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Security Analysis

Ponzi Schemes: Psychology of Victims

The term Ponzi scheme dates its origins back to the early 20th century. In 1919, a clerk in Boston named Charles Ponzi, was credited with running the first scam of this kind. Hence, the term Ponzi scheme was born. Every year, hundreds of people are affected by Ponzi schemes and the illegal actions taken by the scheme artists. A Ponzi scheme is a fraudulent investing scam promising high rates of return with little risk to investors.[1] The scheme generates the returns due to earlier investors through funds brought in by new clients. The scam only works if the investors of the scheme, who are unaware they are being deceived, continue to receive their payments. This means the scam can only last until the scheme artist can no longer find new investors and their money to steal. Once the artists are unable to find new investors, they are unable to pay the returns due to the old investors and the scheme collapses. So, how do the scheme artists attract new investors into their scams? Why are people, in general, constantly falling victim to Ponzi schemes? Are the new investors greedy or just negligent? What are the red flags investors should recognize about a Ponzi scheme? Are the victims able to recover any losses sustained from a Ponzi scheme? The purpose of this paper is to highlight the answers to the previous questions, bring awareness to the harm Ponzi schemes bring, and look into the overall psychology of the victims.

In order for a Ponzi scheme to work, the scam artist must find initial investors to borrow money from in order to get the ball rolling. So how do the victims become convinced to

[1] "Ponzi Scheme Definition | Investopedia." *Investopedia*. N.p., 25 Nov. 2003. Web. 22 Mar. 2016.

"invest" their money with the scammer? To begin, let us take a look at the characteristics of the scammers. According to a survey done by KPMG, a big four accounting firm, typical fraudsters are most likely males between the ages of 35 and 55. The perpetrators may be or may interpret to be CPA's, attorneys, or qualified financial advisors such as stock brokers, insurance people, or bank wealth management persons.[2] However, most Ponzi scheme artists are not licensed brokers. Often times, the scammers may be a member of an affinity group, meaning a group of people related to one another for a specific reason. Examples of affinity groups are Church groups, race, nationality, or political affiliations.[3] This is important because most Ponzi schemes have a certain target group. The Ponzi scheme artists also use things such as internet blogs, emails, television programming, and investment seminars to sell their investment offers to potential clients.[4]

The first mistake of the investment clients is falling victim to the deceitfulness of the name of the company the perpetrator operates his or her business out of. The company names will often times sound like some other recognized name or will frequently have a very similar logo.[5] An example of this can be seen by the name Trans Continental Airlines. Many people know of the airline company Continental Airlines, therefore, they recognize this part of the company name and associate the investment with this company. The victims lose sight of the word "Trans" and often times do not inquire about it or fail to even look online to see if the company exists. The perpetrators will also place words such as "Secured", "Guarantee",

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[2] McHale, P.A.
[3] Ibid
[4] Ibid
[5] Ibid

"Trust", "Capital", "Fidelity", or "Insured".[6] These words are used to not only deceive the clients, but to give them a sense of reassurance that either the company or the investment itself if trustworthy. For example, the scammers will claim the investment to be insured by known entities such as the Lloyds of London or FDIC Insured.[7]

After the perpetrators are able to get the clients in the door and pitch them their investment opportunity, the client is usually very confused about how the investment is going to make them money. This is because most victims in Ponzi schemes are not real investors, meaning they have no background in the financial world. The clients fail to ask the necessary questions needed to clear up any confusion they have and when they do begin to ask questions, the scammer usually begins to explain why they cannot answer. The scheme artists will make excuses such as, "Our computers have recently crashed" or "We just changed our software system and were unable to transfer data from previous years so I apologize but I cannot answer your question precisely at this time."[8] They are often times also reluctant to allow inspection of records because they know the records are phony.

Perhaps the worst way the schemers reel in their victims is to guilt trip them in. If the potential client shows hesitation in his or her commitment to the investment, the schemer will say things such as, "I've got another client on the other line who really wants in on the deal but I'm giving you the first opportunity at it" or "this is a one-time offer, take it or leave it." This technique puts pressure on the client to answer right away and since no one wants to be left out, the clients foolishly accept the offer to invest with the schemer.

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[6] McHale, P.A
[7] Ibid
[8] Ibid

But why is the potential client in this scenario in the first place? How is the client financially motivated to meet with the investment scammer? There are number of factors that could impact a potential client's decision to invest with the investment advisor. First off, it needs to be pointed out that there is a distinction[9] between greed and negligence. In some cases, the clients are the victim of their own greed. Some people are constantly looking to make money through whatever means possible. These people are simply looking for higher interest rates leading to higher returns. However, some people actually have a great deal of negligence when it comes to investments and how they work. Often times, the potential clients are looking for a way to protect current assets they have or protect their current income stream.[10] This could be due to recent downturns in the financial markets. However, a large number of Ponzi scheme victims are people who are either retired or are looking to retire and want to begin setting up income streams for the future. These retirees usually have health issues and may need extra money to help pay for medical expenses. These are a few of the motivational situations people face before becoming a victim of Ponzi schemes.

So what are some ways people can defend themselves from falling victim to Ponzi schemes? What are some red flags a potential investor should recognize when speaking to and investment advisor? The first red flag that should be recognized by the clients is if the investment sounds too good to be true.[11] It doesn't take much knowledge of the financial world to see if someone is offering you an abnormally higher return than you could get in the market. A second red flag is if the investment advisor uses emphasis words like "Guarantee

[9] McHale, P.A.
[10] Ibid
[11] Ibid

returns".[12] It is common sense, I believe, that most things are not a guarantee, especially in the financial world. A third red flag that clients should recognize include advisors having offshore "headquarters" for their business. For example, locations could include the Bahamas, Costa Rica, or Honduras.[13] One reason you may hear for the headquarters being located off-shore is asset protection, meaning the company doesn't trust being headquartered in the U.S. Other red flags are the scammers claim to have their investment opportunity insured by the Lloyds of London or another prestigious insurance company. They claim the investment is a revolutionary idea that is going to change the financial world.[14] Or, as stated previously, they may guilt trip the client in by claiming their offer is only for a limited time period.

To avoid these red flags, the prospective clients should Google the company to, first, see if it actually exists and, second, read about the company officials and try to find out their background in the financial world. They should also compare the websites of the fake companies to the websites of real companies because the fake company websites are often times very flashy with many pictures and impressive testimonials to help attract clients[15]. In all, the victims could protect themselves if they take time to run proper background checks.

Finally, is it possible for the victims of Ponzi schemes to recover any of their losses? The answer to this question is yes; it is possible for Ponzi scheme victims to recover some of their losses. However, the victims do not have any right to recovery.[16] In most cases, recoveries are not made directly from the scammer. Although this is one possibility, the main way victims get

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[12] McHale, P.A.
[13] Ibid
[14] Ibid
[15] Ibid
[16] Ibid

their money back, if they can at all, is through clawbacks. Through what is now known as Clawback Litigation, not only is the scammer's money taken, but the other investors, who had previously received their return on investment, money is taken as well. As the money is slowly gathered by bankruptcy officials, the funds are redistributed back to the victims in proportional amounts. If one ever becomes a victim of a Ponzi scheme, attorneys recommend to get in touch with them immediately in order to begin recovering the lost money. Through the help of attorneys, it is possible for victims to recover some of their losses through tax refunds. The IRS acknowledges Ponzi schemes as "theft losses," and there are several methods of tax recovery available.[17] There are three tax refund options available for victims of Ponzi schemes.

> The first option is called "Theft Loss." Theft loss is an extremely valuable tax deduction that could have a cash value equal to 35 to 50 percent of the lost investment, depending on city, state and federal income taxes. The second option is called "Capital Returns." In certain cases, funds that were paid from a Ponzi scheme and reported as "income" in a previous year may instead be considered a return of the defrauded investor's capital. The third option is called "Phantom Income." Income taxes paid by Ponzi investors on what turns out to be fake profits may be recovered as theft losses or under certain circumstances by re-characterizing the income as non-existent.[18]

Attorneys also warn not to enter into any premature settlements that, convert theft losses into capital losses of lesser value, and to contact them before settling to discuss available options.

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[17] "Find A Financial Attorney To Help With Ponzi Scheme Recovery". http://ponzi-scheme-tax-recovery.whocanisue.com/. March 19, 2016.

[18] Ibid

Although the above options are available to help victims recover their money, in most cases, the victims will never recover even half of their original investments. Looking at the chart in Appendix A, we see six Ponzi scheme cases with details highlighting the scam. One can see from examining the chart, that the highest percentage of funds recovered for the victims was 74.67% in the 1031 Tax Group case. In the Pearlman case, only 1.11% of the $450 million in funds were recovered. The other cases labeled show only moderate success in fund recovery. This highlights the fact that it is very difficult to track down the funds of the victims, particularly if cash was involved. All in all, it is possible for the victims to recover losses sustained from Ponzi schemes, but will very likely never recover their full investment, if even half of it.

In conclusion, the Ponzi scheme victim's first mistake is being deceived by the name of the scam artists business. The victims fail to ask the necessary questions needed to clear up any confusion they have with the investment opportunity. If they show any hesitation to acceptance of the investment opportunity, the schemer tries to guilt trip them into acceptance. The fear of missing a good opportunity causes the potential clients to accept. The potential investors also fail to recognize the red flags that should trigger questions about the investment and investment advisor as a whole. Once one becomes a victim, they should immediately contact an attorney to discuss the potential options of fund recovery. Most funds are recovered through what is now known as Clawback Litigation. However, there are also three tax refund options available to the victims. Although it is possible for the clients to recover some invested funds, it is highly unlikely that all investor funds will be recovered and returned.

Appendix A[19]

	Ponzi Schemes, Securities Fraud, and Perpetrator Characteristics					
		Ponzi Schemes				
	1031 Tax Group	Pearlman	Ameritrust	Barsota	Ashley Financial	Waterford
Amounts Involved	150 Million	450 Million	50 Million	132 Million	20 Million	16 Million
Recoveries (Note 1)	112 Million	5 Million	92 Million	92 Million	4 Million	7 Million
%'age	74.67%	1.11%	20.00%	70%	20.00%	43.75%
Length (Years)	2	20+	2	15	3	4
Sociopathic Perp	Y	Y	Y	Y	Y	Y
Unsophisticated Investors	NA	Y	Y	Y	Y	N
Investors Greed (Note 2)	No	Y	Y	Y	Y	Y
Affinity Program	NA	Y	Y	Y	Y	NA

Note 1: Recoveries represent amounts actually returned to investors and are estimated in ceratin older cases

Also certain cases such as 1031 and Pearlman are ongoing and additional recoveries are anticipated

Note 2: Greed is difficult to define, but certainly the investors were all seeking above market returns

[19] McHale, P.A.