a single person.

Lastly, Madoff was sentenced to 150 years of prison after admitting that he had not reinvest any money from his clients but deposited them at Chase Manhattan Bank and agreed to pay 7.2 billion dollars in damages to the clients, however the clients are still fighting to get their wealth back.

One of the reasons he was able to run such scam for so many year is that he was well respected financier and helped to establish NASDAQ and his portfolio held large stakeholders and prominent clients such as: Fairfield Greenwich Group, Tremont Capital Management, Banco Santander as well as Steven Spielberg, John Malkovich, Larry King and many others.

Sources

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