Understanding Ponzi Schemes: can better financial regulation prevent investors from being defrauded?

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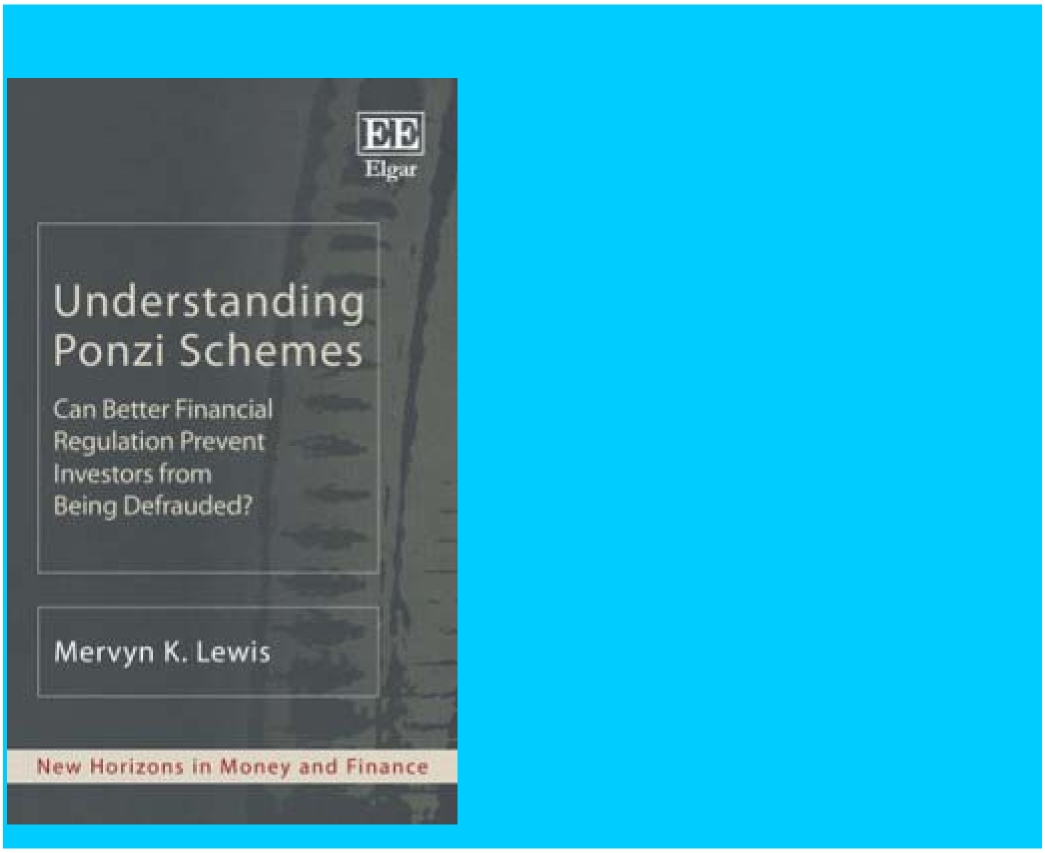
Book review by Sally Ramage

> ***'I keep six honest serving-men***
> ***(They taught me all I knew);***
> ***Their names are* What *and* Why *and* When**
> ***And* How *and* Where *and* Who.**
> ***I send them over land and sea,***
> ***I send them east and west;***
> ***But after they have worked for me,***
> ***I give them all a rest.***
>
> ***I let them rest from nine till five,***
> ***For I am busy then,***
> ***As well as breakfast, lunch, and tea,***
> ***For they are hungry men.***
> ***But different folk have different views;***
> ***I know a person small-***
> ***She keeps ten million serving-men,***
> ***Who get no rest at all!***
>
> ***She sends 'em abroad on her own affairs,***
> ***From the second she opens her eyes-***
> ***One million* Hows, *two million* Wheres,**
> ***And seven million* Whys!'**
>
> **Rudyard Kipling**



The author of Ponzi Schemes (Edward Elgar publishers)

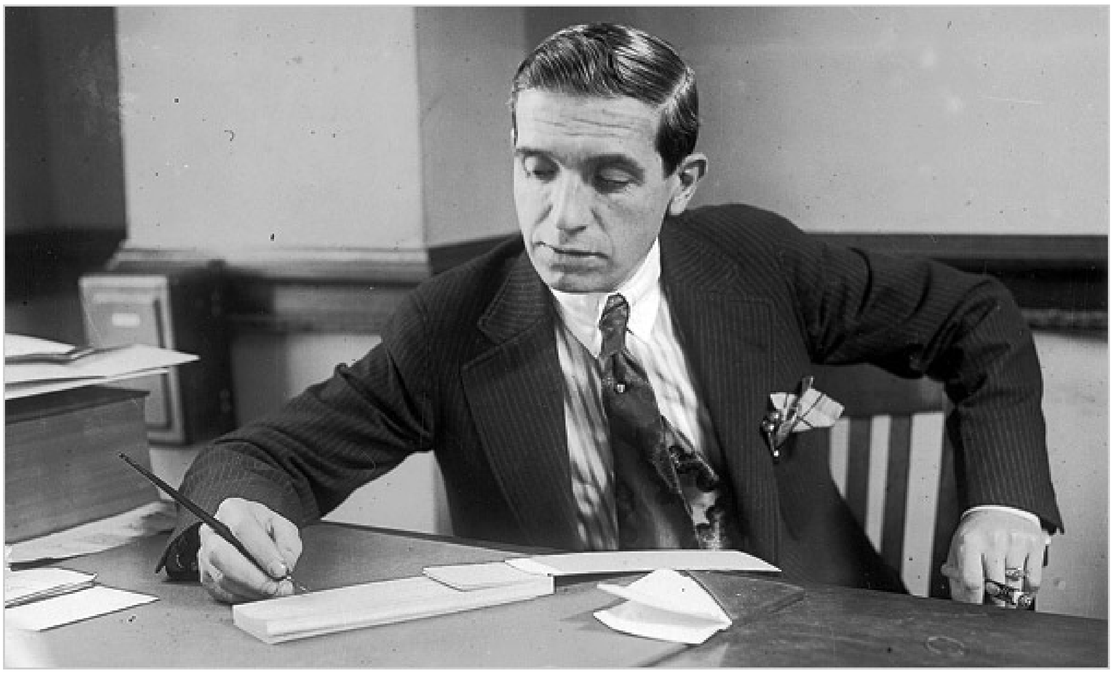
Professor Mervyn K. Lewis is listed on his Internet homepage as being an 'Adjunct Professor in the University of South Australia Business School' who took retirement in December 2013 when, until then, he had been Professor of Banking and Finance in the School of Commerce at the University of South Australia Business School from 1996 to 2013. He had taught at Nottingham University, England, United Kingdom for 12 years to 1996 when he left for Australia, having held the position at Nottingham University as its 'Midland Bank Professor of Money and Banking'. His expertise is business and therefore he is endowed with sound knowledge of business law also. His academic prowess includes the fact that he has written 24 books; 72 journal articles and 90 book chapters before his jurisdiction move to Australia in 1996 and his biographical details have been listed in Debrett's *People of Today* from 1990 to 2015. He is esteemed Fellow of the Academy of the Social Sciences in Australia; Member of Australia and New Zealand Shadow Financial Regulatory Committee; and Member of the Economic Society of Australia, South Australia Branch.[1]

I am grateful to Professor Lewis for writing this book on Ponzi schemes. Most have heard of a Ponzi fraud but most do not fully understand what it really is and especially how a swindler Charles Ponzi (1877-1949) and his fraudulent methods could have an effect on present day investors.

What is a Ponzi scheme of fraud?

A Ponzi fraud is essentially an investment fraud wherein the operator promises high financial returns or dividends that are not available through traditional investments. Instead of investing the victims' funds, the operator pays 'dividends' to initial investors using the principle amounts 'invested' by subsequent investors. The fraud is generally unravelled when the operator flees with all of the proceeds, or when a sufficient number of new investors cannot be found to allow the continued payment of 'dividends'. This type of fraud is named after Charles Ponzi of Boston, Massachusetts, US, who operated an extremely attractive investment scheme in which he guaranteed investors a 50 percent return on their investment in postal coupons. Although he was able to pay his initial investors, the

So who was Charles Ponzi and what did he do?



Charles Ponzi. Source: Google.

Charles Ponzi was an immigrant to the United States (US) from Italy and he was known to have been a forger, a dishwasher, and a smuggler. Ponzi realized that he could buy up international postal-union reply coupons at depressed prices in certain foreign countries and sell them in the US at a 50% profit. He became bored with the slow return on this scheme so he decided to attempt to get investors to lend him a lot of money and promised then a 50% profit on their capital investment within three months. Investors' money rolled in abundantly and once he began to pay out the promised quarterly 50% profit, even more investors' money flooded in. It was reported that in just one day in the year 1920, an amount of $2 million dollars arrived at Ponzi's offices from eager investors and as long as new investors' money came in, Ponzi was able to fulfill his promise of 50% interest in 3 months. When investigating journalists became suspicious after six months, Ponzi served law suits on them and in the meantime he enjoyed himself using unsuspecting investors' money- he bought himself an elegant mansion; expensive suits to wear and diamond tie-pins too. However the *Boston Post* newspaper was the first newspaper to publish their findings concerning Charles Ponzi's criminal past history.

Charles Ponzi's US criminal record

Charles Ponzi had been imprisoned in Montreal, having been convicted of forgery. He had also been imprisoned in the state of Atlanta (United States) having been convicted of smuggling illegal aliens into the US. This news shocked investors and the flood of investment into Ponzi's scheme quickly stepped, collapsing his fraudulent scam and he was then unable to teem and ladle' funds from new investments to pay the interest promised on the older investments.

Imprisoned for wire fraud and theft -deported to homeland Italy

The Police were informed. After police seized his bookkeeping record it was discovered that the investment funds were many millions of dollars in deficit. He was charged, tried and convicted and spent four years in federal prison for wire fraud and then seven years in prison in Massachusetts for theft offences. After he had served his prison sentence, he was then deported back to Italy and from there he traveled to Rio de Janeiro. He died in 1949 in Brazil.

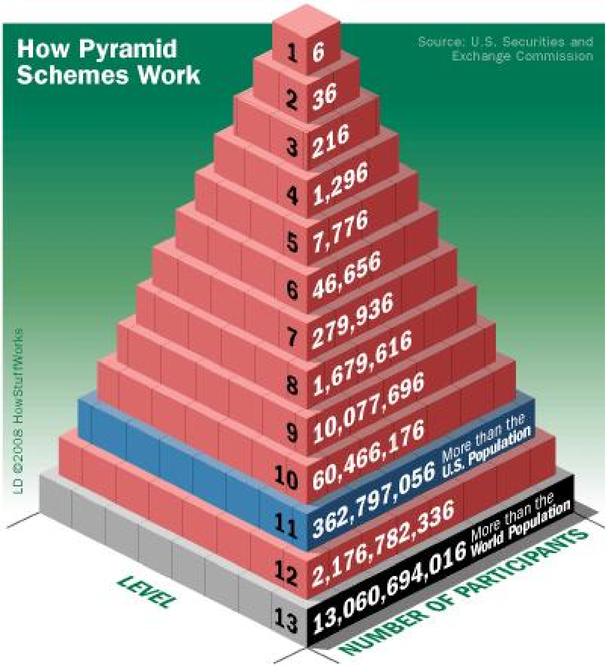
Bernard Madoff operated a brazen Ponzi scheme

Bernard Madoff- Ponzi scheme fraud of $64 Billion

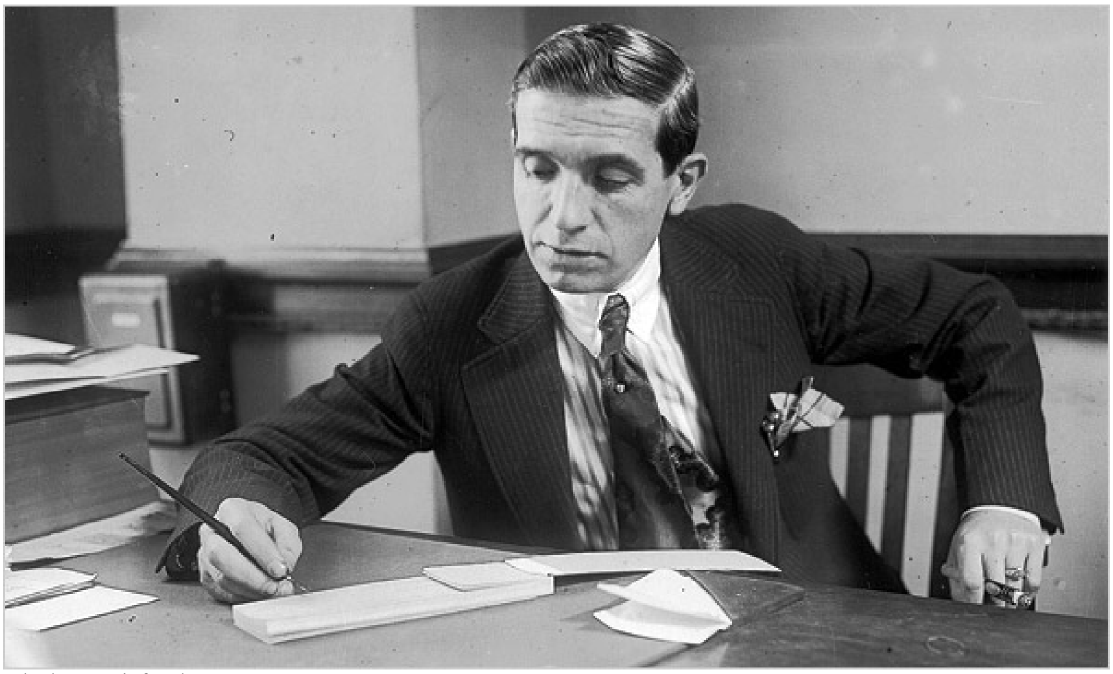
Professor Lewis gives several examples of Ponzi fraud in this book and he includes Bernard Madoff's outrageous and ultra-brazen Ponzi scheme of 64 Billion US dollars.

The difference between Pyramid and Ponzi schemes

Pyramid Schemes are another common form of High Yield Investment Fraud. In Pyramid Schemes, as in Ponzi Schemes, money collected from new participants is paid to earlier participants.



In Pyramid Schemes, however, participants receive commissions for recruiting new participants into the fraud.



Charles Ponzi- fraud

Can better regulation prevent investors from being defrauded?

This important subject has been addressed by academics internationally.[3] As recession continues to deepen across the world and corporate malfeasance and bankers' greed continue unabated, the role of corporate governance is being questioned as follows: What differentiates the frauds and malfeasance of AIG, Lehman Brothers, Merrill Lynch, Madoff and Satyam from the Enron[4], WorldCom and Tyco of yesteryears'? Why have we learnt no lessons yet? Why have bankers wasted public money to aggrandise executives? Why has neither the US draconian law of Sarbanes Oxley Act 2002 nor the 'light touch approach' of 'comply or explain' in other countries worked? Why are boards of directors not able to manage 'risk' and 'opportunity'? Will more regulation work? How can we rebuild investors' confidence? [4]

Confidence tricksters

Governments around the world are addressing these issues, but however many regulations are put in place, history has shown that once in a while there will be a confidence trickster who has the sheer audacity to defraud investors in this way, practicing their deception on the gullible.

Charity fraud

In 1995 there was discovered a Ponzi fraud using a company called *New Era Philantrophy*, which had promised 'double your money' windfalls to hundreds of nonprofit institutions and private investors.

New Era Philantrophy filed for bankruptcy and listed $551 million in liabilities to 300 universities, churches and other uninsured creditors, sending shock waves worldwide in this, the biggest charitable fraud in history.

FBI pursues serious corporate fraud for the US government

In the US, the lead agency investigating corporate fraud [5]is the Federal Bureau of Investigation (FBI), which has focused its efforts on cases which involve accounting schemes, self-dealing by corporate executives and obstruction of justice. The majority of corporate fraud cases pursued by the FBI involve accounting schemes designed to deceive investors, auditors and analysts about the true financial condition of a corporation.

Through the manipulation of financial data, the share price of a corporation remains artificially inflated based on fictitious performance indicators provided to the investing public. In addition to significant financial losses to investors, corporate fraud has the potential to cause immeasurable damage to a country's economy and to investor confidence.

A recent worldwide Ponzi scheme dealing in imaginary gold -successfully brought to justice

In January 2016, the United States FBI released news of the conviction of the persons dealing worldwide to the tune of many dozens of million dollars in electronic investment in alleged gold, which caused losses to millions of investors worldwide. A husband and wife, who simply collected all the investment money coming in for their own purposes, implemented the Ponzi scheme. The FBI has managed to seize some of this money, which they are in the process to repatriating to some of the investors. This had been a long and laborious criminal investigation for the US authorities and just shows that people worldwide will chase after the most improbable scheme when common sense tells them that this investment was improbable- this greed by investors taking them to sad losses of their savings and pensions. For investors the marketplace for gold and silver and other precious metals, in 2015 -and years before this -has lost any real connection to the regular forces of supply and demand. The issuance of electronic documents stating that one owns a certain amount of gold and silver one paid good money to invest in -has allowed a separation from market forces. It has divorced the true monetary values from the quantities of precious metals that are actually in existence. This has vastly inflated the supposed supply, thus putting a downward pressure on the real price of real gold and real silver also. The reality is that there is far less physical gold and silver than the supply of the paper equivalence supposedly represented. This situation is still being allowed to exist because of course the US has no governance over other jurisdictions globally where Ponzi schemes for gold and silver investment continues. There are many players and speculators in the global financial market that do not actually take possession of their holdings. What they have instead, are just pieces of paper.

An impression of ownership of tangible assets

These bits of useless paper give an impression of ownership and one is reminded that scientific progress has put mankind into space where he can travel to the moon; can survive for many months in space; can travel to Mars in electronically manoeuvred machines. Yet Mankind is continuously being defrauded by schemes like the Maddox Ponzi Scheme ($64 Billion) and the Ponzi Gold schemes.

Ponzi investment gold scheme through company *OSGold*

In March 2001 defendant Reed founded a company named OSGold, and deceived investors that OSGold was a licensed on-line 'bank' that could provide its customers with Internet banking services purportedly backed in part by gold bullion reserves stored in an off-shore vault.

Gold bullions

Customers opened accounts at OSGold by wire-transferring money through intermediaries to bank accounts controlled by Reed and others, and were able to track their supposed OSGold account balances through the OSGold website. In May 2001 Reed began to offer OSGold customers the opportunity to invest in a 'high yield investment program' known as "OSOpps" which, promised a 30% compounded return over three months, or a 45% rate of return for investments left for 12 months, and that an investor's principal was fully guaranteed.

Investment returns from OSOpps were supposedly transferred into the investor's OSGold account and OSOpps investors were affirmed access to their OSGold accounts on-line and assured the viewing of the apparent returns they received from their OSOpps investments. Mr Reed represented that the OSOpps investments could achieve the advertised high returns because the investors' money was traded in foreign exchange markets. Between March 2001, when Reed started OSGold, and June 2002, when OSGold ceased operations, customers throughout the world opened an estimated 66,000 accounts with OSGold/OSOpps, transferring a total of at least approximately $12.8 million to three bank accounts controlled by Reed and his associates.

As in a classic Ponzi fraud scheme, for the first few months of its operation, OSGold appeared to operate reliably and developed a reputation as a secure way to engage in Internet banking while OSOpps provided investors with online statements purporting to show promised rates of return on investments.

In reality, neither Reed nor anyone else at OSOpps engaged in any foreign exchange trading with the funds customers had invested. Instead, Reed and his co-conspirators laundered the customers' funds through numerous bank accounts controlled by Reed and his associates in the United States, Mexico, and Latvia, and elsewhere; and withdrew customers' funds via cash withdrawals and/or cheques made out as 'cash' cheques. These withdrawn funds were then employed for personal expenses of Reed and his associates. They bought airplane tickets for Reed and his family to travel to Mexico; vehicles for the use of Reed and his associates; and businesses in the name of Reed and his associates in Cancun, Mexico, including a nightclub, a shopping mall, and a gymnasium. To deceive his customers, Reed, through his employees manually altered OSOpps account statements in order to make it appear to customers that they were receiving the advertised investment returns. In March 2002 an

OSOpps investor unsuccessfully attempted to withdraw approximately $10 million from OSOpps accounts. Other customers also attempted to withdraw their money from OSGold and OSOpps. OSGold and OSOpps ceased operations in June 2002 and Reed fled the United States for Mexico. Millions of dollars of the investors' and depositors' money, including principal sums have never been returned. No gold bullion reserves associated with OSGold have ever been located. . Mr Reed, aged 38 years old in 2009, was arrested in Columbia, South Carolina, where he had moved after having lived in Mexico for years. He was then charged with one count of conspiracy to commit money laundering, one count of money laundering, and three counts of wire fraud. The offences of conspiracy to commit money laundering and the money laundering offences each carry a maximum sentence of 20 years in prison and a maximum fine of $500,000. Each wire fraud offence carries a maximum prison sentence of 20 years and a fine of $250,000, or twice the gross gain or loss from this wire fraud offence. This case, investigated by the FBI, was assigned to United States District Judge John G. Koeltl.

The FBI investigation continued on until the year 2015. Note how long and laborious the work incurred for prosecution and conviction in such cases, with verification and analysis to millions of documents over many years. This investigation was a multi-agency investigation including the Computer Hacking & Intellectual Property group of the Major Crimes Unit of the United States Attorney's Office, with US Attorneys in charge of the prosecution with a vital Victim Witness Coordination team at the United States Attorney's Office for the Southern District of New York.[6] This Ponzi scheme is but one of many its kind around the world.[7]

Jim and Pamela Fayed trading as 'Goldfinger Gold and Bullion'

Jim Fayed & Pamela Fayed- *Goldfinger Bullion and Coin*. Source: Google.

The FBI termed this scheme 'Fool's Gold'. Federal authorities returned nearly $12 Million in recovered losses to more than 1,000 victims of this Ponzi Gold Fraud Scheme. In seven years, *Goldfinger Coin & Bullion* operated a company set up in California to operate an Internet website purporting to provide an easy way for customers to invest in precious metals. Users were deceived into believing that they could buy, hold, and transfer gold and silver on the Californian company's online platform, *www.e-Bullion.com*. Investors were assured that they could convert their holdings into cash at banking automatic cash machines (ATMs) around the world. The operation seemed to these investors, a lucrative bet. But as investigators discovered in 2008, the company was doing much more than trading in precious metals.

Gold bullions. Source: Google.

Goldfinger Coin & Bullion had in fact been operating almost solely as a money-transmitter, and the company had no licence to trade as a financial investment organisation. Its sole directors/owners were a married couple named Jim and Pamela Fayed, who defrauded investors worldwide of millions in charging fees on users' transactions. The Internet website called *Goldfinger Coin & Bullion* touted no fees for establishing or funding an account, but there was a cost for converting virtual holdings back into real money. FBI and Inland Revenue Service (IRS) of the United States determined that about $35 million per month was funnelled through *Goldfinger Coin & Bullion* at the peak of this Ponzi fraud and, importantly, FBI investigators noticed that very little of the incoming funds was due to trading transactions in precious metals, a strong indication that this was a fraud.

The crucial clue to the fraud was that a genuine gold dealer would mostly be trading precious metals-buying gold and holding on to this gold- not buying and selling gold because there would be extremely little profit made by buying and selling gold. There should have been much money coming in and very little money going out, unless it was to buy gold. The investigators were not witnessing this.

Rather, investigators noticed that the company had about one million users and was charging huge profits on transaction fees, mostly related to this illegal Ponzi-type activity. The FBI and IRS then shut down *Goldfinger Coin & Bullion* Internet website in the year 2008 following the murder of co-founder Pamela Fayed and the subsequent arrest of Jim Fayed, her husband, who had hired the men to murder her. He had since been convicted of murder, and is at present in Death Row Prison in the state of California.

Bitcoin currency-bypassing the global banking system

Apart from use of bitcoins bypassing normal banking systems, it is little understood.

The Bitcoin logo. Source: Google.

One factor for the bitcoin success is secrecy.

Conclusion

Ponzi schemes cannot be instantly closed down due to new people joining the schemes where word had not yet spread that the scheme promises were false and hundreds and thousands of investors had already joined because they had not yet realised that the police were since involved in dismantling such schemes. Another setback that influences fraud schemes such as Ponzi Schemes is police ‘lack of funding. (Editor, ‘Lack of funding leads to tough choices at police training council’, *Concord Monitor* (Canada), 6 December 2015. See http://www.concordmonitor.com/news/nation/world/19856885-95/lack-of-funding-leads-to-tough-choices-at-police-training-council, accessed 25 January 2016). Inadequate budgets disallow time and training necessary to catch such criminals operating investment frauds red-handed. (Editor, ‘Lack of funding leads to tough choices at police training council’, *Concord Monitor*, 6 December 2015. See http://www.concordmonitor.com/news/nation/world/19856885-95/lack-of-funding-leads-to-tough-choices-at-police-training-council, accessed 25 January 2016. However not all countries have been cutting back on police funding. See Editor, ‘SA police force won't get cut funds back in budget, doesn't need to cut jobs, says Premier Jay Weatherill’, *The Advertiser*, 13 February 2013, although within this report was stated that ‘*Mr Burns told Parliament's Budget and Finance Committee that ‘job losses were "on the cards" as a result of the $150 million in State Government cuts to his budget*’. See http://www.adelaidenow.com.au/news/south-australia/sa-police-force-wont-get-cut-funds-back-in-budget-doesnt-need-to-cut-jobs-says-premier-jay-weatherill/story-e6frea83-1226577010104, accessed 25 January 2016).

British Police Officers. Source: Google.

In the UK, the situation has remained unchanged for years, always due, still ongoing today, to police budget cuts. (Editor, ‘Police force could lose 22,000 jobs under new spending cuts’, *Guardian*, 31 August 2015).

As long as seven years ago, when UK fraud was about £20 billion a year in the UK, there were complaints by the police of inadequate budgets to fight fraud. It is an established fact that UK fraud victims do receive initial coping help from the police. It is now known that such help as it is, often remains incomplete and inadequate.[8]

It is time we are reminded of an empty fraud of such magnitude that its collapse threatened to overturn monarchies and governments, the South Sea Bubble. Its failure delayed the introduction of modern market economies by two generations. Yet the full scale of this monumental deceit was quietly covered up and hidden, its enduring legacy a poorly understood colloquialism: *the South Sea Bubble*. It was all planned by one ambitious promoter, who had decided to launch ‘a company for carrying on an *undertaking of great advantage, but nobody to know what it is’*. We live in an age of Internet, Smartphone, and robotics and yet we remain as gullible now as then. See Balen, M. (2003) *A very English deceit: The secret History of the South Sea Bubble,* London: Fourth Estate.

The book *Understanding Ponzi Sch*emes (by Mervyn L. Lewis) comes highly recommended.

Endnotes

1. See http://www.unisanet.unisa.edu.au/staff/Homepage.asp?Name=mervyn.lewis, accessed 7 January 2016.
2. See Ramage, S. (2009) *Fraud investigation*, New York: iUniverse.
3. As a result of its deceptive accounting practices, including the creation of earnings, the manufacture of cash flow, and the concealment of debt-the Enron Corporation ('Enron') generated financial statements that were misleading and wholly inaccurate. Since1 December 2006, there were 35 individuals charged in connection with offences of illegal accounting practices. Of these individuals, 23 pled guilty, including former Enron Chief Financial Officer ('CFO') Andrew Fastow, former Chief Executive Officer ('CEO') Jeffrey Skilling, and former Chairman and CEO Kenneth Lay (whose conviction was later vacated due to his death).
4. See papers from the '10th International Conference on Corporate Governance: Getting REAL with Corporate Governance', *Institute of Directors*, October 2009. The conference was held at the Royal Overseas League, Mayfair, London, United Kingdom.
5. US Corporate Fraud investigations involve the following activities: falsification of financial information, including false accounting entries; bogus trades designed to inflate profit or hide losses; false transactions designed to evade regulatory oversight; self-dealing by corporate insiders, including insider trading, 'kickbacks', backdating of executive stock options; misuse of corporate property for personal gain; individual tax violations related to self-dealing; fraud in connection with an otherwise legitimately-operated mutual or hedge fund such as late trading, certain market timing schemes,
falsification of net asset values, and the fraudulent or abusive trading practices by, within, or involving a mutual or hedge fund. Other corporate fraud is the obstruction of justice designed to conceal any of the above-noted types of criminal conduct, particularly when the obstruction impedes the inquiries of the Securities and Exchange Commission (SEC), other regulatory agencies, and/or law enforcement agencies.
6 http://www.usdoj.gov/usao/nys/victimwitness.html/
accessed 6.1.2016.
7. See Editor, 'Day Trading broker steals more than $6 Million from Investors in Long-running Ponzi scheme', FBI News (San Diego Division), 2 June 2015. See https://www.fbi.gov/sandiego/press-releases/2015/day-trading-broker-steals-more-than-6-million-from-investors-in-long-running-ponzi-scheme, accessed 6.1.16.
8. In 2008, the then David Kirk, director of the Fraud Prosecution Service for England and Wales, said that the crime was increasing because of the credit crunch. Mr Kirk told the BBC that pressures on police budgets had led to a drop in fraud squad officers from 600 to 400 over the past decade to 2008. Mr Kirk said that a great deal of fraud was taking place in the banking sector and through 'boiler room' investment schemes selling worthless shares and that mortgage fraud had come back with a vengeance because of the credit crunch and organised crime moving into mortgage fraud. Each mortgage fraud scheme contains some type of material misstatement, misrepresentation, or omission relating to the property or potential mortgage relied on by an underwriter or lender to fund, purchase or insure a loan.