



# Perils of Ponzis

**Regulators need to stop Ponzi schemes before they gain momentum, especially in developing countries**

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**O**NE hundred and fifty years after Charles Dickens wrote in *Little Dorritt* about London investors succumbing to the fraudulent investment schemes of Mr. Merdle's bank, trusting victims are still tempted by such get-rich-quick swindles.

Ponzi schemes, which lure investors by paying high returns from other investors' money, thrive even in developed countries. The sophisticated regulatory framework in the United States did not prevent the rapid growth and collapse of Bernard Madoff's \$65 billion scheme in late 2008 or the subsequent collapse of several others during the global financial crisis.

But the impact of Ponzi schemes has been greater in countries with weaker regulatory frameworks. This unfortunate pattern is illustrated by the case of Albania in 1996, when riots resulted in the fall of the government and even deaths, and by more recent cases. For instance, Jamaican schemes caused losses as high as 12½ percent of GDP and spread to a number of other Caribbean jurisdictions. The collapse of schemes in Colombia, which had taken in an estimated US\$1 billion, was followed by riots and violent protests in 13 cities, and the government was forced to declare a state of emergency. A scheme in Lesotho lost the money of about 100,000 investors, many of them poor and highly vulnerable. The damage these schemes can inflict requires a determined regulatory response to shut them down at an early stage, before they gain momentum. Regulators and receivers allege that these and the other operations mentioned below are Ponzi schemes, although in many of these instances court cases are still pending.

## What are Ponzi schemes?

Ponzi schemes—named after Boston con man Charles Ponzi, who perpetrated a fraudulent investment scheme that collapsed in 1920—are a type of investment fraud in which returns

are paid to investors out of the money paid in by subsequent investors rather than from genuine profits generated by an investment or business activity. These schemes generally lure investors by offering higher returns than any legitimate business activity could plausibly sustain. Ponzi schemes usually have to attract new investments at an exponentially growing rate to sustain payments to existing investors, and inevitably collapse when the new investment needed exceeds the ability to lure further contributors. At that point, most investors lose their money, although early investors—including the scheme's founders—may have realized high returns or extracted windfall rents if they cashed out soon enough.

The "business opportunity" advertised to lure investors can vary widely in nature. For instance, a Jamaican scheme (OLINT) claimed to undertake foreign exchange trading, a company in Lesotho (MKM Burial Society) selling prepaid burials began to offer investment products, and a Colombian scheme (Group DMG) sold prepaid debit cards. Schemes often specifically target individuals from a group or community sharing a common affinity, such as ethnicity, religion, or profession, hoping to exploit mutual bonds of trust. Schemes have lured investors of all levels of income and wealth.

## Selected investment schemes

Ponzi schemes hit developing countries hard.

Country	Name(s)	Year of collapse	Amount invested/lost	
			(U.S. dollars)	(percent of GDP <sup>1</sup> )
Antigua and Barbuda	Stanford Financial Group	2009	8 billion	n.a. <sup>2</sup>
Grenada	SGL Holdings	2008	30 million	5
Jamaica	OLINT, Cash Plus, World Wise, LewFam, for example	2008	1 billion	12.5
United States	Madoff Investment Securities	2008	65 billion	0.5
Colombia	DRFE, DMG, for example	2008	1 billion	0.4
Lesotho	MKM Burial Society	2007	42 million	3
Albania	VEFA, Gjallica, Kamberi, for example	1997	1.7 billion	79

Sources: Newspaper accounts; IMF staff estimates; and for Jamaica, Caribbean Policy Research Institute (2008).

<sup>1</sup>All references are to home country GDP, although some schemes also attracted nonresident investors.

<sup>2</sup>Antiguan investors were not permitted to invest in this offshore institution.

Many scheme operators managed to extend their operations through ostentatious charitable contributions, significant political contributions, and lavish demonstrations of their own or their scheme's wealth. For instance, a Ponzi scheme in Jamaica (Cash Plus) sponsored the national soccer league in 2007, Allen Stanford sponsored an international cricket tournament, and the founder of Group DMG in Colombia owned a private jet and fleet of cars. Prior to collapse, operators may be regarded as pillars of their communities—the founder of OLINT in Jamaica was selected as business personality of the year by a business newspaper.

### Economic and financial damage

Ponzi schemes inevitably inflict financial damage on most of their investors and divert savings from productive investment. If left unchecked, they can grow exponentially and cause broader economic and institutional damage as well, undermining confidence in financial institutions and regulatory authorities and creating fiscal costs if bailouts occur. They can even lead to political and social instability when they collapse.

The most dramatic case was in Albania. When several schemes collapsed there in 1996, there was uncontained rioting, the government fell, the country descended into anarchy, and, by some estimates, about 2,000 people were killed.

Recent schemes have varied widely in size (see table), which may reflect a variety of factors, but the speed and effectiveness of the regulatory response is clearly crucial. The data are rough estimates, because establishing even basic facts such as amounts invested or lost and numbers of investors or accounts involved is difficult in light of the inaccuracy or lack of financial statements, absence of regulation, and disappearance of funds, records, and principals. But clearly, a wide range of countries in a variety of circumstances have seen the emergence of large-scale Ponzi schemes.

Such examples demonstrate the importance of a rapid policy response. However, authorities have faced difficulties in dealing with recent schemes in Colombia, Lesotho, and a number of Caribbean countries—Jamaica, Grenada, Antigua and Barbuda, and St. Vincent and the Grenadines (Carvajal and others, 2009). Controlling and closing down schemes is often difficult, for a variety of reasons. In many cases, neither the perpetrators nor the schemes themselves are licensed or regulated. And in many countries regulators lack the appropriate enforcement tools, such as the ability to freeze assets, to shut down schemes at an early stage. Some schemes have also successfully delayed enforcement actions through court challenges.

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Once a scheme becomes large, government authorities may become increasingly reluctant to trigger its collapse, because if they do—curtailing its ability to meet cash flow obligations—subscribers could blame the government's intervention rather than the scheme's inherent flaws. Conversely, when the schemes collapse by themselves, experience shows that governments may face criticism for failing to act more promptly.

### Key regulatory actions

Prompt and decisive regulatory action is required to prevent Ponzi schemes from taking root and spreading. Regulators must be prepared to work on several fronts.

**Investigate schemes.** Ponzi schemes, especially those perpetrated through unregulated entities, are usually not easy to detect, because many of them operate in an opaque—even secretive—way, requesting confidentiality from investors. Regulatory agencies should increase efforts to detect Ponzi schemes by developing effective investigative tools, including red flags that point to investment fraud, tools to facilitate research on the Internet as well as through other mass media, and mechanisms to receive and act on complaints from the public.

**Seek emergency relief.** Completing a full investigation to bring civil, administrative, or criminal charges can take a long time, during which scheme operators or investors' money may disappear. Once a regulator has reasonable evidence of the existence of a fraud perpetrated via a Ponzi scheme, it should immediately seek emergency restraining orders, such as freezing assets, to protect investors' interests while the investigation continues.

**Bring charges.** Financial regulators should employ the civil or administrative remedies at their disposal while also submitting files to the criminal authorities. In Jamaica, cease and desist orders against OLINT were not followed by criminal charges, which delayed the closure of the scheme. Regulators should stand ready to help the authorities build a criminal case, or have the power to bring charges themselves. Civil or administrative remedies differ from criminal remedies with regard to both the authority responsible for their prosecution and imposition and the burden of proof required and gravity of the sanction.

**Coordinate and cooperate.** A Ponzi scheme may constitute a violation under several financial laws, which can be pursued by more than one regulator. Close dialogue with the criminal authorities can lead to more effective enforcement. Financial regulators need effective mechanisms for the exchange of information and cooperation on curbing unregulated schemes. The multilateral memorandum of understanding of the International Organization of Securities Commissions is becoming one important such tool.

**Keep the public informed.** Broad financial literacy programs can help stop unregulated schemes. In addition, it is crucial that regulators keep the public informed, through general warnings regarding the methods used to defraud investors and the need to question potential investments' financial viability and invest only through licensed entities; notices and lists of individuals or entities that hold or do not hold a license to

carry out financial activities; and a database of actions taken against specific individuals and entities. A Web posting by the St. Kitts and Nevis financial regulator that the Jamaican OLINT scheme was not authorized to operate there appears to have prevented that scheme from taking root.

### Preconditions for early response

Country experience has shown that regulators are more likely to be proactive and act quickly and decisively when the following conditions are present; in their absence regulatory responses come, at best, with significant delay.

**Broad authority to investigate and prosecute unregulated schemes.** The experience of many developing countries suggests that gaps in regulations and in the legal and regulatory framework governing enforcement of financial laws have been a key factor in financial regulators' inadequate response to Ponzi schemes. Four elements are important: clear provisions to prosecute the schemes; broad investigative authority, especially to "follow the money" by accessing banking information; authority to seek or impose civil or administrative remedies, such as financial penalties or withdrawal of a license to operate, as well as criminal sanctions; and authority to take emergency action, such as freezing assets.

**Independence of financial regulators.** In many of the cases studied, there was no political—or even popular—support for regulatory action to stop the schemes. For instance, a junior government minister in Jamaica described a raid on OLINT as a "Gestapo-like invasion," which was a "vulgar abuse of state power." Financial regulators need sufficient independence to act without additional approval from the government, even if the schemes have the tacit support of members of the government. And the regulatory framework must protect staff and commissioners against lawsuits arising from the execution of their duties.

**Broad authority to cooperate and exchange information with other financial regulators.** Ponzi schemes may operate across many jurisdictions: OLINT had offices in Jamaica, was headquartered in Panama and later in the Turks and Caicos Islands, and solicited investors in the United States and, through subschemes, in Grenada, Dominica, and St. Lucia. The lack of authority to exchange confidential information, in particular banking information, and to provide assistance to foreign regulators has hindered the investigation and prosecution of Ponzi schemes in many developing and emerging markets. Some regulators also face problems in exchanging confidential information with other local regulators.

**Adequate resources for enforcement.** In countries just beginning to tackle the problem of Ponzi schemes, a lack of experienced personnel impedes prompt action. Training can help bridge this gap, as can the development of internal manuals on conducting investigations and an organizational structure capable of dealing with the investigation and handling of cases.

**Specialization and speedy disposition by the courts.** Because many decisions a financial regulator takes to stop a Ponzi scheme are subject to judicial approval or review, it is critical that judges have the necessary expertise and are able to give

priority to financial matters, in particular those involving emergency action. For example, OLINT was able to continue operating for several years while the courts resolved challenges to the regulator's cease and desist order and a commercial bank's attempt to close the scheme's bank accounts. The bank's action was appealed to the level of the Privy Council in the United Kingdom, Jamaica's final court of appeal.

### Developing countries more vulnerable

Case histories demonstrate that Ponzi schemes can occur in any financial market, industrialized or developing. Although the business opportunities these schemes claim to offer and their legal operating structures are diverse, their promoters employ similar techniques to make their pitch, identify target groups, get publicity, and build credibility.

Regulators in most industrialized countries have a wide range of enforcement tools at their disposal, including the ability to freeze assets as soon as a scheme is discovered, and the judiciary has supported such measures. As a result, although large and long-lasting schemes can emerge in industrialized countries, as the Madoff case reminds us, they are more likely to be stopped in these countries soon after discovery.

That has not been the case for some developing countries. The lack of a strong regulatory response, along with underdeveloped formal financial institutions, has allowed Ponzi schemes to develop and continue operating even after many red flags have been raised, and is a reflection of a broader problem: the challenge of developing credible enforcement programs. Many regulators in developing countries lack the necessary enforcement tools, resources, and—sometimes—political independence to cope with financial misconduct, including the operation of Ponzi schemes. In a global financial market, regulators must be able to exchange information and cooperate with one another. This has proven critical in combating unregulated schemes, given their demonstrated ability to relocate from one jurisdiction to another. But for many developing country regulators, legal limitations mean such cooperation is still beyond their reach.

Ponzi schemes are a concern around the world, but especially in countries whose relatively less developed regulatory frameworks may be unable to contain their exponential growth. The key lesson is to act early before schemes gain momentum and imperil unsuspecting investors. ■

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