Ponzi Rides again (And Again)

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“Confidence – The feeling you have

before you fully understand the situation …”

Ponzi schemes are all the rage these days. In fact many new fraud schemes have been dubbed Ponzi schemes, “mini Madoffs” and other titles, no matter how much they resemble this particular scheme or not. Nevertheless, there is something particularly instructive about Ponzi schemes, their continued popularity with … victims. While Carlo “Charles” Ponzi did not invent the methodology, he did bring it to the front of the public’s attention and his name has been associated with these schemes since the 1920’s.

While there are many classic fraud methodologies, the Ponzi scheme is particularly unique for its ability to ensnare individuals and institutions, “mom and pop” types, sophisticated investors, and leading multinationals. Its’ very notoriety should make it the easiest fraud scheme to spot, and yet it continues to be one of the most profitable models for the fraudster to employ. According to the FBI they are now working more active Ponzi scheme investigations, nearly 500, than any time in FBI history. The FBI, Postal Inspectors, the SEC, all of these offices are being flooded with Ponzi reports, indicating both the number of schemes operating and the impact of the economy on the fraudsters. What was formerly perceived as a small scale scheme must now be acknowledged as one of the prime money makers in the fraud world.

There are several good sources to learn the history of the schemes (consider Joe Wells “Frankensteins for Fraud” for one), but the purpose of this paper is to explore the successes of these schemes and identify failings and factors that fraud examiners can use to be more effective in detecting and preventing fraud. For that is the ultimate lesson of Charles Ponzi, despite all of the scholarship, education, automation, technology products and advanced audit systems, these schemes still work. And they work well.

Ponzi schemes run many years (by some accounts Madoff’s version ran 40 years) and regularly cause hundreds of millions and now billions of dollars in losses when they finally implode. So what is it about these schemes that make them so seductive to investors or all sizes and levels of sophistication? And what is it about our due diligence and even the fraud examination process overall that allows these schemes to grow so large without detection? Why are the perpetrators regularly able to victimize sophisticated investors, including wealthy people, investment firms, financial managers, leading banks, and global insurance companies? Why is it so hard to convince enforcement professionals to look into these schemes and shut them down?

The essential elements of a Ponzi scheme are trust, precision, and most importantly spin. Every scheme involves a compelling story where the purported returns are based on a loophole, limited opportunity, or other “secret methodology” that provides outsized profits with minimal risks. Despite the story, the perpetrator uses the funds for their own purposes, providing the appearance of legitimacy by making payments to early participants from the cash inflows of later participants. By this means the scheme appears to function, encouraging still more participants.

So to begin with an examination of the namesake version of the scheme: it involved postal coupons purchased in Europe and redeemed in the United States. The pitch alluded to the possibility of arbitraging international currency exchange rates for a stable profit on each transaction, yielding significant profits when done in volume. The slight flaw of course was that the cost of doing it in volume ate up the claimed profits. The true profits were reaped by not purchasing any postal coupons and using the excess inflow of cash from new participants to cover the purported profits that were distributed as outgoing cash to earlier participants. While the “using Peter to Pay Paul” model here is well documented, it is the second half of the transaction that is more instructive. As the scheme continued, early participants greed caused them in “invest larger and larger amounts of money in the scheme. More importantly it caused them to recruit more and more people to the scheme. Based on the payments they received, and the amounts they had invested, they found it impossible to believe that the scheme was fraudulent. As we will see later, there are instances where investors, recognizing the scam, continue to recruit others, so that they can reliably extricate themselves. Interviews from the 1920s nearly exactly mirror interviews from Madoff’s victims this Spring.

This is the side of these schemes that fraud examiners must learn and understand. This is the reason that sophisticated investors and entities get dragged into these schemes, and this provide the first key to designing programs the spot, stop and prosecute these schemes.

To protect themselves, perpetrators often use connections to influential people, real or imagined, political contributions, and high profile positions to intimidate investigators. Alleged fraudster Allen Stanford maintained just this kind of high profile, sponsoring and contributing to political events nationwide. Bernie Madoff capitalized on his status as a leader on Wall Street and former Chair of the NASDAQ exchange.

Norman Hsu gained political connections as a leading fundraiser for various state and national level politicians. Outside of Politics he ran Next Components, a business finance company that purported to make short term and bridge loans. Hsu founded and bankrupted a series of companies in the 1980s. Despite his track record he had no trouble inducing investors into his business ventures. By the late 1980’s he created a surgical glove company, but used none of the proceeds to build the company, instead using them to keep the investors happy and live well. He was charged with operating a Ponzi scheme, plead no contest to grand theft and then fled before sentencing. While abroad he founded and bankrupted two more companies, before returning to the US in 1998. Upon his return he expanded his version of the classic scheme to include using investor proceeds for political contributions as well as attracting new investors. He began driving contributions to selected politicians as soon as he fled the country to avoid the sentence in the case he pleaded no contest. Despite his history, his contributions were accepted, and as later allegations arose he was defended by the politicians he had financially supported. After years of allegations he was eventually charged with operating a series of Ponzi schemes where he used $60 Million in investors’ proceeds to finance his lifestyle and make the political contributions that provided cover for the scheme.

Lou Perlman used his background and connections in the music industry as the foundation of his multi-year $300 Million Ponzi scheme. His business history, which includes huge musical successes, also includes Trans Continental Airlines, through which he enticed investors with companies that existed only on paper. He illustrates another common trend in scheme promoters, outside of his scheme, he has outstanding commercial success. Just like Madoff, he had the opportunity to use his legitimate business to wind down his Ponzi scheme, but elected not to. Not because he could not have, but to end the scheme, would appear to present failure, and these perpetrators would rather continue the scheme to its unavoidable collapse than work themselves out of it.

Lance Poulsen, used Ponzi style techniques to create and manage debt for his company, National Century Financial Enterprises. This eventually grew to $3 Billion again indicating the constant and unsustainable growth of these schemes. Poulsen was described by the sentencing judge in his case as “the architect of a fraud of such magnitude it would have made financial experts shudder.” Of course this would not last as he has convicted in October 2008, just weeks before Bernie Madoff became a household name. His defense focused on the fact that historically his actions would have been handled civilly, and he claimed that his prosecution was politically motivated. Prosecutors, in contrast, described his schemes as “the largest private fraud investigated, prosecuted and sentenced in U.S. history.

William Crotts and Thomas Grabinski used the cloak of religion to provide the appearance of legitimacy. They used the Baptist Foundation of Arizona to dupe investors out of $585 Million. This scheme, eerily similar to the above, was marketed through small churches and word of mouth from pastors and congregants to entice participants. The use of a name and marketing mechanism instills confidence and deflects investigation is a common theme in these schemes. It also indicates the vulnerabilities these frauds expose. Where many people see protections, controls and security, these fraudsters see an easy path to riches. As evidenced by the popularity and success of these schemes, one can only conclude that they are correct.

Martin Armstrong highlights another common theme in Ponzi schemes, the innate intelligence of the perpetrator. Armstrong was a self made millionaire by the time he was 15, developed a proprietary trading practice and built it into a successful hedge fund, and was a regular contributor to academic and industry journals. Eventually his trading practice failed and he resorted to a Ponzi scheme to conceal the losses in an attempt to trade out of the losses. Like Nick Leeson (Barings Bank) and many others before him, and possibly Bernie Madoff and others after him, he discovered that is nearly impossible to accomplish. When finally charged, he battled with the judge, serving seven years for contempt of court charges and then plead guilty in 2007 when he was sentenced to 5 additional years in prison. He continues to write academic articles on the investment conditions of the market today. In the end his company, Princeton Economics International, marketed worthless securities to Japanese investors for a total of $3 Billion in losses.

Kenneth Kasarjian exploited another using a financial firm, and marketing a poorly understood product, lease service contracts. This area, business leases, is a very popular one for Ponzi artists, in that the product, cash flow, can be easily manipulated, and is supported by contracts for leases that can easily be falsified. Since the investors have no contact with the leases, they are dependent on information provided by the perpetrator. In this case, Bennett Funding Group was a Ponzi scheme that caused losses of $1.5 Billion from the sales of over $850 Million in leases that were nearly all fictitious. In contrast to the above cases, even though he had plead guilty to fraud charges in 1997, it took until 2003 for the SEC to press a civil case to resolution. Kasarjian was so confident in his scheme he even allowed his home to be profiled in Architectural Digest. This brazen willingness to hide in plain sight is a common element in Ponzi style perpetrators. His scheme involved the resale of leases to third party investors, promising them cash flow from the lease payments, but actually selling the lease payments to multiple parties and using their funds to cover the payments until the scheme collapsed. Had the leases actually existed it is possible that the investors could have received some return on their investment. But in a chilling precursor to Bernie Madoff, the leases were nearly totally nonexistent, causing the investors to lose everything.

Steven Hoffenberg used another financial services firm, a debt collection agency, to mirror the same techniques. Closely controlled financial results yield easy ability to make investors see anything the perpetrator wants to present. By marketing up to $450 Million in securities backed by fictitious financials, Hoffenberg was able to fund the expansion of his empire, seeking at one point to buy the New York Post. Showing cunning as well as caution, Hoffenberg promised his investors, not skyrocketing returns, but rather consistent outperformance of the market. If the rate of the street as 5% he promised 9%, enough to drive funds in, but not enough to trigger suspicion. One of his defenses was that he had not promised unrealistic returns. However, since the investments did not exist, and the funds were actually used to sustain his lifestyle, any return was unrealistic. This nuance is a common defense in some Ponzi schemes, but can easily be refuted by looking at the reasonable return generated by the actual use of the funds and comparing it to the promised use and returns. Ordered to serve 20 years in Prison and pay $426.5 Million, his investors received less than 1 penny on the dollar for their losses. Again, as with many of these perpetrators, the quest for legitimate operations provides a path to winding down the fraud, but is actually used to expand the scheme.

John McNamara, found another hidden flaw. Many companies appear to be in one business, when they actually make most of their revenue in another entirely. He operated an automobile dealership and financed the fleet purchases for resale through General Motors. By falsifying paperwork, inflating vehicle value and creating fictitious vehicles, he received financing for over 70,000 vehicles that never existed.

Nicholas Palazzo was a Karate Instructor with a curious past. He has no real history before arriving in Des Moines, Iowa, where he opened and operated a Karate Studio. Following a common pattern, he recruited investors from his students and their families, defrauding 25 people out of over $800,000. He used the funds for personal expenses. Some press sources speculated that he was in the witness protection program, as an explanation for his scant history. His case disappeared from the press quickly after that clam was published.

Nicholas Cosmo created a Ponzi scheme that combined the two most common types of concealment, a financial firm with religious overtones. His company, Agape World, provided business loans and eventually duped over 1,500 investors out of more than $370 Million. Like many others listed here, he preferred smaller investors, using past successes to induce new participants. May of his investors had put everything they had into his scheme. And also common with the above fraudsters, he used the proceeds to finance a lifestyle and none of his investors could afford.

Arthur Nadel found himself in hot water as the Madoff scandal unfolded. Although not involved with Madoff, the press was full of allegations of improper activities in investments, prompting many of his investors to call in their funds. Promising them that he was not like Madoff, he was supposed to make a $50 Million dollar return of capital on January 15, 2009. Instead he disappeared. It later turned out that he had essentially used the investors’ money to fund a day trading business, causing investor losses of at least $300 Million.

Joseph Forte, an investment manager, is alleged to have bilked investors out of at least $50 Million. His scheme, which ran from 1995 to 2008, is common in that he claimed that none of the money remained.

As evidenced above, the first element that fraud examiners have to contend with is the fact that the victims do not want to believe that the scheme is a scam. There is resistance from all levels, potential investors are looking for profitable ventures, existing investors depend on the feedback/profits they are already receiving to validate its performance, and past investors, use their success as additional marketing for the scheme.

These schemes also involve a defined intangible: the particular expertise of the perpetrator. By claiming expertise in a specified area, industry, or profit making venture, the scheme self authenticates. That is, the scheme self legitimizes itself by differentiating its abilities from other based on knowledge, expertise, or insights that are not commonly available – providing a clear justification for its claim of being able to deliver uncommon results.

Finally, the scheme actually delivers. Every Ponzi scheme relies on the success of past participants to recruit others. Therefore, the scheme must deliver initial results to those early investors. While many see this as proof of legitimacy, the reality is that this is a simply business concept – the loss leader. This practice is no different than a company using below cost pricing to “buy” market share, or a retailer providing deep discounts on popular items to induce people to pay more for staples.

This leads the first underlying reason for these schemes success: they are not set up as crimes; they are set up as business operations. By focusing on the fictitious front the investor is fooled. By focusing on the criminal aspects, the fraud examiner is fooled. These are profit centered money making operations that happen to be illegal. Their illegal nature provides additional costs and risks, but does not alter the business fundamentals under which they operate.

Second, these schemes provide a needed solution. Investors seeking returns, financial firms seeking to enter a new investment space, fund managers seeking diversification, retired executives seeking additional financial security – each potential investor, regardless of sophistication, has a problem that needs solving. Ponzi schemes provide unique, tailored, and seeming rational solutions to those problems. Just like a drowning man will drink any fluid offered, and a starving animal will eat the first available food, the needs of the investors limit their willingness to question the viability of the solution.

Third these schemes rely on statistics. Ponzi promoters rarely make hard sells. They do not have to. Ponzi promoters understand that the key to success is letting the program sell itself. The goal is the increase the number of participants, not by selling every potential investor, but by putting the program in front of as many potential investors as possible. Hard sell techniques create questions and concerns, and some time report to regulators. Soft sells, even when declined, rarely create any official attention. Thus the Ponzi operator is much more focused on marketing, than sales. Bernie Madoff has been described by many victims as recommending smaller initial investments to his scheme, knowing that with effective marketing even more funds will flow in.

Fourth, they have an exit strategy. Unlike embezzlement, tax evasion and other financial crimes, Ponzi schemes have a defined end game. As understood by their promoters, there is a mathematical failure point for every Ponzi scheme, and the promoter will actively work to manage, delay and control that point. But he is always aware that the end game will occur is often begins making plans for the collapse at the inception of the scheme. This involves hiding funds, laundering money out of the organization and often the country.

Finally, these schemes are sold. They are envisioned, promoted, and run by people with exceptions sales skills. One of the tenants of fraud examination is to ask questions. The basis of due diligence is to question. A core concept in auditing is skepticism of claims. And yet, when presented with these opportunities, in hindsight, it appears that these questions were not asked, this skepticism was not present. In truth, the questions are often asked and the skepticism is usually present – but the promoter is more skilled than the potential investor. Through knowledge of the scheme, the promoter can anticipate the questions that will be asked, and prepare answers, documents and testimonials designed to defuse the concerns and refocus the investor on the positive points. Much like the stereotypical man in a singles bar, Ponzi scheme promoters refine their “lines” until they attain an acceptable level of success.

Combined these points:

* Business Operation
* Necessary Solution
* Actuarial Statistics
* Exit Strategy
* Active Salesmanship

provide a reasonable assurance of success for the scheme promoter. By using the established business science behind risk, insurance and sales, they can build a sustainable model. One that will apparently face scrutiny, but will actually never be effectively tested. That is the final element that leads to their success, the ability to navigate the environment, appearing to have been vetted by all, all the while having nobody look behind the curtain.

So given this highly successful modus operandi, and given the realities of human nature that make it so often successful, what can fraud examiners do to reduce its effectiveness? How can we, when presented with these engagements, ensure that we are not called in front of congress and lambasted for failing to see what in the rearview mirror is blindingly clear?

First fraud examiners have to begin by being honest. The problem with these schemes is not that the perpetrators are smart. The problem is that the tools and techniques used by fraud examiners are either disregarded, insufficient or unused. Making progress against these substantial fraud schemes, and their perpetrators requires us to take a critical look at the work we do and acknowledge that our current tool set is not working. And that requires us to change both what we do and how we do it. It is not enough for regulators, sophisticated investors and others to use fraud examination techniques in forensic engagements – those that take place after the fact and document the mistakes. It is time that these techniques be included in the due diligence process, with fraud examiners actively looking for fraud on the horizon, rather than just in the rear view mirror.

This is the challenge our profession faces. To move beyond reconstruction and provide forward view solutions that enable individuals, organizations and governments to act effectively while reducing the risk of fraud loss exposure.

The lessons that these Ponzi schemes teach have not changed in the past 90 years. To stop from falling victim to them requires careful consideration of the claims, methodical examination of the process, and skeptical interpretation of the motives of the promoters. What has changed is that today there is a professional class, armed with the information necessary to implement these protections, educated as to the methodologies, motivations and mechanisms used in these schemes, and prepared to challenge the fraudsters’ assertions. It is time to recognize that fraud is not an accident, a failure of control or process, and definitely not a cost of doing business. Fraud schemes, as in these listed examples are a specific predatory business practice, one that can be defined, diagnosed and destroyed. Carlo Ponzi made these schemes a household name; it’s time for fraud examiners to put them to rest.