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The Madoff/Ponzi Scheme — Part 1

Thomas A. Buckhoff
For 40-plus years, Bernard L. Madoff was well respected within the Jewish and investment communities. In 1960, he launched his Wall Street firm, Bernard L. Madoff Investment Securities, and served as its chairman until 2008.

In the early '90s, he served for three years as chairman of the NASDAQ stock market. In addition, Madoff was invited to serve on a government advisory panel on stock market regulations, served on numerous charitable organization boards and started a family foundation.

Madoff’s investment firm consistently reported annual returns of 10 percent to 12 percent, even in down markets. Such amazingly consistent returns created a frenzy of demand to invest with his firm, which reportedly was valued at $65 billion.

However, on Dec. 10, 2008, Madoff confessed to his two sons that his exclusive investment fund was “one big lie.” Irving Picard, the court-appointed trustee charged with liquidating BLMIS, could only identify assets “with an approximate total value of $946.4 million.”

On March 10, 2009, Madoff pleaded guilty to 11 criminal counts, including securities fraud, mail fraud, wire fraud, investor advisor fraud, money laundering, false statements, perjury, false filings with the SEC and theft from an employee benefit plan.

On June 29, 2009, Madoff was sentenced to 150 years, which he is serving at a medium-security federal prison in North Carolina.

Ultimately, Madoff had bilked investors out of billions of dollars using one of the oldest and simplest fraud tricks of the modern era: the Ponzi scheme.

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The Ponzi scheme

A Ponzi scheme is a fraudulent investment “opportunity” in which current investors are paid abnormally high returns out of the money paid in by newly-recruited investors rather than from the profits generated by any real business activity.

The scheme is named after Charles Ponzi, an Italian immigrant who bilked U.S. investors out of millions of dollars in 1920.

The typical Ponzi scheme works as follows: The investment promoter promises or even “guarantees” an extraordinary return on an investment, such as 10 percent per month.

The source of such extraordinary returns is typically attributed to something that sounds impressive, but is intentionally vague. Some examples: hedge fund futures trading, global currency arbitrage, high-yield investment programs or, as in Madoff’s case, the split strike conversion strategy.

If pressed by skeptical investors for more detail, the promoters will evade answering the question and instead talk about how recently-recruited investors have been receiving the promised returns.

Since the investment opportunity has no track record, early investors are only tempted to invest relatively small amounts such as $10,000 and wait to see if the promised returns are paid. After one month, the investor receives a check for $1,000, so the investor truly believes she has earned the promised return. What the investor doesn’t realize is that the $1,000 was a return of the investment and not a return on the investment.

In other words, the $1,000 return came from the $10,000 initially invested rather than from the profits generated by the investment opportunity. After a second month yields another $1,000 payment, the investor is “hooked” and typically will invest larger amounts in the scheme and will enthusiastically inform friends and family members about this “fantastic” investment opportunity.

(To be continued: Part 2 will appear in BiS on April 21.)

Thomas Buckhoff is an associate professor of accounting at Georgia Southern University and a partner with Forensic Solutions LLC, a forensic accounting firm specializing in fraud detection, investigation and prevention consulting services. He can be reached at 912-478-7142 or tbuckhoff@georgiasouthern.edu.

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