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# THE NEVER ENDING ATTRACTION OF THE PONZI SCHEME

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## **ABSTRACT**

*In the 1920's, Charles Ponzi engaged in a notorious money making scheme. This scheme had been tried before but no one prior to Charles Ponzi had managed to swindle millions of dollars out of unsuspecting people. Thus, the scheme bears his name. In December 2008, Bernard Madoff, a major Ponzi schemer, was exposed. He managed to con investors out of over \$65 billion over a thirty year period. Madoff was a highly respected financial expert. The investors were mostly well educated and supposedly financially savvy. How did this happen? This paper will examine some theories which may help explain both the reasons individuals fall victim to Ponzi schemes as well as how legitimate business professionals can become involved in unlawful Ponzi schemes. The paper will also provide some suggestions on how to avoid falling victim to such illegal ventures.*

## **INTRODUCTION**

Bernard Madoff ran the largest reported Ponzi scheme in history. He operated a \$65 billion Ponzi scheme for over thirty years. How was this possible? Society is much more sophisticated today than it was in the days of Charles Ponzi, the man for whom the scheme is named. How could educated, streetwise investors be taken in by such an old ploy. How could respected professionals become involved in such schemes? There is an old saying that the more things change, the more they stay the same.

This paper will explore the factors that may contribute to the success of Ponzi schemes. It will discuss the multidimensional theory of gullibility proposed by Greenspan, (2009), the principles of influence and persuasion proposed by Cialdini, (2001), and the nature of affinity fraud which is what some schemes such as Madoff's involved. The paper will discuss possible explanations for the Ponzi schemer's behavior. This will include the desire for control, the illusion of control, neutralization theory and cognitive dissonance as possible explanations for the Ponzi schemer's behavior. The paper will also present ways to detect and avoid becoming a victim of such schemes.

## **Factors That Draw Individuals to Ponzi Schemes**

### **Theory of Gullibility**

Greenspan (2009) considers gullibility to be a sub-type of foolishness. He defines a foolish act as, "one where someone goes ahead with a socially or physically risky behavior in spite of danger signs, or unresolved questions which should have been a source of concern for the actor (Greenspan, 2009:22)."

Greenspan (2009) proposes a multidimensional theory of gullibility to explain the success of Ponzi schemes. The four factors Greenspan (2009) believes contributed to the success of the Madoff Ponzi scam and could be responsible for the success of other Ponzi schemes are situation, cognition, personality, and emotion. Each of these factors will be examined.

### **Situation**

In a scam the individual is presented with a challenge to consider. The challenge is whether or not to invest in a risky venture and thus, engage in a foolish act. An individual is more likely to engage in gullible behavior, “if the social and other situational pressures are strong and less likely to occur if the social and other situational pressures are weak (Greenspan, 2009:22).” The Madoff scam, for example, had strong social feedback pressures. Madoff was a prominent philanthropist. Thus, the reputation of the schemer may affect the judgment of the potential victims. This was a factor in the Madoff scheme.

Madoff was rarely involved with the individual investors. He relied on feeder funds to collect money from individual clients and pass it on to him for investment. The hedge fund managers trusted Madoff because of his reputation and the fact that he had been giving steady returns over a long period of time. However, his name was unknown to most of the investors in the feeder funds. Since the individuals were dealing with long established and reputable hedge funds, they didn’t question how the returns were achieved. They relied on the hedge funds and assumed the investments had been carefully studied. The risks they presented were assumed to be acceptable.

### **Cognition**

Gullibility can also include a lack of clear thinking. Individuals can have a high IQ yet still be quite gullible. Impulse and intuition driven by emotion often lead to irrational decisions even among the most intelligent. As Greenspan explains:

In my own case, the decision to invest in the Rye fund reflected both my profound ignorance of finance, and my somewhat lazy unwillingness to remedy that ignorance. To get around my lack of financial knowledge, and my lazy cognitive style, around finance, I had come up with the heuristic of identifying more financially knowledgeable advisors and trusting their judgment and recommendations. This heuristic had worked for me in the past and I had no reason to doubt that it would work for me in this case (Greenspan, 2009:24).

A willingness to take the easy way out and place complete trust in others helps the Ponzi schemer to succeed.

### **Personality**

Julian Rotter (1980) wrote of the importance of trust. Human relationships depend on interpersonal trust. Distrust causes relationships to disintegrate. Rotter states that, “unwarranted distrust can result in serious negative consequences but “foolish trust,” or gullibility, can also

lead to serious consequences (Rotter, 1980:1). An unwillingness to contradict or question a trusted colleague helps the Ponzi schemer. "Greenspan (2009) reminds us that the wise person knows when to trust and when not to. In other words, sometimes the nice guy has to say "no."

## **Emotion**

Emotion is part of every gullible act. The Ponzi scheme investor has an overwhelmingly strong desire to increase his wealth. This desire is so strong that it interferes with logical reasoning and causes the individual to exhibit gullible behavior (Greenspan, 2009).

## **The Principles of Influence**

Robert Cialdini (2001) has written extensively on how influence and persuasion factors can affect behavior. These factors can be used to explain the success of a Ponzi schemer. Cialdini describes principles of influence. These principles explain how even the most intelligent people can be persuaded to engage in less than intelligent ventures. The principles include:

**Reciprocation** – The returning of a favor. This was not a factor in the Madoff scheme but could be used in other Ponzi schemes.

**Commitment and Consistency** – People tend to honor their commitments even after the original motivation to do so is removed.

**Social Proof** – People tend to follow the lead of others they trust.

**Authority** – People tend to obey authority figures even if these figures engage in objectionable acts.

**Liking** – People can be persuaded by individuals they like.

These factors lead to an almost blind obedience to the schemer. A groupthink situation develops where no one wants to be the one to challenge the supposed all knowing leader.

## **Affinity Fraud**

This is yet another possible explanation for the success of some schemers. Affinity crime is defined as those whose victims share some sort of bond. It can be ethnic or religious, or people who travel in the same social circles. This common bond gives the victim a reason to trust the schemer. The common belief is that someone from your background would never cheat you. The same sales pitch presented by an outsider would never be considered. In the case of Madoff, the majority of his investors were from his inner circle, ethnic group.

It is this same bond which makes it difficult for people to ask the hard questions which should be asked before an investment. It is considered inappropriate. It would be like asking a close relative for a receipt. The schemer is well aware of that and uses it to his advantage.

Cass (2008) made an interesting observation about Americans and affinity fraud:

On one level, the number of these affinity frauds is a testament to the strength of communities in America. Alexis de Tocqueville – one Frenchman generally admired by Americans for his good sense and understanding of our nation – observed that we are a nation of different organizations and clubs, of civic groups and church groups, a web of social and ethnic and religious communities ( Cass, 2008:A19).

## Factors That May Create a Ponzi Schemer

### The Need For Control

Piquero et.al., (2005) discussed the desire for control as a possible explanation for unlawful behavior among individuals in white collar professions. The desire for control is defined as the desire to have absolute and total control over everyday events. This is what may lead law abiding individuals in responsible positions to commit crime.

The illusion of control may also be used to explain the commission of a crime by individuals in white collar professions. Individuals who experience the illusion of control have developed a false or exaggerated sense of their ability. They feel infallible. This feeling extends to events governed by chance ( Piquero, et. al., 2005). This belief may encourage them to take unrealistic risks.

### Neutralization Theory

This theory suggests that most individuals, even law violators, believe in the rule of law. They share the values of the dominant culture. Since they share this commitment to the dominant culture, contemplating unlawful behavior can have a negative impact on their self-esteem by generating feelings of guilt or shame. The potential for generating a negative self-concept is what keeps most people from engaging in unlawful behavior. Individuals can only engage in unlawful behavior if they are able to rationalize their behavior as necessary or unavoidable. Thus, the individuals continue to accept the dominant culture yet engage in unlawful behavior because they interpret their actions as acceptable. Sykes and Matza (1957) described five specific techniques of neutralization that allow individuals to neutralize moral blame. They are:

1. **Denial of Responsibility:** The offender is absolved of responsibility for the activity by blaming external forces that led him to his actions. Denying responsibility prevents the offenders from experiencing guilt.
2. **Denial of Injury:** The offender can neutralize blame because there is no immediate victim. For example, the victim had insurance and so suffered no real loss.
3. **Denial of Victim:** The offender can neutralize blame by convincing himself that the victim is an enemy or undesirable.
4. **Condemnation of the Condemners:** The offender can neutralize blame by questioning the authority or legitimacy of those who judge. For example, one might question why the police monitor speed traps rather than fight actual crime.
5. **Appeal to Higher Loyalties:** The demands of loyalty to friends may cause an individual to engage in dangerous behavior.

Individuals learn these techniques of neutralization as they become involved in unlawful behavior. They are able to sustain their participation in unlawful behavior by surrounding themselves with others who share their feelings about the unlawful behavior they are engaged in.

## **Cognitive Dissonance**

Cognitive Dissonance is a psychological theory closely related to Neutralization Theory which may further explain the need to feel good about one's self. This theory suggests that if an individual holds beliefs that are psychologically inconsistent, for example, embezzlement is wrong yet I have engaged in this behavior but I am a good person, the individual would experience dissonance and must find ways to reduce the dissonance. There are two ways to achieve this. The individual can either change his behavior or change his beliefs.

Most people want to believe that they are morally good. They will do what it takes to preserve a positive self-concept. They will neutralize the challenging beliefs through a series of justifications.

## **Protection From Ponzi Schemes: Red Flags For Individuals**

Given the fact that it is possible for even the most respected individual to successfully neutralize unlawful behavior and avoid feelings of guilt or shame, it is up to the consumer to be aware and avoid becoming the victim of a fraudulent scheme. Benson (2009) describes a series of red flags that should serve as an alert. He indicates that:

1. Investors should be suspicious if their investments constantly outperform competitors with similar investment strategies, or offer returns above the legal rate or market rate. Investing is risky. This means that returns should vary based upon the market. Guaranteed rates of return should be investigated.
2. Investors should make it their business to obtain and understand all the information regarding their investments.
3. Investors should not accept vague explanations from advisors.
4. Beware of secrecy. If an investment is legitimate, there should be full disclosure about it.
5. There should be proper segregation of duties. The money manager should not be the broker or have custody of the funds.
6. Investments should not be based on the "irrational excitement" of others. Remember the initial investors in a Ponzi scheme often get great returns but it comes from the money invested by the gullible people wanting in on the action.
7. Individuals should not be star struck because admired individuals have invested in the venture or share a religious or ethnic affinity. Many swindlers get reputable people to invest hoping that others will follow their lead. Often swindlers appear extremely successful. They make large charitable contributions and live extravagant lifestyles.
8. It is important to take note of which firm is auditing the portfolio. Auditors should know the industry and the specialized auditing procedures related to that industry. The auditor of a feeder fund, should make sure that they understand the client's

investment strategy, and the due diligence performed before placing their assets with the broker-dealer. The auditor should make sure that the historical returns claimed by the broker-dealer make sense, that open lines of communication exist, and that the auditor of the broker-dealer is competent.

## CONCLUSION

The Ponzi schemer shares the values of the dominant culture. He wants to see himself as a good and moral person. In order to do this and still engage in unlawful behavior, he must adjust his beliefs. He must rationalize, neutralize, or remove dissonance. Neutralization theory, cognitive dissonance and the need for control provide some explanations for how the schemer can maintain a positive self image despite his illegal actions.

The vulnerability of individuals to Ponzi schemes is due in part to the times we live in. We live in a time of information overload. People are bombarded with enormous amounts of information available over the Internet. It is often easier to accept the available information as fact than to investigate the sources and be certain of the accuracy. If respected individuals believe in the investment, then it must be secure. Ponzi schemers rely on the fact that investors often confuse acquaintance with friend. It is the endless networking that has blurred the lines between acquaintance and true friend and allows the schemers to succeed. The way to prevent becoming a victim of a Ponzi scheme has remained the same for years. Do your own research. Don't assume that the investment broker has done due diligence.

What's remarkable about Ponzi's legacy is that, no matter how many times investors lose money, new schemes keep coming forward. And greedy, naïve people of all sorts line up to throw good money after bad (Walsh, 1999:14).

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