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PRACTICE - REGULATORY/COMPLIANCE

Warning Signs for Ponzi Schemes

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A partner with Diamond McCarthy of Los Angeles, Kathy Phelps has over 22 years of experience in bankruptcy law and fraud litigation. She is also the author of The Ponzi Book: A Legal Resource for Unraveling Ponzi Schemes *and the forthcoming* Ponzi Proof Your Investments: An Investor's Guide to Avoid Ponzi Schemes*. Here she discusses the need for financial advisors to stay alert to potential Ponzi schemes on behalf of their clients and the red flags and warning signs they should look out for.*

1. Where did the term Ponzi scheme come from?

The word 'Ponzi' comes from Charles Ponzi who ran his scam circa 1920. It was an international postage coupon scheme, where Ponzi said he could buy postage coupons cheaply abroad, bring them back to the States and redeem them for a 400% profit. He offered 50% returns to investors in a short period of time, and he brought in about 15 million dollars worth of investment, which in those times was just a whole lot of money.

It turned out he never actually purchased one coupon, but it sounded really good and people were just throwing money at him. It wasn't the first time that anyone had ever engaged in that type of conduct, but that was the name that stuck, although people have asked me, "Why isn't it now called the Madoff scheme?" since Madoff dwarfs all the other schemes that came before him.

2. What can advisors do to help their clients identify this sort of fraud?

Number one, if you can't understand the business model after about a five-minute explanation, you probably shouldn't invest. And certainly, if it's not clear why investor dollars are needed, you shouldn't invest. Most of these types of businesses claim to have an auditor because they want legitimacy. So it's always worth a phone call to the auditor, or at a minimum a public search, to see whether in fact the auditor exists, is legitimate, licensed and not affiliated with an insider.

Background checks of the key figures of an investment program are essential. I would venture to guess that maybe 50% of the principals in these schemes had a prior record of some sort, and background checks would pick up a lot of problems.

You also want to make sure that you're getting some sort of a regular reporting, an account statement of some sort. You know it was very telling what was going on in the Madoff case. They only issued paper statements; there was no electronic access to their data, and in the securities business these days that's pretty much unheard of. But Madoff would make up the numbers after the markets had closed and mail those statements out to people. And if you looked at them closely, you would have seen trades recorded that were taking place on the weekends; there were trades taking place that were outside of the daily trading range for the particular securities that were being traded. There were some real glaring red flags had anyone bothered to read the paperwork.

Another real important thing to look at is the relationship of the returns being promised to the market returns for a similar or the same type of investment. With Madoff the numbers were just way out of whack. Harry Morkopolos, the whistleblower, did a study, I think it was over an 83-month period of time, and he compared what the S&P 500 was doing to what Madoff said he was doing. The S&P lost money in 57 months over that period, while Madoff claimed a loss in only three. There was just no correlation to what was really going on.

The same thing took place in the Stanford Financial scandal. The returns that were promised on the certificates of deposits were not in line with what CDs

were paying out elsewhere. That was a real red flag.

And then, you know, these traders just love to cloak themselves in credentials: I have this educational degree, and I have this work experience, and I offered this and I'm the president of that — and all these things are worth a little bit of investigation. In my practice, I have seen people claim to have earned a Ph.D. from such and such a university, where the university never heard of this person. Those things are very easy to invent and investors generally don't call to verify.

I tell people, if you're thinking of making an investment, you should search the Internet and look for news coverage. You obviously want to read any negative news coverage, to probe it. You want to see if you can talk to the people who were actually reporting it. But with positive news coverage there's another problem. You have to be very careful, because anybody can issue a press release themselves, and there's a really strong chance that any positive news or testimonials are coming from a perpetrator himself.

3. Are foreign-based schemes more difficult to identify?

Yes, and those really have an allure. Foreign exchange Ponzi schemes and tax havens abroad are very tempting for investors because they're represented as guaranteed and tax free. Well, how do you turn something like that down? But they're also much harder to vet.

The same level of regulation just doesn't exist outside the United States, so it's easier for a perpetrator to get away with fraud overseas.

It's also important to realize that frauds or Ponzi schemes involving advisors or financial securities are, in my view, only a small percentage of such schemes worldwide. In just the last six months, we've seen some enormous Ponzi schemes, involving millions and millions of dollars, that have nothing to do with the securities industry. There was one in India that involved goats. If you purchased a goat to be reared by the Ponzi scheme perpetrator, the goat was guaranteed to give you four kids in the first year. Meaning, if you sold them to other investors, he claimed you could make four times your money.

4. When it comes to various private investments, what type of due-diligence questions should an advisor ask?

That's going to vary. There was another scam, it was a potato bond scheme. And this company claimed to buy potatoes when they're really cheap, freeze them and then sell them when the price goes up. Guaranteed 20% return on your money, they claimed. Well, some of the questions that should have been asked are: "Is there ever a 20% fluctuation in the price of potatoes?" "Are potatoes any good after you freeze them?" "How can you guarantee 20% returns, when you don't know what the price of potatoes is going to do?" Depending on the type of business model you're thinking about investing in, the type of due diligence questions that you ask may be very different.

5. How are these types of frauds typically instigated?

Well, most Ponzi schemes are affinity schemes, meaning they're not coming from the broker and they're not coming from the perpetrator. They're coming from a close set of confidants of the perpetrator; family and friends, or church members or some sort of a community group, and they're reaching out to their friends and so on and so on. These things spread within communities, and no-one bothers doing their due diligence because so and so recommended it, so it must be good.

6. When a client wants to make a dubious investment of this sort, what can an advisors do to dissuade him?

I have had a number of brokers and salespeople come up to me and say, "It makes me crazy. My client comes to me and says 'I want to invest in this thing,'" and the broker tries to explain why it's a bad idea, "No, don't do it. There're all these red flags." And time and time again, the client does it anyway.

And again it's because, "Oh, but it's my dad's best friend and he's known him for 20 years, and he's been making money and paying returns. Why, of course, I'm going to do it. Why wouldn't I do it?" And that's the problem. The insidious nature of the Ponzi scheme is that it's people -based, and it gets victims to invest based on emotion and trust without doing their due diligence.

7. What kind of people are targeted by these schemes?

The elderly, the retired. There was one where the perpetrator was deaf and an Evangelical Christian, so he actually targeted fellow deaf Evangelical Christians with his affinity scheme!

8. Do you ever represent brokers who were invested in some sort of Ponzi scheme?

A broker can be involved in a lot of different ways. A broker could be sued by an investor for negligence for not fully vetting a product. A trustee could potentially sue a broker on the same basis. Brokers could potentially bring actions against others, or against law firms or auditors, if they relied on false financial statements or private placement memorandum, so brokers can find themselves in the mix. Brokers also get sued for fraudulent transfers, for

commissions that they may have been paid for bringing people into a Ponzi scheme. On fraudulent transfer theories, they can be sued for actual fraudulent intent, that the money they received was money paid out of the Ponzi scheme and so it needs to be returned. Or on a constructive fraudulent transfer theory, that the commission they paid was too high and above market and they should pay back the difference; there may be breach of fiduciary duty claims that a client could bring against them if they feel that the broker did something contrary to their interests. So there's a few different theories that brokers can get sued on.

9. Are firms and regulators doing enough to watch over brokers and advisors who might be misleading clients?

I don't know. Twenty-two billion dollars — that's the amount of fraud of this type that's reported annually, but, as I noted earlier, that's probably just the tip of the iceberg.

At the advisor and broker level there are increasing regulations and reporting requirements. It seems like more are being put into place every day. Elsewhere, in terms of financial institutions, there are certainly a lot of regulations in place; I'm not sure that they're all being complied with or enforced as vigorously as they ought to be. They definitely made mistakes in the Madoff scheme, their own internal report fully acknowledges that. Whether their staff attorneys and investigators are better equipped, better trained and better funded today, I don't know.

Unfortunately we won't know until the next Madoff scheme breaks and we find out what was happening — if there was something happening — that we weren't aware of. But, certainly the SEC is freezing assets and appointing receivers in cases where it is detecting fraud and it feels that there's a case to be made. But I don't know how many reports are submitted to the SEC; that's not available information, so I can't tell you whether the agency is doing a good enough job.

10. How did your law practice come to focus on Ponzi schemes and related types of fraud?

I've been practicing law for about 23 years now, and early on in my career these fraud cases sort of found me. When I was younger and just starting out the cases were smaller, but as I moved forward in my career the cases got bigger, and I started being asked to represent trustees and receivers and sometimes investors in various types of fraud cases. Many of them have turned out to be Ponzi scheme cases. Four or five years ago, I was involed in a particularly large Ponzi scheme case, and I was looking for a resource that would assist me in filing complaints and determining the best way to proceed. At the time, there really wasn't anything out there, which is when I started writing the Ponzi book as a legal resource. In the process of writing it — I thought it was going to be an 80-page handbook (laughs) and it turned into an 800-page legal treatise — I got into it as the issues grew and unfolded. Then I started writing The Ponzi Scheme blog and following the news. As all this was happening, my practice followed along with it. With this most recent book, Ponzi-Proof Your Investments, it's become almost a personal quest of mine to educate the public to ask the questions, instead of just investing based on trust. I see the same story repeat itself again and again. And it's frustrating from where I sit, because it's quite obvious in a lot of these cases that it really is the same basic pattern repeating itself over and over. If you change the actors and their accents, their costumes and the scenery, the underlying story remains the same. There's no reason why people shouldn't be able to see that, and that's my mission; I want to help them see it.

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