

A review of the Government Gazette and new developments in law

Madoff's fraud holds lessons for us

A \$50BN pyramid scheme which recently collapsed in the US needs to be carefully analysed by SA's tax authorities to ensure that our tax laws do not allow similar schemes to operate within our jurisdiction without detection.

On December 10 last year, it is alleged that Bernard Madoff informed his two sons, Andrew and Mark, that the asset management division of his firm, Bernard L Madoff Investment Securities LLC, was a giant Ponzi scheme.

The \$50bn fraud that federal authorities say Madoff perpetrated has been called the largest Ponzi scheme in history. In a Ponzi scheme, named after flamboyant con man Charles Ponzi, potential investors are wooed with promises of unusually large returns, usually attributed to the skill of the investment manager (or some secret technique). The returns are repaid, at least for a time, out of new investors' principal, not from profits. This can continue as long as new investors line up with cash, and old investors don't try to withdraw too much money at once.

Ponzi schemes are also known as pyramid schemes, from the shape of any chart that reflects their basic premise – that ever-growing layers of new recruits are needed to provide gains to the smaller, earlier cohorts.

Charles Ponzi's original scam followed a particularly spectacular course. He began telling New York investors in December 1919 that investments in foreign postage coupons could yield 50% returns in 45 days. By redeeming coupons bought cheaply overseas for much higher amounts in the US, he could double their money in three months, he claimed. As the fever spread, millions of dollars were coming in every week, most of it from ordinary working-class people investing as little as \$10.

With successive waves of people entrusting him with their cash, Ponzi needed only enough money to pay off those people redeeming their coupons. In the end investors were left holding the bag and the brief reign of Ponzi came to an end. He was convicted of mail fraud in 1920 and served time in federal and state prisons before he was de-



A protester in front of the apartment of Bernard Madoff moments before he was driven for a scheduled bail hearing in New York last month. Picture: AP

ported to Italy in 1934.

So what did Madoff do or not do?

Madoff exploited his social networks to create an elaborate Ponzi scheme that promoted his investment strategy to a largely upper class Jewish clientele. The Jewish clientele were linked to educational foundations and charities and over time he convinced the foundations and charities to invest their charitable funds with his firm. He focused on the Jewish community to establish an elaborate affinity fraud with the sole purpose of gaining access to significant amounts of money, but more importantly, to maximise the possible benefits that could be derived

the market meltdown last year which led to extraordinary demands for cash by investors in December that led to its collapse.

Some of the biggest losers included the world's largest investment managers and hedge funds that got caught up in the scheme wanting to make unusually large returns for them or their clients.

The biggest losers included Fairfield Greenwich (\$7,5bn), Tremont (\$3,3bn), Santander (\$3,2bn), Gabriel Capital (\$2,7bn), Kingate (\$2,5bn) and Fortis (\$1,3bn). There is still \$15,558bn unaccounted for and will need to be reconciled in the next few months. A further 21 known companies make up \$402,5m and include some well known companies such as Nordea, Shell and Société Générale (still reeling from the rogue trader scandal).

In November 2005, Harry Markopolos, an accountant, complained to the US Securities and Exchange Commission (SEC) on identifying 29 red flags suggesting that Madoff was a fraud. His identification of the red flags was based on an extensive assessment performed on supposed trading practices and returns at Madoff after his employer, Rampart Investment Management, were keen to learn how they could match Madoff's double-digit returns.

His assessment was simple: to assess the steady profits delivered to clients regardless of market conditions. Markopolos developed a complex mathematical model to simulate Madoff's returns using information he had gathered about Madoff's trades in stocks and options. When Markopolos

from a federal law specific to foundations. His focus on foundations was based on a federal law that required foundations to pay out 5% of their funds each year. As long as the foundation's principal earned 5% a year the foundation or charity would endure and survive and so too its sponsor: Madoff.

This meant that for every \$1bn in foundation investment, Madoff was required to fund \$50m in withdrawals each year. By targeting foundations and charities Madoff could avoid the threat of sudden or unexpected withdrawals and would be able to continue with his Ponzi scheme. His scheme seemed to operate well in a closed circle environment until

Pyramid scheme

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could not simulate Madoff's returns he soon realised that he was either running a Ponzi scheme — using money from new clients to pay off old ones — or he was “front running” stocks, improperly trading in investors' private accounts ahead of orders the firm received from outside clients. After he lodged his formal complaint to the SEC he received little response until Madoff came clean.

RISK management specialists and forensic accountants believe that two simple risk management techniques could have been used to uncover the fraud at Madoff's brokerage. One of these is called the bias ratio — a mathematical technique that identifies abnormalities in the distribution of a series of investment returns and examines “month-to-month changes in net asset value” against various statistical return patterns, by asset class. This technique would have shown that the returns being declared were inconsistent with the statistical return patterns by asset class.

Forensic accountants use a similar and simple technique called Benford's law to detect possible accounting fraud. A physicist named Benford discovered that “numbers with low first digits occurred more frequently in the world”.

The application of Benford's law could infer that sustained steady growth would have been highly improbable and should have led to an investigation.

A third simple assessment would have shown that the risk profile of the Madoff brokerage compared to its peer group would have shown it to be inconsistent with his claimed investment style. This in itself should have been a red flag to regulatory authorities.

The regulatory authorities locally need to take note of the establishment and operation of the scheme as it was allowed to circumvent the compliance and risk management techniques implemented to uncover corporate mischief. The localisation of the scheme needs to be assessed to ensure that local tax laws do not allow similar schemes to operate within our jurisdiction without detection.

A cooling off period should be considered for officials that have previously worked for the stock exchange and regulatory authorities to joining private investment firms to ensure that these individuals do not benefit from relationships established at the stock exchanges and regulatory authorities that may allow them to also operate undetected.

The red flags identified over a number of years at Madoff's empire were not investigated and ultimately led to the biggest corporate scandal to date. The South African Institute of Chartered Accountants should assess the red flags identified in the scandal and see how further disclosure and transparency can be promoted.

The Independent Regulatory Board for Auditors (Irba) should use the scandal to include new mechanisms and techniques to uncover fraud, theft and corruption. Specific training interventions should focus on Ponzi schemes and how these operate in the local jurisdictions. The better the training interventions the better prevention.

We are fortunate that in SA the King Code on Corporate Governance has gone a long way to addressing many of the issues raised in the Madoff scandal.

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