A PERSPECTIVE ON THE RECENT THEORETICAL AND EMPIRICAL FINDINGS REGARDING THE PONZI SCHEMES

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Abstract: *This article aims is to define what a Ponzi scheme is, to present the known types of Ponzi scams and how they operate, focusing also on the legal implications for Ponzi scams, as well as on the warning signs for the potential victimis and authorities. The paper adopts both qualitative and quantitative research methods. In achieving the objectives of the study, data were sourced from secondary materials, i.e. relevant books, journals and internet materials.*
Keywords: *Ponzi scheme, scams, financial fraud, white-collar criminality.*

Introduction

Phelps and Rhodes (2012) define Ponzi scams for U.S. law enforcement, according to the following criteria:

- Investors have deposited funds.
- The debtor (offender) presented himself to investors in a false manner as someone who conducts legal business activity, but in fact either never conducted such activity at all, or engaged in it only to a limited extent.
- The alleged business activity of the debtor yielded very little profit or did not yield any profit at all.
- The source of the payments transferred to the initial investors in the fraud is in cash deposited in the fraud by new investors.

The main characteristic of a Ponzi scam is that funds presented to investors as profits or as the return on their investment, are in fact the fund money of investors who invested in that fraud later. This process involves persuading victims to invest using false claims that it is a secret idea that yields excessively high profits. Charles Ponzi, for example, claimed that he was investing in a financial product issued by the Postal Authority, when in fact the authority did not hold the product to the extent promised by Ponzi (Cohler, 2017).

The FBI defines a Ponzi scam as an activity that guarantees a high return or dividends that are not available in traditional investments. Instead of investing the victims' money, the crooks pay "dividends" to investors who previously joined the activity using the first investors' money (FBI, 2020). The scam is often exposed when there is a slowdown in the financial markets, investors stop their activities and the whole scam collapses (Cohler, 2017).

Springer's research also deals with the definition of what a Ponzi scam is (Springer, 2020). Her study does not classify multi-level marketing (MLM) pyramid scams as a Ponzi scam, unless it has been classified as Ponzi scams by federal authorities in the U.S. The difference between the two scams (Pyramid and Ponzi) lies in the fact that in a network marketing pyramid, there are "layers" of participants who are themselves responsible for recruiting new participants, while in a Ponzi scam, there is a lone principal offender who controls the entire operation or a regular group of criminals who do so.

Ponzi scams are not classified as a specific crime, but are defined by the U.S. Securities and Exchange Commission (SEC) as a type of fraud, and its dealers violate many regulations and laws, including non-registration as an investment company, as an investment advisor or as a stockbroker.

Another characteristic of a Ponzi scam is entrepreneurship - the criminals create opportunities for themselves to do business, usually within an illegal company, and also hold senior management positions such as CEO and CFO. Springer's study (2020) distinguishes between white-collar offenses - which are defined as such based on the environment in which they occurred, for example, in a large company - and white-collar offenses that are defined as Ponzi scams, according to the following characteristics:

- *The nature of the offense*: Taking money from victims who joined the investment at a later stage to pay the victims who joined at an earlier stage.
- *Criminals*: There are criminals or entrepreneurs.
- *Business Association*: There is a business entity, a limited company, or an investment house.
- *Number of victims*: There are more than one victim.
- *Damage*: Loss to victims in excess of $100,000 cumulatively.

Mapping Ponzi scams by categories

Springer (2020) conducted the most comprehensive review in the United States of all Ponzi scams recorded in the databases of federal bodies accessible to the general public. She reviewed only those cases defined by federal bodies as Ponzi scams. The data was reviewed from databases of the Securities and Exchange Commission (SEC), the FBI, the Department of Justice, the State Attorney and the Postal Authority. This survey examined 1,359 scams that took place in the years 1962-2020.

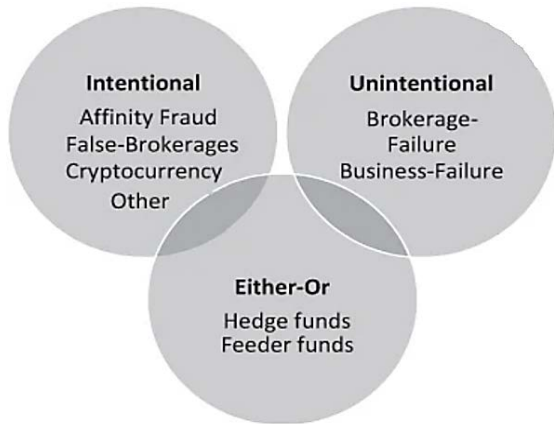
The criteria for selecting the cases were: (1) the use of the term "Ponzi" in federal documents, (2) documentation in the databases of federal bodies accessible to the general public, (3) cases in which administrative steps were taken by the Federal Civil Agency and / or cases in which there was a conviction in criminal cases (Springer, 2020). Many of the Ponzi scams reviewed in Springer's study (2020) belong to more than one category. The study presents three “supergroups” of Ponzi scams:

- *Intentionally committed scams.*
- *Scams committed unintentionally in the first place.*
- *Ponzi scams that are committed intentionally in the first place.*

In most cases, the Ponzi scams were committed intentionally in the first place and were well planned. The criminals are intelligent, well-articulated and sometimes described as sociable and charismatic.

The main characteristic of Ponzi scams is that funds presented to investors as profits or as repayment of the fund they invested, are in fact the fund money of investors who invested in the fraud later. Intentionally committed Ponzi scams are most often discovered while investigating another aspect of the scam, such as tax evasion, unlisted shares, money laundering or mailing scams.

Fig. 1. The supergroups and subgroups of Ponzi scams



Source: Springer (2020: 37)

The perpetrators create a false representation of a legitimate and successful business to attract victims. They produce false professional material as well as fictitious financial reports that seem credible, and the victims are convinced of the truth of their words. They specialize in issuing false documents, for example, annual reports, account statements and financial statements.

The criteria for U.S. law enforcement agencies to determine whether or not a Ponzi scheme was committed intentionally in the first place are:

- Whether the investment house is legally registered with federal agencies?
- Did the business function legally and then fail (business failure)?
- Was the investment house legally registered with the Securities Authority or the CFTC, and was the entrepreneur authorized to engage as an investment agent or investment advisor. If so, there is documentation in these entities that the investment house did carry out trading as promised and in fact made failed transactions. In this case, the fraud will be defined as one that occurred following a failed investment house. In the eyes of lawmakers, despite the fact that Ponzi scheme entrepreneurs do not usually make investments in their victims' money, the very promise on their part to do so while they are not legally authorized to do so is considered an offense.

Types of Ponzi scams

3.1. Illegal investment houses: False Brokerages

Investment houses that were not registered with the SEC or the CFTC (Commodity Futures Trading Commission), but nevertheless acted as investment companies, presented themselves as licensed by these entities are considered false brokerages. Some have argued to investors that they are not required to register and may have even made transactions for them. But in all cases, the perpetrators presented themselves as investment agents, traders, or licensed investment advisers, even if not on behalf of the SEC and similar federal regulatory agencies. There were some that were indeed registered as state regulatory bodies, but did not complete the registration with the federal bodies. Only 12% of the subjects in this study (Springer, 2020) were legally registered with federal bodies.

3.2. Affinity Fraud: "Community-based Fraud"

The entrepreneur seeks prey on populations with which he has some affinity, and the deception is made possible due to the trust placed in him by the victims due to their identification with him and the commonality between them and the crook. Examples of this are communities to which the affiliation is based on: profession, nationality, religion, ethnic origin, sexual orientation, physical disabilities, etc. Immigrants have also fallen victim to offenders who are also immigrants, with the common language and historical background being the elements that create the affinity between them (Springer, 2020) (friends and family members are not included in this category).

Most of the affinity scams examined in the study occurred within religious organizations, and are called "religion-based scams." Their numbers are high, but not all of them report fraud to the authorities due to the victims' refusal to believe that they were indeed deceived on the basis of their religious beliefs, and even though some of them were "treated" within the organization itself. In some cases, there was a double link between the offender and the population that fell victim to the fraud, for example, on the basis of religion and ethnic origin together, or religion and nationality together.

133 of the cases reviewed in Springer's study, (2020) were defined as affinity scams. 91 were on the basis of religion, 45 on the basis of nationality, 25 on the basis of ethnic origin, 6 on the basis of occupation, 2 on the background of the deaf community, and 1 on the background of sexual orientation.

3.3. Ponzi scams based on distributed currency: Cryptocurrency Ponzi Schemes

The decentralized currency market has been gaining momentum since it first burst in 2017, and includes cyber, digital, virtual, electronic and bitcoin currencies. In general, this currency is perceived as a Ponzi scheme by many of the leaders of the financial industry and government officials, because it is an artificial market, including currencies that are not tangible and not produced by governments. These currencies are illegal for commercial purposes and no country is a guarantor of their value. This market is a fertile ground for Ponzi scams - no enforcement agency oversees its operations, and investments in it are made anonymously and online by investors from all over the world. Therefore, law enforcement agencies have difficulty investigating and applying state laws to scams in the decentralized currency market.

3.4. Ponzi scams committed unintentionally in the first place

The entrepreneur or partnership runs a successful business or investment house, but then experiences some financial problem, following which the entrepreneur or partnership is forced to survive by committing fraud (Dorminey *et al.*, 2012). The business entity started as a legal business, and there was no initial intention on the part of the owner to commit fraud. But they were forced, in their view, to commit fraud for the business's survival. They are aware of the fact that this is an offense, but believe that they will generate profits and that they will be able to return the money to investors.

3.5. Ponzi scams following a failed investment house

This type of Ponzi scheme was first committed following the failure of legal business entities, investment houses, investment advisers, commodity pools and hedge funds, due to the financial crisis or previous financial events. The entrepreneur decides to "borrow" money from new investors to pay the profits he promised to previous investors and also to continue to run the business. Unlike fraudulent acts committed in the first instance, the offenders in these cases were legally registered with federal bodies and were allowed to engage in their field.

The Financial Crisis Inquiry Commission (FCIC) ruled that the main cause of the financial crisis was the "subprime mortgage" crisis, which led to the failure of businesses that invested large sums of money in the mortgage-related stock market, where they failed to make their investment on time and suffered losses.

Ponzi criminals do not really invest the money of their victims and are therefore exempt from registration, and as a result they are not subject to any supervision as applies to registered investment houses. 74 of the cases reviewed in Springer's study (2020) were classified under this category.

3.6. Businesses that failed

54 of the cases reviewed in Springer's study (2020) were classified under this category. In these cases, the owner of the business has acquired assets or engaged in a business activity other than the financial market, and even made profits before becoming a Ponzi scam. Most of the scams occurred during the real estate bubble and the financial crisis. Many of them dealt with the real estate and mortgage industries.

3.7. Feeder Funds

Often, existing Ponzi scams attract other investment entities, such as hedge funds in the securities market and stock market futures. These entities are referred to as "Funds of Funds" or "Feeder Funds". This is a rather complex set up which investors and the authorities find difficult to monitor. Many times, these will be hedge funds. Victims who invest their money in feed funds are not necessarily aware of this. For example, Stephen Greenspan invested in a fund of funds, which then invested in Madoff's.

In some cases, the main owner of the feed funds was not prosecuted because he was unaware that he was investing in a Ponzi scheme. 27 of the cases reviewed in Springer's study (2020) were classified under this category.

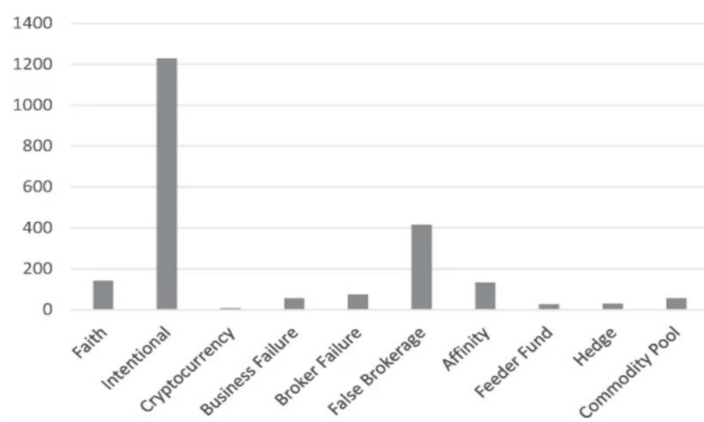
3.8. Hedge funds and commodity reserves

These hedge funds are investment entities subject to legal registration with the SEC or CFTC. Investors' money is deposited in the fund and they take part in the profits and losses of the fund, in accordance with the percentage of their investment in the fund. Hedge funds are particularly sensitive to market volatility and are considered as a high-risk investment, and indeed some fail after failing to raise the necessary capital (Johnson, 2010).

These funds are set up by private investment groups, whose managers set a high entry threshold in terms of the financial status of the fund's investors (equity of over $ 1 million). They are not required to register with the SEC, and are therefore a perfect partner in Ponzi scams. In Madoff's case, many feed funds invested in the scam he committed, although it is not known how many of them did so knowingly and how many were actually victims. In some cases, the hedge fund was a Ponzi scam in the first place, and in other cases, it was legal and then fell victim to a scam that seemed credible and actually served as an unknowingly feeding fund. 29 of the cases reviewed in Springer's study (2020) were hedge funds.

Commodity reserves are funds that invest the money of a group of investors as one piece, and are supervised by a regulatory body (the CFTC). Similar to hedge funds, in commodity reserves, investors share in the profits and losses of the investment made by the portfolio manager. But unlike hedge funds, there are no minimum requirements regarding the financial status of the participants in the pool. In many cases, even though it was not legally registered, the developer claimed the business was legal and presented false documents as a proof. 56 of the cases reviewed in Springer's study (2020) were classified as stockpiles of goods.

Fig. 2: A comparison between the preference for the different types of Ponzi scams



Source: Springer (2020: 63)

The graph (Fig. 2) shows a comparison between the different types of Ponzi scams reviewed above. The vast majority are scams committed intentionally - in about 1,225 of the cases. 415 of the cases were scams committed as a result of failed investment houses, and they account for about a third of the cases defined as intentional in the first place. 85 scams were based on hedge funds and commodity reserves. The frauds committed unintentionally in the first place - failed businesses and investment houses - accounted for 128 of the fraud cases.

The circumstances for carrying out a Ponzi Scheme

Jory and Perry, Professors of Economics and Finance at the University of Michigan School of Management, performed a critical analysis of Ponzi scams. They point out that the circumstances and environment in which Ponzi scams thrive are (Jory & Perry, 2011):

- *When there is an asset bubble or a sharp positive acceleration in the economy.*
- *In a market where the number of investors is high.*
- *In an environment where there is access to financing from multiple savings or from the possibility of obtaining credit.*

On the other hand, the chances of Ponzi fraud being exposed increase when the above elements are reversed, i.e., during a period of economic recession and / or when investors stop their activities and / or during a period of credit squeeze. This was the case, for example, in 2008-2009, when many Ponzi scams were exposed following an economic recession.

Who are the Ponzi criminals and which common traits characterize them

Bhattacharya (1979) counts 3 components of Ponzi scams:

- *The offender convinces others about an idea to invest in it.*
- *The offender promises high returns.*
- *The offender keeps his promises in the first stage and transfers money to investors in order to acquire their trust.*

Jory and Perry (2011) add the element that refers to the fact that offenders often present investments as a sophisticated and complex array. Ponzi criminals promise profits at a level that goes against any economic principle. It is likely that Ponzi criminals are charismatic salespeople, who manage to market their wares with great talent. They are renowned in their field and are involved in the community, Ponzi entrepreneurs being known as generous donors to charities, educational institutions and election campaigns.

Initially, the offenders address audiences who are socially or professionally identified with them. The method they use is by psychologically influencing potential investors, as opposed to creating a false representation of false facts - taking advantage of the trust the victims place in them due to the common background between them and the perpetrators. However, when criminals need more victims to continue the scam, they will search for more victims who do not belong to the same original identification group. Family members or friends of the entrepreneur are responsible for the management of the scam and usually are not substituted due to the need to continue hiding it.

Jacobs and Schain define the elements that make a person a Ponzi scheme criminal and indicate the urge to be in control; this urge is defined as a desire for complete and full control of everyday events, and characterizes many white-collar criminals. Due to the illusion that they control what is happening, these criminals feel overconfident in their abilities even in luck-dependent situations (Piquero *et al.*, 2005), and as a result, sometimes take particularly high risks.

They cite the theory of neutralization - most people believe in the rule of law and act according to social norms. They refrain from committing criminal activity, contrary to these norms, due to the feelings of guilt and shame that accompany it. Therefore, criminals justify their actions in a variety of neutralization techniques that neutralize guilt, and surround themselves with others who share this perception. Neutralization techniques include (Sykes & Matza, 1957):

- *Denial of responsibility and blaming others for their actions.*
- *Denial of the damage, for example, when the victim had an insurance plan that covered the economic damage caused to him.*
- *Denial of the victim, for example, on the grounds that the victim is an enemy or an unwanted entity.*
- *Condemnation of the accusers, that is, an appeal against the authority or legitimacy of the law enforcement agencies.*
- *Higher loyalty to other parties, for example, engaging in risky activities out of loyalty to friends.*

Legal implications for offenders

When the fraud collapses, whether due to its discovery or because the entrepreneur has failed to recruit new investors with whose money he would pay to their predecessors - the law and enforcement authorities enter into the picture. The victims are demanding their money back, and the offender is filing for bankruptcy as an inevitable part of the whole process. An in-depth investigation is being conducted by the authorities and an assessment is being made as to the extent of the money stolen from the victims as part of the fraud. Subsequently, legal proceedings are initiated such as punishment of the offender and an attempt to return the money stolen to their owners.

The SEC (US Securities and Exchange Commission) has the authority to monitor Ponzi scams and prosecute its perpetrators (Cohler, 2017). Following the exposure of the fraud, the SEC initiates legal proceedings against its developer. A trustee is then appointed whose job it is to try to recover back lost funds, in order to return them to creditors and investors. It is rare that only the fraudster will bear the consequences, and there will usually be other factors that may carry them. The main reason for this is their disregard of warning lights and proper inspection, and/or their activity as fraudulent funds. These factors are (Jory and Perry, 2011):

- Any person or entity that has poured money into fraud ("feed fund"), even unknowingly. This is especially true in the case where the feed fund has received funds from others and has not performed a proper inspection or ignored warning lights.
- The bank where the offender committed the fraudulent activity - because the bank had access to the offender's accounts and may even have been aware of exceptional activity within their framework.
- Investment Bank - If the offender served as an investment agent, raised financing, was an asset manager, set up investment accounts or had access to marketing materials.
- Organizations that have received donations from the offender - may be forced to return the donations.
- Funds in hedge funds that are suspected of conspiring with the developer or were aware of the fraud - the SEC may prohibit them from working in the investment market again.
- Family members - Their assets may be frozen and / or confiscated.

In 2020, the Securities Authority carried out 715 enforcement actions against individuals and entities. 405 of them were initiated by the Authority itself, that is, they did not constitute a continuation of existing legal proceedings. Segmentation of the enforcement areas were: in the area of securities (32%), investment and investment consulting companies (21%), various financial statements (15%), transactions through an investment agent (10%) where a large part of the securities enforcement activities are considered enforcement against Ponzi scams (Ogden-Glazer-Schaefer, 2020).

Prevention and warning signs

Many entities issue warnings to the public and tools for detecting Ponzi scams in order to raise awareness of securities fraud. The FBI, for example, warns the public against illegal securities activities, such as pyramid and Ponzi schemes, forex scams, hedge fund scams, etc. It also defines the characteristics of Ponzi and pyramid scams; high yield returns and down payment scams. The FBI encourages citizens to exercise discretion, request details and information, check whether a complaint has been filed with the regulator against the company or developer, and file a formal complaint in the event of a fraud (FBI, 2019).

Benson and Simpson (2009) enumerates a series of warning lights for potential victims of Ponzi scams: a promise of high returns or high performance from competitors on a regular basis; Vague explanations from investment advisers; Confidentiality or non-disclosure of information; Lack of decentralization among business executives; Excessive enthusiasm about investing; Introducing celebrities as participants in business activities; The company's accountant does not specialize in its field of business (Benson & Simpson, 2009; Jacobs & Schain, 2011). In addition to all that has been mentioned, the SEC also mentions the use of secret or particularly complex strategies. Madoff, for example, was quoted as saying to potential victims: "If you invest in me, you must not reveal to anyone that you have invested in me."

Additional warning signs will be: high profits with low or zero risk, which is inconsistent with the inherent high risk in investments that yield high profits; Frequent recurrence of fixed-income gains, which is incompatible with the natural volatility of the investment market; Investments that are not legally registered, and therefore it is also impossible to test the reliability of the company or the products offered for investment; Unlicensed sellers; Secret and complex strategies; Account management irregularities; Difficulty in making profits, which indicates an attempt on the part of the Ponzi criminals to keep investors in the scam (Ogden-Glazer-Schaefer, 2020).

Conclusions

In fact, out of all the scams reviewed, only in a few cases was any investment or business activity actually made. In most cases, no financial activity took place in reality. In some cases, although the fraud was defined by the authorities as a "Ponzi scheme", it also included other offenses, such as mortgage fraud, insurance offenses, banking offenses and tax offenses. The criminals cheated both private victims and banks, official institutions, pension schemes and insurance companies.

In most of the scams, the victims were presented with an investment instrument, or a combination of instruments, such as securities, bonds and commodities. A large part of them were presented as a combination of investment in both mortgage and real estate, mortgage only or real estate only - but no investment in practice. Some of the scams that took place during the housing bubble period (2002-2006) actually started as a failed legal business, but most of them arose from the outset as Ponzi scams.

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