

MADOFF — A 21ST CENTURY PONZI SCHEME

Bernard Madoff perpetrated a multi-billion dollar scam that defrauded investors around the world for decades until his arrest in December 2008. Madoff's fraud led many to financial ruin and his name is now synonymous with what many consider one of the largest Ponzi schemes in history. What every investor should know is that Ponzi schemes, even as extensive as Madoff's, are not too difficult to detect if you know the warning signs. A few simple actions can help investors sidestep the potentially devastating impact of a classic Ponzi scheme.

What is a Ponzi Scheme?

The "Ponzi Scheme," named after the 1920's swindler Charles Ponzi, is a ploy where earlier investors are paid with funds given by subsequent investors. In a Ponzi scheme, claims of underlying investments are bogus; very few, if any, actual physical assets or financial investments exist. As the number of total investors grows and the supply of potential new investors dwindles, there is not enough money to pay off promised returns and cover investors who try to cash out. A Ponzi bubble bursts when the con artist simply cannot keep up with the required payments. In many cases, the perpetrator has spent investment money on personal expenses, depleting funds and accelerating the bursting of the bubble.

The Madoff Case

For decades, Madoff investors received consistent and steady annual returns through elaborate, fabricated account statements and other documentation that were provided to investors to convince them that their money had been placed in actual investments. The investments "appeared" legitimate, especially to people receiving payments. But in reality, there were no actual investments and no actual returns. Madoff paid the initial investors "returns" with money provided him by a steady flow of new investors.

In 2008, as the global economy began to decline, large numbers of Madoff investors needed money and began asking to cash in their investments. That's when Madoff's Ponzi scheme burst – he did not have enough money to cover his investors' requests and new investor money was hard to be found in the economic downturn.



How to Protect Against Ponzi Schemes

- **Beware of promises of unrealistic returns.** This is perhaps the easiest way to spot a Ponzi scam. Any legitimate investment involves risk. Guarantees of unrealistically high returns are a clear warning sign. But delivering consistent 10 percent returns for decades, as Madoff purported to do, is unrealistic too, if not impossible. “Too good to be true” should be considered a red flag.
- **Diversify – everything.** Don’t put all of your eggs in one basket. Diversify not only your assets but also your money managers, accounts, and financial institutions. Spreading your money around will limit your exposure to the financial problems of any one institution. Victims in the Madoff case who were financially stable after the scam were the ones who invested only a percentage of their assets with Madoff, not their entire life savings.
- **Don’t rely on reputation or word of mouth alone – understand your investment.** Con artists are experts at building networks of trust, making investors think they are getting an “inside” track on a hot investment. Many of Madoff’s victims invested because people they knew and trusted, such as friends and even family members, encouraged them to do so. If someone gives you an “inside” tip, don’t just hand over your money.
- **Verify the investment details.** Ask detailed questions about the investments and those selling the investments, and get clear and direct answers before you invest. In the Madoff case, clients were told that the investment strategy was proprietary and would not be disclosed. If the investments are not explained to you in detail, walk away. If you don’t understand an investment, don’t invest.
- **Auditors.** Check the auditor, or ask your financial adviser to check the auditor of any fund or company for you. Auditors sign and certify financial statements of companies and investment funds. Investors rely on these audit reports since auditors are liable for inaccuracies. A legitimate investment company managing multi-billion dollars of assets under management would use a reputable, nationally known auditing firm. In the Madoff case, with over \$50 billion in purported funds, the fact that the auditor was unknown, hard-to-locate and had only three purported employees responsible for reviewing such an extensive portfolio should have been a red flag to investors.
- **Background Check.** Check with the West Virginia State Auditor's Office, Securities Commission at 888-724-3982 to determine if the individuals and firms selling the investment are properly registered with the State of West Virginia. Remember, anyone selling a security must be registered. If the promoter says he’s exempt, follow-up with your regulator to confirm the claim. You can also check the promoter’s complaint history when you call.
- **Report fraud.** If you’re a victim of a Ponzi scheme, call West Virginia Securities Complaint Line at 888-509-6567. Local securities regulators can investigate the matter and your call may help others from being victimized by the same scam.

→ *Contact information for all state and provincial securities regulators is available on the North American Securities Administrators Association website at www.nasaa.org*

