

Ponzi Schemes

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Outline of Talk

- Ponzi schemes
- Why study them ?
- Description
- Some examples
 - Berne Madoff, USA
 - Allen Stanford, Caribbean
 - FTX: USA, Hong Kong, Bahamas
- Features of Ponzi schemes
- Illustrations
- Discussion

Ponzi Scheme

Promoter sets up the scheme.

- Promises above average returns
- Tells a plausible investment story
- Uses specious arguments
- Money collected from later investors used to pay earlier investors
- Scheme needs an expanding base of new investors to survive
- Eventually fraud is exposed
- Promoter is sent to prison
- Investors *may* get partial compensation

Ponzi Scheme

In plain language

- Promoter lies to his investors
- He steals their money
- He is a crook
- Gives worthless guarantees to clients

Bernie Madoff's Ponzi scheme

- Largest scheme in history; \$64 billion notional USD
- Collapsed in 2008 due to financial crisis
- His strategies evolved over time
- Adapted new technologies
- Family, friends, Jewish groups, feeder funds, European banks
- Survived six SEC investigations
- Madoff sent to prison for 150 years
- He died in prison in 2021

Allen Stanford's Ponzi scheme

- Scheme lasted from 1992 to 2008
- 280,000 investors lost \$8 billion USD
- Moved Head Quarters to Antigua, laxer laws
- Influenced regulations, bribed regulators
- Offered CDs with above average returns
- Engaged in extensive philanthropic ventures
- Stanford is now serving a 100 year sentence

FTX , Crypto-scam with some Ponzi features

- Sam Bankman Fried MIT grad
- Proponent of *Effective Altruism* EA
- EA mantr:a Doing good better.
- Started Alameda Research hedge fund in 2017
- He founded FTX crypto-exchange in 2019
- FTX was a trading exchange for crypto currency
- Started in Hong Kong, moved to Bahamas in 2019
- *Siphoned* money from FTX to cover huge losses in hedge fund
- Total losses \$11 billion
- Last month, SBF got 25 years in prison

Features of a Ponzi Scheme

- Promoter
- Plausible story
- Trust building mechanism
- Promised return
- How to attract and continually expand investor base
- How to evade regulations
- Exit strategy

Promoter

- Normally male
- Typically has some investment background
- Experience, unique qualifications, good sales skills or mystique
- Madoff had experience in securities markets
- Madoff got his suits from Savile Row
- FTX founder Sam Bankman Fried, physics degree from MIT
- SBF started with Jane Capital
- SBF sported a messy hair style (like Einstein) Image of a mathy nerd
- Allen Stanford, BA in finance, started in real estate
- AS: 6 foot 5 inches, cricket loving, knighthood in 2008

Nassau conference, 2022 Three amigos?



SIR(?) Allen Stanford



The (fake) story

- Has to be plausible
- Provide investment strategy not currently available
- Disclose enough details to whet the appetite
- But not too much. Claim it is confidential proprietary
- Examples
 - Madoff claimed superior stock picking and timing ability
 - Madoff professed to use a sophisticated options strategy
 - Stanford claimed investments were insured with Lloyd's of London
 - Dolphin Trust claimed to convert German listed buildings into luxury apartments

Promised return

- Choice variable for promoter
- Must appeal to investors
- Hence cannot be too low
- Promised return cannot be too high
 - It is hard to sustain scheme if rate is too high
 - If rate is too high regulators become suspicious
- Madoff reported S&P returns with an annual volatility of 2.5%
- This is about *six times* lower than market volatility
- Strong attraction for risk averse clients

Building trust

- Acquire profile and status
 - Tout experience
 - Join industry committees
 - Donate to charity
 - Give money to political parties
 - Become a director
 - Mingle with celebrities
- Stanford hosted charity polo games attended by William and Charles
- Hired Michael Owen and Vijay Singh as ambassadors for his empire
- Stanford claimed to be related to Leland Stanford
- Madoff was influential member of key industry committees
- Perch on moral high ground (Alameda) through Effective Altruism
- SBF Celebrities and politicians

Expanding investor base

- Advertise
- FTX Super Bowl ad
- Use word of mouth
- Affinity fraud: exploit social or ethnic connections
- Form relations with other financial institutions
 - Eg banks pension plans feeder funds
- Expand to other countries Madoff European private banks
- Madoff 720,000 European investors settled for \$15.5 billion USD

Avoiding and evading detection

- Move to a more lax regime (Stanford, FTX)
- Influence regulations (Madoff, Stanford)
- Bribe the regulators
- Curry favour with politicians (FTX)
- Launch strategy before regulations get formulated
 - China: P2P platforms eg Ezubao
 - Crypto-currency: Worldwide regulations are being gradually introduced
- Run legitimate business alongside the Ponzi scheme

Two questions

- (A) Why would a rational agent start a Ponzi scheme
- (B) Why would a rational agent invest in a Ponzi scheme

Question A

- Perhaps started out ethically but became corrupted
- Maybe places disproportionate weight on current consumption
- Enjoys the risk taking aspect ?

Question B

- Believes the returns are real
- Taken in by the hype
- Hope they can surf the wave. In early leave early

References

- Mr Madoff's Amazing Returns, An Analysis of the Split Strike Conversion Strategy, *Journal of Derivatives* 17(1), 62-76, 2009, Carole Bernard and Phelim Boyle
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