1. An outline of the book

INTRODUCING PONZI SCHEMES

A dictionary might well contain the following entry:[1]

> **Ma-doff** n. 1: a selfish and excessive desire for more of something (such as money) than is needed; 2: a person who commits unconscionable financial fraud – see GREED.

The name Bernard Madoff is now synonymous with greed and he has a special place in the annals of infamy as the man who conducted if not the longest running, most certainly the largest, Ponzi scheme and investment fraud in history, amounting to paper losses of $64.8 billion if promised returns are included.[2] However, Ponzi frauds and the schemes built around them come in all shapes and sizes, as will be made clear by the 11 case studies examined in later chapters and, as well, in the profiles of the 'rogues' gallery of con men'[3] set out in the next chapter.

Stripped to its essentials, and with the huff-and-puff and 'spin' that invariably surrounds them removed, a Ponzi scheme is one of the simplest, yet effective, financial frauds to engineer, and is named after Charles Ponzi who ran such a scheme in Boston in 1920. The promoter of the scheme promises investors an attractive return on investment and declares it to be secure, but in reality no real 'investment' takes place. People are encouraged to invest in the scheme, and the money deposited by those early investors is used to pay the first 'dividend' until investors feel comfortable and decide to invest more. Many investors then encourage their family and friends to join, boosting the inflow of funds. Eventually, however, the scheme falls apart because the promoter starts to spend the money too quickly, old investors withdraw their balances, or the pool of new investors dries up. But there are many idiosyncratic factors at work, and these 'triggers' can speed up or slow down the life cycle of the operation.

The psychologist Stephen Greenspan (2009a, 2009b, 2009c) argues (indeed, in part from personal experience) that situation, social pressures and the personalities of those involved count a great deal in a Ponzi fraud. Consequently it seemed appropriate in this volume to adopt a case study approach, along with lessons learned, in order to understand, as far as possible, the circumstances in which the schemes evolved, the rationale offered for the success of the scheme, and the factors which led to its demise (recognizing of course that some schemes likely are still in operation and seemingly successful).

A MOTIVATION FOR THIS BOOK

My interest in the subject began with the shock discovery that many of my neighbours and acquaintances in the township (covering 7 square km, including eight parks, and with a population of 2947) in South Australia, where I have lived for 47 years, were victims of a Ponzi operation perpetrated by a trusted and respected member of the community (Allan McFarlane). As well as being able to talk to some of the victims and generate primary research material, it was both instructive and saddening to see the dramatic impact on the lives of those caught up in the fraud. It then became an obligation to them to research the topic, and endeavour to understand the 'never ending attraction of the Ponzi scheme' (Jacobs and Schain, 2011), and consequently to write this book, which understandably includes this experience as a case study. Perhaps because of this particular vantage point, this volume, unlike some others (e.g. Frankel, 2012), is much less judgemental of Ponzi victims and does not fault them for their seeming gullibility and 'failing to do their homework' (Henriques, 2012b). Knowing both the victims and the fraudster may colour my impressions, yet at the same time it may enable a different perspective to emerge that is worth sharing with readers. Over-trusting, rather than gullible, is the preferred description of the victims, while unmitigated – yet plausible – scoundrel best applies to the fraudster.

CASE STUDIES

Of the other ten case studies, one derives from the UK (Kautilya Nandan Pruthi) and another from New Zealand (Jacqueline Bradley).

The others all relate in some way to the United States, although one of them involving Allen Stanford straddled the United States, the United Kingdom, the Caribbean and South America. In terms of its international reach and scale of operations, the Stanford scheme is the only one that rivals Madoff. Surprisingly, at least in comparison with Bernard Madoff, the Stanford scheme has not been studied extensively – an oversight corrected here. The Stanford case study was initially prepared by Dr Ian Tregoning of the University of South Australia, and I am indebted to him for allowing me to use the material. The other cases are more localized, but nevertheless touched many different and geographically dispersed communities in the United States. Somewhat astonishingly, a particularly bold Ponzi scheme targeted members of the FBI and other federal law enforcements officers across the States (Kenneth Wayne McLeod).

Three case studies (John M. Sensenig, Monroe Beachy, Timothy Moffitt) cover Ponzi schemes that focused on the Amish communities, but were by no means confined to the traditional groupings in Pennsylvania and Ohio, involving for example monies collected across America and a seemingly fraudulent operation in Florida. All three schemes, however, had surprising end results in terms of the response of the victims. Another Ponzi scheme – undoubtedly a harbinger of things to come – was conducted via the internet using bitcoins (Trendon T. Shavers).

Yet, no volume on Ponzi schemes would be complete without a study of the Charles Ponzi scheme and that of Bernard Madoff, regardless of the amount of ink spilt on both. Revisiting the former has benefited from the development of mathematical models of Ponzi schemes and how they can evolve under various assumptions. Similarly, the account of the Madoff affair given here has been enriched by a statistical study of forensic accounting methods examining the performance of a feeder fund thought to be employing the Madoff investment strategy. Both the computer simulation of the Charles Ponzi scheme and the study of the Madoff feeder offer new insights into these schemes, as well as indicating potential ways for regulators and others to detect future frauds.

Nevertheless, notwithstanding this new material, this book reveals details that ought to have sent out warning signals at the time. While many are familiar in general terms with the Madoff episode, how many are aware that no fewer than 21 'red flags' were raised about Madoff? Not all blame for failing to act on these can be laid at the door of the US Securities and Exchange Commission (although a lot can). Had these signs been pursued and investigated with any measure of diligence, the sorry saga might have been brought to an end much sooner.

The analysis has also been illuminated considerably by the frank and honest account of a psychologist, Stephen Greenspan, which for some reason has been overlooked in some other leading works on the subject. Greenspan, a renowned expert on gullibility, was still drawn into the Madoff scheme, although fortunately he did not lose all of his savings.

The red flags that were not heeded, and the psychological dimensions, highlight the need for a broad-ranging approach to the topic that embraces the bureaucratic decision-making behaviour of regulators and institutions, and the decision-making processes and mindset of victims and perpetrators alike. These issues frame the rest of the volume.

QUESTIONS EXPLORED IN THIS VOLUME

First, it has been argued above that the bare bones of a Ponzi scheme and how it is marketed are very simple, but how does it get started? How complex is the fabric of the story into which it is woven? How is the plausibility test overcome? What are the conditions that might allow the schemes to be sustained? Why, almost by necessity, do they fail? What gives them away? Is failure inevitable?

Second, in what ways does a Ponzi scheme differ from a pyramid scheme or a multi-level marketing operation? How does Ponzi finance differ from a Ponzi scheme? Is it reasonable to view social security and unfunded pensions as giant Ponzi schemes?

Third, how are we to explain the appeal of Ponzi schemes? Why do people apparently fall for the same old tricks? Or have the schemes changed over time? Or have fraudsters become more clever? Does the old adage 'if it sounds too good to be true, it probably is' still hold good? But what is 'too good' in modern financial markets? What is a reasonable or believable rate of return?

Fourth, who is to blame? What psychological and other factors come into play? Can anything be done to protect investors? What role can be played by the financial sector in all of this? Should more be expected of auditors, regulators and financial custodians? Or are the whole assumptions underlying regulatory policy misplaced? Is it reasonable to expect that people will behave sensibly when undertaking unprotected investments?

Fifth, what other solutions exist? Can financial regulators learn from other disciplines, not only mathematical modelling and statistical analysis, but from those aspects that are psychologically based? What, for example, are the insights gained from behavioural economics (thinking fast and slow, the dual process model, belief perseverance, confirmation bias) and a variety of psychological theories (gullibility, Big Five model, principles of influence, affinity crime, desire for control, neutralization theory, cognitive dissonance)? What can be learnt from theories of trust? When, and under what conditions, should trust be extended by investors? Can neuroeconomics be brought to bear on matters? On these and other subjects, the author, although trained as an economist (albeit with two daughters as psychologists), has sought to adopt a multi-disciplinary approach.

NOTES

1. With thanks to Leonard (2010).
2. As will be seen later, there are legal issues involved in how to measure the scale of a Ponzi fraud. The amount as declared in the statements inclusive of 'earnings', rather than the actual amounts put in, invariably features most prominently in the eyes of the investors.
3. 'Con man', an old term, is short for 'confidence man', a trickster who plays on obtaining the confidence of the victim.