BEWARE OF FALSE PROFITS

The Ponzi scheme is alive and well and seeking your money.

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Time and time again, the financial press reports the breakdown of another Ponzi scheme. Bernard Madoff's $20 billion long-running Ponzi scheme received widespread coverage, and while the magnitude and duration of Madoff's scam are mind-boggling, he certainly isn't the first to perpetrate this type of investment fraud. Just take a look:

December 2011: The U.S. Securities & Exchange Commission (SEC) alleges that Wendell A. Jacobson and his son, Allen R. Jacobson, of Fountain Green, Utah, have operated a Ponzi scheme since at least 2008 and have stolen more than $220 million from approximately 225 investors.

November 2011: The SEC accuses Garfield M. Taylor of Bethesda, Md., of defrauding approximately 130 investors of more than $27 million in a Ponzi scheme from 2005 through 2010.

April 2011: Dante DeMiro, who ran MuniVest Financial Group, based in Southfield, Mich., pled guilty to multiple counts of fraud for running a Ponzi scheme that bilked investors of approximately $10 million.

April 2010: Thomas Petters of Wayzata, Minn., was sentenced to 50 years in prison; he ran a $3.65 billion Ponzi scheme from 1994 to 2008, ensnaring more than 430 investors.

The victims in these cases aren't exclusively individual investors—they also include institutional investors, such as local governments, school districts, banks, credit unions, charitable organizations, and commercial businesses. Though you would think that institutional investors would have greater business acumen than individuals, a Ponzi scheme often isn't detected until it collapses and the maximum damage has occurred. For example, Bernie Madoff's fraud began to unravel when investors requested about $7 billion in redemptions and he couldn't pay them. Yet the SEC had received detailed evidence of a Ponzi scheme on at least five occasions over 10 years from Harry Markopolos, the Certified Fraud Examiner (CFE) and Chartered Financial Analyst (CFA) who discovered Madoff's fraud years before it collapsed. This is a painful reminder that organizations and individual investors can't always rely on government regulators to protect them from Ponzi schemes.

How can you help protect *your* organization from being victimized by this type of investment fraud? The key to answering that question lies in understanding how a Ponzi scheme operates.

Table 1: Perpetuating the Fraud

The number of investors needed to sustain a Ponzi scheme grows exponentially, making it harder and harder for the perpetrators to sustain the fraud.

MONTH	NUMBER OF INVESTORS REQUIRED	MONTH	NUMBER OF INVESTORS REQUIRED
1	2	9	512
2	4	10	1,024
3	8	11	2,048
4	16	12	4,096
5	32	13	8,192
6	64	14	16,384
7	128	15	32,768
8	256	16	65,536

The Namesake: Charles Ponzi

The fraudulent investment scam known as the Ponzi scheme is named after Charles Ponzi, an American immigrant born in Italy. In 1919 and 1920, he defrauded almost 40,000 investors of more than $10 million by promising to nearly double their investment in 90 days. Ponzi stated he could generate this phenomenal rate of return by using the investors' funds to purchase international postal reply coupons. Ponzi claimed he could buy these coupons in bulk from European countries that had had their currencies nearly decimated by World War I, then redeem them for U.S. postal stamps and convert the stamps into the much stronger American dollar at a significant profit. He didn't clearly explain the process to investors but did state, "A little dollar could start on a journey across the ocean and return home in six weeks, married and with a couple of kids."

Ponzi had been paying a high apparent return to the early investors (and to himself), but this money came from later investors and didn't, in fact, represent any kind of return on their investments. When the fraud was eventually exposed eight months after it began, Ponzi possessed all of approximately $30 in postal coupons.

Mathematically Impossible

The structure of a Ponzi scheme inevitably dooms it to failure because it's mathematically impossible to sustain. Because few, if any, of the victims' funds are actually invested in a legitimate income-generating activity, the scheme can continue only for as long as the cash received from new investors exceeds what's paid out to existing investors. The promised rate of return is such that this requires an exponentially increasing number of later investors, whose funds are used to pay returns to the earlier investors. Inevitably, the cash flow dries up, and the fraud is exposed. No matter how you crunch the num-

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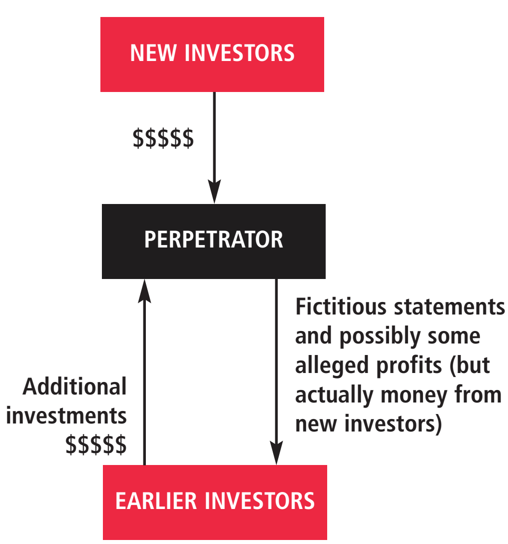
bers, there's no magical math that will allow a Ponzi scheme to exist indefinitely.

The speed with which the scheme grows (and inevitably collapses) varies depending on the number of initial investors, the promised rate of return, the time frame within which the return is promised, the number of investors cashing out instead of agreeing to reinvest the return, and the number of new investors that can be found to sustain the fraud. For example, if two initial investors are sought, the number of investors required to continue the scheme swells exponentially in a relatively short period of time, as shown in Table 1.

Thus, a Ponzi scheme by its very nature is doomed to fail—it's a classic illustration of "robbing Peter to pay Paul." The so-called returns provided by the perpetrator aren't actual profits or returns *on* investments but, rather, are returns of other investors' funds (see Figure 1). A

Figure 1: A Vicious (and Expensive) Cycle



Ponzi scheme is a pyramid scheme in the sense that it requires exponentially increasing numbers of new investors to sustain the fraud. No products are sold or services provided; the organization, such as it is, makes money primarily by recruiting new people to join its ranks.

The subtle difference between a Ponzi scheme and a pyramid scheme is that, in a Ponzi scheme, the perpetrator pools all funds and the victims aren't rewarded directly for recruiting additional investors. Typically, the perpetrator recruits the investors and promotes the Ponzi scheme as an investment opportunity rather than as a pyramid where different levels or ranks are hyped. Thus, victims have no idea that they're being drawn into a pyramid-type scheme.

Red Flags Are Raised

The most obvious red flag in a suspected Ponzi scheme is the promise of an unreasonably high return. All across the United States, from Idaho to Texas to Florida, prosecutors have accused Ponzi perpetrators of guaranteeing investors outlandish returns on their money, in some cases in excess of 50% a year. And lest you think these schemes are rampant only on U.S. shores, think again: One Russian Ponzi scheme in the mid-1990s promised returns of up to 1,000% annually! And in Canada in 2009, the Ontario Securities Commission alleged that a Toronto fund manager oversaw a Ponzi scheme that promised returns of 1% a *week* while robbing investors in Canada, the U.S., and China of approximately $60 million.

Another Ponzi red flag is that the high returns are overly consistent, regardless of the economy. Genuine investments tend to earn varying returns over time, including negative returns on occasion. Harry Markopolos found that Bernie Madoff stated positive returns for more than 96% of the months he reported on, which would be equivalent to a Major League Baseball player batting .960—three times above what even the most talented player is capable of accomplishing!

Other red flags suggesting a Ponzi scheme include promises of little or no risk to the investor ("guaranteed" returns), assurance of a quick payoff, and a vague description of how the phenomenal returns are generated. For example, Madoff explained to investors that his returns were generated through a hedge fund strategy that he called a "split-strike conversion." Other equally vague descriptions include "offshore investment," "global currency arbitrage," "hedge futures trading," or "high-yield investment programs." This is often followed by a cryptic explanation along the lines of "I can't explain it to you in detail because then I'd be giving away my secrets" or "It's too detailed to explain."

In Madoff's case, in as early as 2001 a *Barron's* article questioned how he was able to generate such impressive returns. "Madoff's investors rave about his performance—even though they don't understand how he does it," wrote Erin Arvedlund, author of the article "Don't Ask, Don't Tell." She quoted a "very satisfied investor" as admitting, "Even knowledgeable people can't really tell you what he's doing." She also quoted a strategist at a major investment bank, who had been asked to run some numbers on behalf of a client who was thinking of investing with Madoff, as saying, "I've been replicating this strategy six ways to Sunday, and I can't make the returns come out right."

Additional red flags can include a perception of exclusivity—not everyone's allowed to participate in the investment opportunity—and, as in Madoff's case, a discount off the perpetrator's customary fees. Also, since the scam artist is skimming the funds for his own use, he's typically enjoying an extravagant lifestyle.

The Foundation Crumbles

Often, organizations and individuals that are victimized in a Ponzi scheme not only reinvest their phantom earnings but also invest additional principal. After all, this investment is paying a much higher return than other available opportunities. Thus, the perpetrator doesn't have to pay out much money and can simply provide the investors with statements reporting impressive earnings. (See Table 2 for other warning signs of a Ponzi scheme.)

Problem is, these statements are usually fictitious and bear little resemblance to standard industry account statements in terms of the level of information in them and how often investors receive them. Legitimate investment firms provide detailed, professional statements on a regular basis, usually monthly, quarterly, and annually. These statements clearly indicate where the investor's money is invested and whether gains or losses were incurred during the reporting period. For example, Harry Markopolos noted that Madoff's statements contained numerous deviations from standard industry statements, including 1980s print technology, missing commas in large numbers, differing type sizes in an account number, and an absence of beginning balances.

As investors begin to request cash from their accounts, the pyramid comes crashing down—the funds simply aren't there. The perpetrator has skimmed the money for his own use (the boats, the fancy cars, the house in Tuscany) as well as siphoned some off to earlier investors in the guise of returns. Thus, another red flag can be pressure from the perpetrator to reinvest any earnings so that no payout need occur or there's a series of delays before any "profits" are disbursed.

Table 2: Ponzi Red Flags: A Baker's Dozen

1. A promise of unreasonably high returns
2. Overly consistent positive returns
3. Little risk for the investor
4. Short time period until promised returns are generated
5. Vague explanations regarding how the investment plan works
6. "Exclusive" investment opportunity
7. Waiver of customary fees
8. Lavish lifestyle of perpetrator
9. Pressure to reinvest earnings and forgo any payout
10. Delays in paying earnings
11. Nonstandard account statements
12. Word-of-mouth advertising
13. Perpetrator is charismatic and apparently trustworthy

Word-of-Mouth Hype

Another red flag worth noting is that advertising is usually minimal, if it exists at all. Generally, Ponzi schemes don't need to be advertised. Current investors, thrilled with their supposedly high returns, tell new investors. Word-of-mouth advertising alone is sufficient.

For example, consider the former treasurer of the University of Pennsylvania, who relied on word of mouth when investing school funds with the New Era Philanthropy. His was one of approximately 180 organizations, and 150 of the most financially wise philanthropists in the U.S., that were victimized by the largest Ponzi scheme to strike the nonprofit sector. This scheme, masterminded by John Bennett, received more than $400 million over the six years from 1989 until 1995. To pull it off, Bennett claimed he had a group of extremely wealthy donors who wanted to remain anonymous and who would match funds raised by nonprofit institutions. The catch was that the investors' contributions had to remain with New Era for a minimum of six months, during which time they would be invested in Treasury bills. The interest from the T-bills would cover the administrative fees, and the minimum holding period would allow for enough time to find a matching donor. Eventually, the waiting period increased to nine and 10 months, with Bennett claiming the time frame was specified by the anonymous donors. In reality, the outflow of funds needed to be slowed down because Bennett needed more time to bring in new investors to pay off the earlier ones.

From the outset, the university treasurer was skeptical about participating but was convinced after hearing that two Philadelphia museums had doubled their money. He invested $600,000 and was thrilled when New Era delivered on its promise to find the matching funds within the stated time period. Like most victims, the university invested additional funds after that.

Before the scheme collapsed, the treasurer was quoted as saying, "I can fully understand why this would be suspicious to a lot of people. It sounds too good to be true, and it's got all the earmarkings of a Ponzi scheme." Why, then, did he invest? He's probably still asking himself that same question.

Charismatic Salesmen

Keep in mind that a Ponzi scheme is simply another type of con game where "con" is short for "confidence." The perpetrator must gain the confidence and trust of his victims in order to lure them into his scheme. Charles Ponzi was, by all accounts, quite dapper and magnetic—always smiling, dressed impeccably, and strutting along with an impressive-looking walking stick in hand. According to reports, nearly 75% of the Boston police force invested in his scheme. And in Madoff's case, who better to trust than the former chairman of NASDAQ?

In Montana, investors lost approximately $6.8 million in the state's largest Ponzi scheme, which was perpetrated by Pat Davison, a CPA who ran for the Republican nomination for governor in 2004 but lost in a four-way primary. When his fraud was discovered in 2006, it was learned that he started his Ponzi scheme nine years prior to his bid for the state's highest office. He was also running the scheme while he served on the state Board of Regents and while he served as the finance chairman for one of Montana's senators during his reelection campaign. Known as a religious man, Davison was shown on the front page of a local newspaper, holding rosary beads that Pope John Paul II had blessed during Davison's visit to the Vatican four years before his scheme was uncovered. He had years of experience as a businessman and a financial advisor, and he was highly regarded in the community as a philanthropist. Yet his victims included charitable organizations, family members, business partners, and friends. He had lost his securities license years earlier, a fact that his investors were unaware of. From all outward appearances, Davison had a stellar reputation and was completely trustworthy. Why would anyone question investing with him? After all, he was a pillar of the community, and he even had a private audience with the Pope!

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Skipping Town

If Ponzi schemes are doomed to fail eventually, how do the perpetrators plan their exit? The first and probably most obvious way is to simply leave town and disappear before or as the scheme collapses, taking whatever funds are left. This strategy might work for a relatively small Ponzi scheme, but for the larger ones, such as Madoff's, it may be impossible for the perpetrator to simply disappear given how well connected and well known he is.

A second potential strategy is to turn—or return—the business into a legitimate company. According to Mitchell Zuckoff, a journalism professor at Boston University who wrote a book about Charles Ponzi, this was Ponzi's intent. Apparently, Ponzi had great plans for international postal arbitrage, but he couldn't get the logistics to work out.

In the case of Pat Davison, the Montana gubernatorial candidate, rather than starting out as a fraud and hoping to turn the scheme into a legitimate business venture, many of his friends believed the reverse to be true: that the investing business began legitimately, but the scheme started after one or more investment mistakes. In cases like these, rather than admit the error, the perpetrator believes that the loss suffered is only a temporary setback and that he'll be able to return to profitability again. In the meantime, he can keep up the illusion of his investment acumen by paying off earlier investors with money from later investors and make it up with a successful big gamble later when he dreams up something brilliant. This exit strategy nearly always fails because typically there isn't a large enough subsequent profit to cover the deepening debt that the scheme generates. This strategy appears to have been Pat Davison's intent—if you can believe him, of course. He's currently in a federal prison in Sheridan, Ore., serving a 10-year sentence.

Given that Bernie Madoff had been an investment manager since 1960 and that his Ponzi scheme seems to have been ongoing for some 20 years, a few experts have guessed that he may have held out hope to return it to a legitimate business at some point. In these cases, is the perpetrator overly optimistic, in deep psychological denial, or simply delusional? It's difficult to tell. Regardless, the investors have become victims.

Peeling Back the Layers

How do you protect your organization from becoming a Ponzi victim? These prevention strategies aren't mutually exclusive and, in fact, are closely related:

If the investment opportunity sounds too good to be true, maintain a healthy dose of skepticism. Exactly *how* can the investment generate the promised high return in such a short period of time? Investigate, ask questions, and don't settle for vague responses.

Remember that blind trust is no substitute for due diligence. The perpetrator will be charismatic and may have a stellar reputation in the community. People selling most investments must be licensed in your state. Trust, but verify.

Resist the temptation to succumb to peer pressure and join in the investment opportunity. Don't rely on word-of-mouth endorsements, which essentially transfer the effort of investigating and understanding the investment from your organization to others. Remember that, in order to be successful, a Ponzi scheme must pay the promised return to earlier investors.

Don't allow emotion to overcome logic. If it walks like a duck, swims like a duck, and quacks like a duck, it's probably a duck.

Most victims who succumb to a Ponzi scheme consider only one possibility, to their everlasting economic detriment: that the investment is legitimate. These victims then are prone to a confirmation bias, searching only for evidence that supports that possibility and ignoring any evidence that disputes it. Effective due diligence requires that the alternative possibility—that the investment is a fraud—also be considered.

Despite some recent high-profile convictions, the ugly reality is that Ponzi schemes are alive and well, employing arcane instruments as financial weapons of mass destruction throughout the world. Perhaps Harry Markopolos said it best in his recent book, *No One Would Listen: A True Financial Thriller*: "Madoff wasn't an aberration; he was a creation of the profit-at-all-costs culture of Wall Street. And maybe the scariest thing about Bernie Madoff? He isn't the only one. Like unvanquished monsters, there are more of them out there in the dark."

The key to preventing your organization from becoming victimized is to understand how each investment opportunity works and to be wary of the red flags. It's almost impossible to defraud an organization that's educated about the fundamentals of a Ponzi scheme and thus knows what to watch out for. With this in mind, it may be prudent to scrutinize your organization's current investments to help ensure you aren't being "Ponzi-ed." Your financial health may be at stake! **SF**

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