CASE 11

Frauds of the Century*

Before Bernard Madoff, the average consumer likely never heard of a Ponzi scheme. This little-known crime soon became a front-page headline in December 2008 when highly respected securities trader Bernard Madoff admitted to operating a Ponzi scheme for more than a decade. Tom Petters, former CEO and chairman of Petters Worldwide, had already been arrested for an alleged Ponzi scheme in October of that year. A few months later, respected financier R. Allen Stanford was arrested for a Ponzi scheme that cost investors $7 billion. A Ponzi scheme is a type of white-collar crime that occurs when a criminal—often of high repute—takes money from new investors to pay earnings for existing investors. The money is never actually invested and, when the scheme finally collapses, newer investors usually lose their investments.

Ponzi schemes are often mistaken for pyramid schemes. Both types of criminal activities have the same basic structure. Pyramid schemes are illegal but can be hard to detect. They occur when there are no legitimate products or sustainable investments to sell. The difference between a pyramid and a Ponzi scheme is that the perpetrator of the Ponzi scheme asks individuals to invest in something with an above average return. No other action is required. Also, pyramid scheme typically collapse much faster because it requires exponential increases in participants to sustain it. By contrast, Ponzi schemes can survive simply by persuading most existing participants to reinvest their money, with a relatively small number of new participants.

A pyramid scheme offers an opportunity for an individual to make money that requires effort. Usually this is in the form of an investment, business, or product opportunity. The first person recruited then sells or recruits more people, and a type of financial reward is given to those who recruit the next participant. The key aspect of a pyramid scheme is that people pay for getting involved. Each new individual or investor joins in what is believed to be a legitimate opportunity to get a return, which is how the fraudster gets money. However, unlike a legitimate organization, pyramid schemes either do not sell a product, or the investment is almost worthless. All income comes from new people enrolling. Much like Ponzi schemes, when enrollment dries up, the pyramid scheme dissolves. Newer enrollees lose their investments. Both Ponzi schemes and pyramid schemes are highly damaging to consumers and the financial industry at large. In general, it may be difficult to determine if a business opportunity is initially a pyramid scheme.

This case analyzes the detrimental impact Ponzi and pyramid schemes have on society. The first part of this analysis examines the harmful effects of Ponzi schemes as well as some of this century's most infamous Ponzi schemers. We then examine pyramid schemes, their negative impacts, and their confusion with legitimate business models. We conclude this

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analysis by reemphasizing the unique nature of white-collar criminals and reiterating the need for transparency, internal controls, and compliance standards within an organization.

THE IMPACT OF PONZI SCHEMES ON SOCIETY

Ponzi schemes are highly detrimental to society, not only because of the financial losses they incur but also for the lack of trust consumers feel toward business in general. The financial industry in particular experienced a wide-scale loss of trust because of financial misconduct such as Ponzi schemes. One or two schemers can have a wide ranging impact on the entire industry. Ponzi schemes do not seem to be decreasing: since 2010 there have been approximately 100 actions taken by the SEC against 200 individual Ponzi schemers and 250 companies.

Many people who were victims of Ponzi schemes lost major investments in the fraud. Victims range from low-income to high-income individuals as well as companies and nonprofits. Organizations are often impacted the most because of the significant investments they are able to make. For instance, in the Madoff scandal, many nonprofit organizations lost millions after the fraud was revealed. While some investors make money if they invested early enough from fictional profits taken from newer investors, others may lose their entire life savings in the fraud.

Additionally, while Ponzi schemes appear to thrive in the financial industry, they can be present in any industry where investments are made. In India, for instance, farmers were made to believe that there was a significant market for emu meat, feathers, and oil. Farmers who purchased emu chicks received the promise from the con artist that the adult emus would be purchased at double the price originally paid for them. They were also promised monthly payments. However, when the scheme collapsed and the payments stopped, approximately 10,000 farmers were left with about 100,000 birds without any use for them. Albania was also the victim of several Ponzi schemes. In 1996 companies engaging in Ponzi schemes started promising Albanian investors more than 30 percent returns per month. Three million people whose average income was $8,000 per year invested more than $1.2 billion in the schemes. After they lost their investments, the Albanian economy collapsed and a massive uprising resulted in the deaths of 2,000 people.

It is also not uncommon for the victims of Ponzi schemes to unknowingly propagate the scheme through the recruitment of others. Investors with Bernie Madoff often convinced their friends and family members to invest as well and get in on the deal. The community of Lexington, North Carolina, was duped by a $600 million Ponzi scheme from online company ZeekRewards. Many investors were recruited by others in the community, resulting in a massive loss for the town when the scheme collapsed.

Fortunately, there are red flags for Ponzi schemes. These warning signs include high and/or consistent returns with little or no risk, unlicensed sellers, secret methodologies or strategies not divulged to investors, and paperwork problems. The biggest red flag is high and consistent returns. The reason is because the market itself is not consistent, so although an investor may have long-term profitability, short-term profits should vary yearly. Most Ponzi schemers are unlicensed sellers and use what they deem to be "secretive" strategies to confuse investors. Lack of paperwork is another warning signal because Ponzi schemers want to avoid releasing information that could arouse suspicion.

Unfortunately, Ponzi schemers are usually white-collar criminals who, rather than being a stereotypical criminal, are often seen as successful people who inspire trust. The following examples bear this out.

The Original Ponzi Schemer

The Ponzi scheme was named after Charles Ponzi, who in the early twentieth century saw a way to profit from international reply coupons. An international reply coupon was a guarantee of return postage in response to an international letter. Ponzi determined he could make money by swapping out these coupons for more expensive postage stamps in countries where the stamps were of higher value. Ponzi convinced investors to provide him with capital to trade coupons for higher-priced postage stamps. His promise to investors who joined in his scheme was a 50 percent profit in a few days.

Touted as a financial wizard, Ponzi lived a fairly opulent life outside of Boston. He would often bring in as much as $250,000 a day. Part of Ponzi's success came from his personal charisma and ability to con even savvy investors. People trusted Ponzi because he created an image of power, trust, and responsibility—much as Bernard Madoff did a century later. The largest problem with his scheme was that in order to keep giving earlier investors their promised returns, Ponzi had to continually draw new people into the scheme. In July of 1920 the *Boston Post* ran an article exposing the scheme, and soon after regulators raided Ponzi's offices and charged him with mail fraud, knowing his fabricated investment reports were mailed to his clients. Mr. Ponzi's scheme self-destructed in about one year. More recent cases are unusual because the fraudsters were able to continue their fraud for many years.

Tom Petters

It is quite simple to ignore the case of Tom Petters' alleged Ponzi scheme outside his home state of Minnesota. His arrest was eclipsed by that of the more infamous Bernard L. Madoff a few months later. However, Tom Petters has been accused of operating the third largest Ponzi scheme in U.S. history at $3.65 billion. Petters was a highly successful entrepreneur and CEO of Petters Group Worldwide (PGW). The company was involved in a number of different industries, including airlines, direct marketing, Internet auction sites, and retailing. Petters acquired more than 150 companies, including the Polaroid brand and Sun Country Airlines.

However, all was not well at PGW. The company wholesale brokerage firm Petters Company Inc. (PCI) was operating a massive Ponzi scheme. PCI issued promissory notes to investors, who invested money they believed would be used to purchase merchandise for retail stores. As a result of their investment, the company promised investors consistent returns of 15 to 20 percent. Rather than being used to purchase merchandise, the money was used to pay returns to earlier investors and, according to prosecutors, fund Petters' lavish lifestyle and company acquisition spree. Investors were provided with falsified purchase orders to make them believe the purchases took place. The scheme was believed to have gone on for more than a decade.

This changed after a business executive involved in the fraud confessed to authorities and agreed to help investigators gather evidence against Petters in exchange for leniency. Others involved in the fraud also agreed to cooperate. Authorities wire tapped conversations between Petters and his associates that lent evidence to his knowledge and participation in the fraud. Victims of the Ponzi scheme included pastors, hedge funds, missionaries, and more. Petters was arrested in October 2008 and eventually sentenced to 50 years in prison without appeal.

Petters continues to maintain his innocence, stating he did not find out about the fraud until shortly before his arrest. He maintains he trusted his associates, including the woman who blew the whistle on him, to handle the wholesale brokerage firm and had not been involved in the management of PCI since the 1990s. He claimed he was provided with the same falsified documents as everyone else and his biggest mistake was trusting the wrong people. Although he appealed his conviction to the U.S. Court of Appeals for the Eighth Circuit, they upheld his conviction. He appealed to the Supreme Court, but that court refused to hear his case. Petters has been trying to get his conviction thrown out, claiming his lawyer never told him about a deal prosecutors were willing to make that would have lessened his sentence in exchange for a guilty plea.

Bernard L. Madoff

No man has received so much notoriety for conducting a Ponzi scheme as Bernard L. Madoff. Until Madoff's time, the idea of pulling off a Ponzi scheme of such magnitude was not considered feasible. Much of the reason why Madoff's fraud went so long unchecked likely had to do with his respectability and reputation for being a market genius. For instance, he served as chair of the NASDAQ in 1990, 1991, and 1993. Bernard Madoff was a highly successful, legitimate businessperson. He started a legal investment business in 1960 buying and selling over-the-counter stocks not listed on the New York Stock Exchange (NYSE). Eventually, Madoff began using his legitimate success and high visibility to start a second business managing money. He seemed trustworthy and promised consistent returns of 10 to 12 percent, attracting billions of dollars from hundreds of investors. Part of the appeal of investing with Bernie was the appeal of exclusivity. His inaccessibility and "invitation only" approach to new investors created that climate.

Many of his clients were already wealthy and looking for a stable and constant rate of return. To these people, reliable constant returns managed by one of their own seemed like the perfect way to invest. His stated strategy was to buy stocks while also trading options on those stocks as a way to limit the potential losses. His market timing strategy was called the "split-strike conversion." To continuously draw in new clients, Madoff developed relationships with intermediaries, also known as "feeders." Many of the feeders invested money with Madoff. These feeders profited by receiving fees and ensuring Madoff had a stream of money flowing into his operation.

Madoff later admitted he never invested any of his clients' funds. All of the money was deposited in banks, and Madoff simply moved money between Chase Manhattan Bank in New York and Madoff Securities International Ltd., a U.K. Corporation. When the economy collapsed in late 2008, more clients requested their deposits back. Because he knew the game was up, he turned himself in to his sons. Madoff was arrested on December 11, 2008. The official charge was criminal securities fraud. Madoff declared to his sons he had roughly \$200–300 million left in the company. The SEC records showed the firm had \$17 billion in assets at the beginning of 2008. After his trial, Madoff was sentenced to 150 years in prison for his crime.

Thousands of people submitted claims for restitution in the Madoff case. However, paying back all these investors will be a difficult task. Although Madoff's fraud is billed as a \$65 billion Ponzi scheme, Madoff never had anywhere near that amount of money. The figure of \$65 billion is the total amount Madoff told people they invested and earned with him. The actual amount may be well below \$10 billion.

The Securities and Exchange Commission was highly criticized for not detecting the fraud earlier. Christopher Cox, SEC chair at the start of the fraud investigation, indicated the SEC examiners missed "red flags" in reviewing the Madoff firm. Allegations of wrongdoing started in the early 1990s, and Madoff confirms fraud dating back to that time. Repeated investigations and examinations by the SEC showed no investment fraud. In 2001 Harry Markopolos, a security industry executive, raised concerns about Madoff's activities. Once again the SEC did not find evidence of improper practices. Because many SEC employees ended up working in the investment business on Wall Street, there has been speculation that an overall lack of objectivity clouded these investigations.

R. Allen Stanford

R. Allen Stanford was a highly successful financier who received knighthood from the islands of Antigua and Barbuda. Stanford was the founder and CEO of Stanford Financial Group, a group of financial services firms with its main operations on the island of Antigua. Stanford offered investors certificates of deposits (CDs) with consistent returns of 9.87 percent compounded annual interest. One red flag for investors was this percentage was six percentage points higher than the U.S. average CD rates at the time. While higher returns are not necessarily indicative of fraud, consistently higher returns with few fluctuations should have acted as a warning signal. Another red flag was that employees at Stanford Financial did not appear to be know how the company was able to generate such high returns. When investors inquired, they were told the information was proprietary.

In fact, Stanford allegedly operated a $7 billion Ponzi scheme for two decades. As early as 2003, people began accusing Stanford of a Ponzi scheme. Five years before the scheme was revealed, a former employee alerted the SEC and the National Association of Securities Dealers to what she believed was a Ponzi scheme. Yet nothing came of her claims. In 2006 the SEC began an investigation into Stanford Financial but closed it. One year later the firm paid a fine of $20,000 for violating net capital agreements.

Possibly due to the Madoff scandal shaking the financial world, authorities began to investigate Stanford Financial's consistently higher returns on its CDs. They found evidence Stanford had misused funds and misrepresented and falsified documents to hide the fraud, including providing false information about the bank's investment portfolio. According to SEC allegations, although Stanford Financial told investors their investments were invested in safe, liquid securities, in reality they were invested in real estate and private equity. Approximately 30,000 people are estimated to have been victims of the Ponzi scheme. Stanford was arrested and found guilty on 13 of 14 counts of operating a Ponzi scheme. Although he continues to maintain his innocence, Stanford was sentenced to 110 years in prison. Because claims that Stanford Financial operated a Ponzi scheme had been made years prior to the arrest of Stanford, many stakeholders criticized the SEC for not detecting the fraud earlier.

PYRAMID SCHEMES

As mentioned earlier, pyramid schemes occur when an investment or product of limited value is being offered. Pyramid schemes are illegal because of their intent to defraud. Those who recruit additional participants benefit directly, but a failure to recruit typically means no investment return. A pyramid scheme is an unsustainable business model that involves defrauding investors and customers. Pyramid schemes can be hard to detect, but according to the FTC, two signs that a pyramid scheme might be taking place include inventory loading and a lack of retail sales. Inventory loading occurs when investors must purchase large amounts of inventory when they invest, with automatic purchases at regular intervals. The products usually do not sell because their value is less than their price.

The FTC began to take action against pyramid schemes in the 1970s, and one of its first actions was taken against Koscot Interplanetary, Inc., which recruited people for a fee, charged them for purchasing makeup supplies, and then provided them with fees by recruiting others without encouraging them to sell any product. Sometimes pyramid schemes are associated with direct selling. Direct selling is a legitimate business model, and multilevel marketing is a compensation model.

Multilevel marketing members can make an income through selling the company's legitimate products without signing up new members. The independent contractor (member) can advance beyond the person who recruited him or her. Multilevel marketing is a compensation method that provides commissions for growing the network of sellers. The important distinction between the multilevel marketing compensation method and a pyramid scheme is the revenue is derived from selling products, not paying commissions for joining the network. Internal consumption occurs when people join the network just to buy the product at a discount. Other members join to earn money for a short period of time and then exit the network. Amway was accused of operating a pyramid scheme in the 1970s, but the FTC determined Amway was engaging in multilevel or network marketing.

In 2012 Herbalife, the third largest global direct seller, was accused of being an elaborate pyramid scheme by hedge fund manager William Ackman. Accusations against Herbalife included the following: 1) the majority of distributors for Herbalife lose money, 2) Herbalife pays more for recruiting new distributors than selling actual products, and 3) only the top 1 percent of distributors earns most of the money. Herbalife sells highly respected nutritional products. The product is used in Los Angeles for firefighters and LAPD officers through its fitness center. The product has even been adopted by some Chinese Olympic teams. There is every indication that the Herbalife product is a high-quality nutritional product sold on a global basis. Herbalife vehemently denied Ackman's allegations. Many others support Herbalife's model, stating that if it was a pyramid scheme, it would not be so successful but would have collapsed. Another hedge fund manager Carl Ichan defended Herbalife and invested in the firm. Additionally, because Ackman shorted Herbalife stock (he earns money if the stock goes down), some question whether he has a conflict of interest regarding Herbalife's stock. Most companies that use a multilevel marketing compensation method deal with accusations they are a pyramid scheme because of a misunderstanding that a true pyramid scheme does not have a legitimate product to sell.

The Internet made pyramid schemes even easier to execute due to the ease of networking and recruiting others. In 2003 the FTC charged Arizona Internet company NexGen3000.com and its principals of operating an illegal pyramid scheme involving what the company called Internet "shopping malls." The firm marketed these "malls" to investors as a way to earn substantial income. Principals marketed these "products" through the NexGen site. Investors purchased a "Basic WebSuite" for $185 and a "Power Pack WebSuite" for $555. Investors were told they could earn commissions on each "WebSuite" they sold. In actuality most investors lost money. The FTC found deceptive marketing claims were used to deceive investors as well as convince them to unknowingly deceive others into investing.

This is a complex issue, and investors, distributors, and other stakeholders must exert caution when investing. Perhaps the best advice guarding against pyramid schemes is the same as guarding against a Ponzi scheme: do not put all your eggs in one basket, at least until you thoroughly research the company. In terms of pyramid schemes, investors should carefully examine the business' model and determine if a legitimate product is being sold before investing large sums of money to join the network or buy products.

CONCLUSION

White-collar criminals dupe their victims by establishing themselves as trustworthy and respectable figures. Victims of white-collar crime are trusting clients that believe there are sufficient checks and balances to certify that an operation is legitimate. For instance, Bernard Madoff was an educated and experienced individual in a position of power, trust, respectability, and responsibility who abused his trust for personal gains. Fraudsters of both Ponzi and pyramid schemes use promises and elaborate deception to carry out their scams. While many times these types of fraud collapse fairly quickly due to their unsustainable nature, as this case shows adept white-collar criminals are able to carry on the fraud for many years.

White-collar crime is unique because it is often perpetrated by a rogue individual who knowingly steals, cheats, or manipulates in order to damage others. Often, the only way to prevent white-collar crime is to have internal controls and compliance standards that detect misconduct. In Ponzi and pyramid schemes that continue for a long time, the opportunity exists to deceive others without effective audits, transparency, or understanding of the true nature of the operation. As a result of these more recent cases, individual investors, institutions, and hopefully regulators will exert more diligence in demanding transparency and honesty from those who manage and/or solicit investments.

QUESTIONS

1. How do Ponzi schemes and pyramid schemes differ? How are they similar?
2. Why are white-collar criminals such as Madoff able to carry out their schemes for so long when similar types of fraud often collapse at an early stage?
3. What should be done to ensure large-scale fraud such as Ponzi schemes and pyramid schemes do not happen in the future?

SOURCES

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