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A Historical Perspective of Ponzi Schemes

by
Elizabeth Ann Geny

A thesis submitted to the faculty of The University of Mississippi in partial fulfillment of the requirements of the Sally McDonnell Barksdale Honors College.

Oxford
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Approved by

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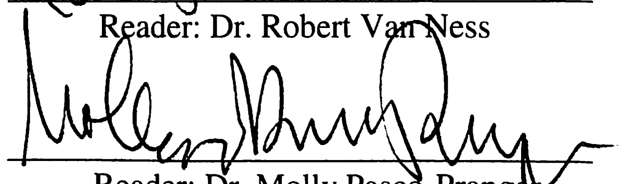

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ABSTRACT

ELIZABETH ANN GENY: A Historical Perspective of Ponzi Schemes
(Under the direction of Dr. Van Ness)

In 2008, the largest Ponzi scheme was discovered—Bernie Madoff cheated investors out of over $50 billion. This left the public with many questions regarding Ponzi schemes. This paper reviews the history of Ponzi schemes including what a Ponzi scheme is. It analyzes Ponzi schemes prior to Bernie Madoff, analyzes Madoff's scheme, and analyzes Ponzi schemes discovered after Madoff. This paper also analyzes various Ponzi schemes throughout history and the role the SEC has played in them. It reviews why the SEC missed Madoff and precautions they are taking to never let such a large scale scheme pass them again. It also provides a description of who the SEC is, what they do, and how investors can avoid investing in a Ponzi scheme.

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# Introduction

With the discovery of Bernie Madoff's $50 billion Ponzi scheme in 2008, people are left to wonder how such a scheme could occur. Bernie Madoff did not orchestrate the first Ponzi scheme. Ponzi schemes can be dated back to the late 1800s up until 2008 when Madoff was discovered, and even more Ponzi schemes have been discovered since Madoff's scheme. The Securities and Exchange Commission (SEC) is the regulatory body that monitors such fraud. Although the SEC had numerous chances to discover Madoff, they did not; however, the SEC has a new chief and she is making changes to never let another $50 billion Ponzi scheme escape them. The SEC is not the only one who needs to investigate. Investors need to conduct their own research to ensure they are not investing in a Ponzi scheme.

## Chapter 1: A Ponzi Scheme

While Ponzi schemes can be different from one another, all possess four main components. First the scheme must have some sort of capital infusion from investors. Second, some sort of fraud is involved--the Ponzi operator is not doing what he originally promised his investors. The third component of a Ponzi scheme is that the money is being paid out to investors so new investors are continually needed to keep the scheme running. The final component of a Ponzi scheme is promising extremely high returns. No matter the type of Ponzi scheme, you will find that it encompasses all of these components (Hicks, 2010).

## Chapter 2: Ponzi Scheme Versus Pyramid Scheme

Ponzi schemes are often confused with pyramid schemes because they are closely related; however the two are not the same. A Ponzi scheme is generally run by one individual, while a pyramid scheme involves multiple people who are in on the scheme (Wells, 2010). Pyramid schemes come in many forms; "however, they all share one overriding characteristic. They promise consumers or investors large profits based primarily on recruiting others to join their program, not based on profits from any real investment or real sale of goods to the public" (Valentine, 1998). In a pyramid scheme an actual product exists, while in a Ponzi scheme no real product is being bought or sold, but a promise of high returns on an investment is being made.

To make a pyramid scheme seem legitimate, the person running it makes it appear as a multi-level marketing program, which to some extent it is; however, it is an illegal version of one. Defined by the Federal Trade Commission, multi-level marketing "is a way of selling goods and services through distributors. These plans typically promise that people who sign up as distributors will get commissions two ways - on their own sales and on the sales their recruits have made" (Advertising and Marketing, 2000). The key difference between a pyramid scheme and a multi-level marketing program is that multi-level marketing pays commissions for the sale of goods or services, not for getting new recruits (Valentine, 1998).

## Chapter 3: History of Ponzi Schemes

The Ponzi scheme is named for Charles Ponzi, however he was not the first one to run this sort of scheme. William Miller is thought to be the first person to ever run a Ponzi scheme. In 1899, he cheated investors out of an estimated $1 million, which today would be about $20 million. He was able to scam his investors while reportedly promising a 520% rate of return (Altman, 2009).

Charles Ponzi, an Italian immigrant who moved to Boston in 1903, is the man behind the name of the infamous Ponzi scheme. He embodied the qualities needed by a successful schemer--charm and imagination. In 1919, Ponzi started a firm called the Securities Exchange Company to conceal his scheme. He was promising investors a 50% return on their money in forty-five days by converting foreign postage coupons into U.S. currency ("Who Was Charles Ponzi," 2009). His scheme lasted for approximately eight months, but he never actually bought the postage coupons; he was paying off old investors with the new investors' money the entire time (Chernow, 2009). Paying off old investors with new investors' money is the main component of a Ponzi scheme.

## Chapter 4: Ponzi Schemes Prior to Madoff

Although currently the most recognizable Ponzi scheme was run by Bernie Madoff, many Ponzi schemes preceded him. A few notable Ponzi schemes prior to Madoff were run by Robert McLean, Bayou Hedge Fund Group, and the Allied Deals companies. Each of these Ponzi schemes is considered large, yet each is on a different scale and targets different groups of people. Robert McLean targeted his local community of Murfreesboro, TN; the Bayou Hedge Fund Group's main investors were fund of funds, and the Allied Deals companies targeted large scale banks.

Robert Mclean did not begin by running a Ponzi scheme. He worked as a broker and in the late 1980s started day trading. McLean was unsuccessful and suffered substantial losses. Despite continually losing money, he continued to accept new investors. In return for the investor's money, McLean issued unsecured promissory notes, which are basically IOU's. In hindsight, some ask why an investor would accept an unsecured promissory note for his money. These unsecured promissory notes were given to them by a reputable, trustworthy, and successful man, who promised returns of up to 20%. McLean kept his business very close-knit. He had only one small office and one outside CPA. "McLean never provided a prospectus to investors; however, if requested, he would send a bogus Statement of Account. His business grew through trust and by keeping his investors happy with high and steady returns" (Benson, 2010).

McLean lived an extravagant lifestyle marked by multiple homes, large scale donations to Middle Tennessee State University, a $1.5 million donation to the Country Music Hall of Fame, and donations to students to help pay their tuition and living expenses. This extreme lifestyle led some to wonder where McLean's money was coming from. The money was coming directly from investors; in the final four years of McLean's scheme he had little to no income from business, but only income from new investors. In 2007, the collapse of McLean's scheme began when his biggest investor, Ron Vannatta, demanded $400,000. McLean did not have the money and continually avoided Vannatta by making up excuses. Vannatta became suspicious and hired an attorney who advised him to keep putting pressure on McLean. Vannatta finally met with McLean who showed Vannatta a brokerage account statement of which Vannatta secretively took a picture with his cell phone. An investigator confirmed that the account had been closed for several years. Several lawsuits were filed against McLean and he ended up filing Chapter 7 bankruptcy in 2007. McLean shot himself the day before his hearing. His Ponzi scheme stole over $50 million from investors (Benson, 2010).

The Bayou Hedge Fund Group was founded in 1996 by Samuel Israel III, who ran the Fund along with Daniel Marino. Bayou Hedge Fund Group was located in Connecticut. Bayou Hedge Fund group had many prominent investors, among those investors were Stern Investment Holdings, Hennessee Group, and Silver Creek Capital Management of Seattle. Bayou Hedge Fund Group was promising to grow its assets to about $7.1 billion in 10 years. However, shortly after their start in 1996, Israel and Marino began seeing large losses, which brought on the Ponzi scheme that swindled $450 million. (Sarna, 2010).

Amanda Cantrell, a staff writer for CNN Money, claimed "Most institutional investors demand audited returns from hedge funds and look for a well-known auditor's name on the work." Knowing investors would want to see audited returns, the Bayou Hedge Fund Group formed Richmond-Fairfield Associates, which was a fake accounting firm created to generate fake audits to potential investors for the Bayou Hedge Fund Group.

This large scale Ponzi scheme came to an end in mid-2004 when "investors received a letter from Israel announcing that Bayou would return their money and shut its doors" (Sarna, 2010). When the money was never received, the authorities were contacted and an investigation began on the Bayou Hedge Fund Group. Israel and Marino withdrew about $161 million from various bank accounts in the summer of 2004, and then went into hiding in the summer of 2005 until September 2005. Israel pleaded guilty to conspiracy, investment adviser fraud, and mail fraud; while Marino pleaded guilty to the same charges plus wire fraud. They were both sentenced to twenty years in prison. On the day Israel was supposed to show up for his prison sentence, his car was found abandoned on the Bear Mountain Bridge over the Hudson River. "Suicide is painless" was written in the dust on the window of the car. However Israel did not commit suicide. With the help of his girlfriend, Debra Ryan, Israel tried to fake his own death. Israel had an extra two years added to his twenty-year sentence for bail jumping and his faked suicide.

In the aftermath of the large fraud committed by the Bayou Hedge Fund Group, many inconsistencies in Israel's resume appeared. The information Israel gave to his investors about his career and the information on file with the Central Registration

Depository (CRD), which is a database of background information on brokers and firms, were very different. Israel began his financial career in 1982 at Frederic J. Graber & Company where he worked for six years. His employment at Frederic J. Graber & Company was the longest in his twenty-three years working on Wall Street, not including his eight years at Bayou. From working at this first job on Wall Street until opening Bayou, Israel worked at various places for short periods of time. He worked at Midwood Securities Inc., for nine months; Gerard Klauer Mattison & Company, an institutional brokerage firm, for six months; Gruntal & Company for ten months; a hedge fund, named JGM Management, for one year; and Concorde Asset Management for six months. After working at all of these jobs for short periods of time, Israel worked at Omega Advisors, which is a large hedge fund run by Leon Cooperman. This job is where the largest discrepancy in Israel's past lies. The sales materials provided to Bayou investors stated that while working his four years at Omega "Mr. Israel was responsible for all equity and financial futures executions as well as sharing responsibility for hedging the portfolio through the use of futures and options" (Morgenson, 2005). However, according to his CRD and an Omega executive, this information is false. Israel's CRD claims he worked at Omega for only eighteen months, not four years, and an Omega executive said that Israel's position while at Omega was "an administrative one, not a high-level trading job" (Morgenson, 2005). If someone lies about their previous job experience, what prevents them from lying about your investments?

In 2010 Sarna wrote that, " Twenty banks, including JP Morgan Chase, Fleet National Bank, PNC Bank N.A., KBC Bank N.V., Hypo Verins Bank N.A., Dresdner Bank Lateinamerika AG, China Trust Bank, and General Bank, were victims of $680

million in losses in a Ponzi scheme orchestrated by Anil Anand, a former chief financial officer for Allied Deals, Inc." Allied Deals, Inc., Hampton Lane Inc., and SAI Commodity, all located in the United States, and RBG Resources, located in the United Kingdom, (collectively, the "Allied Deals companies") were reportedly trading metals such as nickel and cobalt. The Allied Deals companies were controlled by brothers--Narendra Rastogi overseeing the United States companies and Virendra Rastogi overseeing the United Kingdom company. The Rastogi brothers and Anil Anand were the ringleaders of the Allied Deals companies' Ponzi scheme.

The Allied Deals companies were not running their Ponzi scheme by either investing or claiming to invest in stocks. As stated by the United States attorney, Allied Deals companies were selling metal in legitimate "arms-length" transactions (a transaction in which the buyers and sellers of a product act independently and have no relationship to each other). To finance the metal sales, Allied Deals companies arranged for loans with banks, usually to be repaid after 180 days. "As collateral for the loans, the banks relied on Allied Deals' accounts receivable (the money that Allied Deals was due from the customers for the metal transactions), expecting that the loans would get paid when the customers paid Allied Deals for the metal that had been purchased." Many of these metal transactions upon which the loans were based did not exist. Anand, along with the Rastogi brothers and their co-conspirators, had set up and controlled an elaborate network of fake companies (which they called "group companies") to serve as fake purchasers of metal from Allied Deals so that Allied Deals could get loans from the victim banks. Allied Deals used the money they were receiving for the loan from one bank to pay off a different loan owed to another bank.

Anand, the Rastogi brothers, and their co-conspirators went to extreme lengths to keep the banks believing in all of their shams. For the scheme to work the banks had to believe that the loans they were making to Allied Deals were for the purchases of metal, which was to be sold to a legitimate company. According to the United States Attorney, "a number of co-conspirators posed as Allied Deals customers, established offices and phone lines for the sham companies in the United States and abroad, arranged for fake letterhead and bank accounts, and were prepared to field calls from bankers or auditors." Allied Deals provided seemingly legitimate customers by recruiting friends of Anand to set up fake metal companies in New Jersey, New York, and California. To further show that these were real companies, Anand helped to create fake credit histories for these "customers" and provided them with false financial data. To solidify these documents, the conspirators established a fake credit reporting agency, which "generated false credit reports attesting to the credit-worthiness of the sham companies." Allied Deals employees forged many documents, which the bank required in the loan application process, and even sent documents between fax machines at Allied Deals to make it seem as though the documents had originated from overseas. Anand participated in meetings with bank officials, during which he and his co-conspirators gave presentations regarding the nature of Allied Deals' metal transactions. To keep up the appearance of the metal transactions, the conspirators actually shipped the metal between customers at different ports around the world, using each repeated metal transaction to support an additional loan. Anand and his co-conspirators went to great lengths to keep this charade from being exposed.

The scheme began to unravel when "J.P. Morgan Chase became suspicious in September 2001 when it discovered four of its loans to Allied Deals were backed by the same assets that Allied used to get loans from other banks" (Noelle, 2002). At this point other banks began having problems with Allied Deals as well. In May 2002, an auditor at the accounting firm "Ernst & Young tried to verify the existence of some of Allied Deal's customers." Some of the offices could not be found; at some there was at most a single person with a desk, a chair, and a telephone. In May 2002 Shankar Rastogi, Narendra Rastogi, and Anil Anand were arrested (Doward, 2002). The United States Attorney reported in 2008:

> Fifteen defendants have been arrested in the United States in connection with this case. Nine--including Anand--pleaded guilty; five were found guilty at trial; and one was acquitted. Two defendents in the U.S. case remain at large.
>
> Anand pleaded guilty to one count of conspiracy, one count of bank fraud, one count of conspiracy to commit money laundering, one count of tax evasion, and one count of making false statements to federal agents.
>
> As part of his cooperation, Anand testified in 2004 in New York against six of his co-defendants five of whom were convicted after trial. As further part of his cooperation, Anand testified in London in the fall of 2007 at the UK trial of Virendra Rastogi and three others. That trial recently ended in the conviction of three of the defendants, including Virendra Rastogi. On June 5, 2008, Virendra Rastogi was sentenced to a term of nine and half years imprisonment.
>
> Anand, age 46, resides in Plainsboro, New Jersey.

This scheme allegedly began around May 2000 and ran for about two years. Although the scheme did not last for a significantly long amount of time, it still generated about $680 million in losses. Kevin Donovan, assistant director of the FBI in New York said, "These defendants raised deceit and misrepresentation to an art form. This is

larceny as surely breaking into the bank vault and hauling off bags of cash" (Noelle, 2002).

The Ponzi schemes of Robert McLean, the Bayou Hedge Fund Group, and Allied Deals companies each show different ways in which a Ponzi scheme may be conducted. Robert McLean targeted his local community, Bayou Hedge Fund Group targeted fund of funds, and Anil Anand targeted large scale banks. Mclean and the Bayou Hedge Fund Group used false investments to lure in investors, which is a typical type of Ponzi scheme. Allied Deals companies' Ponzi was conducted in a more unconventional manner: They targeted large scale banks by gaining loans through the false sale of metals.

## Chapter 5: Bernie Madoff

Bernie Madoff seemed to be an upstanding family man, however he ran one of the largest Ponzi schemes in history, stealing over $50 billion. He was born on April 29, 1938 in New York City. Madoff attended the University of Alabama for one year then transferred to Hofstra University where he earned a bachelor's degree in political science. His wife, Ruth, graduated from Queens College with a focus on finance. Madoff went on to Brooklyn Law School, but dropped out to start his own investment firm. Madoff and his wife founded Bernard L. Madoff Investment Securities, LLC in November 1960 (Kirtzman, 2009).

Madoff had a seemingly pristine background. He was in the U.S. Army Reserve, member of the board of governors of the National Association of Securities Dealers, chairman of NASDAQ in 1990, 1991, and 1993, on the board of trustees at Yeshiva University in New York City, and chairman of Yeshiva University's Sy Syms School of Business in 2000. He was also a prominent philanthropist for many foundations including the Madoff Family Foundation, which was founded in 1998 (Kirtzman, 2009). Besides holding these various titles, Madoff ran in the most elite circles in New York City, which added to his appeal and sense of trustworthiness. The only red flag in Madoff's background came from his parents. On August 6, 1963 Gibraltar Securities and Second Gibraltar Corp., broker-dealer firms registered in Madoff's mother's name, were

investigated by the Securities and Exchange Commision (SEC). On January 23, 1964 Gibraltar Securities and Second Gibraltar Corp. agreed with the SEC to close and not face legal action for neglecting to file reports of their financial condition, which is a violation of the SEC reporting requirement ("A Brief Summary...," 1964). They were allegedly trading stocks illegally, but since there was no formal hearing the facts surrounding what they were doing were not verified.

On March 29, 1960, when Madoff was 22, he passed the General Securities Representative exam and the General Securities Principal exam, which licensed him to run a brokerage firm. Just eight months later he started Bernard L. Madoff Investment Securities. Madoff has claimed that he started the firm with money he saved from lifeguarding in the summers and installing sprinkler systems. However, he has also claimed that he started the firm with a loan from his wife's father, Saul Alpern. Saul Alpern allowed Madoff to work out of his accounting firm, Alpern and Heller. At this point Madoff was in the business of over-the-counter (OTC) stocks; much of what he was trading is referred to as penny stocks, as the stocks tend to have a low dollar value. Madoff's customers were not the rich and famous of New York City, but new or unknown companies who could not afford to trade on the New York Stock Exchange (NYSE). Madoff was still an outsider in the world of finance, but with his charm and presence he was well on his way to becoming a Wall Street insider (Kirtzman, 2009).

Madoff knew the real money to be made on Wall Street was investing money for wealthy individuals. He got the jump start he needed when he met Carl Shapiro in November, 1960. Carl Shapiro was an entrepreneur in Massachusetts; he founded Kay Windsor, Inc. (now a subsidiary of Vanity Fair Inc.), which was, at that time, one of the

largest women's apparel companies in the United States. At the request of a mutual friend, Shapiro met with Madoff. However, Shapiro did not originally want to because he already had investments with other firms. Nonetheless, Shapiro was immediately captivated by Madoff. Shapiro gave Madoff a test--he asked Madoff to conduct an arbitrage deal, which is the buying and selling of the same security, commodity, or foreign exchange in different markets to profit from unequal prices. Without the use of advanced technology that we use today, trades generally took three weeks to complete; Madoff completed this deal in three days. Shapiro was impressed with Madoff and gave him $100,000 to invest for him. This investment was the beginning of a long friendship for Madoff and Shapiro (Kirtzman, 2009).

Madoff gained clients through word-of-mouth recommendations. Saul Alpern, Madoff's father-in-law, was a quiet and frugal man; he began soliciting his friends and acquantainces to invest with Madoff. Since Alpern was investing his money with Madoff, other people thought it was a wise and smart investment. Cynthia Arenson, who knew Alpern through their vacation homes in Sunny Oaks, New York, stated, "They'd give you eighteen percent. No more and no less." When her husband did not want to invest with Madoff, Arenson said, "Look, it's Saul Alpern's firm. He's a mild-mannered guy. He's a modest man. He doesn't live high off the hog" (Kirtzman, 2009).

Frank Avellino and Michael Bienes, both accountants at Alpern and Heller, also recruited investors for Madoff. Bienes represented Madoff in a tax audit in the late 1960s from which they began to form a friendship. Madoff invited Avellino and Bienes to his son's bar mitzvah, and later Bienes told a reporter from *Fortune* magazine, "We were saying, 'Thanks for having us,' and he said, "Hey, come on--we're family, aren't we?'

And at that moment, he had me. He had me. We were family"(Bandler, 2009). From then on, Avellino and Bienes began soliciting investors for Madoff, promising returns of up to 20 percent. Saul Alpern's partner, Sherman Heller, passed away in the 1960s and Alpern retired in 1974 leaving the firm to Avellino and Bienes. At this point the accounting firm only had one client--Bernie Madoff (Kirtzman, 2009).

Bernard L. Madoff Investment Securities grew and it moved its location to 40 Exchange Place, merely a block away from the NYSE. Madoff was finally beginning to achieve his goal. In 1971 the National Association of Securities Dealers Automated Quotations (NASDAQ) was launched. NASDAQ was a computer based system that allowed brokers across the country to see all of the non-exchange listed securities up for trading and their prices. Madoff was quoted saying that he had a hand in creating NASDAQ, however this fact was disputed by various individuals. Either way, NASDAQ helped catapult Madoff's career. With a more efficient marketplace, than the OTC market, Madoff was able to offer cheap and fast trades (Bandler, 2009).

Madoff Investment Securities occupied two and a half floors in their building. The trading floor resided on 19 and the software programmers worked on 18, both part of his broker-dealer business, and a mysterious part of the firm worked on half of the 17th floor. Not only did Madoff have a significant presence in New York, but Madoff Securities International opened in London in 1983. He even became a member of the board of governors of the National Association of Securities Dealers in January 1984 adding to his credibility (Kirtzman, 2009).

Madoff continued investing peoples money and making them extremely high returns. He became part of an elite circle in New York and in the places he vacationed.

By the mid-1980s Madoff was considered to be a big man on Wall Street. He lived in a penthouse on Manhattan's Upper East Side; owned a yacht; vacationed in the summer at his oceanfront house in Montauk, Long Island; and vacationed in the winter in Palm Beach. Although Madoff was new to the elite crowd in Palm Beach, he was welcomed with open arms due to the endorsement of Carl Shapiro. With the vast amount of wealth in Palm Beach, Madoff was not short on people wanting to invest with him. The word had gotten around that Madoff was making people millions, and everyone wanted a piece of him.

Shapiro was not the only one introducing clients to Madoff; Bienes, Madoff's accountant, was still bringing Madoff clients, but not in New York. Bienes had moved to Florida where he reinvented himself with the money Madoff had made him and he was considered one of the best party hosts in Fort Lauderdale. Bienes and Avellino were not the only people who worked for Madoff who were close to him. Madoff Investment Securities was a "family" business. Peter, Madoff's brother, joined the firm in 1967. Mark, Madoff's son, joined the firm in 1986 and Andrew, Madoff's youngest son, joined the firm in 1988 (Kirtzman, 2009).

Madoff turned investors away; this was part of his allure. It was almost like a secret society; no one talked about investing with Madoff. When potential investors asked too many questions about the Madoff's investments, he would inform them that he did not have any more openings for new investors (Bandler, 2009).

Madoff continued to gain new investors and live the good life for years, until the economy took a turn for the worse in 2008. Madoff could no longer attract the large capital from investors that he once could since the economy was in a recession. Without

the infusion of new capital, Madoff could no longer pay out his returns of up to 20%. Realizing the scheme was coming to an end, Madoff confessed the scheme to his sons. His sons reported the Ponzi scheme to authorities on December 10, 2008 and he was arrested the following day (Kirtzman, 2009).

In March 2009, Madoff was charged with eleven felonies: securities fraud, investment adviser fraud, mail fraud, wire fraud, international money laundering to promote specified unlawful activity, money laundering, false statements, perjury, making a false filing with the SEC, and theft from an employee benefit plan (Sarna, 2010). After pleading guilty to his crimes, Madoff told Judge Chin, "I am actually grateful for this opportunity to publicly comment about my crimes, for which I am deeply sorry and ashamed." Madoff claimed that he started the fraud with the belief that it would only last a short time--long enough to extricate himself. Many Ponzi schemes begin with the belief that the scheme will only last a short time. Madoff said, "As the years went by, I realized my risk, and this day would inevitably come. I cannot adequately express how sorry I am for my crimes" (Woodruff, 2009). On June 29, 2009, Madoff was sentenced to 150 years in prison, which is the maximum allowed.

## Chapter 6: Clues to Madoff's Fraud

On August 31, 2009, the Office of Investigations of the SEC filed a report titled "Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme." In this detailed and thorough report, the Office of Inspector General (OIG) found that "the SEC received more than ample information in the form of detailed and substantive complaints over the years to warrant a thorough and comprehensive examination and/or investigation of Bernard Madoff and BMIS for operating a Ponzi scheme, and that despite three examinations and two investigations being conducted, a thorough and competent investigation or examination was never performed."

The first sign of Madoff's fraud was brought to the attention of the SEC in 1992. An investor that was contacted by Avellino in Bienes became skeptical. The investor contacted the SEC about Avellino and Bienes' incredible returns. Government lawyers investigated the two, but could not find any documentation for an investment company run by Avellino and Bienes, although they purportedly managed $440 million for 3,200 investors. Their accounting firm was not registered to trade securities, and neither man had a required license to trade securities. In an interview on PBS, Avellino is documented saying that he asked Madoff multiple times if they needed to be registered, and he always replied no. Investigators filed a law suit against the pair in November 1992. To the investigators' surprise, Avellino and Bienes had an airtight excuse--Bernie

Madoff managed the money. Over the course of a few days, Madoff returned the $440 million dollars to the investors. The accountants made a deal with the SEC to shut down their company, pay a $350,000 fine, and submit to an audit. With regard to the audit, Avellino claimed to Price Waterhouse, the court-appointed auditor, that he did not keep any books. He said, "My experience has taught me to not commit any figures to scrutiny when, as in this case, it can be construed as 'bible' and subject to criticism." The audit was put to rest when Madoff answered Waterhouse's questions. Madoff produced documents that Avellino and Bienes could not; Waterhouse testified that Madoff was "forthright" with the information and even helpful (Bandler, 2009). The information Madoff gave to authorities was enough and ended the investigation on Avellino and Bienes; however the investigators did not think to ask the important questions about Bernie Madoff, a high profile man of Wall Street (Kirtzman, 2009).

According to the SEC's report documenting their investigation, the second complaint the SEC received attesting to Madoff's fraud was from Harry Markopolos. Markopolos, who is now considered a whistleblower in the case of Madoff, has an educational background in finance. He received a bachelor's degree in Business Administration from Loyola College in Maryland in 1981, obtained a Master's degree in Finance from Boston College in 1997, and earned a Chartered Financial Analyst (CFA) designation, and a Certified Fraud Examiner (CFE) designation (Carozza, 2009).

Markopolos' journey investigating Madoff began in 1999. He was a portfolio manager for an equity derivatives firm in Boston when Frank Casey, a marketing senior vice president at the firm, asked Markopolos to reverse engineer Madoff's strategy for making such high returns. Casey wanted to learn how Madoff's firm was so successful

so their firm in Boston could implement his strategy. It did not take long for Markopolos to realize Madoff was committing fraud, and most likely running a Ponzi scheme. Not only did the numbers not add up, but Madoff's name was not on the marketing materials (Carozza, 2009).

Markopolos began actively investigating the Madoff case. He worked closely with his colleague Neil Chelo on replicating Madoff's strategy. No matter what way they looked at it, it seemed that Madoff was getting his returns illegally. Markopolos documented his findings and submitted them for the first time to the SEC's Boston Regional Office in May 2000. After nothing resulted from his submission of evidence, Markopolos resubmitted his findings to the SEC in 2001, 2005, 2007, and 2008 (Carozza, 2009).

In Markopolos's book, *No One Would Listen: A True Financial Thriller*, he documents his investigation on Madoff. In the appendix, Markopolos provides a copy of his submission to the SEC on December 22, 2005. In this submission titled "The World's Largest Hedge Fund is a Fraud," Markopolos describes two possible scenarios of Madoff's fraud: Madoff is involved in insider-trading or Madoff Securities is the world's largest Ponzi Scheme. He described the latter scenario as highly likely. Markopolos proceeds to list and describe thirty red flags that point to Madoff committing fraud. A few of the red flags include:

> •Why the need for such secrecy?
> •Madoff does not allow outside performance audits.
> •Madoff's returns are not consistent with the one publicly traded option income fund with a history as long as Madoff's.
> •Only Madoff family members are privy to the investment strategy.
> •Bernie Madoff's Sharpe Ratio (a measure of how many units of return you earn for each unit of risk you take) of 2.55 is unbelievably high compared to the Sharpe Ratios experienced by the rest of the hedge fund industry.

According to the OIG, Markopolos was not the only one sending complaints to the SEC concerning Madoff. In May 2003, a respected Hedge Fund Manager sent the SEC a complaint expressing concern about Madoff's investing strategy. He documented issues in Madoff's strategy and stated that Madoff's strategy was "indicia of a Ponzi scheme."

A fourth complaint was sent to the SEC through multiple emails in April 2004. A person who was registered with the SEC sent the emails identifying multiple red flags in Madoff's investments. The person used information available to the public to conduct their due diligence. One of the emails provided a step-by-step analysis of why Madoff's options trading was a fraud (U.S. Securities and Exchange Commission Office of Investigations, 2009).

The OIG documented a fifth complaint, which the SEC received in October 2005 by an anonymous investor in Madoff's fund. The informant stated, "I know that Madoff's company is very secretive about their operations and they refuse to disclose anything. If my suspicions are true, then they are running a highly sophisticated scheme on a massive scale...After a short period of time, I decided to withdraw all my money (over $5 million)."

The OIG stated that the sixth and seventh complaints were sent to the SEC by a "concerned citizen." In December 2006, the informant expressed among other things that Madoff was running a 'scandal of major proportion.' In March 2008, the same informant resent the SEC the previous complaint and added that "It may be of interest to you that

Mr. Bernard Madoff keeps two (2) sets of records. The most interesting of which is on his computer which is always on his person."

Along with these formal complaints the SEC received warning of Madoff's fraud through public media. In May 2001, Madoff had two articles written about him asking how he produced such high returns. The title of Ocrant's article for *Mar/Hedge*, a financial newsletter, was "Madoff Tops Charts; Skeptics Ask How." Ocrant questions Madoff's investment strategy citing that individuals who use the same strategy can not achieve such high returns on a consistent basis. Ocrant's article sparked Arvedlund, a writer for *Barron's*, to write an article titled "Don't Ask, Don't Tell: Bernie Madoff is so secretive, he even asks his investors to keep mum." Both of these articles shed light on Madoff's unusual investing practices, yet nothing was done about it (Bandler, 2009).

In response to these series of complaints, the OIG reports that the SEC performed two investigations and three examinations related to Madoff's investments. The SEC launched its first formal investigation on Madoff in 1992 when Madoff's associates were accused of fraud. As stated earlier, the SEC focused its efforts on Avellino and Bienes, not on Madoff. The OIG claimed that the SEC should have sought records from a Depository Trust Company (DTC) (an independent third-party) not solely records provided by Madoff. The OIG report stated that, "Had they sought records from DTC, there is an excellent chance that they would have uncovered Madoff's Ponzi scheme in 1992."

In 2004 and 2005, the SEC conducted two examinations, each in different offices unbeknownst to one another, prompted by the hedge fund manager's complaint and the emails they received from someone registered with the SEC. The OIG claimed these

examinations were run by teams who were inexperienced. They discovered that Madoff's secretive hedge fund was making quite a bit more money than his well-known market-making operation, but this revelation did not concern them. When the investigators grew concerned about Madoff, they usually disregarded their concerns. However, if the investigators did ask Madoff questions, they accepted the answers no matter how far fetched they seemed. Both of these examinations left the SEC with unresolved questions; however, there was no serious attempt to answer them.

After Markopolos' first complaint in 2000, he conducted a meeting at the SEC's Boston District Office (BDO) explaining Madoff's strategy and pushing them to investigate Madoff. "After the meeting, both Markopolos and an SEC staff accountant testified that it was clear that the BDO's Assistant District Administrator did not understand the information presented. Our investigation found that this was likely the reason that the BDO decided not to pursue Markopolos' complaint or even refer it to the SEC's Northeast Regional Office (NERO)" (U.S. Securities and Exchange Commission Office of Investigations, 2009). Markopolos, along with his fellow informants, handed Madoff to the SEC on a silver platter, yet they did not find enough evidence to indict him for any illegal activity.

## Chapter 7: Overview of the SEC

With the stock market crash in October 1929, Congress held hearings to find a way to restore investor confidence in the capital markets. Based on the findings in these hearings, Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934, which created the SEC. On their website, the SEC sums up these two acts into two ideas:

> Companies publicly offering securities for investment dollars must tell the public the truth about their businesses, the securities they are selling, and the risks involved in investing.
>
> People who sell and trade securities – brokers, dealers, and exchanges – must treat investors fairly and honestly, putting investors' interests first.

The SEC is made up of five commissioners, five divisions, and eighteen offices, which are staffed by about 3,800 people. It is the responsibility of these employees to:

- interepret federal securities law;
- issue new rules and amend existing rules;
- oversee the inspection of securities firms, brokers, investment advisers, and ratings agencies;
- oversee private regulatory organizations in the securities, accounting, and auditing fields; and
- coordinate U.S. securities regulation with federal, state, and foreign authorities (Securities and Exchange Commission).

There are six main laws that the SEC uses to regulate the securities industry in the United States: the Securities Act of 1933, Securities Exchange Act of 1934, Trust Indenture Act of 1939, Investment Company Act of 1940, Investment Advisers Act of 1940, and Sarbanes-Oxley Act of 2002. The four laws that pertain to regulating Ponzi schemes are the Securities Act of 1933, Securities Exchange Act of 1934, Investment Company Act of 1940, and Investment Advisers Act of 1940.

As stated by the SEC, the Securities Act of 1933, referred to as the "truth in securities" law, requires that investors receive financial information and any other significant information concerning securities being offered for public sale. It also prohibits deceit, misrepresentations, and other fraud in the sale of securities.

The Securities Exchange Act of 1934 gives the SEC the power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agents. It also regulates the United States' securities self regulatory organizations, which include the New York Stock Exchange, American Stock Exchange, and the Financial Industry Regulatory Authority, which operates NASDAQ. This act also gives the SEC the authority to require periodic reporting of information by companies with publicly traded securities.

The Investment Company Act of 1940 regulates the organization of companies that participate primarily in investing, reinvesting, and trading in securities, and whose own securities are offered as investments to the public. The principal focus of this act is on the full disclosure of information to public investors about the fund and its investment objectives, and on the investment company structure and its operations.

The Investment Advisers Act of 1940 regulates investment advisers. It requires that firms or individuals who are compensated for advising clients on securities must register with the SEC and abide by their regulations. This law is designed to protect investors. Only advisers who have a minimum of $25 million of assets under management or advise a registered investment company must register with the SEC.

## Chapter 8: SEC Reform

Madoff turned himself in December 2008 even though the SEC had not yet discovered his fraudulent activities. This lack of discovery was not due to lack of warnings. The SEC received tips that Madoff was running a Ponzi scheme as early as 1999. SEC examiners visited Madoff's firm twice, but did not come up with evidence of illegal activity. The SEC never found evidence of illegal activity because they did not request a subpoena on Madoff's records. The investigation was of the documents, which Madoff provided, which proved to be false documents (Moyer, 2008).

After the Ponzi scheme of Bernie Madoff came to light, the SEC was faced with major decisions. How can the SEC ensure that a multibillion-dollar Ponzi scheme, such as that of Bernie Madoff's, does not occur again? The SEC is instituting reforms to help insure that they do not miss large scale frauds in the future.

In 2009 the SEC hired a new chief, Mary Schapiro. In an interview by *Money* magazine, Shapiro explains the changes being made to help mitigate the risks so that a future Bernie Madoff size scheme will not happen again. She says that they "passed a rule that will help ensure that when investors entrust their assets to an investment adviser who doesn't use a truly independent custodian [an entity unaffiliated with the adviser that holds clients' assets], their money is safe." The SEC receives thousands of tips each year and they did not have a unified system to handle them. Shapiro brought in a consulting firm to help build an integrated system to help track the tips and see which ones were

worth pursuing. She also had the people handling the tips educated on what to look for when reviewing data, because the examiners who received the information on Madoff did not truly understand what they were looking at. To subdue claims that the SEC is too cozy with Wall Street, Shapiro says that they have brought new leadership into the enforcement division, and taken a layer of management out of that division to put on the front line. The SEC has more than doubled the number of Ponzi schemes they shut down in the past year. Here is a full list of the changes being made within the SEC:

- Revitalizing the Enforcement Division
- Revamping the handling of complaints and tips
- Encouraging greater cooperation by 'insiders'
- Enhancing safeguards for investors' assets
- Improving risk assessment capabilities
- Conducting risk-based examinations of financial firms
- Improving fraud detection procedures for examiners
- Recruiting staff with specialized experience
- Expanding and targeting training
- Improving internal controls
- Advocating for a whistleblower program
- Integrating broker-dealer and investment adviser examinations

## Chapter 9: Ponzi Schemes Discovered After Madoff

After Madoff turned himself in, an embarrassed SEC diligently worked to uncover Ponzi schemes to prove itself. Many Ponzi schemes have been discovered since Madoff, yet not all of them were discovered by the SEC. The falling economy, which contributed to Madoff's collapse, was a main reason many Ponzi schemes collapsed after Madoff's. Scott Rothstein, Arthur Nadel, and Nicholas Cosmo are examples of three Ponzi schemes discovered after Madoff's.

Scott Rothstein conducted a $1.2 billion Ponzi scheme from 2005 to 2009; however, the SEC did not investigate Rothstein, rather the United States justice system did after he admitted to his crime. Rothstein began his career as a lawyer. He graduated with a Bachelor of Arts from the University of Florida in 1984 and graduated from Nova Southeastern University's Law School in 1988. Rothstein co-founded Rothstein Rosenfeldt Adler, which was his law firm in Fort Lauderdale, in 2002 (McCoy, 2009).

Many Ponzi schemes begin by the need to cover for losses for what the schemer hopes is a short period of time, however Rothstein's scheme began out of the desire to be great. In a letter to his Court Judge Rothstein wrote, "At the time I began to steal I had no actual fiscal reason to steal other than unbridled, pure greed and the absolute inability to deal with even the lightest notion of failure." When Rothstein and his partner opened their law firm in Florida it began growing at an unprecedented pace. Rothstein told everyone that the firm's growth was to help his clients, but he wrote that the growth was

powered by his desire to have a law firm that would make everyone envious. However, Rothstein's firm had the resources to be the biggest and best law firm. Rothstein began self-promoting the law firm--lying about its size and its success. Rothstein's lies are what drove the Ponzi scheme. Rothstein created the illusion of a huge, powerful law firm, so he had to create one in order to keep up with his lies. The only way to have a huge, powerful law firm in his mind was to begin running a Ponzi scheme (Rothstein, 2010).

Rothstein's infusions in the beginning came from people who trusted him. He told them he needed a loan, since his ego could never let them know the truth. For each loan he devised an elaborate lie, for example he wrote in his letter that he told clients the money "was for bridge loans and the like for important clients and that the clients would pay outrageous interest to keep the loan confidential." Since there was never a real client needing a loan, Rothstein created more lies telling the client that supplied the loan that he would guarantee it. He wrote, "the facade I had masterminded made my word as good as gold."

In Rothstein's letter to the judge he described the Ponzi scheme and the money as a drug. He said, "the high only lasted until the next round of payments were due to my 'investors' and the vicious cycle repeated. I would crash hard." In October 2009, when Rothstein knew his scheme was coming to an end, he fled to Morocco where he wired $16 million. Rothstein had every intention of committing suicide, however he had an epiphany and decided he must turn himself in. While Rothstein was still in Morocco, he had his attorney contact the United States Attorney and tell him that Rothstein was turning himself in. The FBI met Rothstein at the airport when he returned from Morocco.

Rothstein cooperated with the government by telling them everything about his scheme and the contribution of others in the scheme. He also went undercover for the government on more than one occasion to assist in catching other criminals (Rothstein, 2010).

A month after Rothstein returned to the United States, he was arrested. In January 2010, he was found guilty of two counts of fraud and three counts of conspiracy, which included wire fraud and federal racketeering and sentenced to fifty years in prison (Walter, 2010).

Arthur Nadel was a hedge fund manager in Sarasota, Florida who was running a $350 million Ponzi scheme, which allegedly started in 2004. Nadel, along with his seemingly innocent partner Neil Moody, invested people's money with six Nadel-Moody hedge funds starting in 1999. The scheme came to an end in January 2009 when a partner at the fund reported to the SEC that all the money was gone. With this complaint, the SEC did a thorough investigation. On January 21, 2009 the SEC charged Nadel with defrauding investors and overstating the value of the hedge funds by about $300 million (Sarna, 2010). In this case the SEC investigated correctly and found the Ponzi scheme, as opposed to Madoff's when the SEC ignored signs and performed weak investigations.

*The New York Times* reported that Nadel was arrested by the FBI on January 27, 2009 in Florida, but was sent to New York and charged because he traded through a brokerage firm there. Nadel died in prison in New York on April 17, 2012 at the age of 80 (McCool, 2012).

In 2010, Sarna wrote that Nicholas Cosmo, who owned a Long Island investment company--Agape World Inc., surrendered to federal authorities and was charged with an

alleged $370 million Ponzi scheme on January 27, 2009. Later the Ponzi scheme was found to have accumulated to $413 million. Chad Bray of *The New York Times* reported that Cosmo told investors "that he would use their money to fund short-term, secured bridge loans to small businesses and the loans would generate high rates of return." These high rates of return ranged from 48% to 80% a year. In October 2011, Nicholas Cosmo was sentenced to twenty-five years in prison for stealing his investors' money (McCoy, 2011).

If the exceptionally high returns Cosmo were promising was not a big enough red flag, his 1999 arrest should have been. Cosmos's arrest in 2010 was not the first time he had been accused of fraud. In 1999, Cosmo was sentenced to twenty-one months in prison for pleading guilty to mail fraud. If the investors had performed due diligence on Cosmo, they might have discovered his history of fraudulent activities and avoided losing their money.

Rothstein, Nadel, and Cosmo exemplify three different Ponzi schemes caught after Madoff's. Rothstein turned himself into the FBI, one of Nadel's investors turned him into the SEC, and the FBI also arrested Cosmo. The SEC did not take the complaint against Nadel lightly and were able to indict him. On the other hand, if investors had adequately looked into Nicholas Cosmo, they could have avoided losing millions of dollars.

## Chapter 10: Investors

The SEC is not solely responsible for catching fraud. Investors must perform due diligence before they invest their money. Defined by Merriam-Webster, due diligence is "research and analysis of a company or organization done in preparation for a business transaction." Investors should not be blindsided by greed; they must research their investments before making any transactions.

The SEC lists five questions on its website to ask before investing. The first question to ask is if the seller is licensed. Ask the seller himself, but do not accept his answer--always conduct your own research to verify the information.

The second question to ask is if the investment is registered. Any offer or sale of securities must be registered, unless it is exempt from registration. Examples that would be exempt include private offerings to a limited number of persons or institutions, offerings of limited size, intrastate offerings, and securities of municipal, state, and federal governments. To check if an investment is registered or if it is exempt, you can use the SEC's EDGAR database or contact the SEC via phone (SEC.gov).

The third question the SEC advises to ask is how does the risks compare with the potential rewards? The riskier the investment, the greater the rewards could possibly be. Asking this question is very important. Often investors get greedy and ignore this

knowledge. If an investment is offering you a high return with little to no risk, it is probably too good to be true (SEC.gov).

The fourth question to ask when potentially investing is do you understand the investment? Never invest in something that you do not understand. If you are not savvy with finances, ask a trusted financial professional for help.

The fifth question the SEC advises an investor to know the answer to is where can I turn for help? If an investor is ever unsure about the legitimacy of an investment, do not invest and contact an authority. You can bring any questions or concerns about an investment to the SEC, FINRA, or your state's securities regulator (SEC.gov).

The SEC is not the only one trying to protect investors from getting scammed. Pat Huddleston, former Enforcement Branch Chief at the SEC, founded Investor's Watchdog, which is an investor protection company. Investor's Watchdog offers investors services to help them conduct adequate due diligence (Investor's Watchdog.com, 2012).

Investor's Watchdog offers three main services--BrokerSnapshot report, Winnow investigation, and a Constant Patrol subscription. A BrokerSnapshot report provides basic information on a stockbroker. It includes history of the stockbroker not reported by the Financial Industry Regulatory Authority (FINRA) and an Investor Watchdog's Broker Safety Score (ranging from 40 to 80). The Broker Safety Score is calculated using a culmination of a stockbroker's history such as their education, employment, disciplinary history, and licensing among other background information (Investor's Watchdog.com, 2012).

Investor's Watchdog.com describes a Winnow investigation is "what a due diligence investigation ought to be, focused on detecting and preventing the type of fraud that will continue to plague investors for the next generation and beyond." Investor's Watchdog has the experience and capabilities to detect fraud early when other investigators are not able to. Every Winnow investigation examines the investments to confirm the identity and background of the people behind the investment, reads all disclosure documents, travels to confirm representations made by the promoters, and also investigates the attorneys, auditors, and others involved. The third service Investor's Watchdog offers is a Constant Patrol subscription. This subscription protects the investor by immediately alerting you to an red flags related to your broker (Investor's Watchdog.com, 2012).

Conducting due diligence is extremely important when investing. You can either conduct your own research by following the SEC's guidelines, look to a financial advisor, or enlist the help of an outside source such as Investor's Watchdog. Taking these simple steps in researching your investment could save you from losing everything.

# Conclusion

Ponzi schemes have been cheating investors out of their money since the late 1800s. Although Ponzi schemes were discovered before Madoff, the discovery of Madoff's large scale scheme, brought attention to this particular type of fraud. Although the SEC missed catching Madofff's Ponzi scheme multiple times, they are not solely responsible for his fraud. The SEC is the regulatory body, which monitors for fraud, and they have implemented reforms since 2008 to make certain another Madoff size fraud does not happen. However, the SEC cannot solve the problem on their own. It is also the investors responsibility to conduct due diligence when investing their money. If every investor conducted adequate research before investing his or her money, Ponzi schemes would never have a chance.

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