Ponzi Scheme Puzzles
April 11, 2012

ERIC ROITER: Good afternoon and welcome to Ponzi Scheme Puzzles, broadcast through the virtual museum and archive of the history of financial regulation at www.sechistorical.org. I am Eric Roiter, Lecturer in Law at Boston University School of Law, a Trustee-elect of the SEC Historical Society, and moderator for today's program.

Ponzi schemes have a long history and it sometimes seems a long future. There has always been a human desire to make a lot of money at little or no risk, and for people to be attracted by investments that guarantee very high returns, giving us an edge over others. The term Ponzi scheme comes from an actual person, Charles Ponzi. When we joined this broadcast we saw a photo of him from 1909 when he was incarcerated in Canada. A decade later out of jail, Charles Ponzi made his name forever infamous. In 1920, he set up an investment scheme using discounted international postage coupons that promised high profits over a very short period. In fact he was using investments from later investors to pay off his earlier investors. When the scheme collapsed within nine months, his investors had lost over $20 million. In recent years, we have witnessed the unraveling of a startling number of Ponzi schemes, the most notorious perpetrated by Bernard Madoff that led to losses of well over $10 billion.

In our program today we would like to examine the elements of Ponzi schemes. What makes for a successful Ponzi scheme artist? What makes people vulnerable to Ponzi schemes? We then want to look at what the legal system can do to prevent such schemes and how we - the investors - can protect ourselves.

Joining with me today are Tamar Frankel, Professor of Law, Boston University School of Law, a well-known scholar and author in the areas of mutual funds, securitization, financial system regulation, fiduciary law and corporate governance. Don Langevoort is the Thomas Aquinas Reynolds Professor of Law at Georgetown University Law Center and a member of the SEC Historical Society's Board of Advisors. Don has helped to build the museum collection over the years, most notably sharing his expertise in the September 2006 Fireside Chat on Behavioral Economics. And finally, Francis Morrissey of Morrissey Wilson & Zafiropoulos, an experienced bankruptcy litigator and counselor with considerable experience dealing with the aftermath of Ponzi schemes. Welcome to you all.

Tamar, let me turn to you first and ask you to talk to us about the basic design of a Ponzi scheme and how it is distributed and marketed.

TAMAR FRANKEL: The first point is: not all investors lose in this scheme. The first investors may receive a generous return and later there are some who receive something but many, if not most investors, lose everything. And that result really derives from the description of a Ponzi scheme. So how does it work? Well, first of all look at the stories, the con artists' stories. These stories must answer the question of where does all this money come from? After all: you promise us so much without any risk. So there is a tremendously large list of these plans or these stories that you find in in court cases. I researched cases for the facts they describe. They appear in my forthcoming book: The Ponzi Scheme Puzzle. The list includes investments in synthetic rubies and hydroponic farming and windmills and tropical islands and the Malaysian latex glove manufacturing company, and investments in gold mining, oil, in precious stones, in telecommunication systems, and more of the same. What is interesting is what one of the con artists said: "Gold," he said, "that's just a small part of it. You know what gold is? It glitters, it gets people excited." The stories give the feeling of a treasure-hunt and, to some extent, I think this is part of the attraction.

In addition, you have the use of words that is quite interesting. For example, Charles Ponzi used the name Securities Exchange Company. Then you have a company that says: The full faith and credit of BFA, that's the company name, stands behind its investment products. Well, you know what that reminds us of, USA, Another is: we give you our promise "with recourse." Now people, who are not lawyers, think that there is something special in the word but lawyers know that it's "without recourse" which has a meaning. So you have a tremendous amount of this type of words. You have also the hidden part. All these wonderful things happen abroad. And you wrap it together with reluctance of the con artists to accept the money. There are many of those con artists who say, "No, no, no, I don't want it really. Don't force me to take it." Then you have satisfying need for friendships and especially from victims that crave friendship. There is a man who spent 57 months in prison in 1994 and had to pay $1.9 million that he has already taken. And he goes to New York and he shows that he doesn't have any money but at the same time he promises at least two women to marry and enjoys a very high level of living.

So when you summarize all of that you see a design that includes high return, low risk, interesting stories, inability to prove their truthfulness, exciting words and friendships. And this is the mix that seems to attract many people.

ERIC ROITER: Don, let me ask you: What separates Ponzi schemes from other types of frauds?

DONALD LANGEVOORT: There are probably more things that make it similar to other kinds of frauds than separate it. What we mean by a Ponzi scheme is when somebody who has all the stories and enticements that Tamar was talking about does not have a legitimate investment plan, and isn't actually going to try to make any money by investing. He is just going to bring in more money, paying the first round of investors off so they think this is legitimate. Build on that sense that it is real until he's pumped out the system at which point he has to have an exit plan. There are pyramid schemes that are a little bit different, and there are straight forward sham transactions. What's key to the Ponzi scheme is the lie that "I have this brilliant way to make money," when in fact it doesn't exist.

ERIC ROITER: And does the Ponzi scheme artist always start off to be a scam artist or do some fall into it after trying initially to establish a legitimate investment program?

DONALD LANGEVOORT: I would say overwhelmingly the latter. Even for Charles Ponzi, there is some evidence that at the beginning he thought this stamp scheme would work. But if you make promises to people you honestly believe you can fulfill and then you go out and it doesn't work, those people are still looking for their money. If you have another round of investors coming in tomorrow, it's awfully tempting, rather than admit that you failed, to take some of that and pay them off.

ERIC ROITER: Sort of like the embezzler who works at a bank thinking I am just going to borrow this money overnight and I will find a way to replace it with other money in the morning.

DONALD LANGEVOORT: Absolutely. That explains part of the psychology of who gets into this world. There are sociopaths, of course. There are people who are just plain crooks. But overwhelmingly what we know about white collar criminals -- and I think it applies to a fair number of Ponzi schemers -- is they start out with thinking of themselves as normal, decent individuals and find themselves knee deep in mud, as they used to say, and can't acknowledge themselves to others they made a mistake. So they keep getting in deeper and deeper.

ERIC ROITER: Well, that leads me to ask Tamar, is everyone vulnerable to a Ponzi scheme? Does it matter how intelligent one is, how well versed in finance or investment one is? Are we all vulnerable at some point to the Ponzi scheme artist?

TAMAR FRANKEL: There are two parts to this answer or to an answer to this question. One is that many, as Don has said, many of these schemers are very similar to legitimate business. After all entrepreneurs are very excited about their mission, their vision. Ponzi schemers have interesting stories. Besides, we don't always tell the entire truth. For example, we laugh at jokes that are not funny because we want to please. So you find that much of the behavior of Ponzi schemers is shared by everyone. And so the real cruncher is at the moment when they recognize that they have failed. Many people say "I failed, I winded the business up, I will try again." Others, the schemes may say "I failed but let me try a little more and see maybe it works." And by the time they realize that it really doesn't, it's too late.

ERIC ROITER: Maybe there's really no bright line that separates somebody who falls victim to a Ponzi scheme artist and the rest of us who are tempted to take a flier on something that seems rather exotic, even if we know that the operation has some unsavory aspects to it. We have people lining up around the block, for example, to buy mega-million lottery tickets knowing that their chances of winning are infinitesimally small.

TAMAR FRANKEL: There was at least one study, but there may be more, that suggests the characteristics of the victims. It includes gullibility, they are ready believers, but in addition they have strong belief in their own intelligence and knowledge and they are risk takers. There is an excitement in taking a risk and finding out: "Will I succeed? Maybe not this time, then another time." So the victims that have these tendencies can fall for such schemes. In addition, there are some victims who may even suspect that something is wrong, but they might believe that they can take as much as they can, and get their money out in time.

ERIC ROITER: One would surmise that any one of us could fall victim *the first time* to a Ponzi scheme artist. But once a victim is burned, have you found that some, knowing that they have lost out on a Ponzi scheme, nonetheless return to the next Ponzi scheme?

TAMAR FRANKEL: I think so. My research is based either on cases or on research that was done by others. And it seems that some of the victims are addicted to the game. They try it again because they have a very low value for loss and a very high value, a real excitement about the chance of gain. And when they gain that's what they remember, they don't remember as much the losses and so that brings them to con artists again.

ERIC ROITER: It seems though that we have these innate human tendencies that don't fully insulate us from the risk of a Ponzi scheme. I wonder whether a Ponzi scheme artist himself or herself, although I am not aware of any female Ponzi scheme artists. Would they ever fall for a Ponzi scheme?

DONALD LANGEVOORT: Certainly there is a mystique to "scamming a scammer." So in mythology, at least, the Holy Grail for any con artist is to find another con and take advantage of him. I don't know that if we have enough data to know for sure. But what Tamar was saying is very important and I want to put one spin on it. A good con artist reads his or her marks and tries to figure out how to be one step ahead. For example what Bernard Madoff did to dig himself so deeply is the opposite of what Tamar was talking about. This wasn't thrill. This wasn't the outsized returns. In fact he was selling the scam on "We want safe and steady. Those risk takers, let them fall off the cliff. You are not like that, are you?" Playing on ego, playing on somebody's sense that I am in control, I know what I am doing. "I can fend for myself" is one of the con artist's favorite things to hear. Because the person with that inflated sense that they can protect themselves is setting themselves up to be taken advantage of.

ERIC ROITER: Complexity seems to be intrinsic to a Ponzi scheme; there is something that is irreducibly unknowable. Does this perhaps explain in part the Madoff Ponzi scheme? Apparently nobody really understood how you can have this perpetual motion machine that always produced consistent results, especially when the victims were given an elaborately complex explanation involving the use of options. Was that the key to his success?

DONALD LANGEVOORT: Well, you have to have a good story and with respect to something that is transparent and simple, it's hard to concoct a good story to cover it up. So absolutely -- you want something that nobody could easily see through, figure out, ask questions about, and has to have a high level of complexity. And then you want to be able to tell a story that allows somebody's mind to be motivated to buy into this.

FRANCIS MORRISSEY: I think that's a defining feature of the pitch. We have a secret recipe, we have a special insight, we can't tell you otherwise, you will publicly lose the advantage. So it's held in mystery and it's not explained and it's really one of the defining features of how they recruit investors. I want to return to the victim's comments. There is another dimension of the victims that I think is very important to discuss and it came up in the Madoff scheme as well as every scheme I am aware of. That's the concept of affinity groups. There is a commonality among the victims and I would be interested to hear what Tamar and Don had to say about the affinity groups and how these Ponzi perpetrators exploit certain segments, certain special groups of people that they have relations with.

DONALD LANGEVOORT: Sure. Working through churches, working through charitable organizations, all contribute to Tamar's story. First of all, if you are a part of the same church, you have all of a sudden answered some of the credibility issues, you have allayed some of the promoter concerns. Would this person actually take advantage of people? You also set in motion what psychologists call social proof which is, if I see

Frank making an investment and I see Frank two weeks later with a smile on his face. I assume certain things from that well beyond anything I really should. One of my favorite quotes from Charles Kindleberger, the famous author, says "Nothing is more disturbing of a man's judgment than watching a neighbor get rich." And when that neighbor is part of your church, part of your community, you can see all these things coming together to tell a story about why this is legitimate. Again, if somebody is motivated to want to believe, they don't need a story that would persuade a hard-nosed prosecutor. They need a story that will pass the brain test and at this point the brain is not being terribly demanding.

TAMAR FRANKEL: And there is one more thing: most or many of the con artists offer the victims a feeling of being special. Madoff did that by having many groups but each group was small and exclusive. Sometimes the con artists offer a story that is something that cannot be disclosed, maybe a little bit illegal but not dangerously illegal, and that draws people together. I trust you. Of course, you will trust me.

DONALD LANGEVOORT: The assumption is also "He would never do it to me." He might be a little crooked but he would never do it to me because I am in the affinity group and I am special. He has taken me into the circle of trust.

ERIC ROITER: I think it's fair to predict or assume that each of us -- as well as those listening -- at one time or another have gotten a letter from somebody in Nigeria. Why do those keep coming? Maybe technically these aren't Ponzi schemes. But why would somebody reach out to me from Nigeria saying that he or she is a former government minister and has access to some huge amount of funds, and part of those funds are available to me if I would just send a little transaction fee or some payment in order to unlock that vault. Are there Ponzi schemes that succeed notwithstanding the lack of affinity or even lack of knowledge of who the promoter of the scheme is?

DONALD LANGEVOORT: It's very complex. We know a lot about Internet scams, games like that, and so we could go over a long list. My favorite, which the SEC helped uncover a couple of years ago, was that somebody did essentially robo-calls late at night when peoples' answering machines would go on and would leave a message apparently meant for somebody else with a stock tip. All somebody has to think is "I just got really lucky, somebody left something by mistake on my answering machine." What we know about neuro-psychology is the active prefrontal cortex part of your brain, the so-called smart part, should be saying to itself, "There are a bunch of questions we ought to ask about this." But deep inside the brain instead is "I want that." And those more animal portions of the brain can essentially force the front to rationalize -- to give explanations for why we are going to do what we want to do. There can be any number of antecedents, but you get that message and something going on in your life says "This was meant for me." So you think this really is true. We know from studies of scams that an unusually large number of people who are taken advantage of have recently have had a negative event: a divorce, an illness, a death in the family. If anything is going on that suggests at the moment you open that email, the letter, that "life owes me," then there is a story about why this time it's different. You are vulnerable and with billions of people in the world you can go through cycles of those scams that work, that make money.

ERIC ROITER: Both the promoters and the victims are adept at rationalizing their actions. There are others involved, Frank, besides the victims and the Ponzi scheme artists themselves.

FRANCIS MORRISSEY: In my view Ponzi perpetrators never act alone. There are accumulators, there are feeder funds, there are brokers, the all snaring victims to the scheme.

ERIC ROITER: Can you explain what a feeder fund is?

FRANCIS MORRISSEY: A feeder fund is a vehicle where potential victims can accumulate their investments and then a feeder fund would place it with the Ponzi operator. Not always, but often, some of the funds and the brokers are complicit in the fraud, often but not always they are willfully blind. And there is a reason for that. They get a commission. They have a financial incentive not to be attuned to the risk and the potential for fraud involved with the scheme because they are competitive. They get a fee for snaring investors to the scheme.

ERIC ROITER: On a sliding scale of culpability or intent, are these intermediaries gathering up assets and sending them on to the Ponzi Scheme artists aware of their wrongful conduct?

FRANCIS MORRISSEY: It's a case by case analysis but let me give you a scenario that's all too familiar. Someone would be pitching a feeder fund and have a deck of PowerPoint slides to tell them about their proprietary model, their special insights into the market, all the due diligence they are doing and explanation of why they are getting a bump back on returns. And with in fact they are just handing over the money to Mr. Madoff without any due diligence, without even the smallest due diligence with respect to who is his custodian of the securities he claims to have, who his auditor is. And in exchange for this turnover of the money they big fees, they get 2% of the money invested and 20% of the phony profits that are showing up on the statements generated by the scheme. So I think those people have a lot of culpability in these situations and the Ponzi perpetrator couldn't operate without them. The fine feature of a Ponzi scheme is returns to investors, whether styled principle or profit, are coming from later investors who are similarly defrauded.

ERIC ROITER: I think that we have also identified another element that is important to the Ponzi scheme on top of complexity and affinity groups. That is the patina of respectability and even government oversight and regulation. You point out that these collectors of money fed to the con artists have a regulatory status as broker-dealers or advisers. Is that true in most cases?

FRANCIS MORRISSEY: Not in all cases but in many cases. If you went into investment advisory offices you would see signs, 'Insured by SIPC', 'Member of SIPC', and there is sort of a governmental review of what he is doing. The government knows this person, he is regulated, he is being reviewed, he is being audited. And that wasn't the case.

ERIC ROITER: This is a description of what's been happening unfortunately in the United States. Are Ponzi schemes unique to the United States?

TAMAR FRANKEL: Not at all. These schemes have been highly successful in Australia, in Russia, in England, in India, and resulted in investors' riots in Albania. In Romania about a hundred such schemes have operated and the largest was Caritas. Estimates of the number of Caritas investors vary from 2 to 8 million people, and the amount of the money involved was in the billions. Some say up to a third of the country' liquid reserves were invested. Costa Rica had two brothers who had this scheme. Haiti had a scheme that some say covered about 60% of the country's GDP. So the answer is, it is not an American invention and especially not unique to America; it's all over.

ERIC ROITER: I guess that's a testament to the ingenuity and the gullibility of the human race.

FRANCIS MORRISSEY: I always thought we did it better than everyone else in the United States.

ERIC ROITER: Is there a copycat phenomenon? Does a Ponzi scheme trigger copycat Ponzi schemes or are they indigenous to the countries in which they are sold?

FRANCIS MORRISSEY: They are indigenous and very diverse. They will pick up on something of particular importance to that country at that moment. In Albania, as it was moving from a very backwards communist nation to try to enter the world's global economy, there was privatization. What you do you have got a game to play is find out what it was about privatization that put money in people's pockets. What kind of scam would people be unfamiliar with? It's not what Bernard Madoff would do would spread, that in many ways was unique to the wealthy portion of the world. It was a wealthy people's game. What's in Albania is by no means a wealthy people's game.

ERIC ROITER: What was singular about the Madoff scam was that it was a trans-national fraud.

FRANCIS MORRISSEY: It wasn't just located in the United States; he stole money from people in Europe and the Middle East as well.

TAMAR FRANKEL: However, he used the local population. He used the feeders of the particular country, who knew the local population. I don't think he went directly to that population; that he did only in the United States.

ERIC ROITER: If somebody sticks a gun in your ribs and demands money from your wallet, there is no doubt in your mind that you are being robbed. There is no benign explanation for why that gun is stuck in your ribs. I would suggest, however, that elements we talked about that characterize Ponzi schemes are not exclusive to Ponzi schemes. They also could describe non-Ponzi schemes. The exotic nature of the investment, the complexity of an investment, the affinity group. How do we know that, with the compilation of red flags, that we are actually staring at a Ponzi scheme?

FRANCIS MORRISSEY: We don't and obviously the victims are lulled into a sense otherwise. What are the things to keep in mind about Ponzi schemes? It goes back to what we were talking about before. They don't always start out as Ponzi schemes. It's the point at which there is an abject lie about what it is that at least historically in our culture we say as the equivalent of putting a gun to the chest, it overrides the free will. Because we are in a nation and we have thrived because of it that supports trust. The law of fraud in the United States says “If somebody makes a representation to you that needs tests of materiality and triggers right to rely, you are allowed to depend on that and you can be victimized.” All of us.

TAMAR FRANKEL: I still think that there are some unique situations, Number one, an enormous amount of return.

ERIC ROITER: As opposed to investing in Apple 20 years ago?

TAMAR FRANKEL: The other case, and that differs from Apple, there is promise of no risk, it’s a sure thing. The combination is unreasonable and people who listen to both and understand what risk means and what return means should know. And the third one is, there’s no proof. Apple is a good example because it is unique. So people who understood that and still invested, they are not victims. But the people who don’t understand that, are.

ERIC ROITER: When you are saying ‘no risk’ element, is that crucial? For example in the Madoff scheme did he try to actually instill in his victims or his intermediaries the notion “Well, nothing is guaranteed here, I am going to try to do my best. I am not going to try during times of exorbitant bull market conditions to replicate those returns. You should know there is a little bit of risk. Just judge me by my returns. I will try to give you that 8 or 10% return each year.”

TAMAR FRANKEL: However, he was very unique. As a matter of fact this is one of the features that makes him unique. He attracted people who wanted retirement investment.

ERIC ROITER: They were greedy but not too greedy.

TAMAR FRANKEL: It wasn’t even a question of greed. For them low risk meant a great deal, more than for others. They saved for retirement. And what Madoff’s investments offered is that regardless of the market, investments were level. even though he said he was investing in the market.,The returns remained not as high, they weren’t 10% a month, but they were always the same

FRANCIS MORRISSEY: He wasn’t above mark. The returns he was selling, he was selling zero volatility. Part of the story was he had a very sophisticated edging strategy so that he had maintained a continuous return to people.

ERIC ROITER: So in a sense his elimination of risk was the elimination of fluctuating returns?

FRANCIS MORRISSEY: Correct, which is not consistent with our experience in real investments, even Apple had some down quarters.

ERIC ROITER: Let’s go now to after the blow up of the Ponzi scheme. That’s where a lot of law is being made and that’s where a lot of the very difficult issues about how to treat victims must be addressed. Frank, can tell us how successfully the courts and the SEC are doing in treating victims as fairly as possible?

FRANCIS MORRISSEY: That’s a few questions, Eric but let me start with the following comment. Ponzi schemes at the outset are by definition insolvent. There is no genuine business activity going on and there is no real investment happening. Distributions to participants in the fraud are coming from other investors, so as a result they are necessarily insolvent and it's just a matter of time before they end where they always end up, which is in insolvency liquidation. Usually that liquidation takes place under the aegis of the Bankruptcy Code but there are other forms as well. For the law professors on the panel, I recommend to you *Cunningham v. Brown*, the Supreme Court case that arose out of the Charles Ponzi fraud. It's written by Chief Justice Taft and it's a very lucid explanation of how they work and the pros and the rhetoric in the cases is terrific. Your law students will appreciate this; it is all of about three pages.

So the first point is these cases always end up in bankruptcy or in some other insolvency proceedings. And that introduces a new player to the Ponzi theater which is the state fiduciary, the SIPC trustee in the Madoff case – Irving Picard - or the bank's trustee in another situation or the receiver in this record. People who invested in these schemes should appreciate that every dollar they received back from a Ponzi operator is potentially disgorgeable in any insolvency proceedings.

ERIC ROITER: So spend it right away?

FRANCIS MORRISSEY: Well, no, you may have to return it. If you spend it you may not have it available to give it back. Let me tell you how a simple bankruptcy lawyer would look at money distributed to an investor in a Ponzi scheme. It's a very simple analysis: money in, money out. And insolvency lawyers to our distinction between fictitious profits and return of principal. Let me explain that a little bit more because this is going to be relevant when we talk about clawback litigation, which is on the front page of the Wall Street Journal and The New York Times lately. In any Ponzi schemes there are net winners and there are net losers. Net winners are people who got back more than their principal investment in the scheme. And insolvency lawyers look at that as two payments. One payment is fictitious profits. There was no investment going on, there were no business activities going on and anything above the principal received is phony profits.

The second type of distribution is the return of principal. That's the principal that the victim invested in the scheme. And that loser is someone who received back less than the principal he invested. The intuition that insolvency law is premised on is the difference between a net winner and a net loser. A net winner typically invests first and gets the return up first and the principal back first; net losers typically invest later. There is no material difference between the two types of investors as long as they are not culpable, as long as they don't have actual knowledge of the fraud. There is no difference between a net winner and a net loser other than in timing. What bankruptcy law does is try to implement an equality norm. By way of example, fictitious profits are universally subject to disgorgement. The money you received as a profit or return on your investment in the Ponzi scheme came from another defrauded investor. Distributed justice says that you should return that money to the estate so that it can be distributed out to a similarly situated defrauded investor. That's not a return on a real investment. The equality in principal further says that investors who get their principal back should all get the same prorata distribution on their principal. You shouldn't get more principal back than Tamar or Don, it should be a prorata distribution on the principal invested.

Fictitious profits are uniformly disgorgeable. Principal is also as a prima facie matter disgorgeable but the investor has a defense. If the investor took for value and in good faith they may not be required to return the principal. And the way that works is as follows. An insolvency lawyer would look at the return of principal to a victim as an exchange on account of reasonably equivalent value because, for every dollar you get back from a Ponzi scheme, the victim is having their claim for rescission and restitution satisfied. So that's deemed to be an exchange on account of antecedent debt and reasonably equivalent value. You as a victim would get to keep the principal provided you acted in good faith. The good faith analysis in insolvency tracks what Don and Tamar have been talking about, it's a red flag analysis. Were you on enquiry notice that there was a fraud taking place and it's a fact and circumstances test. And some of the features that one would look at in determining whether or not a fraud was going on was are there above market returns, were they zero volatility? What did the actual account statements look like? Madoff's pitch was he had this very complicated computer-assisted hedging strategy. But the accounts statements that the investors received looked like something from high school computer class in the '70s, perforated paper, green and white rows. It almost speaks for itself when you get a document like that. Investors couldn't check even feeder funds. Even those big feeder funds in Greenwich, Connecticut and so forth couldn't check their account balances online. Lack of an auditor, lack of a custodian. These are the types of red flags that potentially put an investor on notice and puts their principal at risk.

ERIC ROITER: That's a lot in a short time and we are not going to try to teach a short bankruptcy course here. I want to pick up on what you said at the outset that one of the general objectives here is to treat the victims equally. Equal justice under law is certainly an aspiration. There must be complications however that lead to some differences between how victims are actually treated and the aspiration of equal justice and equal treatment. One thing is the relevant statute of limitations. Does there come a point when a victim can say "I got my money back so long ago that it would be unjust for you to force me to give money back that has been spent. I don't have anything approaching the amount of money that you claim I must return. It was ten years ago." The law also values finality. That's why we have statutes of limitations. How does this play out?

FRANCIS MORRISSEY: There are a number of look-back periods. The look-back period for preference to a non-insider is just 90 days. A look-back period for a preference with respect to an insider is just a year. A look-back period for the federal fraudulent transfer statute is just two years. A look-back period under state law varies under a uniform fraudulent transfer act, its four years and under the uniform fraudulent advance act, its up to six years.

With the Madoff scheme, he stopped investing by his own admission in the '80s. That fraud went back decades. So if you can't get back to when he originally stopped investing and became a Ponzi scheme, some people are going to get more from the scheme than others. And if you implement that in the equality one you have to have push back period that captured everybody that participated in the Ponzi scheme from the very outset. One of the singular things about the Madoff scam is that it went on for decades and he got away with it for a long time and the reach back periods don't go back that far. And the other practical dimension to it is bank records. I don't think Mr. Picard had succeeded in reconstructing distributions to the early investors in the Madoff Fund.

ERIC ROITER: And they are not voluntarily coming forward, tell him how much they did get out? But what you are saying I think, Frank, is that if you got out early enough outside the statute of limitations, you get to keep not only all the principal you got back but fictitious profits as well?

FRANCIS MORRISSEY: If the SIPC trustee doesn't know about the transfer and you have a positive statute of limitations case defense, you get to keep it.

ERIC ROITER: You are home free.

FRANCIS MORRISSEY: The problem is that the insolvency laws apply to both Ponzi Schemes where there is not an underlying business but on account of the design, the other situation, the more common situation, the honest but unfortunate debtor who has a failed business enterprise and so there is this common law that's targeted towards Ponzi schemes. But the statutes aren't ratcheted to deal with this specific problem.

ERIC ROITER: Let's talk about SIPA for a moment, the Securities Investment Protection Act. Explain to us what SIPA does and how it applies to the victims of Ponzi Schemes?

FRANCIS MORRISSEY: A SIPA liquidation is essentially a variety of a bank's liquidation. SIPA, the Securities Investment Protection Act is an amendment to the 1934 Exchange Act; it requires registered broker-dealers to be part of the SIPA system. And if a registered broker-dealer like Bernard Madoff Investment Securities becomes insolvent SIPA through its regulated SIPC, Securities Investment Protection Corporation, can sue in district court and the case is then administered in large part under the Bankruptcy Code and bankruptcy rules and using bankruptcy processes and the judge is the bankruptcy judge in the first instance, it's removed from the district court and is transferred to a bankruptcy judge is administered in the course of bankruptcy norms.

ERIC ROITER: Let's now turn to what we can do going forward, first through the legal system. What changes can we make to our laws, to our rules to how bankruptcy estates are administered to deal with Ponzi schemes? Are there things that we can do in changing law that could, if not eliminate, at least reduce the frequency or the magnitude of Ponzi schemes?

DONALD LANGEVOORT: There are certain things we can try. We have already alluded to some of them. To the extent that the enablers of a Ponzi scheme are accountants, investment advisers, broker-dealer firms, all of whom face some degree of federal and state regulation, maybe by stepping up the quality of that regulation -- with respect to custodial funds, with respect to clearance and settlement, etc. You just make it less easy for Ponzi schemers to find willing enablers. The problem is we already do that to a large extent, but we have more than 11,000 investment advisers in this country. We have broker-dealers supervising 108 million customer accounts. The ability to have our system shed light on all those spaces is beyond the resources and the capacity of the system. We do not have a totalitarian investment regulation regime and therefore other than some common sense reforms it's hard to think much else you could do.

ERIC ROITER: I think a lot of people might have been surprised when they learned that Madoff didn't have to turn over funds to an independent custodian. Because he had a broker-dealer firm, the rules that govern custody of client funds allowed him to self custody. And why should that not be something that we can change?

TAMAR FRANKEL: I have heard, and I am not sure where we are now, but there is a lot of objection to precisely this kind of solution because more brokers say it is too costly.

ERIC ROITER: Nobody has an inalienable right to be a broker-dealer or an adviser and it seems almost a first principle that if you want to be entrusted with other people's money and you are given discretion over that money you ought to at least be prepared to have some unaffiliated institution have custody.

DONALD LANGEVOORT: I don't disagree with that, but the opposite argument is, yes, we could shut down the system, lock it down so that we have squeaky clean auditors and custodians all the time. But that's costly and that cost is spread throughout the investment industry, throughout honest players in the industry. Ultimately the costs are spread to all of us. One of the other big elephants in this room is an awful lot of people think if you are a victim of a Ponzi scheme, you deserved it and we ought not be reordering American society to prevent it from happening to people who have only themselves to blame.

FRANCIS MORRISSEY: I have a comment on that. I agree to the extent that some of the Ponzi victims aren't the most sympathetic in the world. But there are some people that just have very compelling stories that would injure them in such a subtle way it's more violent than a bank robbery. We had a workshop for victims in a Ponzi scheme that we were administering as the counsel for receiver. I would have elderly and middle-aged people come in and they said they didn't tell their families, they were too embarrassed to tell them that they lost all their money. Those people are compelling people and one of the things Irving Picard is doing is a program to help ameliorate some of the problems that these people are incurring.

ERIC ROITER: Discretion is part of the solution for us. Tamar, you take a skeptical view of what we can do through law. Are there things outside of new rules and new statutes that we should think about?

TAMAR FRANKEL: I think we should think about changing a some of our culture. Americans seldom choose the middle road. They do not like limits on freedom, caution and risk taking; and they hitch their wagons to a star. But America is wealthy and maybe it can afford this kind of fraud. The question is whether it wishes to spend its resources in this fashion. Each person can determine that. A person may ask: Where is my weakness where is my self-control? Let me wait at least 24 hours before I invest. That may seem to me to be a better answer.

ERIC ROITER: Again being aspirational, how can we help people?

TAMAR FRANKEL: Leadership.

ERIC ROITER: From government or from where?

TAMAR FRANKEL: We have private leaders, we have government leaders. We have a variety of leaders and they should come up and say, "Hey, this is too much. We have gone too far. Hold off."

ERIC ROITER: What do we think about the quality of the disclosure requirements? I suppose, Don, that a lot of the scam artists here would disclose whatever you want them to disclose, even if, of course, it is a lie.

DONALD LANGEVOORT: With respect to disclosure, we are talking about things that have very little effect. It goes back to what everyone here has been saying. This is fraud. It is criminal fraud. It is not like the law is tolerating this, looking the other way from this. These are transactions exploited by very clever people. I don't disagree with certain reforms in the custodial area, certainly in the audit area. But in the end maybe the right thing to do is the message Tamar was talking about coupled with a willingness to clean up the mess when it happens because these messes are always going to happen.

ERIC ROITER: Frank, any last thoughts on what changes if any to the law we might make here even if it is after the Ponzi scheme explodes?

FRANCIS MORRISSEY: I think Don and Tamara said it aptly. I suppose the way to deal with it would be to outlaw greed. I don't think that's a legislative solution. I think that's a community solution and a leadership solution as Professor Frankel so articulately pointed out and emphasized.

ERIC ROITER: I want to thank each of our eminent participants, thanks for your insights and to today's audience as well as museum visitors who access the program in the future will benefit from your wisdom.

Today's program is now permanently preserved in audio format in the virtual museum and archive at www.sechistorical.org and a transcript will be added later on. Thank you all.