Statement
Of
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Before the

Committee on Financial Services
Of the
U.S. House of Representatives

2:00 P.M.

January 5, 2009
Room 2128
Rayburn House Office Building

Mr. Chairman and Committee members: I greatly appreciate the opportunity to appear before you and to discuss the nature of Ponzi schemes, the importance of trust in the securities markets and the need for regulatory reform in light of the revelation of the Madoff Ponzi Scheme.

I am a Professor of Law at Boston University School of Law in Boston Massachusetts. My work focuses on the regulation of the financial system, including the institutional and market intermediaries, who advise investors, and hold and manage other people's money. Among my publications are a recent teaching book Fiduciary Law (2008), a treatise on securitization (2d ed. 2006), a book entitled Trust and Honesty, America's Business Culture at a Crossroad (Oxford University Press 2006), a teaching book entitled Trust and Honesty in the Real World (2007) (with Mark Fagan), and a treatise on the regulation of mutual funds, entitled The Regulation of Money Managers (2d ed. 2003) (with Ann Taylor Schwing). I have researched and written, but did not yet publish, a manuscript entitled Con Artists and Their "Marks," which analyses Ponzi schemes, and their success, drawing on various sources including hundreds of court cases. (A more detailed resume is attached to this statement).

The first part of my testimony analyzes Ponzi schemes, reflecting on the recent allegations against Bernie Madoff. The second part of the testimony addresses three points: (1) The nature of trust in general and investors' trust in financial intermediaries and the financial system, in particular; (2) The current break-down in investors' trust: and (3) a proposal to change the way in which the regulation of financial intermediaries is currently conducted.

Ponzi schemes[1]

The Nature of Ponzi schemes. Ponzi schemes are simple. A con artist offers obligations that promise very high returns at seemingly very low risk from a business that does not in fact exist or a secret idea that does not work out. The con artist helps himself to the investors' money, and pays the promised high returns to earlier investors from the money handed over by these and later investors. The scheme ends when there is no more money from new investors.

Ponzi schemes are the inverse of compounding in finance. If new investors constituted the only source of additional capital, the number of investors needed to keep the scheme going would be astronomical.[2] These schemes usually last longer than the numbers suggest because many investors are repeat players, rolling over their short-term investments and adding to them. For example, in the 1998 case of the Baptist Foundation of Arizona, 94% of the investments in short-term loans were reinvested, and remained invested until the scheme came to an end.[3]

The amounts involved in Ponzi schemes are usually very large. They catch in their net billions of dollars from very wealthy as well as less wealthy individuals and institutions. The annual losses from Ponzi schemes in the United States vary. Based on litigated court cases, the year 2002 showed the largest amount of losses -- over $9.6 billion. Each of the years 1995 and 1997 showed losses of more than $1.6 billion. Each of the years 1996, 1990 and 1976 showed losses of over $1 billion. These numbers, however, represent only those cases that were litigated in the courts, and do not show the losses outside the courts and on the international scene.

The investors in the schemes are quite sophisticated. Charitable nonprofit corporations, religious organizations and their members have invested heavily with Ponzi operators. Famous sports stars and rich individuals have not been spared either. Banks and insurance companies have been caught in the net as well. Ponzi schemes are not unique to the United States. They have been highly successful in Romania, India, Albania, Russia and England. Thus, Bernie Maddof's scheme is far from special, although it is quite large.

How do Con artists manage to entice wealthy, educated individuals and representatives of large institutions to hand them huge sums of money? First, the schemes offer very high returns. For example, the Romanian scheme, Caritas, offered a return of eight times the original investment within three months. Even in a country beset by inflation this was an unbelievable return.[4] Other schemes are similar.

Second, a bubble market environment leads some investors to believe that such returns are possible. They read about enormous sums made in hours or days, by trading stocks and winning in lotteries, and about the millions earned by corporate executives and investment bankers. If it is possible to make such fabulous amounts without a life-time of hard work, investors may ask themselves: "Why not I?" Why would this offer of such high returns not be the one chance I was waiting for? Therefore, Ponzi schemes are likely to flourish in market bubbles.

Third, the stories of the con artists draw attention, curiosity and admiration. Gary Reeder, who operated a Ponzi scheme, was quoted as saying: "Gold?... That's just a small part of it. You know what gold is? It's the glitter . . . It's neon. It gets people excited." And yet, the very originality of the story should signal danger. Being the first, the business or system cannot be tested. But those who are caught in the net do not pay attention.

Fourth, con artists signal trustworthiness. They act like, live as, and mingle with, the very rich. Appearing that he did not care for money, one con artist offered his services for free. Another was selective in choosing the investors. In addition, con artists always honor redemption demands, even before payment is due. Con artists pay dividends *often and on time*, until the scheme comes to an end. They also offer information although it can often drown the truth. For example, in 1992, a con artist's "business empire swelled to a network of dozens of companies and partnerships, embracing a gold mine, an oil company, a commodities brokerage and a second car dealership..."[5] It was difficult to trace receipts and expenses. It was impossible to determine net worth and find out whether the business could meet its obligations long- term. Enron Corporation hid its scheme by such an abundance of complex details.

Fifth, con artists show great generosity. They make charitable and civic donations. As one court commented, "Mr. Bennett made a large number of civic, charitable and public service contributions and performed good works in the areas of substance abuse, children and youth, [and] juvenile justice."[6]

Sixth, con artists' investments signal safety. The forms of the con artist's obligations and name spell respectability, using words like "trust," "partnership," and "with recourse." Their promises are very specific, not vague. The business names signal high standards: "Security Exchange", for example, was Charles Ponzi's business name.

Seventh, the first investors are the salespersons.[7] Con artists establish a strong following, starting with family members, and friends. Charles Ponzi's followers were Italian immigrants for whom he brought self-esteem and pride.[8] Another con artist targeted the immigrant Polish community in New York and New Jersey (promising investments in mortgages: risk free).[9] As one court explained, "in the initial ...stages of the plan, those investors who wished to withdraw their investments were promptly paid. The effect of such prompt payment, of course, was to convert every investor into a missionary spreading the word of the enormous profits which could be speedily attained with no discernible risk of loss."[10]

Eight, Ponzi schemes thrive in affinity groups, be they religious groups[11], investment clubs, and employees of larger organizations. These groups are vulnerable because their members are in close and frequent contact with each other; among them news travels fast, they share values and tastes, and they trust each other.[12] In Australia a large group of police officers invested in such a scheme, and but for a few who happened to withdraw their money back in time, up to 200 police agents, including the wife of an Australian Federal Police Commissioner, lost their investments. Federal police agents in Sydney, Melbourne and Brisbane were believed to have invested in a Ponzi scheme, in which one couple alone lost $400,000.[13] The fact that the investors belonged to a police organization contributed to the success of the scheme, and its extended longevity.[14] Investors can become devoted to these con artists.[15] Churches can invest with them too.[16] And some con artists create their own churches.[17]

Ninth, the personality of con artists helps. Con artists are charming, captivating, and presentable; good dressers, good listeners, and great flatterers. "[T]he epitome of the natural, fast-developing, big-time con artists, those fascinating, complex, corrupt geniuses who can instill confidence in the most erudite, shrewd Hunt or Rockefeller brother and lead them as eager lambs to the slaughter." [18] Con artists are unbeatable in playing the "nice guy." "The nice guy exaggerates his caring, ability to love, and kills with kindness . . . You cannot fight a Nice Guy!"[19] Con artists can be convincing. Living in the fairyland life of the rich while being poor they can get caught in their own fantasy. In fact, they may get so used to the roles they play that their businesses and their life style, friends and connections, become real to them. "Many first time perpetrators of this crime become so accustomed to the lifestyle it generates that they themselves are in disbelief when it crumbles, convinced over time by their own lies."[20]

Why is it difficult to identify Ponzi schemes?

First, most con artists are similar to entrepreneurs: they are creative and their offerings are usually unique. Like many entrepreneurs con artists are over-optimistic and overconfident -- in themselves and their decisions. When they fail they try again.[21] That may explain their persistent success.

Second, Ponzi schemes are similar to legitimate businesses. Most businesses borrow and pay dividends while in debt. Individual investors buy securities on margin. Ponzi schemers operate the same way. They borrow from one group of investors and pay another. Many operating enterprises "refinance" -- borrow from Peter to pay Paul, for example, when interest rates fall. But if the chances of a successful enterprise are low, and if their managers recognize this fact but continue to borrow and repay creditors, the enterprise may back into a Ponzi scheme.[22] Entrepreneurs may start a true business, but turn it into a Ponzi scheme when they realize that there is no hope of success.[23] The issue becomes one of intent, which is difficult to ascertain.

Third, some con artists are viewed with sympathy. Investments in these schemes are similar to buying a lottery tickets, gambling,[24] and speculating in the stock market, [25] The relationship between Ponzi schemers, salespersons, and entrepreneurs may explain the forgiving attitude towards con artists. Perhaps, looking at Ponzi con artists, successful entrepreneurs may say to themselves: "There, but for the grace of God, go I."

Fourth, there is mixed sympathy for the victims. The general view of sophisticated victims is that they are greedy and gullible. We sympathize with those who could not protect themselves, but not with those who became gullible. In addition, Ponzi schemes benefit some investors at the expense of others.

Conclusion

Con artists and their Ponzi schemes are continuous and successful because they are so close to successful legitimate business. They signal distorted pictures of honest people and true and honest schemes. But every distortion is anchored in the true and authentic. That may explain our ambivalent reaction and the schemes persistence. Both the cons and their victims demonstrate a mix of contradictions that reside in all of us: The admired charming rouge, the driven greedy person, and the gullible and vulnerable investor. The weight of these contradictory pieces shifts depending on the social judgment about human relationship. We ask: How able were the victims in protecting themselves from the fraud? How charming and skillful were the cons in their manipulations, and how much harm did they inflict on the financial system as a whole?

Most importantly, Ponzi schemes accompany market bubbles. When the fever of speculation is driving a herding phenomenon, Ponzi schemes are likely to flourish. So long as these schemes are small, society and the financial system remain untouched. The wealthy "Marks" can absorb the loss. But when the schemes are large in terms of dollars and number of investors, and when the investors represent pools of small investors or the assets of charitable organizations, the schemes can undermine the financial system, and, as was shown in Albania, they can destroy the economic system and the entire fabric of society.

The Need for Regulatory Reform

Americans used to trust the financial system: its banks, insurance companies, pension funds, and mutual funds; its markets, brokers, underwriters, and advisers. For the past thirty years, apart from their homes, Americans have been investing their life's savings in the securities markets. The financial system provides the mechanism by which savers who postpone consumption, transfer their money to borrowers, who produce or consume (and cause others to produce). These transfers are performed with the help of financial intermediaries:

To take advantage of the market, investors must hand over their money or rely on the advice of financial intermediaries. No financial system can exist without investors' trust in the financial intermediaries.

In this context I define trust as "a reasonable belief that the trusted person will tell the truth and abide by his promises." Trust relieves trusting persons from the burden of verification, but exposes the trusting person to abuse of trust, that is, the risk that the trusted person, who receives the investors' money, will not tell the truth and will not abide by his promises. The risk to investors can be high: that they will lose their savings, as most investors who trusted Bernie Madoff did. The extent of the necessary trust depends on the level of the risk from the trusted persons' abuse. The higher the risk from abuse of trust, the lower trust should be and the higher the demand for verification should become.

It should be emphasized that trust does not include gullibility. The buyer of the Brooklyn Bridge is not a trusting person, but a gullible one. The investor who runs with the herd in a bubble market is not a trusting person, he relies on the judgment of others and ignores the information he possesses and discards common sense.[1] However, whatever we might call their behavior, American investors have relied on the financial intermediaries, including their brokers, and advisers and did follow the herd. Ponzi schemes are a classic example of a herd behavior by sophisticated investors, many of whom are fiduciaries managing other people's money.

For many years we have heard the call for investor education, information, and simplification of disclosure documents. The theory here is that investors should NOT trust the market intermediaries. They should investigate, examine, spend the time and educate themselves in the mysteries of the markets. And yet if the Madoff affair shows us something it shows that the theory as beautiful as it is, simply does not work in practice.

Disclosure and education does not protect investors. It is also not very efficient for them to educate themselves and specialize. They should rely on trusted advisers and managers,

[1] Neither does trust include faith, which rejects the need for verification.

as much as they rely on physicians and other experts. But we have moved the focused from the intermediaries that ought to be trustworthy, to the investors who ought to protect themselves. Having lost the balance between trusting and self protection we have lost investors trust.

No one could both trust and at the same time watch with much concern and suspicion the trusted person. So investors trusted when they should have suspected, and finally when they faced a massive fraudulent abuse of trust, they stopped trusting altogether.

When the investors' risk of abuse of trust is high, and yet their cost of verification is high as well, investors might exit the financial system. This is when the law should intervene. Law aims at reducing the investors' risks from abuse of trust by regulating the trusted persons. It reduces the investors cost of verification, for example, by requiring true and full disclosure; Law helps financial intermediaries when their cost of demonstrating trustworthiness is higher than their returns from their services.

Investors will trust the institutions only if the law and other mechanisms guarantee their trustworthiness, that is -- that they will tell the truth and abide by their promises. Market regulation is less strict and relies mostly on disclosure. But it has the clout of criminal provisions as well.

There are rules that apply to con artists engaged in Ponzi schemes. They can be viewed as issuers of securities, in which case the securities acts mandating disclosure (with or without registration) would apply to them, regardless of whether their securities are traded in secondary markets or not traded. Alternatively, these schemes, which result in management of pooled investors' money, can be viewed as unregulated mutual funds, under one or more of the exceptions in the Investment Company act of 1940. Con artists can be viewed as broker dealers regulated under the Securities Act of 1934 and their self-regulating organization. In addition, con artists can be viewed as advisers, subject to the Advisers Act of 1940, unless they enjoy one of the exceptions in the regulatory scheme.

Bernie Maddof was a registered investment adviser since 2006. Having started as a broker dealer, I assume that he was registered as such. He probably offered information to his investors, under the securities acts rules. His managerial activities, however, did not include the registration of the pools of money that he managed. He probably took shelter under sections 3(c) (1) and 3(c)(7) of the Investment Company Act of 1940. Therefore, there are rules and regulations that have governed Bernie Madoff. He will probably be found liable or guilty under these rules.

In light of the nature of Ponzi schemes and the current law, I doubt whether our priority is to pass new rules. We have sufficient rules to punish con artists that have perpetrated fraud and were caught. Besides, new regulation based on speculation about future wrongdoings, might limit innovations and creativity. New regulations based on recent past transgressions might aim at violations that are not likely to occur in the near future. After all, the horse is out of the barn. Something else might come.

What regulators lack is information about what is going on in the markets. Private sector gate-keepers -- the lawyers, accountants, rating agencies, and appraisers -- have left the gates open. They even gained by exploring and pointing to the cracks in the gates. Besides, most gate keepers and financial intermediaries believe that "everyone is doing it." A "little deception," a use of the unclear and unspecific way to move around the rule has become acceptable.[26]

We have accepted the idea that market competition, disclosure, investors' education, and the threat of punishment will prevent fraud and maintain investors trust. This is both incorrect and wrong. When trusted persons are relieved of the requirement of honest behavior and those who are vulnerable are left to protect themselves there is a good chance that they will leave the market. The idea that doing well for oneself is doing well for society, without any emphasis and balance on limitations is corrupting. The idea that investors should trust those to whom they entrust their money, and yet protect themselves from those to whom they entrust their money benefits the trusted persons is untenable. These ideas led to relieving intermediaries from accountability, giving them freedom to speculate with other people's money. We have the laws to prohibit their behavior. But we have no one to stop them in time.

Today, more than ever we need government gate-keeping examiners. We need to change the way the government regulates. Government regulators should conduct thorough and frequent examinations of broker dealers, advisors and money managers, whether they are registered or exempt from registration, so long as they control a significant size of investors' money in whatever form. These examiners should be top notch experts, well paid and highly valued. If we cannot fit them into the government mold they can be employed by a government-owned corporation, or follow the model of the FDIC, or other similar organizations. They should be the police on the beat, carrying the baton, not the shotgun.

All large financial institutions should be visited at least once every six months. A smaller fund or broker dealer may be visited once a year. A fund that evidences problems should be visited in three or even one month. Money pools which are too large to fail must be regulated fully under the Investment Company Act of 1940. Investment companies that receive exemptions should be visited very frequently and followed closely.

This proposal is limited to examinations to enforce existing prohibitions and legal requirements.[27] It shifts the regulatory emphasis to government examination and balances it against disclosure and against active prosecution.

We have a number of examination models, both of banks, mutual funds and broker dealers. Thus, this proposal is not drastic, nor unknown. The applicable laws need hardly be amended with this move. This shift, telling the public that government examiners will police those who keep public money is likely to strengthen the public's trust, and be less drastic to the regulators. The examiners' expertise would supplant the missing expertise of the investors. It can leave intact the private sector gate-keepers, but does not fully rely on them.

Hopefully regulation by a thorough examinations of experts might reduce the threat to the financial system at (ultimately) a lower cost to taxpayers, and to the economy. Examinations need not be a waste of resources even when the examiners find nothing amiss. The very existence of vigilant examinations offers a measure of insurance that lowers the risk of serious violations of the law. We can try this type of examination without drastic changes in our current regulatory system. Most importantly, the existence of expert examinations can help restore a more trustworthy culture on Wall Street, and greater support to the public's trust in the financial system.

Thank you.

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[1] The material and the authorities dealing with Ponzi schemes, is derived from my unpublished manuscript on this topic.

[2] *See From the 'Lectric Law Library' Stacks: How to Avoid Ponzi and Pyramid Schemes, at* http://www.lectlaw.com/files/inv01.htm (last visited July 10, 2001) (it was calculated that "at month 11 the number of new investors must exceed the U.S. population and at month 13 it must exceed the world population").

[3] Terry Greene Sterling, *The Moneychangers; A New Times Investigation; First in a Series*, PHOENIX NEW TIMES, Apr. 16, 1998, LEXIS, News Library, Arcnws File.

[4] Katherine Verdery, *'Caritas' and the Reconceptualization of Money in Romania*, ANTHROPOLOGY TODAY, Feb. 1995, at 3 (and authorities cited there).

[5] Singh, *Fool's Gold*, DALLAS OBS., Nov. 16, 2000, Features, at 1; N.R. Kleinfield, *Unraveling Puzzle of L.I. Car Dealer Reveals Layers of Personal Mystery*, N.Y. TIMES, Apr. 19, 1992, at A26..

[6] United States v. Bennett, 161 F.3d 171, 178 (3d Cir. 1998), *cert. denied*, 528 U.S. 819 (1999).

[7] *Ponzi, at* http://www.crimes-of-persuasion.com/Crimes/InPerson/MajorPerson/ponzi.htm (last visited July 10, 2001).

Brian Trumbore, *Charles Ponzi, at* http://www.buyandhold.com/bh/en/education/history/2000/ponzi.html (last visited July 10, 2001) (citing ROBERT SOBEL, THE GREAT BULL MARKET: WALL STREET IN THE 1920S).

[9] Stockschlader & McDonald, Esqs. v. Kittay (*In* re Stockbridge Funding Co.), 145 B.R. 797 (Bankr. S.D.N.Y. 1992).

[10] New York v. Luongo, 47 N.Y.2d 418, 425 (1979).

[11] *E.g.,* Fox Butterfield, *This Way Madness Lies: A Fall from Grace to Prison,* N.Y. TIMES, Apr. 21, 1996, § 1, at 14 (Ms. Redd hosted many fundraisers for the church).

[12] Paul Whittaker, *Police 'Put Millions' into Failed Loans Plan,* ADVERTISER (South Australia), May 8, 1998, LEXIS, News Library, Arcnws File.

[13] Paul Whittaker, *Police 'Put Millions' into Failed Loans Plan,* ADVERTISER (South Australia), May 8, 1998, LEXIS, News Library, Arcnws File.

[14] *Regulators Sound Alarm on Affinity Scams,* CANADA NEWSWIRE, Jan. 29, 2002, LEXIS, News Library, Curnws File. Among the regulators' warnings to investors is the advice to refrain from investing on the recommendation of members of an affinity group.

[15] Jim Henderson, *Preacher Has Faith in Pitch,* HOUSTON CHRON., May 26, 2002, at 33.

[16] Terry Greene Sterling, *The Moneychangers; A New Times Investigation; First in a Series,* PHOENIX NEW TIMES, Apr. 16, 1998, LEXIS, News Library, Arcnws File.

[17] *E.g.,* United States v. Rasheed, 663 F.2d 843, 845 (9th Cir. 1981); Bruce C. Smith, *Congregation Prepares to Celebrate a Miracle, Faith Baptist Church Rises from Mountain of Debt,* INDIANAPOLIS STAR, Nov. 20, 2000, at A1 (pastor took investors' money to help church and instead lived lavish lifestyle leaving church indebted).

[18] DONN B PARKER, FIGHTING COMPUTER CRIME 120 (1983).

[19] EVERETT L. SHOSTROM, MAN, THE MANIPULATOR 35-39 (1967).

[20] *Ponzi,* http://www.crimes-of-persuasion.com/Crimes/InPerson/Major Person/ponzi.htm (last visited July 10, 2001).

[21] Avishalom Tor, *The Fable of Entry: Bounded Rationality and the Efficacy of Competition* (unpublished manuscript, Harvard Law School, Sept. 2001) (on file with author).
[22] The securitizers of loans started with the belief that they could collect more money than others do. Only when they realized that there was no hope of such collection did they begin "empty refinancing." *See* Amended Complaint, Am. Int'l Life Assurance Co. v. Bartmann (N.D. Okla. 1999) (No. 99-CV-0862-C) [hereinafter Am. Int'l v. Bartmann].
[23] *E.g.,* CHARLES PONZI, THE RISE OF MR. PONZI 68 (1935) (PONZI'S AUTOBIOGRAPHY) at 5-6, 32.
[24] Peter Fimrite, *Did He Have a Deal for You,* S.F. CHRON., Feb. 15, 1998, at 1/Z1.
[25] MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 689 (10th ed. 1999).
[26] TAMAR FRANKEL, TRUST AND HONESTY, AMERICA'S BUSINESS CULTURE AT A CROSSROAD, Ch.1 (Oxford University Press, 2006).
[27] As a simple example, we should know (1) the identity of the custodian, (2) the documents representing the assets, (3) the size of the asset pools, (4) the amounts borrowed or invested, (5) the private sector gatekeepers, (6) the structure of the pools of investors' money, whether they present direct ownership by investors, pools of investors' assets, or pools of pools of investors' assets, (7) who controls the investors' assets? Is it the salesperson, the manager, or others? And (9) how are the controlling persons regulated, if at all?