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How to Make a Madoff

Spectacular investing frauds like the one allegedly created by the New York financier typically happen during investing bubbles—and only get exposed once they pop

By [Ben Levisohn](#)

The popping of an asset bubble has a way of bringing investment fraud out of the shadows and into the light. It looks to be no different with [the case of Bernard Madoff](#)—respected financier, in-demand money manager, former NASDAQ chairman, and current poster boy for investment trickery. Madoff stands accused of operating an elaborate [Ponzi scheme](#), using cash from new investors to pay off older ones, to the tune of \$50 billion. The alleged offenses only came to light because he could no longer raise the money to keep his scheme going, according to the U.S. Securities & Exchange Commission.

Sadly however, Madoff's alleged scam is not unique.

Need proof? There's Richard Whitney—respected financier, in-demand money manager, and former head of the New York Stock Exchange (sound familiar?)—whose own investment company, circa 1938, turned out to be as empty as Madoff's 70 years later. Just as in the 2008 version, investors were wiped out by Whitney's scheme, which began when he started borrowing money to cover investment losses in penny stocks. His victims included the New York Yacht Club, the New York Stock Exchange, and his father-in-law.

LEARNING FROM HISTORY

To experts, one thing is clear: "It happens every time there's an asset bubble," says Robert Wright, a financial historian at New York University.

Bubbles provide the cover the crooked need to perpetrate their scams. When the market's heading up, any investment seems possible. Go back to 1720 and England's South Sea Bubble. Shares became so frothy, investors snatched up stock in a company whose business was so secret it could not be revealed in a prospectus.

Banking stocks were the investment of choice in 1792, when William Duer, a respected investor close to Secretary of the Treasury Alexander Hamilton, rapidly drove up shares of the Bank of New York, only to be unable to meet his obligations. "The greediness of a bubble is a breeding ground for bad actors," says Jeff Marwil, a partner with law firm [Winston & Strawn's](#) Restructuring and Insolvency Group.

WHAT WAS MADOFF'S MOTIVATION?

Complacent investors may enable the fraud. When the market's going up, they assume everyone else is making money and want to also. They have the option of investigating who they invest with, but many get seduced by the combination of stable returns and a stellar reputation. After the fact, many claim they simply trusted their advisers.

But trust is a funny thing when it comes to money. "The financial system is not based on trust," NYU's Wright

says. "Banks don't trust you—that's why they take collateral. You don't trust the bank—that's why we have the FDIC."

Still, no one knows what may have caused Madoff to turn his successful trading firm into an elaborate scam, as he is accused of doing. Here was a man who had money and respect and now is charged with bilking investors, from hedge funds to individuals to banks, of billions of dollars.

"THE EASY WAY OUT"

Madoff has company. Recent frauds include the \$3 billion Ponzi scheme allegedly perpetrated by Tom Petters in Minneapolis—he is accused of using the money to fund a jet-setting lifestyle—or Samuel Israel's Bayou Hedge Fund Group, which created a dummy accounting firm to cover up trading losses.

But while bubbles provide opportunity, it's ultimately the financial wizards themselves that create and perpetrate these schemes. "Sometimes the people at the wheel take the easy way out," says Gregory Hold, chief executive of brokerage firm [Hold Brothers](#).

Others are less forgiving. Says Marwil, who has worked on recovery at Bayou: "I don't think you can reach a conclusion other than they are bad guys." The investors—ranging from charities, universities, and individuals salting away money in 401(k) funds—who are left with massive losses as these schemes blow up might agree, albeit in harsher language.

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