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Ponzi Schemes - What to look for..

Financial historians narrate tales of the South Sea Bubble in the early 1700's or the Tulip Mania in Holland in the late 1630's, panic buying and hefty stock price rises due to speculation, insider trading, media manipulation and even government involvement. Thousands of investors were financially ruined once these investment “schemes” collapsed. A more recent example was the US\$ 6 billion BRE-X gold stock fraud in Canada. Text book financial catastrophes, although it should be pointed out that some made vast fortunes in these bubbles, and naturally chose to keep quiet about their gains.. For every buyer, there is a seller!

Investment plausibility can be exploited when greed is fueled, often with confused regulators not knowing where to look, despite their suspicions - Charles Ponzi became noted in 1920, in Boston, for his supposed arbitrage scheme, which ultimately proved to be merely a masquerade for paying off early investors with the deposits of later investors. The Ponzi Scheme is named after him.

“A Ponzi scheme is a fraudulent investing scam promising high rates of return with little risk to investors. The Ponzi scheme generates returns for early investors by acquiring new investors. This is similar to a pyramid scheme in that both are based on using new investors' funds to pay the earlier backers.”

More recently, Bernie Madoff literally “made off” with US\$ 65 billion, under the very noses of the regulators he was a former chairman of. He received a 150 year prison sentence. The US is sensitive to Ponzi schemes – we are aware of a recent case involving only US\$ 5 million, with a possible sentencing of up to 20 years, in Connecticut, USA. Serious stuff!!

So with above introduction, we bring up the umbrella fund we are investigating in Luxembourg, with not one but 3 identifiable Ponzi schemes. Overnight we have become the Luxembourg experts, although of course Madoff left his mark with many local investors still awaiting their share of recovered Madoff proceeds. All 3 funds had the following features :-

- monthly subscription/redemption liquidity, but investing in long term loans
- monthly distributions to shareholders, mainly paid from new investor monies
- each fund advisor/sponsor hid their backgrounds – inexperience, mismanagement, fraud
- continuously rising share prices (NAV per share) driving investor demand to subscribe
- NAV per share calculated by an “independent” administrator who was actually a shareholder and with directors in the investment manager, essentially acting in concert
- a “big 4” auditor lending its name to the annual audited accounts, misquoting investment maturities, overlooking the clear signs of a Ponzi scheme – on 3 funds

- investor marketing representations mismatching with the reality of the actual investments, with investors “surprised” when informed of the investment portfolio invested in
- shareholder confidence bolstered by major institutional service providers and regulatory oversight
- investor complaints to the regulator were “fobbed” off as they being “well-informed” investors – ignoring the fraud, not market risk, in these fund situations

Net result - € 100 million of losses, almost 400 angry and disillusioned investors, and almost 30 civil and/or criminal complaints, and lessons to be learned. New directors piecing together the history of the frauds.

A trusting financial community was also caught off-guard – custodian banks relying on forged title documents, overseas auditors also contributing to the misinformation, and directors/ investment manager watching the Asset Under management growing exponentially with little regard to the underlying investment portfolios.

Whilst this case study in Ponzi schemes works its way through the courts, let us propose measures for better avoidance of such financial disasters in the future.

- avoid mismatch of open-ended liquidity (eg monthly) with investment duration (eg 3 year loans)
- the AIFM should be kept out of the NAV calculation process, the administrator should not have a carried profit interest in the fund's success and/or growth
- ongoing monitoring of the activities of the people involved in the investment process
- is suspicions aroused, stop and check could avoid bigger future losses
- ensuring that investor material is consistent with the prospectus

Let us hope Charles Ponzi's legacy does not re-appear in Luxembourg any time soon..

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