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SEC Settlements in Ponzi Scheme Cases: Putting Madoff and Stanford in Context

By Jan Larsen and Paul Hinton*



The alleged multi-billion dollar Ponzi schemes perpetrated by Bernard Madoff and Sir Allen Stanford have generated widespread media coverage. The scales of the alleged schemes in the Madoff and Stanford cases, estimated to be as large as \$50 billion and \$8 billion respectively, are indeed greater than in Ponzi scheme cases settled with the SEC over the last six-and-a-half years.¹

The SEC has reached settlements with over 300 defendants in cases related to alleged Ponzi schemes during this period, including settlements in 12 cases relating to Ponzi schemes with alleged fraud of \$50 million or more. We provide an overview of these 12 cases and the associated SEC settlements reached to date.

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¹ NERA's proprietary database contains data on SEC settlements achieved since the Sarbanes-Oxley Act (SOX). The database starts as of 31 July 2002, the day after SOX went into effect. For more information, see Jan Larsen with Dr. Elaine Buckberg and Dr. Baruch Lev, "SEC Settlements: A New Era Post-SOX," 10 November 2008, http://www.securitieslitigationtrends.com/Settlements_Report.pdf.

SEC Enforcement Activity

A Ponzi scheme is a securities fraud in which the promoter makes a false or misleading statement about his investment strategy and money from new investors is used to fund redemptions, resulting in shortfalls in funds available for the remaining investors.² A number of legal remedies exist in Ponzi scheme cases. Entities suspected of operating Ponzi schemes may be subject to criminal prosecution and regulatory enforcement actions by the SEC and Commodity Futures Trading Commission (CFTC).³ Victims of Ponzi schemes can also bring private litigation and may be able to recover some losses through the Securities Investor Protection Corporation (SIPC). In this paper, we present data on SEC settlements in Ponzi scheme enforcement actions, drawing on our proprietary database of SEC settlements.

In the last six-and-a-half years, the SEC has settled with more than 300 defendants alleged to have operated or otherwise been involved in Ponzi schemes.⁴ However, the amounts involved in these cases are generally tiny in comparison to those in the Stanford and Madoff cases. Sixty-two of the settlements have related to 12 cases where the alleged Ponzi scheme raised at least \$50 million. These cases are summarized in Figure 1. While it is clear from the figure that the SEC settlement amounts in these cases are generally small, it is important to note that many of the cases are young and that recoveries obtained through criminal actions or private litigation are not included.

Figure 1. **SEC Settlements in Alleged Ponzi Schemes Involving at Least \$50 Million in Investor Funds**
Since 31 July 2002

| Investment Agent | Complaint Year (1) | Alleged Fraud Size (\$ mil) (2) | SEC Settlements To Date (\$ mil) (3) | # of Defendants Settled With By the SEC (4) | Alleged Fraud Duration (Years) (5) |
|------------------------------------|-----------------------|------------------------------------|---|--|---------------------------------------|
| Mutual Benefits Corp. | 2004 | \$1,067 | \$110 | 16 | 10 |
| Michael E. Kelly et al. | 2007 | \$428 | \$0 | 11 | 6 |
| VesCor Capital Corp. | 2008 | \$180 | \$0 | 1 | 16 |
| Michael J. McNaul et al. | 2008 | \$156 | \$0 | 11 | 4 |
| Private Capital Management, Inc. | 2004 | \$145 | \$112 | 4 | 8 |
| ETS Payphones, Inc. | 2002 | \$96 | \$0 | 3 | 3 |
| Gregory N. McKnight et al. | 2008 | \$72 | \$0 | 2 | 2 |
| Mobile Billboards of America, Inc. | 2004 | \$61 | \$2 | 4 | 4 |
| IPOF Fund | 2007 | \$50 | \$0 | 1 | 6 |
| Real Estate Partners, Inc. | 2007 | \$50 | \$0 | 5 | 4 |
| Tri Energy et al. | 2005 | \$50 | \$0 | 6 | 3 |
| Randall T. Treadwell et al. | 2004 | \$50 | \$0 | 4 | 1 |

Note: Excludes cases with complaints filed pre-SOX.

² See, e.g., Donley III, M. Owens, "A (Very Brief) Encyclopedia of Securities Fraud," *Business Law Today*, March/April (2007): 38. Shortfalls can result from misappropriation of fund assets, from honoring early redemptions based on fictitious returns, or both. Ponzi schemes collapse when the promoter is unable to attract sufficient subscriptions to honor redemptions.

³ To the extent that Ponzi scheme promoters represent that they are engaged in broker-dealer activities, they may also be subject to disciplinary action by FINRA.

⁴ Settling defendants include alleged Ponzi scheme promoters as well as relief defendants who are alleged to have profited from Ponzi schemes, but are not accused of violating securities laws.

Mutual Benefits Corp., the largest alleged fraud in Figure 1, guaranteed rates of return ranging from 12% to 72% through *viatical settlements*, which are investments that consist of the purchase of benefits attached to existing life insurance policies. Mutual Benefits Corp. allegedly represented this as a low-risk investment opportunity.

The Michael E. Kelly, et al. matter involved the sale of “Universal Leases,” which were securities that represented interests in timeshares in Mexican hotels. Investors in this program—largely elderly investors—were allegedly falsely promised annual returns of nine to 11 percent. According to the SEC’s complaint, Mr. Kelly and his partners relocated to Mexico and used a number of Mexican and Panamanian corporations to operate his Universal Lease business, “making it difficult for US regulators to track all of the uses of investor funds and all of the sources of investor payments.”⁵

VesCor Capital Corp. is also alleged to have conducted a Ponzi scheme targeting senior citizens. VesCor allegedly sold promissory notes with interest rates ranging from eight to 24 percent per year. The money raised from the sale of these promissory notes was supposed to be used for real estate investments. In order to sustain the operation over a longer period, the SEC alleges that VesCor encouraged investors to roll over their investments when their notes expired in exchange for higher interest rates.

VesCor is alleged to have been the longest-lived Ponzi scheme in Figure 1, running from 1992 to 2008. It can be seen in the figure that the largest alleged Ponzi schemes also tend to be the longest lived, reflecting the simple fact that it takes time to raise money from new investors. The average duration of alleged schemes that raised over \$100 million is nine years, compared to three years for those that raised between \$50 million and \$100 million.

The Madoff case, which has been estimated to involve up to \$50 billion in investor funds, and the Stanford case, estimated to involve approximately \$8 billion in investor funds, are not included in Figure 1, because no defendants have settled in those cases. There have also been a number of smaller alleged Ponzi schemes recently in which settlements have yet to be reached. For example, on 21 January 2009 the SEC charged Arthur Nadel with an alleged \$300 million fraud in connection with hedge funds that he operated.⁶ The alleged fraud is now thought to be a possible Ponzi scheme.⁷



⁵ Complaint at 3, *SEC v. Kelly*, 545 F. Supp. 2d 808 (N.D. Ill. 2008) (No. 07 C 4979), see: <http://www.sec.gov/litigation/complaints/2007/comp20267.pdf>.

⁶ “Securities and Exchange Commission v. Arthur Nadel, et al.,” SEC Litigation Release, 21 January 2009, see: <http://www.sec.gov/litigation/litreleases/2009/lr20858.htm>.

⁷ John Hielscher, “Nadel Hedge Fund Case ‘Looks Like a Ponzi Scheme,’” *Herald Tribune*, 27 January 2009. In addition, there have been recent SEC cases where it is alleged that investment managers misappropriated fund assets, but where there are not allegations that the funds operated as Ponzi schemes. For example, in *SEC v. WG Trading Investors, L.P., et al.*, it is alleged that over \$500 million was misappropriated from clients’ investment accounts. However, the SEC’s complaint does not allege that returns to investors were paid out of the principal received from other investors. Based on the SEC’s allegations, the *WG Trading Investors* case therefore does not fit the description of a Ponzi scheme, although it has been characterized as such in the press.

Bernard Madoff, however, recently consented to the submission of a proposed partial judgment, which would permanently enjoin Mr. Madoff from violating certain securities laws, freeze certain of his assets, and, for the purpose of establishing disgorgement and civil penalty amounts, would deem the facts alleged in the SEC's complaint to be true.⁸ Furthermore, Mr. Madoff has pled guilty to all charges in the parallel criminal investigation.⁹

SEC Settlements Compared to the Size of the Alleged Fraud

Figure 1 shows that, among the largest Ponzi scheme cases since 31 July 2002, most have little or no monetary SEC settlements to date. Low settlement values can indicate that a case is in its early stages, with the potential for future monetary settlements. While monetary settlements for the cases in Figure 1 have come as long as four years after the filing of the SEC's case, 57 percent of money obtained through SEC settlements to date was agreed to within the first two years following the agency's complaint.¹⁰

Low settlement values may also indicate the inability of the defendants to pay. For example, in the case of McNaul et al., an alleged \$156 million fraud, the SEC stated in reference to two co-defendants that "payment of all but \$20,000 by Tallman, and \$10,000 by Hembree, will be waived, and no civil penalties imposed, based on their respective sworn statements of financial condition and other documents."¹¹

Among the cases in Figure 1, the SEC's largest total settlement to date is in the Private Capital Management, Inc. matter. In this case, the SEC alleges that the defendants enticed senior citizens to investment workshops by offering them free lunches. At these workshops, the defendants allegedly offered the attendees notes paying 5.5 to 8.0 percent returns, on the premise that the funds raised would be used to make secured loans to businesses. The SEC maintains that no such loans existed and that the defendants operated a Ponzi scheme. The monetary settlements achieved to date were with Daniel William Heath, who agreed to pay \$109.3 million in disgorgement and prejudgment interest, and Denis Timothy O'Brien, who agreed to pay \$2.6 million in disgorgement and prejudgment interest. According to the SEC's complaint, Mr. Heath and Mr. O'Brien were the primary organizers of the alleged scheme.

⁸ "Defendant Bernard L. Madoff Consents to Partial Judgment Imposing Permanent Injunction and Continuing Other Relief," SEC Litigation Release, 9 February 2009, see: <http://www.sec.gov/litigation/litreleases/2009/lr20889.htm>.

⁹ Diana B. Henriques and Jack Healy, "Madoff Goes to Jail After Guilty Pleas," *New York Times*, 12 March 2009.

¹⁰ This pertains only to amounts recovered through the SEC's enforcement activities, and excludes any amounts recovered through other channels such as private litigation.

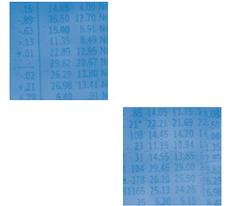
¹¹ "SEC Sues 21 Individuals and Entities For Their Roles in a Massive Oil and Gas Offering Fraud" SEC Litigation Release, 3 June 2008, see: <http://sec.gov/litigation/litreleases/2008/lr20608.htm>.



Other Actions

Of course, SEC enforcement actions are just one mechanism through which investors in a Ponzi scheme can recoup losses. For example, a portion of the money lost by Madoff and Stanford investors may be redeemable through the SIPC. Additionally, Mr. Madoff's guilty pleas in the criminal case against him could lead to monetary restitution to investors.¹² There have also been a number of private lawsuits filed by investors against Mr. Madoff and his firm, as well as against *feeder funds*, which invested their customers' money with Mr. Madoff. Kevin LaCroix of the *D&O Diary* blog currently counts 56 pending lawsuits against Bernard L. Madoff Investment Securities, LLC and feeder funds, 13 of which are separate class actions.¹³ It is likely that the Madoff and Stanford Securities litigations will continue well into the future and may result in recoveries for some investors.

While our focus is on SEC enforcement actions, the CFTC can also bring regulatory actions in connection with suspected Ponzi schemes when such schemes represent that they are investing in the commodity futures or foreign currency markets. In these cases other securities are often involved, resulting in both SEC and CFTC actions. Since the beginning of 2008, the CFTC has filed 20 complaints in which it alleged that investment funds were operating as Ponzi schemes. The typical size of these cases is similar to SEC Ponzi scheme enforcement actions. Only one of these cases, the Joseph Forte matter, involved at least \$50 million of investor funds. This case is also being pursued by the SEC. Mr. Forte allegedly represented to clients that his fund invested in S&P 500 stock index futures (triggering the SEC's involvement) as well as in commodities and foreign currency futures (triggering the CFTC's involvement). To date, neither agency has reached a settlement in this matter.



¹² According to the DOJ, Mr. Madoff faces mandatory restitution to victims. See "Lawyer Says Madoff to Plead Guilty Thursday," Associated Press, 11 March 2009.

¹³ Kevin LaCroix, "The List: Madoff Investor and Feeder Fund Litigation," see: <http://www.dandodiary.com/2008/12/articles/madoff-litigation/the-list-madoff-investor-and-feeder-fund-litigation/index.html>.

Increase in SEC Staffing May Increase Fraud Detection

The SEC's inability to detect the alleged Madoff and Stanford Ponzi schemes, and the resulting media fallout, have led to calls for reform of the agency.¹⁴ Certain members of Congress have criticized the SEC's handling of tips regarding Madoff, which they assert date back a decade.¹⁵ In her first public speech since taking over as SEC Chair, Mary Schapiro named "improving the handling of tips and whistleblower complaints" as one of her priorities.¹⁶ The Senate banking Committee has introduced legislation that will add 100 new SEC enforcement officials as well as officers in other regulatory branches.¹⁷ President Obama has submitted a fiscal year 2010 budget request for the SEC that would represent a 13% increase over the agency's 2008 fiscal year budget.¹⁸

These developments have implications not only for Ponzi scheme cases, but also for cases involving a wide range of alleged investment frauds. In future work, we will examine SEC enforcement actions against hedge funds. Hedge funds are of particular interest because they are largely unregulated.

We will continue to keep our readers abreast of the latest developments in SEC enforcement on our website, www.securitieslitigationtrends.com.

¹⁴ "Sins of the Commission," *The Economist*, 19 December 2008.

¹⁵ Frank Ahrens, "Lawmakers Sink Teeth Into the SEC; Agency Mocked for Not Catching Madoff," *Washington Post*, 5 February 2009. Visit the House Financial Services Committee page for further details, http://www.house.gov/apps/list/hearing/financialsvcs_dem/hr020409.shtml.

¹⁶ Mary Schapiro, Address to Practicing Law Institute's 'SEC Speaks in 2009' Program, 6 February 2009, see: <http://www.sec.gov/news/speech/2009/spch020609mls.htm>.

¹⁷ Edward O'Keefe, "Agencies Await New Leaders and Direction," *The Washington Post*, 6 February 2009, Page A15.

¹⁸ Mary Schapiro, Statement from Commissioner Schapiro on Proposed Budget for SEC," 26 February 2009, see: <http://www.sec.gov/news/press/2009/2009-37.htm>.



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|-------|-------|--------|
| 15.90 | 0.91 | NetNet |
| 11.25 | 0.40 | NetNet |
| 11.25 | 11.55 | NetNet |
| 29.02 | 20.87 | NetNet |
| 28.23 | 13.00 | NetNet |
| 19.98 | 11.91 | NetNet |
| 6.40 | -1.1 | NetNet |
| 16.25 | 19.20 | NetNet |

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