



Inside the Mind and Behind the Numbers: Ponzi Schemes

By: John Hanson, CPA, CFE, CCEP

Many years ago I was awakened by a phone call from a Managing Director at 3:30 a.m. asking if I could be in a city half-way across the country for a meeting at 10 a.m. The consulting firm that I worked for at the time had procured an opportunity to present our forensic accounting services to the newly appointed Receiver in a massive Ponzi scheme. In fact, it was the largest Ponzi scheme in history at that point in time (it was later unseated for that title). During my tenure as an FBI Agent I had investigated many Ponzi schemes and was, at that time, the only person at my firm with such experience. Needless to say, I found a flight.

When we met the Receiver, he did not dispute in the least that this was a huge Ponzi scheme. He asked if we would be able to reconstruct the financial statements and records of the company from the company's internal books and records so that he would know, among other things, how much cash and other assets the business had and where it was. When I quickly responded "no" in response to him, it was as if the world came to an abrupt stop. The Receiver gave me a puzzled look, while the Managing Directors from my firm had one of disbelief, perhaps even some anger – saying "no" to a prospective client, even when it was the right response, was not something they enjoyed hearing.

In explaining my answer, I told the Receiver that what he asked was not possible. Everyone knew and agreed that this was, in fact, a Ponzi scheme, which meant, to someone who had investigated many Ponzi schemes, that almost all of the internal records of the company were fabrications and utterly unreliable. The only way to determine what assets existed and their location(s) was to follow the actual cash flows in bank accounts – an immensely tedious and time-consuming task. Ultimately, the Receiver elected to hire another forensic accounting firm, apparently one that had responded "yes" to his question.

Interestingly, I saw this same Receiver years later speak about this Receivership at a conference. In the context of "lessons learned," he noted that after spending tens of millions of dollars over many months trying to reconstruct the books of the company using internal records, his forensic accountants determined that it wasn't possible and had to start over using records directly from banks. Imagine that.

It has been over a century since Charles Ponzi perpetrated the fraud scheme that bears his name and which has been successfully replicated all over the world countless times. Despite the abundance of warnings in the press and elsewhere, people continue to fall prey to the scheme's promise(s) of high liquidity and consistently large returns with little to no risk.

It seems that almost every day the press reports on newly uncovered Ponzi schemes. They range from the small and unsophisticated, affecting only a few local investors for thousands of dollars, to the economy-shaking mammoths costing thousands of people all over the world tens of billions of dollars. As varied as the schemes are, so too are the victims, who range from the rural, uneducated elderly widow trying to make the most of a small nest-egg to expert, highly sophisticated investment bankers managing massive portfolios.

While it is interesting to recount and study the history of Charles Ponzi and the scheme named after him, I will not focus on that in this work. Instead, I will turn on my forensic accountant's spotlight to answer that one most important and inevitable question that is on everyone's mind "***Where did all that money go?***"

To begin to answer this question, it is necessary to first understand how these schemes *really* work. Dispose of the common fallacy about Ponzi schemes being a rather simple scheme of stealing from one victim to pay another, as though the operator of the scheme were a lesser “con-man” operating a rudimentary scheme. The ability to gain a person’s confidence and the guile of a successful Ponzi scheme operator is as cunning, sophisticated and savvy as Frank Abagnale in his “*Catch Me If You Can*” prime. Also, there should be no doubt that the primary objective of the Ponzi scheme operator is simply this - never pay back anyone.

These con-artists exploit human nature, need, and greed, using their charisma and skill at deceiving and gaining trust to keep investors investing new funds, as well as rolling over and re-investing previous investments. They only pay out those who push too hard or whom they can’t convince to rollover their investment(s). So long as most investors don’t have an urgent need for cash and the con-artist doesn’t make any blunders, the scheme can survive, even thrive.

One reason these schemes have been failing over the last many years is because investors, attracted by short-term (highly liquid) investments paying high returns which they had been rolling over for years, have had sudden and urgent needs for cash due to poor economic conditions. The earliest investors who asked to liquidate their investments, so long as their investments were not particularly large, often got their cash out, interest included. To the con-artist, such necessary payouts are used to bolster their credibility with current investors and to attract new investors. But much like a “run on the bank,” there comes a time when the con-artist simply does not have the funds to pay out large numbers of investors or individual large investors who ask for their funds, particularly when fresh victims are difficult to find, as has been the case over the last several years during the recession.

In smaller, less sophisticated schemes, nearly all of the victims’ funds are used by the con-artists to directly support their personal life-style, with relatively little being used to facilitate and perpetuate the fraud. In many cases, much of this personal spending is not on tangible and recoverable assets, nor do they use sophisticated money laundering techniques to move and hide large amounts of cash into off-shore accounts or other difficult places to find and recover.

The personal use of victims’ funds varies as widely as do the con-artists themselves. Some common uses seen in forensic accounting investigations include, among others: travel, entertainment, professional services (legal and not so legal), tuition, apartment/vehicle leases, club memberships, household/property upkeep and/or improvements, extra-marital or other multiple “relationships”, drugs, gambling, therapy, alimony, loans to family, charitable contributions, educational endowments and clothing.

To the extent that victims’ funds are used by the con-artists to acquire real and personal assets subject to potential recovery and conversion, common uses include: real estate, cars, boats, motorcycles, airplanes, jewelry, gold coins, antiques/furniture, weapons, art, collectibles, time-shares, trust funds and investments in such items as CDs, stocks, bonds, hedge funds, mutual funds, pre-paid tuition and retirement accounts.

It is noteworthy that in these more common, relatively unsophisticated and “small” Ponzi schemes, the majority of victims lose most or all of their investments. According to the 2009 Fraud Examiners Manual, ninety-three to ninety-five percent (93% - 95%) of investors lose their money in such schemes.

By contrast, in the long-lived, unusual, large and sophisticated schemes, there is a lesser relative personal use of funds and a greater amount of “business” use, as well as more sophisticated attempts to launder and hide cash. Though the news may occasionally report about the discovery of extravagant personal properties owned by the perpetrators of these schemes, the overall personal use is not as large or lavish as the general public might expect *when compared with the total amount of victim funds invested*.

The intangible and tangible personal spending of con-artists in these large schemes, while quantitatively much greater, are not different in substance from that detailed above. Interestingly enough, many of the potentially recoverable hard-assets associated with the con-artists are financed or leased, using large down payments where necessary and leaving victims with a meager proportional interest which may take long periods of time to realize. For example, Bernard Madoff operated a multi-billion dollar Ponzi scheme, yet he leased several luxury automobiles rather than purchasing them.

A large portion of the invested funds in these large schemes is often used to facilitate and perpetuate the fraud, which includes operating the business(es) that help or allow the fraud to appear legitimate and successfully continue. Sometimes, in addition to serving as a “front” for the fraud, the business(es) being operated may actually conduct legitimate business. Accordingly, expenditures are those ordinary to operating a business, such as payroll, professional service fees, building/office leases, marketing, office furniture and, in some instances, equipment and/or inventory.

To the extent that the business is viable as a legitimate business or some of the real assets were purchased or largely owned, assuming some value remains and they are convertible, there may be some relief, albeit generally very small, for the victims. In some cases, a complex web of inter-related entities also serves to distance the illicit funds from their true source, akin to “layering” in classic money laundering terminology.

Also, the con-artists that perpetrate these large Ponzi schemes, being entrepreneurial almost by definition, will often invest huge amounts of victim funds in various real estate ventures, private equity deals, troubled company acquisitions, start-ups and high-risk stocks or other investments. They may even include, as in a rather remarkable twist of fate for Allen Stanford, investments into someone else’s Ponzi or fraud scheme. In Stanford’s case, that investment was with Madoff.

Many of these “entrepreneurial” uses are financed with victim funds rather than through bank loans or other traditional and legitimate sources of capital because those sources usually entail more scrutiny and/or audits. Though some con-artists have been known to go to great lengths and expense to fool auditors or others asking questions about their business(es), they will do everything they can to avoid it and will only go through such trouble when absolutely necessary. For example, in Madoff’s scheme, prospective investors were not allowed to examine his books to conduct due diligence because he claimed such activities would divulge his proprietary investment strategies.

Recovery of victim funds from such investments becomes a remarkably complex undertaking. In some cases, particularly in real estate and start-up ventures, the investments may have been made based on verbal agreements with partners with no complicity or knowledge of the fraud. While forensic accountants can trace the funds and identify these investments, a host of legal, valuation, economic, regulatory, political, ownership and public interests complicate the recovery process, making it especially difficult to determine the amount of victim recovery. For instance, imagine how victims must have felt when politicians publicly stated they would turn millions of dollars in political contributions from Stanford over to charity!

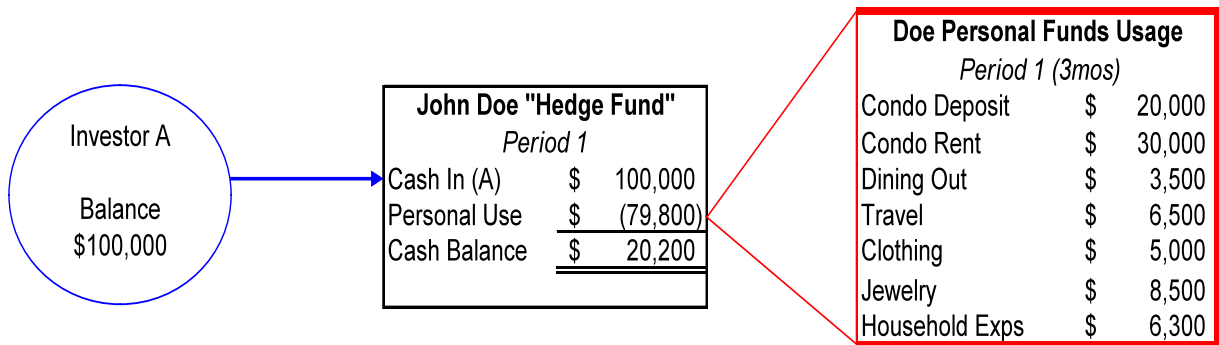
Though labyrinth-like organizational charts have already been made public in some of these large Ponzi schemes depicting complex entity relationships which one might expect to see in money laundering matters, it remains to be seen to what extent the con-artists in these massive frauds actually utilized sophisticated accounting, finance and money laundering techniques to conceal large amounts of cash, either domestically or abroad. While many hope to find such hordes and investigators/forensic accountants are obliged to dedicate substantial resources and time looking for them, it is possible that little such activity will have occurred and such pots of gold do not exist.

The massive nature of sophisticated Ponzi schemes such as Madoff, Stanford and Petters had never been seen before and all these years later they are still sorting out exactly how they used their victims’ funds and how much victims will recover when it is all done.

Now for the forensic accountant's spotlight. Using a hypothetical scenario involving John Doe, a professional money manager operating a Ponzi scheme within the guise of a hedge fund, I will take you on a journey through the typical accounting of a common, non-massive, Ponzi scheme:

Period 1: Being promised a 20% return on a three month investment (Period 1) of \$100,000 or more, Investor A invests \$100,000 in John Doe's hedge fund.

Doe immediately rents a fully furnished million dollar condominium in the most exclusive building in town, using \$20,000 of the funds as a deposit and paying \$10,000 per month in rent. He also uses Investor A's funds to pay other personal expenses throughout Period 1. Doe's total expenses for the three month period amount to \$79,800.

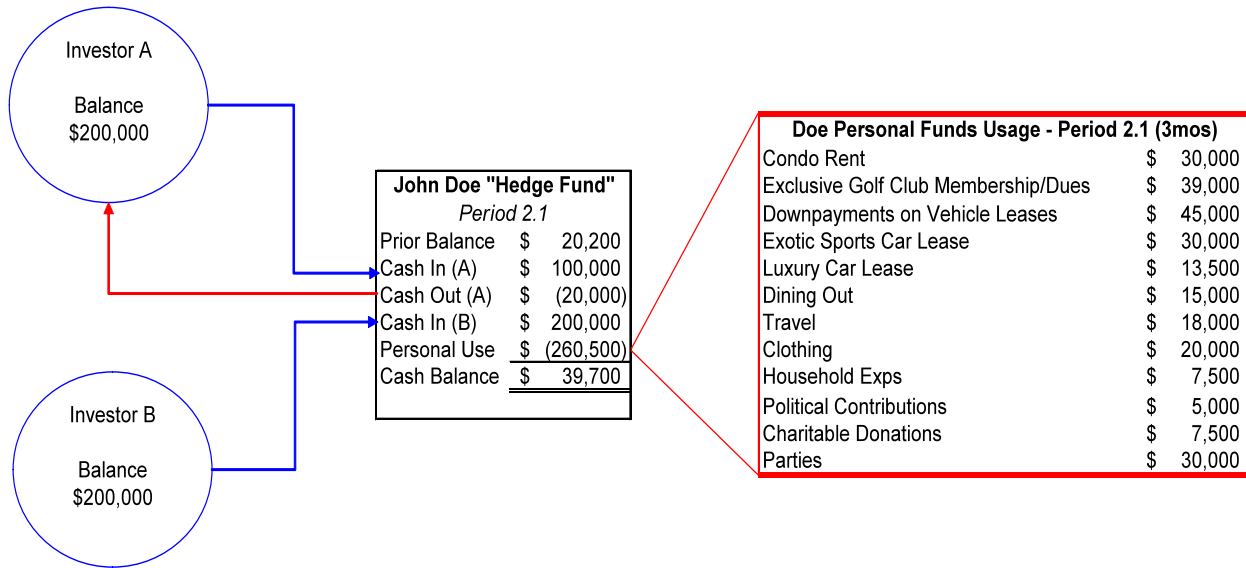


Period 2.1: At the end of Period 1, Doe invites Investor A to his condominium, which he tells Investor A he purchased outright, and gives him a check for \$20,000 covering the interest earned on Investor A's initial \$100,000 investment. Doe assures Investor A that he can pay a 30% return on a six month (Period 2) investment of \$200,000 or more. The perceived success of his initial investment, the check from Doe for the interest earned, the apparent personal success of Doe, and the promise of a 30% return on a six month investment convinces Investor A to roll over his initial principal of \$100,000 and invest an additional \$100,000.

Wanting to share his success with one of his old fraternity brothers who owns a very successful automobile dealership, Investor A tells Investor B about his first investment and Doe's promise about the Period 2 returns. Investor B, also being promised by Doe a 30% return on a \$200,000 or more six month investment, decides to match his buddy's investment and invests \$200,000 also.

During the first three months of Period 2 (Period 2.1), Doe buys a very exclusive Country Club membership for \$30,000, which costs \$3,000 per month in dues. Putting down a combined amount of \$45,000, he leases an exotic sports car for himself and a luxury car for a woman he started dating, whom he fine dines with nightly, takes on frequent trips and buys clothing for. He makes \$5,000 in various political donations, donates \$7,500 to local charities and hosts two large parties, one at the Country Club and one at his condominium. Doe's total expenses for the three months of Period 2.1 amount to \$260,500.

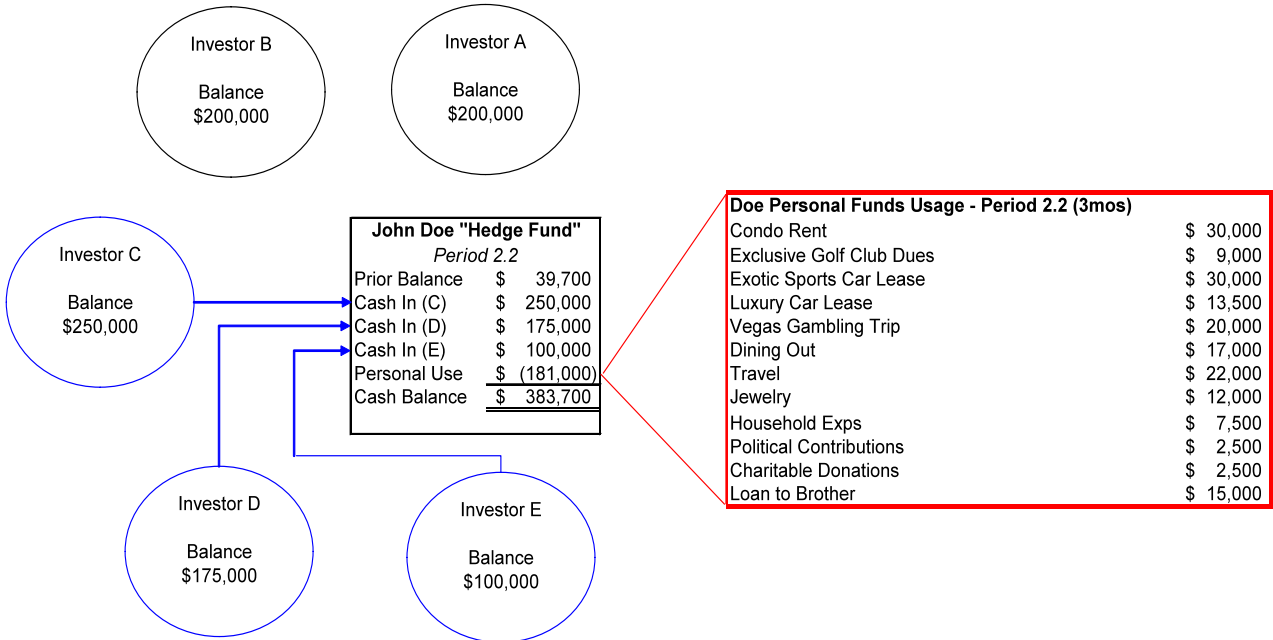
Note that with no actual investment of Investor A and B's funds into anything, even if Doe had not used any of the investors' funds for personal expenses, because of the initial \$20,000 interest payout to Investor A at the end of Period 1, the scheme is already "in the red," with liabilities in excess of the invested funds.



Period 2.2: Three months into Period 2, Doe attracts a Country Club Board Member (Investor C) and a very successful attorney who owns and lives in a condominium in his building (Investor D) to invest \$250,000 and \$175,000, respectively, promising each a 40% return on a three month (Period 2.2) investment of \$150,000 or more. Doe produces fabricated financial documents reflecting historical achievements of such returns to each and takes them to play golf with Investor A, who praises his investment success with Doe. Promising a 35% return, Doe is also able to convince the Minister at the Church he attends (Investor E) to invest \$100,000 in Church funds over three months (Period 2.2).

During the second three months of Period 2 (Period 2.2), Doe loses \$20,000 gambling in Las Vegas, buys \$12,000 in jewelry for himself and his girlfriend, continues dining out at fine restaurants, takes more trips with his girlfriend, makes \$2,500 each in political and charitable donations and loans \$15,000 to his brother, who was laid off from his job. Doe's total expenses for the three months of Period 2.2 amount to \$181,000.

Please see graph on page 6.

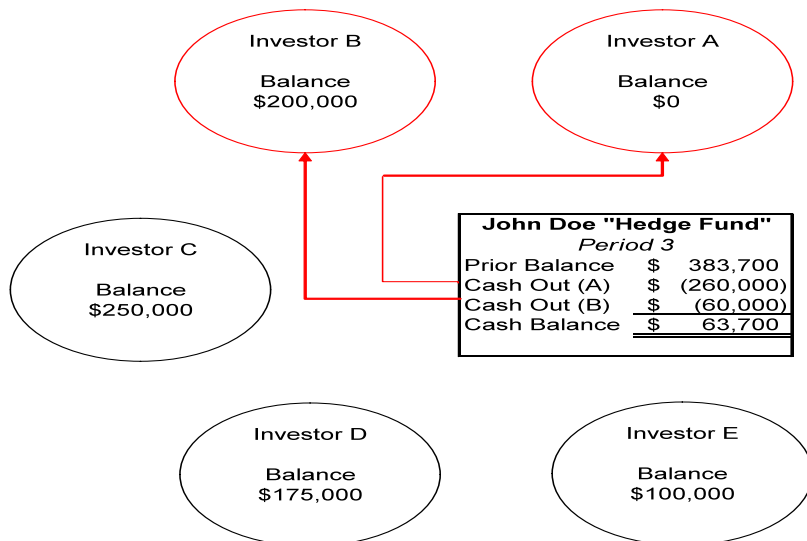


Period 3: At the end of Period 2, Doe is successful in convincing Investors C, D and E to roll their entire principal and interest balances over for another six months (Period 3) at a promised return rate of 45%.

Investor B agrees to roll over his principal, but only for the first three months of Period 3 at a 55% return rate. Investor B withdraws his \$60,000 in interest to cover expenses at his auto dealership, which is suffering from declining sales.

Investor A, who was laid off during Period 2, needs all of his principal and interest paid, amounting to \$260,000. After the interest payout to Investor B, Doe only has \$323,700 and, in the face of pending personal leases and other expenses, tries to buy time with various delays and by offering Investor A even more attractive terms and higher returns if he rolls the investment. Investor A refuses all offers and threatens to file suit if he is not paid immediately. Doe reluctantly pays Investor A and begins desperately scrambling to find new investors.

Below illustrates the standing of Doe and all investors at the beginning of Period 3, prior to any personal spending by Doe.



End Game: Just after Investor A is paid out, Investor D, the attorney, hears through his network of legal friends about Investor A informally inquiring about legal assistance concerning getting his funds back from Doe. He contacts Investor A to discuss and begins asking around town about Doe. He quickly learns that Doe is offering even higher returns than he was offered on new investments covering the same time period as that offered to him. Investor D immediately demands his full principal and interest back from Doe.

Unable to convince Investor D otherwise, and without resources to pay him back the \$245,000 owed to him, Doe avoids Investor D and continues desperately trying to find new investors. Unable to contact Doe and fearing the worst, Investor D files a complaint with the FBI.

Doe is done.

Let's take a look at each investors' ending real balance(s):

Investor Balances

Investor A		Investor B		Investor C		Investor D		Investor E	
Funds In	\$ 200,000	Funds In	\$ 200,000	Funds In	\$ 250,000	Funds In	\$ 175,000	Funds In	\$ 100,000
Funds Out	<u>\$ 280,000</u>	Funds Out	<u>\$ 60,000</u>	Funds Out	<u> </u>	Funds Out	<u> </u>	Funds Out	<u> </u>
Balance	<u><u>\$ (80,000)</u></u>	Balance	<u><u>\$ 140,000</u></u>	Balance	<u><u>\$ 250,000</u></u>	Balance	<u><u>\$ 175,000</u></u>	Balance	<u><u>\$ 100,000</u></u>

Here is how Doe expended all of the funds invested in his scheme:

Use	Amount
Charitable Donations	\$ 10,000
Clothing	\$ 25,000
Condo Deposit	\$ 20,000
Condo Rent	\$ 90,000
Dining out	\$ 35,500
Down-payments on Vehicle Leases	\$ 45,000
Exclusive Golf Club Dues	\$ 18,000
Exclusive Golf Club Membership	\$ 30,000
Exotic Sports Car Lease	\$ 60,000
Household Upkeep Expenses	\$ 21,300
Jewelry	\$ 20,500
Loan to brother	\$ 15,000
Luxury Car Lease	\$ 27,000
Parties	\$ 30,000
Political Donations	\$ 7,500
Travel	\$ 46,500
Vegas Gambling Trip	\$ 20,000
Interest Paid to Investor A	\$ 80,000
Principal Paid to Investor A	\$ 200,000
Interest Paid to Investor B	<u>\$ 60,000</u>
Total	<u><u>\$ 861,300</u></u>

Prior to Investor D's demands for repayment, Doe had a cash balance of \$63,700. Needless to say, it is highly unlikely that that would have remained unexpended for long, given Doe's "personal needs."

Of particular importance to the victims, only \$20,500 of Doe's expenditures were for "hard assets." In this hypothetical, it was all for jewelry. If those pieces of jewelry could be recovered, they may be converted for some portion of their costs. Another \$340,000 was paid back to Investors A and B. In fact, Investor A actually profited \$80,000 on his investment(s). Under the Uniform Fraudulent Transfers Act, which is recognized in a majority of the states, earlier investors may have to pay back the profits they made. If so, this could possibly increase the pot of recovered funds for the victims.

As illustrated, the vast majority of funds Doe expended have very little likely chance of any recovery. Doe's vehicles and condominium were leased and most of his spending was on intangibles and services.

This doesn't paint a hopeful picture for victims, but remember that our example illustrates the source and use of funds seen in more simple and common Ponzi schemes, not those on the scale of Madoff, Stanford or Petters. In these larger schemes, because a very large portion of the victims' funds will have been used for various investments and other more tangible ways to facilitate the fraud, there is more hope for finding recoverable assets. But then, there are a lot more victims looking to recover.

About the Author:

John Hanson has over twenty (20) years of fraud investigation, forensic accounting, corporate compliance & ethics, and audit experience. Much of John's professional experience has been in federal criminal law enforcement, having served for nearly ten (10) years as a Special Agent with the Federal Bureau of Investigation. John has conducted hundreds of investigations involving complex fraud schemes, including Ponzi and Pyramid schemes, embezzlements, money laundering, identity theft, telemarketing fraud, bankruptcy fraud, public corruption, securities fraud, health care fraud, mortgage fraud, charitable fraud and bank fraud. John has extensive experience tracing and securing cash and other assets resulting from illicit activity and often skillfully hidden by sophisticated fraudsters using front companies, off-shore accounts, correspondent accounts and other means. John is also a Certified Public Accountant (Louisiana), a Certified Fraud Examiner and a Certified Compliance & Ethics Professional. John previously led a team of forensic accountants and fraud investigators engaged by victims of a massive Ponzi scheme. He is also currently involved in four Federal Monitorships, two as the named Independent Corporate Monitor, one as the named "Independent Business and Ethics Program Evaluator" and the last in support of the named Monitor.