The Evolution and Impacts of the Ponzi Scheme and Governmental Oversight

An Honor's Senior Thesis Project on the Intricacies of Ponzi Schemes and its Regulating Authority

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Abstract

Ponzi schemes are not complex tools of thievery. In fact, they are quite simple. To formulate one is simple, but to identify and classify one is not. Or is it? Since its creation back in the 1900's, the con has duped unknowing investors into handing over their money under the guise it would be placed into some form of investment to earn a return. Given this is a scam, the money is never invested, yet the "returns" do in turn happen. The question to be asked is not how do these returns result, as the rest of this paper delineates, but how do people, especially the very regulators in charge of preventing this scam, let it happen? A Ponzi scheme takes advantage of the financial system to embezzle millions, or even billions, of dollars from unbeknownst investors blind to the fraud. Some are ill-advised hardworking normal citizens, some are financial gurus simply perplexed at the workings of the person running the scheme, and others are regulators that are ignorant and unable to recognize the fraud for what it truly is. The comprehensive research of various resources has enabled this paper to delve into what a Ponzi scheme is and why governmental agencies are unable to thwart them from continuously occurring. Due to major governmental oversight and the inability to do its job, agencies like the SEC have been oblivious to this type of fraud even when it has been blatantly in front of them. The solutions within this paper describe possible solutions to this incompetency.

I. Introduction, History and Background

Ponzi schemes, although dating back to as early as the 1900's, have recently ravaged society at an alarmingly increasing rate. In just the six-year span from 2008 to 2013, over 500 different Ponzi schemes (excluding Madoff) collectively took over $50 billion; that is billion, with a "b" (Maglich). On average, a Ponzi scheme was uncovered or busted every four days in just that six-year period (Maglich). Since its inception, the Ponzi Scheme has antagonized and cheated humanity, stealing hundreds of millions and sometimes even upwards of billions of dollars in the process. The Ponzi scheme has developed into a convoluted masterpiece in its appearance that has shaped not only the world of finance, but also aspects of law and society as well.

the creator of the scheme, Charles Ponzi's con was so extensive and lucrative that it attracted national attention. As did Miller, Charles Ponzi promised his investors sizable profits, when, in reality, he pocketed a large sum. Collectively, Ponzi's investors lost an estimated $20 million, which totals roughly $280 million in today's money (Grossman).

Due to Charles Ponzi, the term "Ponzi Scheme" has become a household phrase. Before Ponzi, defrauding investors was relatively uncommon, at least to the general public. Although swindlers like William Miller did exist, it was much less widespread and more importantly far less identified. Ponzi, however, brought this type of con into the spotlight. While Ponzi eventually became the face of the scheme, no other swindler has more notoriety than Bernard Madoff. The modern face of financial evil is Bernie Madoff who was convicted in 2008 of running a $50 billion Ponzi scheme (Carbone).

Like his fellow schemers before him, Madoff used investor faith as well as his personal credentials to gain trust and promise an average 10.5% annual "return" to his investors for two decades (Carbone). In reality, the "return" that Madoff followed through with was nothing more than the money his newest clients sought and believed to be invested. There are major similarities that can be found in all three aforementioned men, along with all Ponzi schemes in general. The gaining of investor trust is a major aspect that the schemers must have. Without trust, there simply is no scheme. Madoff, as well as the others, utilized a concept called "affinity fraud", in which fraudsters target potential victims who share a common bond, such as religion, to build a trust (Gurun). While the scheme itself has a simple framework, it is truly able to thrive due to the concept of affinity fraud. Affinity links have been shown to be an important determinant in the success of Ponzi schemes (Gurun). Utilizing affinity links helps build the trust necessary to complete the scam. When it came to Charles Ponzi, he accumulated $9.8

million in the span of 8 months in 1920, of which mostly came from three-quarters of the Boston Police Force (Lewis). Similarly, Madoff utilized his religion to take advantage of his fellow Jewish people. The ability to find a certain group to target allows for the scheme to commence. After that, a strong trust provides the glue that seals investors in and discourages them from getting out. The reason affinity schemes target people with similar affiliations is trust; nobody thinks one of their own is going to cheat them, not when they can cheat so many others (Markopolos 114).

Along with a concrete investor trust, paying off old investors with new investor money is found in virtually every Ponzi scheme. As long as new investors continue to come, those investors that came before would earn lucrative profits. This mode of action, however, is the very reason that such schemes collapse. While the duration of a Ponzi scheme varies, the inevitable downfall occurs when new investor funds cannot pay off the old investors. Once markets hit a rut and investors withdraw, the whole scheme collapses like a house of cards (Altman). Once that house of cards implodes, millions and sometimes even billions of dollars have been lost.

Also prevalent in all Ponzi schemes is the con of swindling investors into believing there is a business utilizing a secret idea (Lewis). It is through this idea that the investment plan can commence and return exorbitant profits. Of course, in reality, this entire strategy is a complete fallacy. As seen in the history of this scheme, Charles Ponzi promised exorbitantly high returns from investing in postal coupons, while the actual postal system substantially lacked in quantity of the amount of money he dealt with. In accordance to Ponzi, 160 million coupons would have had to be in circulation to cover the investments made by Ponzi's firm, when in reality there were only 27,000 according to the US Postal Service (Markopolos 51). Similarly, Bernie

Madoff promised returns on a split

II. Bernie Madoff

To date, Bernie Madoff remains the most notorious financial fraudster in history. Madoff exhibited every aspect of a Ponzi scheme and used his persona to conceal it. What allowed Madoff to steal as much as he did for as long as he did simply was due to who he was and what he represented. Simona Suh, an attorney on the enforcement staff of the SEC during the mid-2000s, admitted that the staff had been skeptical of any fraud claims on Madoff because he "didn't fit the profile of a Ponzi schemer" (Markopolos 157). Anyone who worked in the financial industry, if even for just a short time period, knew the name "Madoff", if not also his background.

The company that he founded, Madoff Investment Securities LLC, was among the most successful broker-dealers on all of Wall Street. In fact, during the early 1990s Madoff Securities LLC alone accounted for almost 10 percent of daily trades on the New York Stock Exchange (Markopolos 26). His company and the magnitude of which it impacted the market made Madoff immensely rich, and enabled him to become one of the most respected men in the entire industry. When the name Madoff was spoken, there was a certain aura that surrounded it. To add to his résumé, Madoff marketed himself as a cofounder of NASDAQ and had served as its chairman; he was a prominent New York philanthropist and a member of numerous industry and private boards committees; Bernie Madoff was a Wall Street King (Markopolos 26). Thus, to claim, and even further, prove Madoff to be running one of the largest Ponzi schemes in history was virtually impossible. No one wanted to believe Madoff was running a lie. Not even the government.

Through his brand name and his guise, Bernie Madoff was able to dupe not only investors, but some of the best and the brightest. Because of who he was and what he'd been

months, Madoff always would yield a profit. There was no existing mathematical model that could possibly explain that consistency (Markopolos 33). Nothing, of course, other than fraud.

While Bernie Madoff continued to baffle many within the industry with his consistent returns, close to none spoke out about it. Whether people believed his absurd explanations behind his strategy, or they saw the illegitimacy, no one said anything. Edward Thorp, a respected and well-renowned hedge fund manager, caught a glimpse at the fraud that Madoff was doing back in 2004. Thorp conducted due diligence on behalf of another investment institution. Due diligence, as it pertains to investing, involves investigating the ins and outs of a company's strategy, ensuring their practices are both legitimate and legal. Thorp indicated that he had gotten ahold of some of Madoff's trade tickets and compared them to OPRA tapes. OPRA is the Option Price Reporting Authority, which is the authority in charge of keeping the permanent records of every trade. What Thorp discovered was that, when comparing Madoff's supposed trade tickets to those on OPRA, he found some "discrepancies" (Markopolos 75).

In reality, due to the scam Madoff was running, his trade tickets would never match up to those housed in the OPRA; Madoff was not making any trades at all. Instead of taking this crucial information to a regulating authority, Thorp simply advised his clients and anyone in his network to stay away from Madoff, but he did not take it any further (Markopolos 75). During this time period in the United States, self-regulating markets were encouraged. The deregulation movement began in the 1970s and was based upon the belief that markets are self-regulating, even to the extent of self-repairing market failures (Thoma). A common viewpoint of the American public was an ideology that markets are self-regulating and best left alone. Thus, the U.S. Government and the SEC took this into consideration. From 1970 up until the 2008 Recession, markets were left to regulate themselves. This posed a major problem.

As evidenced by the actions of Ed Thorp, self-regulation hardly occurred. In turn, if industry practitioners fail to report suspected fraud, nor have any meaningful incentive to do so, and if government agencies lack the systems set up to take in, evaluate and investigate whistleblower tips then self-regulation can never work at all (Markopolos 75). As shown, when illegitimate practices are discovered, many practitioners simply shy away from involvement, but that is the extent of their actions. Similarly, the agencies in charge of dealing with illegitimate practices when reported have been inadequate. Although true that many in the industry have turned a blind eye to skeptical practices, there have been plenty others seeking justice. However, due to the incompetency of regulating authorities, those that wish to speak up and blow the whistle have time and again been ignored.

III. The SEC

The incompetency of the SEC continuously allows for Ponzi schemes and fraud to occur. Some have gone so far as to label this regulating authority as corrupt, but even that would be giving this organization too much credit. To be corrupt one must show a willingness to act in a dishonest way, often for monetary gain. These allegations could be substantiated by a claim that Harry Markopolos provides which was actually made by Bernie Madoff. Madoff concludes, derisively and accurately, that "'These guys, they work for five years at the [SEC], then they become a compliance manager at a hedge fund'" (Markopolos 159). Markopolos goes even further to substantiate this by saying that Madoff knew this was true because every time an SEC investigator came to his office he or she would ask for an employment application (Markopolos 159). Quite clearly, this sheds a very skeptical light on the employees that work at the SEC. However, to call this type of action corrupt is an unfair accusation. Working for this

organization is a great way for these employees to get their foot in the door to Wall Street and meet with its well-known industry gurus. Thus, applying to work for one of the most renowned investors on Wall Street is not condemnable.

Nevertheless, to ask for an employment application while investigating that very same firm is nonsensical. While the argument over the degree to which the SEC is corrupt can go back and forth, the ineptitude of this agency is a set fact. Even the Federal Bureau of Investigations feels this exact same way. Markopolos notes an interesting conversation he had with an FBI agent who discusses a common view of the SEC. The agent said to Harry Markopolos, "'The [SEC] was conducting an investigation for two years and never even figured out there was a seventeenth floor that Madoff worked on; that's how dumb they were. You really shouldn't give them any more of your cases. Your quality of work is way beyond the SEC's capabilities. From now on when you have a case, just give us a call'" (Markopolos 158).

In relation to the Madoff case, Madoff used the 18th floor of his building for Bernard L. Madoff Investment Securities and the 19th floor for stock-trading. The SEC failed to go to this alleged 17th floor where the entire Ponzi scheme operation took place. As the FBI agent notes, the SEC simply is too dumb. Also, the fact that the FBI urged Markopolos not to give his cases to the SEC shows the true ineptness of the SEC. If the very regulators for this type of scam cannot handle cases involving this very type of fraud, then what is even the point of having them at all? The answer is that there is none. The SEC has shown a lackluster inability to regulate markets. It is not that this agency is corrupt, it is simply that they are unable to do their job.

Ponzi schemes are not complex scams, but rather quite simple. One cannot go so far as to say that they are rather easy to identify, but some are much easier than others. When a Ponzi scheme run by one of the most well-known financial advisors in the nation's history totals

upwards of $50 billion, it calls into question the people in charge of regulating. The underlying issues in the case involving Bernie Madoff falls unquestionably at the feet of the SEC. While the

these claims, it is important to discuss the issues Harry Markopolos encountered while attempting to bring the Madoff scandal to national attention.

Markopolos resided in New England, Massachusetts, meaning he would report his fraud submissions to the SEC office located in the New England region. The importance herein lies with the fact that Madoff operated in New York, an entirely different SEC regional office. To most, this would seem inconsequential; Markopolos' submissions would simply be sent from the New England office to the New York office and the investigation would continue. Unfortunately, as history shows this case playing out, it did not occur like this. Thus, we must delve into and seek to find why this, what appears to be normal, sequence of events never unfolds.

Instead of the files being sent to and accepted by the New York office, the case hit a tragic standstill. Harry Markopolos notes that Grant Ward, New England Regional Director of Enforcement at the time, divulged that there was not a lot of respect between the Boston and New York offices for one another (Markopolos 65). Apparently, the offices are very competitive and the chances of the New York office warmly embracing a case handed to them by the Boston office were limited (Markopolos 65). This in and of itself is shameful. This type of behavior hinders the government's ability to regulate the financial markets and protect the public from fraud, the sole reason it exists in the first place. Competition generally is beneficial, in that it drives opposing forces to be better than the other. However, competition between the same entity is entirely counterproductive. This is comparable to one branch of a TD Bank sabotaging a another branch in order to outperform and look better. Overall, the company suffers and these types of actions could cause the total business to go bankrupt. In turn, both branches would no

longer exist. The same principle applies for the SEC: if one office ignores the other, the whole system fails.

IV. Solutions

The SEC is an extremely significant entity for the U.S. stock market. Created in 1934, the SEC's purpose was to restore confidence back in the markets after the Great Depression. Since then, due greatly to this organization, the U.S. is viewed as the most sophisticated and

The problem with the SEC is that its employees lack the drive and incentive necessary to be successful. Throughout Markopolos' involvement, he noted that Chief Meaghan Chung and other executives in her office spent their time investigating minor frauds and getting an occasional conviction and headline (Markopolos 141). This is the major issue: these people were going after the inconsequential cases. Markopolos writes, "In the world of the SEC, a case is a case, and going after a hard target like Madoff counts the same as going after some tiny retail broker…there are no bonuses for the big cases that require a tremendous amount of work" (Markopolos 141). Quite clearly, the types of employees hired by this organization needs vast improvement. The purpose is to protect investors and maintain a transparent and just market, but instead it has prosecuted just enough to scamper by.

Due to the numerous deficiencies exhibited by the SEC, dramatic, yet fairly simple, changes need be instituted. Because the SEC has performed unsatisfactorily and has demonstrated its inability to successfully do its job, enhanced regulation along with innovative policy changes must be put into place. As discussed, the SEC lacks the necessary cohesion that governmental agencies require. Being that this regulator operates via various regional offices, cohesion is key. To lack this aspect undoubs m4(h)-14(as)-5(ul)-2(a)4(t)-2(or)3(ffPa c)4(pc)-6(. ke)-

would motivate its employees to work together. As seen in the Madoff case, pertinent information was ill-received when transmitted from one regional office to the other simply due to competition between offices. Due to this, the case hits a standstill and the fraud continued for several years. Instead, to make things run more smoothly, providing incentives to its employees could drastically change their attitudes. While the competition will likely still remain, it could alternatively be directed towards completing cases in order to capitalize on incentives. If a pair of rival offices, such as the two that hindered the Madoff case from being properly investigated, could positively channel their competitive natures to yield immensely positive benefits. As opposed to one office ignoring crucial information from another, the implemented incentives would allow for the offices to, if even reluctantly, work together to properly do its job. While incentives do not come free of charge, the alternative is far more costly. Had this system been in place, Madoff's $50 billion fraud, and countless others hindered by similar issues, could have been prevented. Due to cases like Madoff's, the SEC has come under intense [illegible] from the public and its legitimacy is constantly under question. In hindsight, the cost of incentives for its employees would undoubtedly be worth preventing the loss of billions of dollars.

In conjunction with providing incentives to employees, the types of people employed by the SEC becomes greatly significant. In the past, SEC employees have acted questionably in the way they have presented themselves. Thus, providing an incentive program to the types of workers previously employed would have little impact. Admittedly, hiring is never an easy task as you can never truly foresee the way a person will act and operate until on the job. Nonetheless, making the hiring process a crucial endeavor is extremely important for this regulating authority. Hiring people who are looking for a short-stay, as seen previously in the SEC, is not the type needed for such a significant entity. Instead, the SEC needs to look for

driven and motivated individuals looking to better society. Also, the SEC's requirements for work experience and exam quality standards were below par for the tasks the SEC deals with. The SEC's capital markets work experience requirements were way too low and the exam quality standards were abysmally low (Markopolos 140). Along with finding those individuals with high aspirations at the SEC, the procedure for evaluating the potential employees also needs improvement. The hiring process must be constantly updated to suit financial markets of the current time, as well as be conducted in a serious manner.

Supplementary to hiring determined individuals, placing employees in the correct jurisdictions is monumental. Even if the proper individuals are hired, it reaps no benefits when these people are placed in the wrong positions.

must be corrected. In the future, employee placement should become a critical component for the SEC.

While the proposed solutions can greatly impact the SEC, being proactive in pursuit and enforcement of current regulations is crucial. Being proactive is truly in conjunction with hiring the right types of people and encouraging collaboration between offices. However, these are not enough by themselves. Being proactive is a necessity for a regulating authority. The role of the SEC is to enforce current regulations in order to prevent or stop fraud in its tracks. Throughout the Madoff case, this type of behavior was lacking, but more accurately it was nonexistent. When Harry Markopolos submitted his findings to the SEC, Cheung and Bachenheimer were skeptical. Markopolos provided a detailed list of countless “red flags” he discovered concerning Madoff’s potential fraud. Instead of utilizing this information, Bachenheimer labeled them as “theories” that had to be tested and substantiated (Markopolos 156). Markopolos theaedn([)4(i)Dtdn([-1(.a)4

work-incentives that further regional collaboration can lead to an increase in not only cooperation, but also productivity.

In order to also improve cohesion, the types of employees and their placement into proper positions can have major benefits. It has been found that the requirements for SEC employees are subpar and need substantial improvement. Also, evident within the SEC is that its employees have lacked the professionalism necessary for this organization. In turn, making the hiring a more involved and significant process should become paramount. While it is a difficulty to know the true character of a potential employee during an interview, it should be stressed that the types of individuals the SEC seeks to hire are driven and committed. Similarly, placing the right people in the right places cannot be disregarded. At multiple points in the Madoff case, highly intelligent people were placed to lead the investigation, yet these individuals had never dealt with nor really knew much about Ponzi schemes. In the end, these employees and the SEC in general were placed at a monumental disadvantage.

In conjunction with hiring the right people and improving cohesion, becoming a proactive governmental agency is a necessity. The role of the SEC is to enforce the regulations that prevent and/or stop fraud. Throughout the Madoff case, the SEC consistently ignored highly beneficial and legitimate findings from a viable source. This is something that simply must not occur. In its place, the SEC must become proactive and utilize good Samaritans that whistle blow. The intent of whistleblowers is more often than not for the betterment of society. As opposed to ignoring them, as seen throughout the SEC's history, this organization need trust and utilize them. Otherwise, its greatest assets, those professionals that constantly deal in the industry, will become alienated and disappear.

Ponzi Schemes have certainly left its imprint on both the financial industry and those within it. While this con is unlikely to stop ravaging anytime soon, people are beginning to further their understanding for how to not only recognize the scam, but also thwart it. By

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