

Ponzi Schemes: Common Tactics, Red Flags, and a Selection of Cases¹

By Louis F. Burke

"Even if they never got anything for it, it was cheap at that price."

A quote by: Charles Ponzi

Ponzi schemes are a type of illegal pyramid scheme based on the "rob Peter to pay Paul" principle, whereby the perpetrator uses money from new investors to pay off the earlier ones until there are no more new investors and the whole scheme collapses.² This paper looks at common tactics which are the driving force behind ponzi schemes and the red flags of fraud.

Ponzi schemes are named for Charles Ponzi, who duped thousands of New England residents into investing in a postage stamp speculation scheme in the 1920's.³ Ponzi thought he could take advantage of differences between U.S. and foreign currencies used to buy and sell international mail coupons, and told investors that he could provide a 40% return in just 90 days compared with 5% for bank savings accounts.⁴ Ponzi was deluged with funds from investors, at one point in 1921 took in \$1 million during one three-hour period.⁵ Ponzi paid a few early investors to make the scheme look legitimate, but an investigation later concluded that Ponzi had only purchased about \$30 worth of the international mail coupons.⁶

Although Charles Ponzi is credited with creating the "ponzi scheme", the first extensively recorded scheme, written about by Mackay in 1841, was conceived by a Scotsman, John Law, in France in 1719.⁷ It was immediately followed by the South Sea Bubble in Great Britain in 1720.⁸ Such types of schemes continued to exist after John Law. For example, in 1899, William Miller defrauded investors out of \$1 million, nearly \$25 million in today's dollars.⁹ Miller claimed to investors to have an inside window into the way profitable companies operated.¹⁰ Miller astonishingly promised these investors a return rate of 520% over the course of a year on their investment.¹¹ Miller enticed new investors by paying out the first few investors.¹² After his racket was exposed by a newspaper investigation, he was sentenced to 10 years in prison, and his creditors received just 28 cents back for every dollar they had invested.¹³

¹ This article was prepared for and presented at the 53rd Union Internationale des Avocats Congress in Seville, Spain before the Litigation Commission on October 29, 2009.

² North American Securities Administrators Association, *Ponzi Schemes*, http://www.nasaa.org/Investor_Education/Investor_Alerts_Tips/8315.cfm (last visited Aug. 5, 2009).

³ *Id.*

⁴ *Id.*

⁵ *Id.*

⁶ *Id.*

⁷ Utpal Bhattacharya, *The Optimal Design of Ponzi Schemes in Finite Economies*, 12 JOURNAL OF FINANCIAL INTERMEDIATION 2, Jan. 2003.

⁸ The South Sea Company was a British joint stock company that traded in South America during the 18th century. Founded in 1711, the company was granted a monopoly to trade in Spain's South American colonies as part of a treaty during the War of Spanish Succession. In return, the company assumed the national debt England had incurred during the war. Speculation in the company's stock led to a great economic bubble known as the South Sea Bubble in 1720, which caused financial ruin for many.

⁹ Alex Altman, *A Brief History of: Ponzi Schemes*, TIME MAGAZINE, Dec. 15, 2008, available at <http://www.time.com/time/printout/0,8816,1866680,00.html> (last visited Aug. 4, 2009).

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

By way of illustration, the following is instructive:

- I. Investor ("A") gives Promoter ("P") \$1,000 on P's promise to repay A the \$1,000 plus an amount interest in a stated time period – let's say 90 days.
- II. During the 90 days, P makes similar promises to investors B and C, receiving \$1,000 from each of them.
- III. At the end of the 90 day period, P may offer A the return of the \$1,000 plus the \$100 interest, but most likely, P will invite A to re-invest the money for a similar or higher return at the end of another period of time.
- IV. Thereafter, A, believing that the investment is safe and a good investment, is likely to agree to the deal, and to bring other investors to P.
- V. In this manner, P collects a pool of money that he can use to pay out those few wishing a more immediate return on their money.

In recent years, Ponzi schemes have cropped up with increasing regularity. Some believe that the increase is due to the boom years of the 1980's and 1990's, which brought about an explosion of financial services, new investment options, and increasingly sophisticated investment vehicles.¹⁴ The advent of the internet and a fast-changing marketplace, have also provided promoters with a perfect environment in which to dress up their schemes and thwart detection.¹⁵ Whatever the vehicle, ponzi schemes continue because they thrive on basic human greed.¹⁶

But how can these schemes work so well, and trap even the most conservative and sophisticated investors? Why have people not learned their lesson after centuries of these schemes? It may just come down to basic human nature - greed. The following common tactics are the real driving forces behind ponzi schemes.

COMMON TACTICS

The "Phantom Riches" Tactic¹⁷

Ponzi schemes thrive on basic greed – a promise to get rich quick.¹⁸ Dangling the prospect of wealth, enticement with something you want but you can't have.¹⁹

The "Source Credibility" Tactic²⁰

¹⁴ North American Securities Administrators Association, *supra* note 1.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ Katy Marquardt, *Why Investors Fall for Ponzi Schemes*, U.S. NEWS & WORLD REPORT, Mar. 12, 2009, available at <http://www.usnews.com/blogs/new-money/2009/03/12/why-investors-fall-for-ponzi-schemes.html> (last visited Aug. 4, 2009).

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

Successful ponzi schemes build credibility by claiming to be with a reputable firm or to have a special credentials or experience.²¹ Many promoters accomplish this by forming relationships with financial institutions.²² With leading reputable banks at their side, promoters add legitimacy to their schemes and can create a relationship in which government regulation of the promoter's activities can be considerably reduced.

Many promoters open a securities or commodities account or both at brokerage firms as customers of these institutions not disclosing that they are in possession of third party funds they will be trading with.²³ The Promoter wants to avoid registration with the SEC or CFTC in order to avoid SEC or CFTC regulation. Promoters will call themselves money managers, hedge fund advisors, or traders.²⁴ But clearing firms carrying the Promoter's account must not accept third party funds for these ventures without having an assurance the Promoter is indeed not required to register with either the SEC as an Investment Advisor or CFTC as a Commodity Trading Advisor or Commodity Pool Operator.

For these clearing financial institutions, increased profits sometimes come before sound judgment and regulatory compliance.²⁵ While current regulations make it difficult to hold clearing firms responsible for the illegal acts of the Promoter, a different result occurs when the clearing firm knowingly provides substantial assistance to the promoter in carrying out the illegal scheme.

The "Social Consensus" Tactic²⁶

The ponzi scheme model is built on leading investors to believe that other savvy investors have already invested.²⁷ Initial investors in the scheme are then paid their promised rates of return, and often with returns considerably higher than those originally promised.²⁸ Frequently, this is the "hard" proof that skeptical investors insist on seeing before they will jump in with both feet.²⁹

One reason that this tactic works so well is that these early investors commonly reinvest their money back into the scheme after they are paid. Thus, the promoter does not actually have to pay out very much. The promoter simply sends false statements and other account documents to the initial investors showing them how much they are earning by investing with the promoter.³⁰ This builds trust and maintains the appearance that the scheme is a legitimate fund.³¹

The "Air of Exclusivity" and "Scarcity" Tactic³²

²¹ Ponzi Schemes Could not Exist Without the Help of Banks, <http://www.avoicemainstreet.com/tags/ponzi-scheme> (Jul. 14, 2009).

²² *Id.*

²³ Marquardt, *supra* note 16.

²⁴ *Id.*

²⁵ Ponzi Schemes Could not Exist Without the Help of Banks, <http://www.avoicemainstreet.com/tags/ponzi-scheme> (Jul. 14, 2009).

²⁶ Marquardt, *supra* note 16.

²⁷ North American Securities Administrators Association, *supra* note 1.

²⁸ *Id.*

²⁹ *Id.*

³⁰ Liz Moyer, *Will Bernie Madoff Get Life?*, NEWSWEEK, Mar. 3, 2009, <http://www.newsweek.com/id/188847>.

³¹ *Id.*

³² Marquardt, *supra* note 16.

Promoters need to sell themselves and their product. Many promoters accomplish this by not promoting themselves. Frequently, promoters rely completely on word of mouth to line up new investors.³³ To start this process, the promoters often concentrate their initial efforts on specific cities, types of investors, family members, groups, professionals or social acquaintances.³⁴ For example, in one ponzi scheme a deaf promoter zeroed in on members of the deaf community.³⁵

Promoters must also keep the scheme exclusive so that people do not ask too many questions in fear that they may be excluded.³⁶ This is also important for those whose money is already invested. This yields the desired result: the initial victims unwittingly aid the swindler by lining up their closest friends, relatives and professional associates as new victims and in doing so don't question the underlying scheme.³⁷ For example, in the Bernie Madoff ponzi scheme, Madoff did not allow everyone potential investor in and he recruited investors through close friends and associates.³⁸

The Fear Tactic³⁹

Fear also plays a role when the ponzi scheme starts to collapse.⁴⁰ Investors are usually slow to admit that they have been swindled.⁴¹ Frequently, there is the fear that public exposure will create a crisis of confidence that could create a run on the promoter and make things worse.⁴² There is also the fear of looking foolish for being blinded by greed.⁴³ The investor may fear that if his suspicions are wrong, he will be kicked out of the high-interest scheme.⁴⁴ And since the Ponzi scheme relies on a sense of community, there is the fear that the first investor who breaks ranks will be blackballed in his professional or social circles.⁴⁵

Investors in ponzi schemes also frequently cling to even the faintest of hopes that everything will work out for the better.⁴⁶ This brand of thinking has resulted in investors defending ponzi promoters as heroes, saints and misunderstood financial geniuses with basically good intentions.⁴⁷ Frequently, an exposed Ponzi operator will capitalize on these sentiments by stating

³³ North American Securities Administrators Association, *supra* note 1.

³⁴ *Id.*

³⁵ Kevin McCoy, *Recession Forces Unraveling Ponzi Schemes into the Open*, USA TODAY, Apr. 17, 2009, available at http://www.usatoday.com/money/markets/2009-04-14-markets-recession-scheme-ponzi_N.htm (last visited Aug. 4, 2009).

³⁶ North American Securities Administrators Association, *supra* note 1.

³⁷ *Id.*

³⁸ Chad Bray, *Bernard Madoff Lieutenant DiPascali Pleads Guilty*, THE AUSTRALIAN, Aug. 12, 2009, <http://www.theaustralian.news.com.au/business/story/0,28124,25918295-5017997,00.html>.

³⁹ North American Securities Administrators Association, *supra* note 1.

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

that he just got in over his head, or that he meant well, but that the situation just got out of hand.⁴⁸

RED FLAGS OF FRAUD

The following are warning signs of investment fraud:

- **Guarantees:** Be suspect of anyone who guarantees that an investment will perform a certain way. All investments carry some degree of risk.⁴⁹
- **Unregistered products:** Many investment scams involve unlicensed individuals selling unregistered securities—ranging from stocks, bonds, notes, hedge funds, oil or gas deals, or fictitious instruments, such as prime bank investments and unregistered commodity pools.⁵⁰
- **Overly consistent returns:** Any investment that consistently goes up month after month—or that provides remarkably steady returns regardless of market conditions—should raise suspicions, especially during turbulent times. Even the most stable investments can experience downturns once in a while.⁵¹
- **Complex strategies:** Avoid anyone who credits a highly complex investing technique for unusual success. Legitimate professionals should be able to explain clearly what they are doing. It is critical that investors fully understand any investment they are considering—including what it is, what the risks are and how the investment makes money.⁵²
- **Missing documentation:** If someone tries to sell you an investment program with no documentation—that is, no prospectus in the case of a stock or mutual fund, and no offering circular in the case of a bond or no disclosure document in the case of a commodity investment—the Promoter may be either selling unregistered securities or an unregistered commodities pool.⁵³
- **Account discrepancies:** Unauthorized trades, missing funds or other problems with your account statements could be the result of a genuine error—or they could be an indication of churning or fraud. Keep an eye on your account statements to make sure account activity is consistent with your understanding and instructions, and be sure you know who holds your assets. For instance, is the investment adviser also the custodian of your assets? Or is there an independent third-party custodian? It can be

⁴⁸ *Id.*

⁴⁹ Brett Arends, *These Red Flags Can Signal Ponzi Scheme*, THE WALL STREET JOURNAL, Dec. 16, 2008, available at <http://online.wsj.com/article/SB122937799268308369.html> (last visited Aug. 5, 2009).

⁵⁰ *Red Flags of Ponzi Schemes*, FRAUD EXAMINER NEWSLETTER (Association of Certified Fraud Examiners, Austin, T.X.), Aug. 2009, available at <http://www.acfe.com/newsletters/fraud-examiner.asp?copy=aug09-ponzi-flags> (last visited Aug. 5, 2009).

⁵¹ Arends, *supra* note 58.

⁵² *Id.*

⁵³ North American Securities Administrators Association, *supra* note 1.

easier for fraud to occur if an adviser is also the custodian of the assets and keeper of the accounts.⁵⁴

- **A pushy salesperson:** No reputable investment professional should push you to make an immediate decision about an investment, or tell you that you've got to "act now." If someone pressures you to decide on a stock sale or purchase, steer clear. Even if no fraud is taking place, this type of pressuring is inappropriate.⁵⁵

A SELECTION OF RECENT PONZI SCHEMES

R. Allen Stanford: In February 2009, the SEC charged Stanford and three of his companies, Stanford Capital Management, Stanford Group Company, and Stanford International Bank, with "massive" fraud. It is alleged that Stanford International Bank sold about \$7 billion of so-called certificates of deposit to about 50,000 investors by promising "improbable and unsubstantiated high interest rates."⁵⁶

George Hudgins: In May 2008, the CFTC charged Texas businessman George Hudgins with fraudulently soliciting the general public to participate in the 3737 Financial L.P. commodity pool, also known as Hudgins Group and Hudg-Investments, which traded exchange-traded commodity futures and option contracts in violation of the anti-fraud provisions of the Commodity Exchange Act. It is alleged that Mr. Hudgins defrauded over 400 investors out of approximately \$88 million.⁵⁷

Bernard Madoff: In December 2008, federal authorities arrested Bernie Madoff and charged him for operating what has been called the largest investor fraud ever committed by an individual. On June 29, 2009, Madoff was sentenced to 150 years in prison for swindling thousands of investors. The Court ordered Madoff to pay restitution of \$170 billion. As of November 2008, prosecutors estimated the size of the fraud to be \$64.8 billion. The investigation revealed that Madoff had not done a trade on behalf of clients in 13 years. The investigation also placed the SEC under fire for not investigating Madoff more thoroughly, since questions about his firm had been raised as early as 1999.⁵⁸

Nicholas Cosmo: On January 26, 2009, Nick Cosmo, dubbed "Little Bernie Madoff" surrendered to federal authorities in connection with a suspected \$370 million Ponzi scheme. Cosmo, through his Long Island-based firm Agape World, promised up to 1,500 investors high returns from his alleged short-term loans to construction companies. Cosmo had done prison

⁵⁴ Kathleen Pender, *How to spot a Ponzi Scheme*, SAN FRANCISCO CHRONICLE, Jan. 11, 2009, available at <http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2009/01/11/BUKO156JB3.DTL> (last visited Aug. 5, 2009).

⁵⁵ *Red Flags of Ponzi Schemes*, *supra* note 59.

⁵⁶ Juan A. Lozano, *Guilty Plea in Ponzi Scheme Sheds Light on R. Allen Sanford Case*, FORT WORTH STAR TELEGRAM, Aug. 27, 2009, available at <http://www.star-telegram.com/804/story/1565582.html> (last visited Aug. 28, 2009).

⁵⁷ *Ponzi Scheme in Commodity Futures Trading Nets \$86M for CFTC from Texas Businessman*, available at http://www.lawupdates.com/summary/ponzi_scheme_in_commodity_futures_trading_nets_86m_for_cftc_from_texas_busi/ (last visited Aug. 28, 2009).

⁵⁸ Diana B. Henriques, *Madoff is Sentenced to 150 Years for Ponzi Scheme*, N.Y. TIMES, Jun. 29, 2009, available at <http://www.nytimes.com/2009/06/30/business/30madoff.html> (last visited Aug. 28, 2009).

time a decade ago for securities fraud.⁵⁹ In conjunction, in March 2009, a lawsuit was filed against Bank of America, claimed that Bank of America “established, equipped and staffed” a branch office in the headquarters of Mr. Cosmo’s firm, Agape Merchant Advance. As a result, the lawsuit contends that the bank knowingly “assisted, facilitated and furthered” Cosmo’s fraudulent scheme.⁶⁰

Stephen Walsh and Paul Greenwood: In March 2009, two former New York Islander bosses were charged with stealing \$553 million from charities and pension plans to buy horses, mohair teddy bears, and a \$3 million home. Prosecutors say that the two took in over \$1.3 billion from institutional investors, such as the University of Pittsburgh and Carnegie Mellon University, by promising huge rates of returns with bogus claims of trading strategy that outperformed the S&P 500 Index for a decade.⁶¹

Arthur Nadel: In April 2009, a federal grand jury indicted Florida based hedge fund manager Arthur Nadel on securities, mail and wire fraud charges stemming from defrauding over 350 clients out of about \$360 million. Nadel surrendered to authorities after one of his partners concerned about the health of their funds after the Bernard Madoff scandal began pressuring Nadel to have their books audited by an independent accountant.⁶²

Marc Dreier: In July 2009, lawyer Marc Dreier was sentenced to 20 years in prison for securities fraud in conjunction with a scheme to sell \$700 million in fictitious promissory notes purportedly issued by companies in the United States and Canada. Dreier was also the sole equity partner of the now dissolved law firm Dreier, LLP, and it is alleged that he also embezzled over \$400 million from client escrow accounts.⁶³

John Bravata and Richard Trabulsy: In July 2009, the SEC charged Bravata and Trabulsy with securities fraud. It is alleged that the men raised more than \$50 million from at least 440 investors by offering them membership interests in a purported real estate investment fund with promised annual returns of 8 to 12 percent, but that no more than \$20.7 million of the more than \$50 million raised since May 2006 through the sale of membership interests in BBC Equities.⁶⁴

Shawn Merriman: In April 2009, the SEC charged Denver-based investment manager, Merriman, through his company Market Street Advisors, with fraudulently obtaining an estimated \$17 to \$20 million from at least 38 investors residing in such states as Colorado, Minnesota, and Utah. Merriman told investors that he would invest their funds in stocks and options, and he reported impressive and consistent annual returns to investors. Instead, Merriman did not trade stocks and options after his first year of operations, during which he suffered trading losses, and

⁵⁹ Robert Chew, *Another Ponzi Scheme? Money Manager Cosmo Busted*, TIME MAGAZINE, Jan. 27, 2009, available at <http://www.time.com/time/business/article/0,8599,1874283,00.html> (last visited Aug. 28, 2009).

⁶⁰ Patricia Hurtado, *Cosmo Indicted for Mail, Wire Fraud in Ponzi Scheme (Update 2)*, BLOOMBERG, Apr. 23, 2009, <http://www.bloomberg.com/apps/news?pid=20601087&sid=auoIOEAnpqag&refer=home>.

⁶¹ McCoy, *supra* note 40.

⁶² *Id.*

⁶³ Benjamin Weiser, *Lawyer Gets 20 Years in \$700 Million Fraud*, N.Y. TIMES, Jul. 13, 2009, available at <http://www.nytimes.com/2009/07/14/nyregion/14dreier.html> (last visited Aug. 28, 2009).

⁶⁴ *SEC v. John J. Bravata, et al*, Case No. 09-CV-12950 (E.D. Mich., filed July 26, 2009), SEC Litigation Release No. 21155, (Jul. 28, 2009), <http://www.sec.gov/litigation/litreleases/2009/lr21155.htm>.

he used millions of dollars in investor funds to support his lavish lifestyle and pay out withdrawals by other investors.⁶⁵

Sidney and Charlotte Hanson: In August 2009, the CFTC settled with Sidney and Charlotte Hanson, the owners of the Queens-based investment company, Queen Shoals Group LLC. It is alleged that the couple fraudulently solicited at least \$22.5 million from individuals and entities to conduct off-exchange foreign currency futures (forex) trading. It is also alleged that the couple lured prospective customers with promises of returns of 8 percent to 24 percent through customers investing via promissory notes for terms of one to five years.⁶⁶

Weizhen Tang: In April 2009, the SEC charged Weizhen Tang (who called himself the Chinese Warren Buffet) with running a ponzi scheme that targeted mostly Chinese-Americans. It is alleged that Tang raised between \$50 million and \$75 million from about 200 investors for his Canada-based hedge fund, Overseas Chinese Fund Limited Partnership. Tang faces similar allegations in Canada, where the Ontario Securities Commission, Canada's main stock market regulator, said it was investigating the alleged scheme run by Tang. The commission has issued a cease trade order against Tang's companies.⁶⁷

⁶⁵ Steve Raabe, *Local Money Manager Faces Ponzi-Scheme Allegations*, DENVER POST, Apr. 9, 2009, available at http://www.denverpost.com/ci_12103015.

⁶⁶ *CFTC Charges Charlotte, North Carolina Couple Sidney and Charlotte Hanson and their Companies with Operating a \$22.5 Million Foreign Currency Ponzi Scheme*, CFTC Enforcement Press Release No. 5689-09, (Aug. 7, 2009), <http://www.cftc.gov/newsroom/enforcementpressreleases/2009/pr5689-09.html>.

⁶⁷ Jeff Carlton, *Weizhen Tang: The Chinese Warren Buffet Accused of Ponzi Scheme*, HUFFINGTON POST, Apr. 6, 2009, http://www.huffingtonpost.com/2009/04/06/weizhen-tang-the-chinese-_n_183732.html.