Ponzi Schemes: Making Sense of the Madoff Mess

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THE TERM "PONZI SCHEME" SHOULD SOUND familiar to anyone who keeps current with the news. Last December, federal authorities arrested Bernard Madoff, a former NASDAQ chairman, for allegedly operating a $50 billion Ponzi scheme—possibly the largest in history. A Ponzi scheme works by paying returns to earlier investors with funds obtained from newer investors. As long as there is a sufficient flow of new "investments," the scheme can continue to operate. The longer the duration of the scheme, however, the greater the likelihood of something going wrong—e.g., major withdrawals of investments during an economic downturn (which is what happened to Madoff)—and exposing the fraud.

The scheme derives its name from Charles Ponzi, a con man who pocketed millions using a stamp arbitrage scheme during the 1920s. Ponzi took advantage of differences in international postage rates by purchasing international reply coupons (i.e., stamp vouchers) in a foreign country, redeeming them for American stamps of a higher value, and then selling the stamps for a profit. Using that get-rich-quick plan, Ponzi lured thousands of mostly unsophisticated investors with promises of 50 percent returns in 45 days. After several months though, investigators uncovered his scheme and imprisoned him for mail fraud.

In contrast to Ponzi's scheme, Madoff's was remarkable for how long it lasted. Most Ponzi schemes unravel within two years; Madoff's scheme may have survived for over two decades. Part of the explanation for this "success" may be that, unlike typical Ponzi schemes that offer suspiciously high returns, Madoff promised a more believable but still very healthy rate of return in the neighborhood of 8 percent to 13 percent. Thus, Madoff did not really employ a get-rich-quick scheme. Indeed, many of his investors were already wealthy and were probably more interested in simply maintaining their wealth.

Consider the fact that a substantial portion of investments came from charitable foundations, which theoretically would be loathe to withdraw investments because guaranteed consistent returns near double digits provide such organizations with an easy way to satisfy the federal rule requiring them to spend 5 percent annually on certain expenses. Undoubtedly, regulatory failure, namely the Securities and Exchange Commission's failure to thoroughly investigate, also played a role in sustaining the scheme.

Still, there were warning signs. For example, Madoff's promise of steady returns covered bad economic times. Surely, his investors must have known that free market economies are inherently cyclical and that one should be wary of anyone who promises to "beat the system." Moreover, there were numerous reports and allegations suggesting that Madoff's operation was a sham, some of which were specifically brought to the SEC's attention.

Although a discussion of the issues raised by Madoff's scheme could fill a library, some points bear mentioning here. First, Ponzi schemes are neither new nor likely to disappear anytime soon. New Jersey should know this all too well, since New Jersey-based investors are often among the victims. Another high profile scam involved New Jersey corporations affiliated with Manufacturers Credit, which began selling high-interest promissory notes in 1948 to investors who thought they were investing in bus companies and related businesses. Instead, by 1966, the scheme failed when its designer ran out of money to meet the high-interest payments.

Another point to remember is the importance of due diligence. Given the appearance of exclusivity and prestige Madoff was able to create, as well as his historical performance, it is understandable why some investors ignored warning signs, but it also underscores the necessity of truly understanding the facts, especially when the temptation to succumb to gullibility is high.

Finally, as is often the case with financial scandals, the call for reform is loud. While reform may be necessary—e.g., perhaps realigning the SEC's incentives so as to better insulate the agency from Wall Street-induced political pressure—the reality is that any system is only as good as the people in the system. ■

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