

The Ponzi Scheme 101 Year Anniversary

Dennis Elam Phd CPA

Associate Professor

Texas A & M University San Antonio

Overview

- What is a Ponzi Scheme?
- History, Pre-Ponzi
- Meet Carlo Ponzi
- Meet Barry Minkow
- Not just the Naïve, meet Big Time Pigeons
- A Socio Explanation of How it Happens
- Early Warning of Ponzi Scheme

Ponzi Scheme

- Improbable Returns are Promised
- An improvised scheme – No real investment
- The first investors are repaid with funds from later investors
- Once payments are made, the hook is to convince all to let money compound, ie no withdrawals
- Lifestyle of the schemer improves

History of Ponzi

- **19th century**
- **1860s**
- Jacob Young, William Abrams, and Nancy Clem ran what author Wendy Gamber argues, in her book "The Notorious Mrs. Clem: Murder and Money in the Gilded Age," was the first-ever Ponzi scheme. [\[1\]\[2\]](#)
- In Munich, Germany, [Adele Spitzeder](#) founded the "Spitzedersche Privatbank" in 1869, promising an interest rate of 10 percent per month. By the time the scheme collapsed in 1872 it had become the largest case of fraud in 19th-century Bavaria.

2000-2009

- Wikipedia lists 29 Schemes in this period
- 2010 to present, over 30
- Socionomics Explains how this happens again and again

Meet Carlo Ponzi

- **Carlo Pietro Giovanni Guglielmo Tebaldo Ponzi**; March 3, 1882 – January 15, 1949)
- 50% 45 days
- 100% 90 days
- Arbitrage Postal Reply Coupons PRC



Early Life

- Born March 3, 1882 to a former successful family
- Accepted Univ Rome La Sapienza, broke and no degree
- Nov 15, 1903 Arrives Boston with \$2.50 &
- \$1 M in hope

Canada

- By 1907 spoke **English, Italian, French**
- Banco Zarossi robbing Peter to pay Paul
- Bank Manager – **Winning Personality**
- Made 6% interest by taking money from accounts
- Forges \$428.58 check, 3 years St Vijcent de Paul Penitentiary
- Wrote he had job as special assistant to Warden

Back in the USA

- 1911 Returns to smuggle Italian illegal immigrants
- 2 Year in Atlanta Prison
- Resourceful – became translator for the Warden
- Wall St speculator Charles Morse in prison became a role model

Boston

- Marries Maria Gnecco, no past jail story
- His Mother warned her
- Began advertising company
- Various businesses including Maria's fruit stand, all failed

Hatching the Scheme

- Summer 1919 set up office **27 School Street**
- Significant location of first public school 1704
- Receives letter from Spain inquiring advertising
- Postal Reply Coupon inside PRC

Postal Reply Coupon

- Allow one to send a letter including PRC and recipient could use it to reply
- Cost of postage in one country exchanged for postage where redeemed
- Postage purchased inexpensively in Italy
- Bought more expensive US postage
- The US stamps could then be sold at a profit
- The Arbitrage Scheme was Born

Financing the Scheme

- Hanover Trust refused to finance purchase of PRC
- Sells Stock to Public
- Promises 100% 90 days
- At first, \$1,250 brings \$750 Interest



in 1920, while still working as
businessman in his office in Boston

Securities Exchange Company Irony Later Acronym 1934 Law

- January 1920 8 people invests \$1,800
- Larger Office, Hired /agents
- By March \$25,000 invested (\$320K today)
- By May \$420,000
- June \$2.5 million (\$32 M today)
- July, a Million Dollars a day
- Growth is Breath Taking – Herding Impulse

Hanover Trust Bank

- Deposits Made There
- Impose his will if enough deposits
- Bank President?
- Buys controlling interest, \$3 M deposit
- SEC branches from Maine to New Jersey

Who Were the Customers?

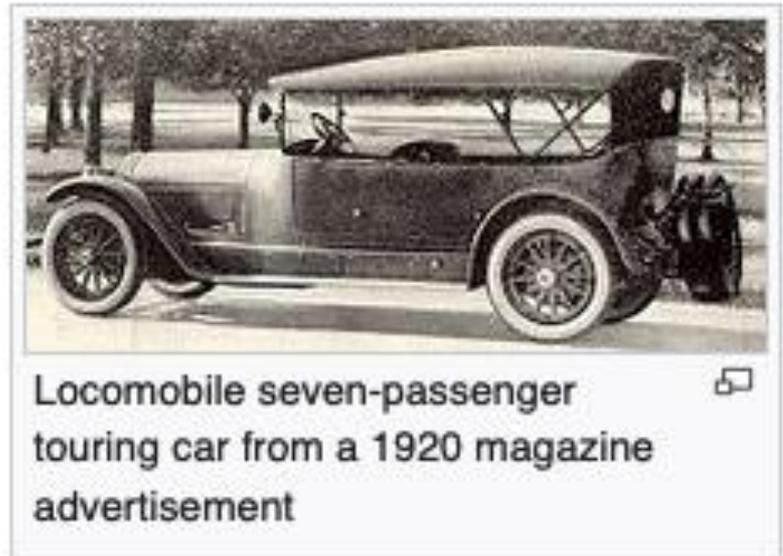
- At first working class
- Later well to do Boston Brahmins
- 75% Boston Police force
- His chauffeur, Brother in Law
- Banker Lawrence, Kansas

Irrational Ratios

- Like Madoff and Minkoff, impossible numbers
- Impossible to exchange enough PRCs for cash, only stamps
- January \$1,800 required 53,000 PRC
- Next 15,000 investors would have required shiploads of PRC
- Barron later noted only 27,000 existed

Luxurious Lifestyle

- Mansion Lexington MA
- Brought Mother from Italy\$
- \$100K donation Home
- Macaroni and Wire firms acquired hoping to use profits to repay investors



Defenses Raised

- Sues Financial Writer, recovers \$500 K
- Legal system moved faster then!
- Boston furniture dealer sues over no pmt
- Investors pull out, Ponzi pays, run stops
- July 24 Favorable Boston Post article
- Article 50% 45 days under that Bank promises 5% annually
- Thousands wait at SEC

MA. Officials Investigate

- MA Authorities met Ponzi day of article
- Ponzi offers to stop taking money during investigation
- Relieved, they calmed
- Records consisted of names on index cards

Post Hires Charles Barron

- Barron Headed Dow Jones company
- Ponzi not investing
- USPS no large quantities PRC bought abroad
- Another run in SEC
- \$2 M withdrawn and paid,
- Coffee and donuts, nothing to worry about
- Many changed their minds, Con Man Par Excel
- Shades of Madoff, Enron, Minkow

Publicist Bites Ponzi

- Hires William McMasters
- End begins late July
- August 2 Post publishes McMasters article
- Daniel Gallagher US Atty MA investigates
- Cannot audit the books
- Bank Commission fears run will ruin MA banks

The Plot Unravels

- Audits reveal borrowing from Hanover Trust
- August 9 Ponzi account overdrawn
- August 11, former criminal activities revealed
- Bank Commission seizes Hanover
- August 12 only \$4 M assets

Surrender

- Surrenders to Federal Authorities
- Charged Mail Fraud, \$25K Bail
- State charges Larceny, \$10 K Bond
- Bail removed flight risk

Losses

- 1920 – about \$20 M
- Today - \$196 M in 2020 dollars
- Madoff's scheme cost \$18 Billion
- Madoff was 53x the losses of Ponzi
- A Socio example of fractal increases in spite of Federal Regulation

Charges and Jail

- 86 Counts Mail Fraud
- Pleads guilty
- Nov 1 1920 sentence five years
- Out In 3.5 years
- Indicted 22 state charges Larceny
- Ponzi thought he had a deal
- March 27, 1922 US Supreme Court rules federal Plea no standing regarding state

More Charges

- Oct 2, 1922 tired on first 10 larceny counts
- Acts as own Attorney, Acquitted
- Second time on five charges, jury deadlocked
- Third trial convicted, sentence Nine Years
- Still receiving Christmas cards and offers of money, in jail

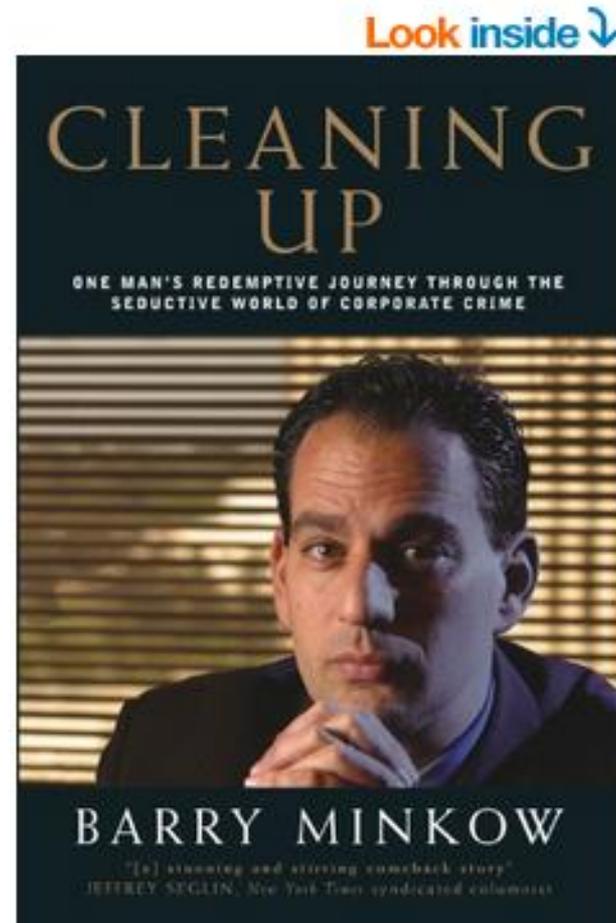
Epilogue

- Poor health, 1941 hear attack, near blind, paralyzed r. leg and arm,
- Dies in charity hospital in Rio de Janeiro 1949
- "Even if they never got anything for it, it was cheap at that price. Without malice aforethought, I had given them the best show that was ever staged in their territory since the landing of the Pilgrims! It was easily worth fifteen million bucks to watch me put the thing over

A Public Ponzi Scheme

ZZZZ Best

- Cleaning Up: One Man's Redemptive Journey Through the Seductive World of Corporate Crime
- That is Barry's Version



ZZZZ Best

- Carpet Cleaning at Age 16
- Customer, supplier, payroll complaints
- Check Kiting, Credit Card Fraud
- Insurance Restoration business – the fraud
- 86% revenues
- Factor Fake Acct Rec\High School Grad 1985
- Jan 1986 Went Public – Ultimate Ponzi Scheme

IPO

- IPO in 1986 as fourth year of bull market
- No due diligence, restoration sites not visited
- Ernst and Whinney anxious for 'boutique client'
- EW agrees to only one inspection
- Minkow has fake job, posting ZZZZ Best posters and installing fake employees
- Thousands of fake invoices

Largest IPO by a Minor

- February 1987 Mkt Cap \$280 M
- Perfect Storm of Fraud
- Merges KeyServ, Sears carpet cleaner
- Half KeyServ size, ZZZ survives
- Minkow President & Board Chair
- Drexel Burnham Lambert offers junk bond financing
- Plans hostile to raise \$700 M for Service Master
- Talks to buy Seattle Mariners

The Revelation

- Customer defrauded in 1984-85 goes to LA Times
- Story hits just before merger
- Loans called, Drexel out, EW resigns
- Non existent company without license
- Stock \$18-\$3.50
- Resigns July 2

It's not Over

- Note ZZZZ peaked after five years bull market just before October crash
- March 27 1989 25 years in prison, \$26M restitution
- Released after 7.5 years, Minister via Liberty University – great con story

The End

- 2009 Accuses Lennar of fraud
- Ironically claiming Lennar was a Ponzi Scheme
- Buys \$20 K Puts betting on decline
- And later bought stock betting on a rebound
- 3/16/11 pleads guilty to insider trading and resigns as Minister Commun Bible Church

Sentence

- Five Years Prison
- \$583 M restitution
- “The church knew who I was when they hired me.”
- A lot like Ponzi on his death bed.
- Leopards don't change spots

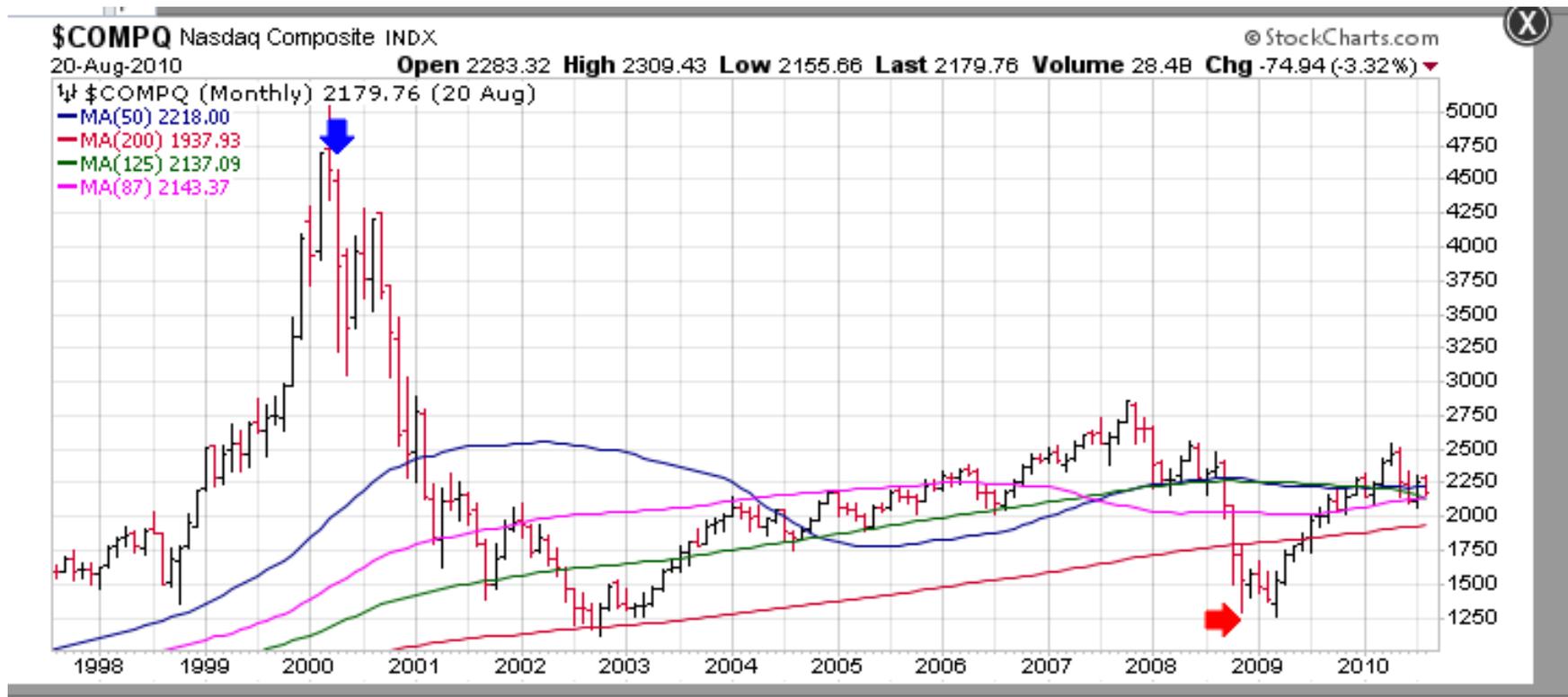


Are Only the Naïve Taken In?

- One might think that such schemes only entrap the uneducated, unsophisticated unable to marshal resources of attorneys and accountants
- Really?
- Time Warner AOL

Corporate Social Mood

AOL Time Warner Google



Social Mood Affects Financial Analyst

- It is probably the most significant development in the Internet business world to date," said Phil Leigh, an analyst
- News of the merger, the largest in corporate history, sent Time Warner's stock up at "do.-com" speed, with shares rising \$25.31, or 39 percent, to \$90.06. The stock has traded as high as \$78.63 and as low as \$57.19 during the past 52 weeks.

Fast Forward to 2009

- [AOL](#) will cut its work force by 10 percent today, laying off approximately 700 employees, as a result of the struggling economy and a decrease in advertising
- The layoffs follow on the heels of [Google's write down of \\$726 million of its \\$1 billion investment](#) in AOL, suggesting AOL's total value is now \$5.5 billion, compared to \$20 billion at the time of Google's 2005 investment in AOL.

1. Social Mood Explains Social Actions

- Social mood motivates social actions, not the other way around.
- Media is forever trying to link movements in the stock market to external events.
- Frauds occur at stock market peaks
- Write offs occur at market bottoms

2. Mood Internally Regulated Not External Forces

Crude Oil - Continuous Contract (EOD) CME

© StockCharts.com

Open 67.69 **High** 74.31 **Low** 65.23 **Close** 72.91 **Volume** 111.8M **Chg** +5.40 (+8.00%) ▲

Weekly 72.91 (20 Aug)



Tenet 3

- Social mood is constantly fluctuating according to a hierarchical, robust fractal called the Wave Principle. Robust fractals are patterned but quantitatively variable.



Fractals

- Despite SARBOX and Frank Dodd,
- Asset Estimates
- Enron \$63.4 B
- World com \$107 B
- Lehman \$576.9 6x size of Worldcom

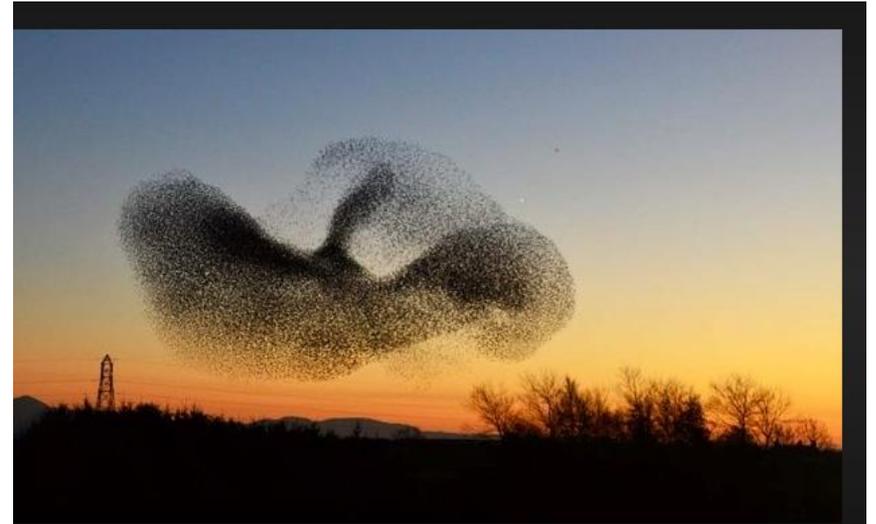
4. Unremembered

- Social mood is unconscious and unremembered
- This allows the Ponzi Scheme to be repeated again and again,
- Ponzi, Minkow, Madoff

5. A Social Phenomenon

Murmuration of Mood

- Waves of social mood arise when humans interact socially. The process appears to be related to the herding impulse.



Signs of a Ponzi Scheme

- Lack of formal education
- No CPA on the job or poor auditing
- Always during a frothy market
- Elementary analysis shows fraud
 - Ponzi needed far more PRC than existed
 - Minkow needed all the jobs in the USA
 - Madoff needed more Hedge options than existed