

# Working Paper

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INTERNATIONAL MONETARY FUND



WP/09/95

# IMF Working Paper

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## Ponzi Schemes in the Caribbean

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Catherine Pattillo, and Brian Wynter*

## **IMF Working Paper**

Western Hemisphere and Monetary and Capital Markets Departments

### **Ponzi Schemes in the Caribbean**

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Authorized for distribution by Paul Cashin and David Hoelscher

April 2009

#### **Abstract**

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In several Caribbean states, unregulated investment schemes grew quickly in recent years by claiming unusually high monthly returns and through a system of referrals by existing members. These are features shared with traditional Ponzi schemes and pyramid schemes. This paper describes the growth of such schemes, their subsequent collapse, and the policy response of regulators, and presents key policy lessons. The analysis and recommendations draw on country experiences in the Caribbean, and in such diverse countries as the United States, Colombia, Lesotho, and Albania.

JEL Classification Numbers: G18

Keywords: Pyramid schemes, Ponzi schemes, Caribbean

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## I. INTRODUCTION<sup>1</sup>

In several Caribbean states, unregulated investment schemes (UIS) grew quickly, particularly during 2006–08, by claiming unusually high monthly returns and through a system of referrals by existing members. Such high returns are usually associated with Ponzi schemes, as defined below. Such schemes are pervasive and persistent phenomena and emerge on a regular basis even in developed countries with strong regulatory frameworks, as shown by the recent experience in the United States with an US\$50 billion alleged Ponzi scheme run by Bernard Madoff. However, their impact has been greater in countries with weaker regulatory frameworks. This is illustrated by the well-known case of Albania, and by more recent and ongoing cases in the Caribbean, Colombia, and Lesotho.

This paper details the operation of such schemes in the Caribbean, and places this experience in the context of cases in other regions, where a number of interesting parallels emerge. The paper also describes the recent experience with two high profile allegedly fraudulent schemes involving regulated entities licensed in off-shore jurisdictions in the Caribbean, in order to draw common lessons with regard to the detection and prosecution of fraudulent schemes.<sup>2</sup> In addition, the paper describes the response of Caribbean regulators and presents key policy lessons.

The paper is organized as follows. Section II defines Ponzi schemes, distinguishes them from pyramid schemes, and describes the case for policy intervention against them. Section III describes the recent experience of the Caribbean with UIS, while Section IV presents policy recommendations. Annex I provides background on the experience in the United States, Colombia, Lesotho, and Albania.

The following disclaimer applies. The information in this note is obtained from public sources. The note does not imply any verification of facts by Fund staff or attribution of wrongdoing to any individuals or entities. The term “scheme” as used in this paper encompasses the investment vehicles, the accounts, the operators, the promoters, and other mechanisms and entities involved. The roles and functions of such mechanisms and entities

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<sup>1</sup> This paper incorporates material prepared by a team consisting of Hemant Shah, Philip Bartholomew, Ana Carvajal, Anna-Maria Kokenyne Ivanics, and Virginia Rutledge. It also draws upon presentations at an October 2008 seminar on “Understanding and Combating Unregulated Investment Schemes in the Caribbean”, which was cosponsored by Jamaica’s Financial Services Commission, the IMF’s Monetary and Capital Markets Department, the U.S. Securities and Exchange Commission, the U.S. Commodity Future Trading Commission, the U.S. Agency for International Development, and the Caribbean Regional Technical Assistance Center (CARTAC); see CARTAC (2008). The authors also thank Paul Cashin, Luis Cortavarria, Alfredo Cuevas, Hamid Davoodi, Chris Faircloth, Enrique Flores, Thomas Laryea, Isaac Lustgarten, Guy Meredith, Thordur Olafsson, Wendell Samuel, and Therese Turner-Jones as well as seminar participants at the Caribbean Development Bank and Eastern Caribbean Central Bank for helpful comments on earlier versions of the paper. The paper covers developments to March 31, 2009.

<sup>2</sup> Those cases raise additional issues in relation to the adequacy of the regulation and supervision of licensed institutions in off-shore jurisdictions. However, this paper focuses on unregulated schemes, how they can be used as a conduit for investment fraud and how regulators can address such problems.

in a scheme are not always clear due to the nature of the schemes, the lack of consistency in various public documents, and the fact that the Fund staff has not verified the facts in this note. As a result of such lack of clarity, the reference to particular mechanisms or entities may not be accurate. Also, references to a scheme or any component of a scheme as regulated or unregulated may not be accurate. No statement in this paper is a judgment on the adequacy or inadequacy of any particular regulatory or judicial regime, of the authority or lack of authority of any regulator, court, or prosecutor or the validity of any legal argument.

## **II. BACKGROUND**

Investment fraud can plague financial markets regardless of their level of development. It encompasses all types of actions aimed at obtaining a financial gain from investors based on deception. Such fraud can take many different forms from very simple schemes such as outright theft where none of the investor's money is returned, to more complex schemes such as Ponzi and pyramid schemes. Schemes can be regulated or unregulated entities and can take different legal forms, from joint stock companies to hedge funds or simple pools of assets.

In a Ponzi scheme, returns may be paid to investors out of the money paid in by subsequent investors rather than from genuine profits. These schemes usually offer higher returns than any legitimate business activity could plausibly sustain, in order to lure investors. Ponzi schemes usually have to attract new investments at an exponentially growing rate to sustain payments to existing investors, and inevitably collapse when the new investment needed exceeds the size of the target market. At that point, most investors lose most or all of their investment, while early investors including the scheme's founders may have obtained high returns. Thus, it can be a matter of plain luck and timing whether an individual turns out to be a victim or a beneficiary of the fraud. Ponzi schemes are insolvent from the moment that they take in money from investors. Their liabilities to investors exceed their assets as the value of liabilities increases at the inflated rate of return, while assets may be depleted by the running costs of the scheme or possibly suffer from other deprecations.

As the experience of different countries has shown, the "business opportunity" advertised to lure investors into putting their money in a Ponzi scheme can vary in nature, from straightforward investments in stocks or bonds, to less traditional financial sector products such as currency trading, to investments in nonfinancial assets, such as real estate, cars, and helicopters. These business opportunities are only limited by the imagination of the perpetrator and the gullibility of the investor.

As indicated above, Ponzi schemes can be perpetrated by unregulated entities, through informal sector vehicles that operate in the shadow of formal financial institutions. In other cases, they are perpetrated by regulated entities, which abuse their regulated condition to lure investors.

The types of investor lured into these schemes vary. Many times, the schemes will have drawn in or specifically targeted as investors individuals from amongst a specific group or community sharing a common affinity, such as ethnicity, religion, or profession. In many

instances the perpetrators promote their schemes through leaders of the affinity group. In some cases, investors are given an explicit incentive to recruit new investors (Box 1). The damage when such schemes reach their inevitable end can be widespread amongst populations with limited income and means to absorb the eventual losses. The resulting combination of anger, betrayed trust, recriminations and sheer loss of wealth and income can also have significant political and social repercussions.

The experiences of different countries show that the exponential growth rate needed to sustain schemes can lead to large-scale economic and institutional damage. The negative consequences include:

- Undermining confidence in financial markets;
- Diverting savings from productive to unproductive uses and, in some cases, from the domestic economy to foreign destinations, with a balance of payments impact;
- Incurring fiscal costs, if bailouts occur;<sup>3</sup>
- Diverting deposits from banks and increasing non-performing loans if loan proceeds were diverted into schemes;<sup>4</sup>
- Causing swings in consumption driven by paper profits or early withdrawals;
- Causing socio-economic strife if a sufficiently large number of households are suddenly exposed to losses; and
- Undermining the reputation of political authorities, regulators, and law enforcers for failing to prevent open frauds and to address money laundering or support of other illegal enterprises by schemes' operators.

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<sup>3</sup> Bailouts appear to be rare; governments bailed out depositors in two Ponzi schemes, involving Dafiment Bank in Serbia and the TAT savings house in Macedonia, both in 1993.

<sup>4</sup> There is anecdotal evidence that some of the schemes presented below diverted deposits and increased NPLs, but not to the extent of posing a systemic risk.

### **Box 1. Pyramid Schemes Versus Ponzi Schemes**

The labels Ponzi scheme and pyramid scheme are often used interchangeably to describe specific forms of investment fraud where sustainability depends on the influx of new “investors” to the scheme. However from a technical perspective, there are differences in the way the two types of schemes operate.

Pyramid schemes are a form of fraud where the expected benefit to members depends primarily on the number of individuals they recruit, which is not necessarily the case in a Ponzi scheme. For instance, each member may be required to recruit five others who each recruit five more, and so on to get the reward, creating a pyramid in which payments flow upward to earlier members—and not necessarily to a central pool of funds, as in a Ponzi scheme. While the large reward draws in members, the number of recruits required to be rewarded grows exponentially, and inevitably exceeds the target population. At that point, the flow of rewards up the pyramid stops, and most members receive nothing in return for their membership fee, as they are unable to recruit new members. Ponzi schemes often grow larger than pyramid schemes as they can take in unlimited amounts from a single individual and can continue to operate indefinitely, as long as payments demanded by investors from the scheme do not exceed payments by investors into the scheme.

A pyramid scheme may attempt to masquerade as a multi-level marketing (MLM) arrangement, which is a legitimate business activity in many jurisdictions. MLM members are salesmen who sell a legitimate product but also receive commissions on sales by their recruits, their recruits’ recruits, and so on. The distinction between a legal MLM arrangement and an illegal pyramid may be difficult to establish. A hypothetical MLM arrangement in which members must buy an initial inventory of products which they neither consume nor sell would be an illegal pyramid scheme in many jurisdictions. A methodology for differentiating pyramid schemes from MLM arrangements is described in Vander Nat and Keep (2002).

There are a number of similarities between the life-cycles of pyramid schemes and Ponzi schemes. Both types of schemes typically proceed through the following stages: initiation; validation, when large and easy rewards earned by initial members generate strong word of mouth publicity; expansion, when a large number of people join or massive investments are received; and collapse, when defaults occur, the inflow of new funds or members stops, and the promoters may seek to abscond with money.

The schemes are inherently likely to collapse and default on most members. Pyramid schemes grow exponentially for a given rate of recruitment until they exhaust the pool of potential members. Inflows in a Ponzi scheme must also grow exponentially, if investors do not reinvest all earnings.

In practice, schemes may incorporate elements of both pyramid schemes and may be difficult to classify. For instance, several of the Caribbean schemes described below appear to have characteristics of both types of schemes.



Country experiences illustrate the financial and socio-political damage of such schemes. The most severe case has been Albania. When several schemes collapsed in 1996, there was uncontained rioting, the government fell, the country descended into anarchy, and by some estimates, around 2,000 people were killed (Jarvis, 2000). More recently, the November 2008 collapse of allegedly fraudulent investment schemes in Colombia, which had taken in an estimated US\$1 billion, was followed by riots and violent protests in 13 cities (see Annex I). Table 1 lists some other major schemes with an indication of their relative size. These cases illustrate that a wide range of countries have seen the emergence of large-scale schemes. They also indicate that a wide variety of circumstances were associated with the emergence of these schemes.

In almost all cases, the data on the relative size of schemes in Table 1 is speculative. Establishing even basic facts such as amounts invested or lost and numbers of investors or accounts involved is difficult. This reflects the inaccuracy or lack of financial statements, the lack of regulation, and the disappearance of funds, records, and principals. In addition, many of the cases are recent, ongoing, and the subject of contentious court proceedings. However, assembling what information is available provides useful context. All figures reported in Table 1 are based on public information, and do not reflect estimates by Fund staff or national authorities.

Table 1. Some Speculative Data on Selected Investment Schemes

Country	Name(s)	Years in Operation	Promised Rate of Return	Amounts Invested/Lost		Number of Investors/Accounts	
				In U.S. dollars	In percent of GDP	Number 1/	In percent of population
Jamaica	OLINT, Cash Plus, World Wise, LewFam, etc.	2004-08	6-20 percent/month	1-2 billion	12 ½-25	50,000	2
Grenada	SGL Holdings	2006-08	7-10 percent/month	30 million	5	...	...
United States	Madoff Investment Securities	-2008	10-17 percent/year	50 billion	0.3	13,000	<0.01
Colombia	DRFE, DMG, etc.	2005-08	300 percent/six months	1 billion	0.4	up to 4 million	<8
Lesotho	MKM Burial Society	-2007	60 percent/year	42 million	3	100,000	4
Albania	VEFA, Gjallica, Kamberi, etc.	1991-97	4-19 percent/month	1.7 billion	79	2 million	57
Macedonia	TAT Savings House	-1997	4-5 percent/month	80 million	3	25,000	1
Romania	Caritas	1992-94	800 percent/six months	450 milion	1.5	2-3 million	9-13
Russia	MMM	1993-94	7,000 percent/six months	1-1.5 billion	0.5-0.8	1-2 million	0.6-1.3
Peru	CLAE	1978?-93	5 percent/month	200 million	0.3	300,000	1.2
Serbia	Dafiment Bank	1990-93	15 percent/month	600 million	...	14 million	133

Sources: Jamaica, CaPRI (2008); Grenada, newspaper accounts; United States, Securities and Exchange Commission; Colombia, newspaper accounts; Lesotho, Central Bank of Lesotho; Albania, Jarvis (2000); Romania, Verdery (2005); Russia, newspaper accounts; Peru, newspaper accounts; Serbia, newspaper accounts; Macedonia, newspaper accounts.

1/ Number of accounts for Dafiment Bank.

Such examples demonstrate the importance of a rapid policy response from the relevant authorities aimed at stopping the operation of the schemes. However, controlling and closing down schemes is often difficult for a variety of reasons. In many cases, neither the perpetrators nor the schemes themselves are licensed or regulated, thus making it more difficult for them to appear on the radar of regulators. In addition, in many countries, regulators have not been able to detect and shut down UIS at an early stage. This difficulty is illustrated by allegedly fraudulent schemes described below in Jamaica, Grenada, Antigua and Barbuda, St. Vincent and the Grenadines, Colombia, and Lesotho. Once schemes become large, the authorities may become increasingly reluctant to trigger their collapse. If government authorities close or suspend a scheme—curtailing its ability to meet cash flow obligations—subscribers could blame the government’s intervention rather than the scheme’s inherent flaws. However, even when the schemes collapse by themselves, the experience shows that governments may also face criticism for failing to act more promptly. Interestingly, many scheme operators have managed to extend their operations by ostentatious charitable contributions, significant political contributions, and pretentious demonstrations of their own or their scheme’s wealth. Prior to collapse, operators may be regarded as pillars of their communities.

### **III. UNREGULATED INVESTMENT SCHEMES IN THE CARIBBEAN**

This section describes the emergence of schemes in the Caribbean, the regulatory framework, the policy response, and their size and impact, while Annex I describes the experience in the United States, Colombia, Lesotho, and Albania.

As noted above, a number of disclaimers apply, which are particularly relevant in light of ongoing legal proceedings in many cases. The case studies do not assess the appropriateness of policy frameworks or policy responses, although it is hoped they provide sufficient information for the reader to make such an assessment. The case studies summarize publicly available information, and are not determinations of fact. No assessment is implied regarding whether regulators acted within their powers, and whether entities or individuals were engaged in fraudulent, criminal, or otherwise illegal activities. Descriptions of legal frameworks are recitations of provisions of relevant laws and decrees, and are not legal conclusions regarding regulators’ powers or lack thereof.

## A. Jamaica<sup>5</sup>

### *Description of the schemes*

Jamaica experienced rapid growth in the number and size of UIS, especially during the period 2006–08. A study conducted by the Caribbean Policy Research Institute (CaPRI), an independent think tank, identified 21 UIS which were operating in Jamaica by January 2008 (see CaPRI, 2008). The business opportunity behind the schemes varied, although a majority of them claimed to be engaged in foreign exchange trading. As will be explained further below, some of the schemes were allegedly conduits to invest in other better-known schemes. A few claimed to be investing in a variety of assets including real estate. The schemes shared a number of common features. They all offered returns significantly higher than those offered by regulated entities; many offered a 10 percent return monthly, a level usually seen only in Ponzi schemes. A few schemes also paid investors a referral fee for bringing in new investors—a feature shared with pyramid schemes. Neither the operators nor the schemes were licensed or registered by the Financial Services Commission (FSC) or the Bank of Jamaica (BoJ). According to the FSC, they provided limited or no information on their business model that would explain such high returns: investors were not provided with a prospectus or with audited or even unaudited financial statements. In most cases, the promoters apparently had limited financial background before starting their schemes. A number of these features are “red flags” for investment fraud (see Section IV.B for additional details).

OLINT Corporation and Cash Plus Limited are perhaps the most important UIS, in terms of the number of investors they attracted, the amount of attention that they received from the media, and the regulatory response to them.

### **OLINT Corporation**

According to court documents, OLINT Corporation claimed to serve as a liaison for members of a club to invest in foreign currency trading through Overseas Locket International, a Panamanian corporation. It was founded by David Smith, a Jamaican national who had worked for several years as a licensed representative of Jamaica Money Market Brokers Limited specializing reputedly in international foreign exchange trading. After leaving the firm, he formed what he described as a club consisting of his friends and other members. New members had to be referred by existing members who were paid a referral commission. The club apparently began operations around 2004.

Members had to sign a customer agreement, which stated that “the sums invested by the customers were to be used as a margin for taking margin leverage speculative currency

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<sup>5</sup> One of the co-authors of this paper, Brian Wynter, was Executive Director of Jamaica’s Financial Services Commission (FSC) until December 2007; he was not involved in preparation of this section of the paper. Sources for this section include FSC press releases and public notices, court documents, FSC presentations in CARTAC (2008), and newspaper accounts.

positions.” According to the agreement, 80 percent of the investment was guaranteed. Several other schemes, such as Lew Fam, appeared to be conduits for OLINT. According to court documents,<sup>6</sup> the promoter of LewFam, Neil Lewis, held two accounts with David Smith and/or OLINT. OLINT and LewFam had about 1,800 and 800 accounts, respectively.<sup>7</sup>

### **Cash Plus Limited**

Cash Plus Limited claimed to be part of a conglomerate, the Cash Plus Group, with subsidiaries engaged in real estate development, telecommunications, food distribution, hotels, and other economic sectors. Its founder was Carlos Hill, also a Jamaican national, who had worked in the financial sector in the United States in the 1980s according to court documents. In the documents given to investors, Cash Plus refers to the money received from the public as “deposits” and to the relationship between the investors and Cash Plus as a lender-borrower relationship. Lenders were paid 10 percent per month in interest, but the lender was locked in for 10 months, after which time the lender could redeem the principal. Cash Plus began operations as early as 2002.

### ***Strategies for growth***

As has been the case in many other jurisdictions, the UIS engaged in highly visible public relations campaigns. These campaigns involved donations to charitable causes and sponsorship of high profile events.

- In September 2007, Cash Plus began a three-year sponsorship of the Jamaican National Premier League soccer at J\$50 million per year, of which J\$24 million was reportedly disbursed.<sup>8</sup>
- In December 2007, OLINT claimed to have donated US\$1 million to its charitable foundation to help needy Jamaicans, especially deprived children. It also sponsored the 2008 Air Jamaica Jazz and Blues Festival.<sup>9</sup>
- In January 2008, World Wise, another scheme which later received a cease and desist order from the FSC, became the title sponsor for a Jamaican entry in the Miss Universe beauty pageant.<sup>10</sup>

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<sup>6</sup> See Supreme Court of the Judicature of Jamaica (2006).

<sup>7</sup> Major Neil Lewis worked with several religious organizations, including Operation Save Jamaica and Family Life Ministries.

<sup>8</sup> See “Football’s Perspective on the Cash+ Debacle,” *The Gleaner*, April 19, 2008. The MMM scheme in Russia employed similar techniques: it financed the 1994 World Cup soccer team, and financed free days on the Moscow subway.

<sup>9</sup> See “OLINT starts foundation with US\$1m to help needy Jamaicans,” *The Jamaica Observer*, December 4, 2007, and “Hotshot Traders,” *The Jamaica Observer*, January 25, 2008.

<sup>10</sup> See “World Wise sponsors Miss Jamaica Universe 2008,” *The Gleaner*, January 7, 2008.

- It was reported that both of the main Jamaican political parties received campaign donations from OLINT.<sup>11</sup>

The UIS succeeded in obtaining support from prominent individuals in Jamaica as well as the media to the point that in January 2007, a business newspaper named David Smith, OLINT's founder, business personality of the year.

### ***The legal and regulatory environment***

The Securities Act (SA) of Jamaica subjects the public offering of securities and of collective investment schemes to authorization by the Financial Services Commission (FSC) (Sections 16 and 17A of the SA). The SA states that intermediaries who carry on securities services have to be licensed by the FSC (Sections 7 and 8). The SA specifies that breach of the registration and licensing requirements constitutes an offense punishable upon conviction by a fine of up to J\$2 million (about US\$23,000) and/or imprisonment for a period up to 2 or 3 years respectively (Section 68(7)). In addition, there are antifraud provisions in Section 49 of the SA, violation of which constitutes an offense punishable with a fine or imprisonment for a period not exceeding one year, in the case of a natural person, and a fine in the case of a company.

The SA states that the FSC has the authority to investigate breaches of the securities laws and regulations. The SA designates breaches of the licensing and antifraud provisions as criminal offenses. Criminal offenses may be prosecuted by the Director of Public Prosecutions (DPP), subject to adjudication by the courts.

The SA states that the FSC may issue of cease and desist orders (Section 68 of the SA). Cease and desist orders can be appealed to the FSC and the courts, and the party affected by the order can request a stay of execution (suspension of the effects) while the court's final decision is being considered. Section 68 of the SA also contains a general provision that allows the FSC to seek in court other "civil remedies," but the SA does not specify those remedies, and there appears to have been no jurisprudence in respect to that provision. In any case, the statutes do not prescribe a specific procedure for the courts to impose these remedies.

The Financial Institutions Act (FIA) indicates that deposit taking is subject to licensing by the BoJ (Section 3). The FIA specifies that failure to comply constitutes an offense punishable with a fine of up to J\$500,000 (about US\$5,700) and up to J\$50,000 for each day of continuance. Also, the BoJ Act states that foreign currency trading is subject to authorization by the BoJ (Sections 22A, 2 and 3). It specifies that violation of this obligation also constitutes an offense punishable with a fine or imprisonment.

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<sup>11</sup> See "OLINT Funded the JLP, PNP", *Sunday Herald*, July 26, 2008. In other cases, schemes have also sought to use political connections. For instance, the Romanian Caritas scheme which collapsed in 1994 obtained an office in city hall from the Mayor of Cluj-Napoca, who was also a losing presidential candidate.

The BoJ Act states that the BoJ has the authority to investigate the breach of such obligations. The remedies available are criminal in nature. Criminal offenses can be prosecuted by the DPP, subject to adjudication by the courts.

### ***Regulatory response***

There was considerable debate in Jamaica concerning whether the activities of the UIS triggered one or more of the provisions described above, and thus required action by the regulatory authorities. According to court documents,<sup>12</sup> the key issue concerned whether the activities of the UIS constituted “issuing securities” therefore covered by the SA, or deposit taking covered by the FIA, or whether they were simply private clubs and as such fell outside of the jurisdiction of both the FSC and the BoJ. Apparently, there was limited jurisprudence on such concepts prior to this case. The lack of clarity over the precise nature of schemes’ activities clouded this debate.

Initially all actions taken against OLINT and Cash Plus came from the FSC, beginning March 2006. They encompassed: (i) issuing cease and desist orders against some of the schemes for alleged breaches of the registration/licensing requirements described above;<sup>13</sup> (ii) providing warnings to the public informing of schemes that were not registered with or licensed by the FSC;<sup>14</sup> and (iii) undertaking a public education campaign “think and check before you invest”. In late 2007, the BoJ issued warning letters to the schemes that purported to be carrying on foreign currency trading stating the need for a license. The Jamaican criminal authorities filed charges against the founder of Cash Plus in 2008, while the Turks and Caicos Island criminal authorities filed charges against the founder of OLINT Corporation in 2009.

### **OLINT Corporation**

The FSC began an investigation of OLINT in early 2006. The FSC and the Financial Investigations Division of the Ministry of Finance and Planning executed search warrants under the Securities Act on the offices of OLINT and LewFam Investments on March 3 and March 6, 2006 and seized documents.

The FSC determined that although claiming to be carrying on foreign currency trading activities, OLINT Corp./David Smith et al, Overseas Locket International/David Smith et al, and LewFam Investments/Neil Lewis et al were engaged in securities activities in breach of Sections 7 and 8 of the Securities Act. The FSC issued cease and desist orders against them on March 24, 2006.

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<sup>12</sup> See Supreme Court of the Judicature of Jamaica (2006).

<sup>13</sup> The FSC issued cease and orders against OLINT, LewFam and Cash Plus, as described below, and also against World Wise in August 2008.

<sup>14</sup> In addition to the Cash Plus notice which will be discussed below, the FSC issued public notices in regard to Swiss Cash (July 2007), World Wise Partners Limited, Higgins Warner (both October 2007), Capital Blu, and PFG Best (both March 2008).

In response, OLINT initiated a protracted legal struggle and continued to operate for several years. In court documents, OLINT claimed it did not fall under the Securities Act and in its opinion therefore did not require a license from the FSC.<sup>15</sup> OLINT and David Smith appealed to the FSC on March 27 to stay the execution of the order directed at the company, and the FSC denied the appeal. OLINT then appealed to the Supreme Court,<sup>16</sup> which in early November 2006 granted a stay of execution of the cease and desist orders on the condition that there be no increase in the membership of OLINT until the hearing of its appeal on March 26, 2007. The appeal was heard in March and June 2007. The key issue in the appeal was again whether the activities of OLINT constituted a securities business under the purview of the Securities Act and therefore required a license. OLINT's argument was that it was not in breach of the SA because its activities did not involve securities, but foreign currency trading. On December 24, 2007, the Supreme Court ruled in favor of the FSC and upheld its cease and desist orders. The Court considered that there was an investment contract between OLINT and its customers and therefore OLINT's activities were subject to the SA provisions.

OLINT appealed this decision to the Court of Appeal, which on February 5, 2008 granted a stay of execution, although imposing certain conditions. The court ordered that there should be no increase in OLINT's membership or clientele pending its determination of the appeal. In addition, the court instructed OLINT to prepare a list of members and submit it to the court in a sealed envelope.

In May 2008, OLINT began failing to make payments to investors according to news reports, and in July OLINT closed its offices in Jamaica. In an e-mail sent to club members, OLINT claimed that the closing was a result of threats to staff including a bomb threat. The e-mail acknowledged that the threats might flow from the failure of the scheme to honor redemptions which it blamed on FSC actions, court conditions for the stay of execution and actions by the banks to close their accounts. The next section provides information on developments with OLINT outside Jamaica.

### **Cash Plus Limited**

The FSC issued a public warning in May 2007 that Cash Plus was not licensed by the FSC. As a result, Cash Plus filed an application to the Supreme Court to determine whether its activities fell under the securities or the banking laws.

The FSC instructed Cash Plus in November 2007 to provide its investors and the FSC basic financial information including details about its assets, liabilities, capital, revenue, and expenses. The action followed media reports indicating that investors were having difficulty making withdrawals and that Cash Plus' founder, Carlos Hill, had served 10 years in a

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<sup>15</sup> The seizure of documents was the basis for an unsuccessful court action by OLINT and LewFam to have the documents returned before the 30 days allowed by the SA and to prevent the FSC from carrying out any further searches. OLINT also sought to recover damages allegedly caused by the FSC searches.

<sup>16</sup> The Supreme Court is the court of first instance in Jamaica.

U.S. prison for racketeering, mail fraud, and making a false statement.<sup>17</sup> There were also reports that Cash Plus had made major acquisitions of businesses and real estate. However, according to the FSC, Cash Plus failed to provide most of the information requested.

Based on the evidence gathered during its investigation, the FSC determined that Cash Plus Limited/Carlos Hill/Kahlil Harris were engaged in securities activities in breach of Sections 7, 10 and 26 of the Securities Act. It issued cease and desist orders against them in December 2007. Cash Plus appealed the orders to the Supreme Court, which granted a stay of execution in January 2008. However, while granting the stay the court imposed certain conditions on Cash Plus including that it could not: (i) take new investors; (ii) accept new funds from existing investors; or (iii) make payouts to existing investors. The Court also required Cash Plus to file a list of its investors under seal.

Shortly thereafter, Cash Plus dropped the suit that it had brought for a declaration on whether its activities fell under the securities or banking laws. It informed the court that it intended to submit to FSC jurisdiction, but would continue with the appeal process regarding the cease and desist orders. In the meantime, the court lifted its stay of the cease and desist order. Cash Plus asked the FSC to lift the order's provision preventing payment to investors. The FSC conditioned a modification of the cease and desist order on the submission by Cash Plus of information on the number of investors, balances due to all investors, the methodology to determine payments to investors in a fair manner, and the source of funds for payments. In late March 2008, the FSC announced that Cash Plus had failed to provide the information requested and subsequently that Cash Plus had informed it that it did not have funds to repay investors on March 31, 2008 as planned. The Supreme Court appointed a receiver/manager from PricewaterhouseCoopers several days later. In April 2008, Mr. Hill was arrested on charges filed by the DPP of fraudulent conversion, obtaining money on false pretenses, and conspiracy to defraud. This action came after investors submitted complaints to the police against Cash Plus for failing to return funds invested.

### ***Actions by commercial banks***

Commercial banks also played a role in responding to UIS. The chairman of the Jamaican National Commercial Bank (NCB) warned the public in September 2006 that the schemes were unsustainable, and would end in disaster.<sup>18</sup> Commercial banks also began reporting all UIS-related transactions as suspicious under the Money Laundering Act, according to November 2007 newspaper accounts. In the same month, NCB sought to close the accounts of OLINT on the basis that it failed to provide requested "Know Your Customer" documents. However, court challenges by OLINT prevented the bank from closing the accounts. A similar injunction prevented NCB from closing the accounts of

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<sup>17</sup> According to court documents, Hill and his collaborators had allegedly defrauded U.S. investors of about US\$8 million. In addition, his conviction on a Texas mail fraud reportedly entailed a cost to taxpayers of more than US\$100 million.

<sup>18</sup> See "Clarke, Bunting slam forex traders; investment banker compares operation to lottery game," *The Gleaner*, November 1, 2006.



Cash Plus. The issue was appealed to the level of the Privy Council in the United Kingdom, Jamaica's final court of appeal, which in January 2009 reversed the injunction by Jamaica's Court of Appeal that prevented the bank from closing OLINT's accounts.

### *The Reaction*

A combination of factors, including the "respectability" that Cash Plus and OLINT had gained through their donations and sponsorships, led to a negative reaction from high profile figures, including politicians, and the media to FSC actions.

- In January 2007, a letter to the editor from a junior government minister described the FSC and Financial Investigation Division's raid on OLINT as a "Gestapo-like invasion" which was a "vulgar abuse of state power." It argued that OLINT was a boon to the Jamaican economy, and that rather than expatriating capital, OLINT's payments to club members were generating foreign exchange reflows of US\$7 million weekly during November–December 2006.
- In November 2007, a prominent attorney wrote that the financial community was trying to sabotage Cash Plus' obvious success.<sup>19</sup>
- In December 2007, several influential church leaders declared that the country would lose if OLINT and LewFam were forced to close, and that individuals should be free to invest once adequate information is given.

Against this backdrop, there were some public manifestations of support from the government for the FSC. In January 2007, Finance Minister Omar Davies warned that people who put money in the schemes did so without the protection of the government. According to a February 2007 FSC press release, the junior minister's comments described above were condemned by the Cabinet as not expressing the position of the government. Later in 2007, the tax administration indicated that all income, including illegal income from UIS, was taxable. Further support from the government came in January 2008, when the Cabinet endorsed the FSC's actions against schemes and indicated that the FSC would continue to act against them.

A leading newspaper stated in April 2008 that a review of its coverage of Cash Plus found that 8 of 55 stories were promotion pieces, 9 of 55 would have failed its current code of ethics, and that it had inaccurately reported several major real estate purchases by Cash Plus which did not actually take place.

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<sup>19</sup> In May 2008, he sued Cash Plus Limited for the repayment of a J\$117 million (US\$1.5 million) loan at a monthly interest rate of 10 percent.

### ***Size and Impact***

It appears that the schemes (Cash Plus and OLINT in particular) grew dramatically after the FSC's intervention on OLINT and LewFam in late 2006. It seems that the intervention served to advertise the schemes, while there were no immediate follow-up actions charging them or their perpetrators with any crime. Apparently, the court's decision to prohibit OLINT from accepting new members while not preventing additional investments was followed by a proliferation of new schemes that attracted new investors and channeled their funds into OLINT through the accounts of existing OLINT members. According to the CaPRI study, a November 2007 survey of 400 investors in UIS found that most had invested in the 12 months preceding the survey.

Cash Plus took in investor funds of J\$22 billion (US\$260 million or 2 percent of GDP) during 2004–07 from 35–45 thousand investors, according to a May 2008 interim report by its receiver. During August 2006–May 2007, two entities associated with David Smith, OLINT TCI and TCI FX Traders, deposited US\$100 million into its accounts in i-Trade FX LLC.<sup>20</sup> For other schemes, there is no reliable information, as they do not provide audited or unaudited financial statements or a list of assets. The January 2008 CaPRI study estimated that Jamaican UIS have taken in investments of 12½-25 percent of GDP. The results of the study's survey of 400 investors suggest that around 50,000 households invested in these schemes, with a typical investment of around J\$200,000 to J\$300,000 (about US\$2,800-US\$4,100). Most of the investors were middle class, which the study argued would limit the potential for social unrest if the schemes collapsed.

### **B. Eastern Caribbean Currency Union and the Turks and Caicos Islands<sup>21</sup>**

This section describes the operations of OLINT elsewhere in the Caribbean. In addition, it describes two recent cases of apparent fraudulent activities allegedly perpetrated via off-shore institutions licensed in the Caribbean: Stanford Financial Group and Millennium Bank.

#### **OLINT**

##### ***Description of the schemes***

OLINT and its offshoots also operated in some Eastern Caribbean Currency Union (ECCU) countries and in the British territory of the Turks and Caicos.

##### **St. Kitts and Nevis**

In April 2006, OLINT advised its clients that it had been authorized by the Government of St. Kitts and Nevis to conduct investment business there. In response, the St. Kitts Financial

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<sup>20</sup> National Futures Association (2008).

<sup>21</sup> Sources for this section include country authorities, the Eastern Caribbean Securities and Regulatory Commission, scheme web sites, and newspaper accounts.

Services Commission issued an advisory that OLINT Corp had never been licensed to conduct investment or any other business in St. Kitts. This web site posting appears to have prevented OLINT or other schemes from operating in the country.

### **Turk and Caicos**

In August 2006, a company associated with David Smith, i-Trade FX LLC, became registered as a futures commission merchant in the United States. For most of 2007, David Smith was listed as one of the company's principals and contributed almost 100 percent of its capital. Smith resided in Turks and Caicos, and registered two companies there, OLINT TCI and TCI FX Traders, which had accounts with i-Trade FX.<sup>22</sup> TCI FX Traders was granted a mutual funds license by the Financial Services Commission (FSC) of Turks and Caicos in October 2006. As described in the next section, it appears that TCI FX was a vehicle for channeling funds to OLINT TCI. OLINT TCI did not as it claimed hold a license, according to the FSC of Turks and Caicos. OLINT TCI apparently attracted funds not only from Jamaica but also from Grenada, as discussed below.

### **Grenada, Dominica, and St. Lucia**

OLINT operated in Grenada via a conduit called SGL Holdings Inc., according to SGL's investment contracts. SGL began operations in August 2006, and first came to public attention through newspaper coverage in December 2006. It was founded by a physical therapist, the owner of a ferry line, and the owner of a security company. SGL claimed that its members were earning an 8 percent monthly return through foreign exchange trading, and that 80 percent of the principal invested was not at risk. Its investment contracts stated that it invests through TCI FX Traders, Ltd., which describes itself as "an open ended investment company incorporated in the Turks and Caicos Islands on August 16, 2006, established for investing through OLINT TCI." SGL's web site provided on-line access to members' accounts. SGL also operated in Dominica, and its name also appeared in the Jamaica FSC's list of UIS operating in Jamaica.

Several other schemes indicated to GARFIN they intended to operate in Grenada. A scheme called Havaway opened an office in Grenada and approached GARFIN regarding a license.<sup>23</sup> Another scheme in St. Lucia, the Wilshaw Forex Club, provided the same web interface and contracts as SGL Holdings and TCI FX Traders.

### ***Legal and Regulatory Framework***

All the countries that are members of the Eastern Caribbean Currency Union share a common central bank, the Eastern Caribbean Central Bank (ECCB). Under the uniform Banking Act

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<sup>22</sup> National Futures Association (2008).

<sup>23</sup> Havaway apparently informed GARFIN that it also planned to start operations in other ECCU jurisdictions.

that has been transposed into local law in each of the countries, deposit taking is subject to licensing by the Minister of Finance based upon the recommendation of the ECCB. The legal and regulatory framework for the nonbank financial sector in the ECCU involves both national and regional regulators. The Eastern Caribbean Securities and Regulatory Commission (ECSRC) regulates the securities industry in all the countries that are members of the ECCU, based on a uniform Securities Act (SA) that has been transposed into local law in each of the countries. The SA specifies that a license from the Commission is required to operate as a broker dealer, investment adviser, and certain related activities, such as operating a collective investment scheme. The SA also specifies that public offerings of securities must be registered, and the ECSRC must approve the prospectus. The SA indicates that the ECSRC has the authority to issue cease and desist orders to entities and individuals operating without a license or in contravention of regulations. The SA also provides for administrative remedies such as suspending or revoking a license, or applying financial penalties. The SA indicates that the ECSRC can also apply to the ECCU's High Court for an order to restrain a person from acquiring or disposing of securities or to appoint a person to administer the property of an entity contravening the conditions of its license.

Other legislation specifies which local regulators supervises other financial services. For example, the Grenada Authority for the Regulation of Financial Institutions (GARFIN) began operations in March 2007 under the GARFIN Act. GARFIN was the first Single Regulatory Unit for non-bank financial institutions established in a Fund-member country of the ECCU. The Act states that GARFIN has authority over a wide range of nonbank financial activities, including money services businesses. It also states that GARFIN may issue cease and desist orders and to take administrative action such as revoking a license or applying financial penalties. The GARFIN Act does not explicitly mention the possibility of applying to the courts for civil relief.

The Turks and Caicos Islands' FSC Ordinance of 2007 states that the FSC supervises the financial services business carried on and its development, in or from the country. The Ordinance specifies that the FSC licenses and regulates national and overseas banks, insurance brokers, investment dealers, mutual funds, money transmitters, and professional trustees. It indicates that licensees should meet fit and proper requirements. The FSC Ordinance of 2007 states that the FSC may compel licensees, former licensees, or persons believed to be carrying on unauthorized business to provide specified information or documents. It also indicates that the FSC may apply to a Magistrate to have a person examined under oath and that a Magistrate may issue a search warrant on the recommendation of the FSC if a person has failed to provide requested information or documents, if such a request could lead to the removal or destruction of documents, or if an offense under the Ordinance is being committed. The Ordinance specifies that the FSC may cooperate with foreign regulatory authorities, including the sharing of information. It indicates that the FSC may inspect premises or assets, undertake compliance visits. The Ordinance provides that the FSC's enforcement powers include revoking or suspending licenses, appointing an examiner to conduct an investigation, issuing directives restricting business as well as cease and desist orders, petitioning the court for a winding up order, issuing public notices, and imposing financial penalties.

### ***Regulatory Response***

The operation of OLINT in the ECCU countries, via SGL, raised a discussion concerning the nature of the activities that SGL was conducting and which regulatory authority had jurisdiction over it. In May 2007, SGL applied for a license to GARFIN, which had commenced operations only two months earlier. SGL's web site originally encouraged potential investors to contact GARFIN regarding SGL, but removed this reference at GARFIN's request.

Initially, GARFIN considered SGL for a Money Services Business license, and began due diligence on the principals of SGL and its operations. According to GARFIN, SGL provided almost all information requested, including its own balance sheet. Based on the information gathered, GARFIN considered that its jurisdiction over SGL was not clear, given that the company purported itself as carrying out foreign exchange trading. GARFIN addressed this lack of clarity on two fronts. First, it sought authority to regulate foreign exchange trading services through a November-December 2007 Statutory Rule and Order (SRO) and the March 2008 amendment to the GARFIN Act. Second, it asked the ECSRC in 2007 to determine whether SGL required a license under the Securities Act; it made this request in writing in March 2008. Pending this decision, GARFIN did not act on SGL's application to GARFIN to be licensed. It also instructed Havaway and other schemes that approached GARFIN not to begin operating. In the same month, the ECSRC issued a notice that all persons soliciting or conducting securities business or providing investment advice in the ECCU must be licensed by the Commission.

GARFIN also pursued efforts to educate investors. It issued general warnings to the public in 2007 and in April 2008. The April 2008 advisory was issued in local newspapers and cautioned investors to ensure that any scheme they invest in was licensed and regulated, and to ask questions about its liquidity and solvency. Nevertheless, public interest in SGL grew sharply during 2007. Commercial bankers were aware of some borrowing and deposit withdrawals, apparently for investment in the scheme.

The ECSRC met with SGL in April 2008. In May, it determined that SGL was a collective investment scheme subject to the jurisdiction of the Securities Act. The ECSRC subsequently issued cease and desist orders against SGL Holdings in Grenada and Dominica and Havaway. These orders forbade the schemes from taking in new members or new funds from existing members. SGL ceased accepting new deposits and began preparing its application to the ECSRC for a license.

In July 2008, the Financial Crimes Unit of the Royal Turks and Caicos Islands Police Force raided the offices of OLINT TCI and froze its assets. According to the FSC, the legal authority for the raid was the Theft Ordinance and the Proceeds of Crime Ordinance. TCI FX Traders was placed in liquidation, with PricewaterhouseCoopers as receiver. OLINT TCI is in the process of being petitioned for liquidation by the Attorney General's Chambers. A study conducted on behalf of the FSC prior to liquidation concluded that the operations represented a Ponzi scheme. In February 2009, David Smith was arrested in Turks and

Caicos and charged with forgery, false accounting, and theft. More recently, attorneys for investors have sought the involvement of U.S. authorities.

After the Turks and Caicos authorities froze the assets of OLINT TCI in July 2008, SGL sent a letter to its customers apologizing for its inability to repay investors over the previous two months. At that point, Grenada's Ministry of Finance issued a press release describing the developments above, and the ECSRC made public its cease and desist orders against SGL in Grenada and Dominica.

### ***Size and Impact***

Newspaper reports indicated that SGL had taken in EC\$80 million (US\$30 million) by July 2008.

The collapse of SGL does not appear to have had a significant impact on Grenada's economy or banking system, although it did leave behind many disappointed investors. The potential impact on confidence in the financial sector appears more significant when seen in the context of the financial difficulties of an unsupervised commercial bank in 2008 and of an off-shore bank in 2000.<sup>24</sup>

## **Stanford Financial Group**

### ***Description of the scheme***

Stanford Financial Group (SFG) described itself as a privately-held group of companies specialized in wealth management, with assets under management in excess of US\$50 billion. The founder and sole owner of the group was Sir Robert Allen Stanford, a prominent financier, philanthropist, and sponsor of professional sports. A fifth-generation Texan, he holds dual citizenship, having become a citizen of Antigua and Barbuda ten years ago. Stanford was the first American to be knighted by that Commonwealth nation.

A U.S. Securities and Exchange Commission (SEC) complaint states that Stanford International Bank (SIB) is an off-shore bank in Antigua and Barbuda, licensed by Antigua and Barbuda's Financial Services Regulatory Commission (FSRC). By contrast, the UIS described above apparently did not, with the exception of TCI FX, have licenses. The SEC alleges that SIB, through a network of Stanford Group Company (SGC) financial advisors, executed a massive Ponzi scheme that sold approximately US\$8 billion of certificates of deposit (CDs) to investors around the world. The CDs promised higher returns than available through traditional banks. In addition, the SEC alleges that SGC advisers have apparently sold more than US\$1 billion of a proprietary mutual fund wrap program, using misleading information. Moreover, Stanford and another executive allegedly misappropriated at least US\$1.6 billion of investor money through bogus personal loans to Stanford which

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<sup>24</sup> The U.S. Attorney for the District of Oregon determined that the off-shore bank, the First International Bank of Grenada, was a Ponzi scheme; see United States Attorney for the District of Oregon (2007).

were never disclosed in SIB's financial statements or other communications with investors. SIB claimed to serve over 50,000 clients in over 100 countries. The SEC alleges that the fraud occurred over a period of 15 years.

While the losses initially estimated are not as significant as the Madoff case in the United States, this case has gained significant attention because of the repercussions that it has already had in several countries in Latin America and the Caribbean, where the Stanford Financial Group (SFG) has operations.

### ***Legal and Regulatory Framework***

The Antiguan International Business Corporations (IBC) Act specifies that the Antigua and Barbuda FSRC may provide licenses for international banking, trust, and insurance business. It also regulates entities operating under the Financial Institution Non-banking Act, the Cooperative Societies Act, and the Insurance Act. The IBC Act states that the FSRC has the authority to revoke licenses granted under the IBC Act if the licensee contravenes the conditions of the license. The Act charges the FRSC with ensuring that international banks maintain a minimum level of prescribed capital, provide quarterly data on the return on customers' liabilities, and prepare annual audited returns. It specifies that the FSRC should examine the affairs of international banks at least once per year. It states that the FSRC may seek a court order if information required for the examination is not forthcoming. It states as well that the FSRC may require that remedial actions, which are not specified in the Act, be taken. The Act provides for a penalty of US\$10,000 if a bank fails to provide information required by the Act, or to comply with written directions from the FRSC.

The United States regulatory framework, in particular the role of the SEC, is described in Annex I.

### ***Regulatory Response***

The SIB allegedly marketed CDs to U.S. investors through SGC under an exemption which allows the sale of unregistered securities to accredited investors. According to the United States SEC's Regulation D, accredited investors include individuals with net worth exceeding US\$1 million or income exceeding US\$200,000, and certain entities such as banks and investment companies.

On February 16, 2009, the United States SEC brought emergency relief actions in District Court, seeking a temporary restraining order, as well as an asset freeze, an accounting, and other incidental relief, and the appointment of a receiver to take possession and control of assets for the protection of the victims of SFG's alleged fraud. On final judgment, the SEC seeks a permanent restraining order, civil monetary penalties and disgorgement of ill-gotten assets.<sup>25</sup> The District Court froze the assets of Sir Allen and other defendants as well as those of SFG, SIB, and another subsidiary, Stanford Capital Management. On February 27, the

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<sup>25</sup> SEC v. Stanford International Bank et al in the US District Court for the Northern District of Texas.

SEC amended its complaint to indicate that SIB was a Ponzi scheme. By mid March, the court issued preliminary injunctions to all of the defendants, including Stanford, effectively extending the asset freeze.

The Antiguan government has publicly expressed its commitment to cooperating with the SEC investigation.

### *Size and Impact*

The Stanford case has had repercussions in many countries where the group had had interests, including Antigua and Barbuda, Canada, Colombia, Ecuador, Peru, and Venezuela. Regulators in all these countries have had to take emergency actions.<sup>26</sup>

- Following significant deposit withdrawals from the Bank of Antigua (BOA), an SFG-owned on-shore bank, the Eastern Caribbean Central Bank took over the BOA. The ECCB then appointed a consortium of five indigenous ECCU banks and the Government of Antigua and Barbuda to manage the BOA. The BOA is a local bank that was not named in the SEC enforcement action, but was controlled by the Stanford group of companies. In addition, the Stanford group holds a significant share of Antigua and Barbuda's public debt and is also the largest private employer in Antigua and Barbuda.
- The Canadian financial regulator restricted the representative office of SIB in Canada to acting as a liaison between other offices of the Bank and any of its clients in Canada wishing to withdraw amounts deposited or otherwise invested with the Bank.
- Ecuadorian and Colombian regulators have suspended the activities of the local brokerage units of SFG.
- Venezuela took control of Stanford Bank Venezuela (SBV), one of the country's smallest commercial banks. The Government announced its intention to sell the bank. It is one of the countries most affected, with an estimated US\$2.5-3 billion invested in Stanford's off-shore business.
- The Panamanian bank regulator took over Stanford Bank (Panama).
- In Peru, authorities suspended the local operations of a Stanford-affiliated broker dealer for 30 days.

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<sup>26</sup> Mexico's bank regulator has stated that mutual fund distributor Stanford Fondos is only authorized to invest in Mexico, and that this unit is therefore unaffected by these developments.



## **Millennium Bank**

### ***Description of the scheme***

Millennium Bank is a licensed off-shore bank in St. Vincent and the Grenadines. The U.S. SEC alleges that since July 2004, the bank has offered CDs to U.S. investors with returns that were several times higher than legitimate bank-issued CDs. The bank allegedly advertised itself through its web site and through luxury lifestyle magazines. The bank's web site claimed that the parent company United Trust of Switzerland S.A., provided "over 75 years of banking experience, correspondent banking relationships, decades of knowledge in privacy and confidentiality as well as extensive training for our customer services professionals." However, the SEC alleges that United Trust of Switzerland S.A. is not a Swiss-licensed bank or securities dealer. Although investors purchasing CDs were allegedly instructed to deliver checks to the off-shore bank, checks were deposited into an account at a U.S. financial institution. The SEC has alleged that none of funds received from investors were ever invested.

### ***Legal and Regulatory Framework***

The International Banks Act of 2004 states that the International Financial Services Authority (IFSA) of St. Vincent and the Grenadines may provide licenses for international banking. The Act states that the licensee must provide the IFSA with written consent of the home country supervisor to establish the branch and be subject to consolidated supervision by the home country authorities. The Act specifies that the IFSA has the authority to revoke licenses if the licensee contravenes the conditions of the license. It charges the IFSA with ensuring that international banks maintain a minimum level of prescribed capital, maintain deposits and ratios prescribed by the authorities, and provide quarterly returns. The Act specifies that the IFSA has the authority to examine the affairs of international banks including through on-site inspections, which are conducted every 12–18 months. The Act also states that the IFSA may, if there are reasonable grounds to suspect a contravention of the Act, petition the court for authority to take any actions it considers necessary to protect the assets of a bank.

The U.S. regulatory framework, in particular the role of the SEC, is described in Annex I.

### ***Regulatory Response***

On March 27, 2009, the SEC brought emergency relief actions in District Court, seeking a temporary restraining order, as well as an asset freeze, an accounting, and other incidental relief, and the appointment of a receiver to take possession and control of the defendants' assets for the protection of the victims of the alleged fraud. On final judgment, the SEC seeks permanent injunctions, civil monetary penalties and disgorgement of ill-gotten assets. The SEC charges that the defendants violated the anti-fraud and registration provisions of U.S. securities laws.<sup>27</sup> The District Court froze the assets of the defendants. On the same date,

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<sup>27</sup> SEC v. Millennium Bank et al in the US District Court for the Northern District of Texas.

the IFSA appointed KPMG to assume control over the affairs of Millennium Bank to preserve records and assets.

### *Size and Impact*

The bank raised at least US\$68 million from over 375 investors, according to the SEC.

## **IV. ADDRESSING UNREGULATED INVESTMENT SCHEMES: KEY POLICY LESSONS**

As discussed above, in the Caribbean Ponzi schemes appeared to have mainly flourished in the form of “unregulated investment schemes”. As demonstrated by the experience of the countries described above and in Annex I, such type of schemes can undermine investor confidence in financial institutions. The longer that they operate, the more damage they are able to inflict. Thus, the main policy lesson that can be extracted from countries’ experiences with Ponzi schemes is the need for a rapid and early response from financial regulators and law enforcement authorities to identify and stop the schemes and protect investors’ interests. However, responding swiftly has proven to be a challenge in many countries. Other policy lessons involve tackling the social dimensions of the phenomenon by means of programs to enhance financial literacy and personal financial responsibility amongst members of the public. In the case of Ponzi schemes operated by regulated entities such as offshore banks, the lessons point more simply towards the dangers of weak regulatory frameworks and inadequate supervision. However, as indicated in the introduction, the latter topics are outside of the scope of this paper.

The recent Caribbean experience has heightened the awareness of regulators and potential investors to the risks associated with UIS. However, awareness alone will not prevent a recurrence, and the experience shows that fraudulent schemes will emerge on a regular basis even in financial markets with strong regulatory frameworks.<sup>28</sup> Thus, it is necessary that countries work together in enhancing their legal and regulatory frameworks. An October 2008 seminar on “Understanding and Combating Unregulated Investment Schemes” was an important step in this direction (see CARTAC 2009).

The next two sections seek to draw lessons from countries’ experiences in dealing with Ponzi schemes and address the following questions: first, what are the key conditions that need to be in place for regulatory agencies to be able to take adequate actions against the schemes, and second, what are the key actions that authorities should take?

### **A. Preconditions**

As was indicated earlier, taking comprehensive actions to stop Ponzi schemes has proven to be challenging for many countries. Analyzed altogether, the cases show that regulatory

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<sup>28</sup> Indeed, several Jamaican schemes emerged and collapsed as early as 2001, including the Community Partner Club, Revolving Plan, and Speedy Cash; see CaPRI (2008).

response is influenced by a set of preconditions.<sup>29</sup> When these preconditions are present, regulators are more prone to be proactive and act quickly and decisively. In their absence, regulatory responses come, at best, with significant delay. These preconditions are: 1) independence of financial regulators; 2) broad authority to investigate and prosecute unregulated schemes; 3) effective mechanisms for domestic and international cooperation; 4) adequate resources for enforcement; and 5) speedy courts with the requisite skills and experience.

### **Independence of financial regulators**

In many of the cases studied, political—and even popular—support for regulatory actions to stop the schemes has been absent. Such lack of support has been the result of a complex set of factors, including limited understanding of the nature of the activities carried out by the schemes and thus of the danger that their unchecked operations may entail for individuals and the financial sector as a whole. In some cases the lack of support can be attributed to direct or indirect contributions by the schemes to governmental or social causes—sports, beauty contests, charities, political campaigns—that make them popular with politicians and the public. In this type of environment, it is critical that the financial regulators have sufficient independence to be able to carry out their mandate without the need for any additional approval from the government and even in circumstances where the schemes may have the tacit support of members of the government.

It is also critical that the regulatory framework contains adequate provisions to protect staff and commissioners against law suits arising from the exercise of their duties. In the absence of such provisions, regulators might not feel completely free to take rapid and strong actions against the schemes given that they might end up causing them personal liability which, even if they expect to be vindicated by the courts, exposes them to the uncertainty of lengthy and expensive litigation in their personal capacities.

### **Broad authority to investigate and prosecute unregulated schemes**

The experience of many developing countries suggests that gaps in the legal and regulatory framework to enforce financial laws and regulations have been a key factor in the lack of an adequate response by financial regulators to Ponzi schemes. Four elements are important: (i) clear provisions to prosecute the schemes; (ii) broad investigative authority; (iii) authority to seek or impose civil/administrative remedies; and (iv) authority to seek emergency relief.

#### *Clear provisions to prosecute the schemes*

Key to the ability of countries to combat Ponzi schemes that operate as UIS is the existence of clear provisions that prohibit and punish the undertaking of certain financial activities without a license/registration from a financial regulator. Such provisions should apply to

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<sup>29</sup> For an in-depth analysis of how countries fare in relation to preconditions for effective enforcement, see Carvajal and Elliott (forthcoming).

deposit taking, securities intermediation, and public offering of securities and collective investment schemes. Depending on the definition of such financial activities in a particular jurisdiction, it might be necessary to include additional “catch all” provisions, for example, prohibiting the collection of money from the public without authorization. In addition, the legal framework should contain provisions that directly prohibit and punish investment fraud.

The experience of some industrialized countries, in particular the United States has been to mainly use the provisions in their securities laws to combat Ponzi schemes. In this regard the U.S. SEC has successfully brought charges against hundreds of schemes based on the registration/licensing provisions and the antifraud provisions of the Securities Act. However, key to the use of such provisions has been the definition of “securities” of the US system, which has been interpreted by courts to encompass a broad range of transactions, including interests in pyramid or Ponzi schemes. Other countries, especially in Africa, have mainly used deposit taking provisions to combat Ponzi schemes carried out through UIS. Other countries have considered that such provisions are too narrow to be able to cover the activities of Ponzi schemes. As a result, they have enacted special provisions, for example prohibiting and sanctioning pyramid schemes (such as Sri Lanka and Afghanistan) or prohibiting the collection of money from the public without a license (Colombia). As indicated above the need for such provisions should be determined based on the legal framework of each country, in particular, the interpretation of key concepts such as securities and deposit taking.

#### *Investigative authority*

Statutes should provide financial regulators with the authority to investigate breaches to financial laws and regulations, including the breaches of the licensing provisions. While that authority is usually given to financial regulators, in many developing and emerging markets they have limited powers to request information, in particular from unregulated entities. That was in part the case in Jamaica where the FSC has stated that it had limited powers to obtain information from the UIS, given their unlicensed status, including the evidence necessary to bring charges.<sup>30</sup> Thus, it is necessary that statutes provide financial regulators with broad authority to request information, including subpoena powers.<sup>31</sup> Particularly important to combating Ponzi schemes and other types of investment fraud is the ability to “follow the money,” for which the regulatory agencies should be empowered to access banking information.

#### *Civil/administrative sanctions and criminal sanctions*

The authorities should have at their disposal a wide range of remedies (sanctions) available to combat Ponzi schemes, including both criminal and civil/administrative sanctions. However,

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<sup>30</sup> In Grenada, GARFIN and the ECSRC were in practice able to gather needed information, except on the off-shore operations of OLINT TCI.

<sup>31</sup> Powers to compel the provision of documents, testimony and other information under pain of prosecution.

as the cases indicate, in some developing and emerging markets, the financial regulators lack the authority to directly impose a broad range of civil/administrative sanctions. As a result, financial regulators lack the authority to prosecute such offenses and have to rely entirely on the criminal authorities. Experience shows that the criminal authorities have other competing priorities and, that in practice they do not pursue all cases. Also, the burden of proof for criminal offenses is significantly higher than that required at the administrative or civil level. Thus, to be most effective, financial regulators need to be empowered to prosecute this type of misconduct as a civil/administrative breach, irrespective of the fact that the same misconduct constitutes a criminal offense also under the jurisdiction of the criminal authorities. However, as will be discussed below, coordination between the two authorities is critical for an efficient and effective use of enforcement powers.

Empowering regulators with sanctioning powers can be achieved in different ways depending on the legal tradition and culture. In some countries, for example the securities regulator has the authority to investigate and prosecute (litigate) all violations of securities laws, including investment fraud, but the imposition of sanctions is done either by an administrative tribunal or by the civil courts (for example in United States). In others, investigation, prosecution (litigation) and the imposition of sanctions is done by the financial regulator (for example, the Ontario Securities Commission in Canada).

Another problem that some countries face is that actual penalties that can be imposed are not sufficiently serious to have a deterrent effect. That problem appeared to have existed in Colombia, where new provisions enacted by the Government following the state of emergency have now increased the penalties for undertaking financial activities without a license.

### *Emergency relief*

Experience suggests that emergency relief is a key shortcoming in many developing and emerging markets vis-à-vis more developed jurisdictions where financial regulators can seek relief such as asset freezes, usually in civil courts under expedited procedures and in some circumstances without the presence of the plaintiff, as is the case in the United States. For example, in Jamaica the FSC statute allows it to directly impose cease and desist orders but does not specify what other type of emergency relief could be sought in civil courts. In Colombia, the relevant decrees specify that the Superintendencia Financiera could impose certain types of precautionary measures against entities that appeared to be undertaking financial activities without its authorization; however, according to the Superintendencia, the standard of evidence required to make such a determination was very high, thus making the process to impose them very lengthy. New provisions enacted by the Government following the state of emergency allow the imposition of a broader set of precautionary measures directly by the Superintendencia de Sociedades (SS), without the need to seek court approval.

In many developing countries such precautionary measures can be imposed under a criminal investigation or an anti-money laundering (AML) investigation, thus the need for even greater cooperation between the financial regulators and the criminal authorities. However in

the end, it is necessary that such authority be given directly to the financial regulators so that they do not have to rely entirely on other authorities to be able to close down the schemes.

*Broad authority to cooperate and exchange information with other financial regulators, locally and internationally*

Experience suggests that the lack of authority to exchange confidential information, in particular banking information, and to provide assistance to foreign regulators has hindered the investigation and prosecution of Ponzi schemes in many developing and emerging markets. In the case of securities regulators, this shortcoming also prevents them from being able to sign the Memorandum of Understanding (MoU) of the International Organization of Securities Commissions (IOSCO). To a lesser extent, some regulators also face problems in exchanging confidential information with other local regulators. Experience also shows that cooperation in practice is a challenge. Thus it is necessary that the legal framework explicitly grants financial regulators with the authority to provide information to their counterparties. As will be discussed below, in particular the ability to follow the money through, among other things, the access to banking information in local financial institutions, but also in financial institutions in other countries where perpetrators might have hidden the money taken from the public, is key to the successful prosecution of Ponzi schemes.

*Adequate resources for enforcement*

A strong legal enforcement framework is necessary but not sufficient to ensure adequate handling of Ponzi schemes. In countries where the problem of Ponzi schemes has just started to be tackled, the lack of experienced personnel has proven to be an important challenge to taking prompt action. Training can help to bridge this gap. In addition, the development of internal manuals on how to conduct investigations can also help to bring an organization up to speed. At the same time, it is important that investigators have at their disposal certain minimal technological tools to allow them to leverage their resources in order to detect, for example, investment fraud conducted via the internet. Finally, there should be an adequate organizational structure to deal with the investigation and sanctioning of cases. This will, in the case of many countries, include improving the expertise and capacity of the state's criminal and civil law departments and other state agencies involved with the prevention, detection and punishment of financial crimes (tax, money laundering, fraud). It may in other cases include building the requisite legal capacity and expertise inside the regulator or developing a roster of private sector attorneys with the skills and experience to handle and advise on such matters effectively.

As the Madoff case has shown, adequate procedures and controls for handling complaints from the public are also key.

*Specialization and speedy disposition by the courts*

As part of the due process of law, many decisions that a financial regulator takes to stop Ponzi schemes are subject to judicial approval or review. As a result, it is critical that judges have the necessary expertise in financial matters. In addition, it is important that financial matters, in particular those involving emergency relief, be given priority. However,

experience shows that this is a key challenge in developing and emerging market countries. For example, in Jamaica the court system required over a year to resolve the legal challenges to actions taken by the FSC to stop the schemes. Moreover the courts granted stays of execution, which would probably not have been the case in jurisdictions where a body of jurisprudence regarding the fraudulent nature of Ponzi schemes had already been developed. Thus we believe addressing challenges of adequate expertise and speedy disposition of financial matters by courts requires special attention by governments since it is not easily achieved in the context of the overstretched and under-funded judicial systems commonly found in developing countries. As indicated above training and specialization of judges is key, as well as the development of expedited procedures for these types of actions.

## **B. Key Regulatory Actions**

Prompt and decisive action is required in order to prevent unregulated schemes from taking root and spreading. Regulators must be prepared to work on several fronts, including: (1) proactive investigation; (2) emergency relief; (3) civil/administrative and/or criminal actions; (4) coordination among relevant agencies (financial and law enforcement); and (5) public awareness.

### **Be proactive in investigating unregulated schemes**

Ponzi schemes, in particular those that flourished in the form of unregulated schemes, are usually not easy to detect, because many of them operate in an opaque—even secretive—way, requesting confidentiality from investors. In addition, the operators use many different strategies to lure investors which might cause confusion regarding the nature of the activities that they carry out. Thus, regulatory agencies should make an even greater effort to detect them by developing effective investigative tools, including:

- Red flags. Experience shows that there are certain hallmarks that point towards the existence of investment fraud. Thus, the development of such red flags creates a basic tool for the identification and investigation of fraudulent schemes. The Caribbean UIS had a number of features considered to be red flags by the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC).<sup>32</sup>
- Technological tools to facilitate research on the internet as well as other mass media. In some cases fraudsters appeal to investors via advertisements in newspapers or via

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<sup>32</sup> Red flags for possible investment fraud identified by the SEC and CFTC include promises of high return, guarantees, low risk, availability only to members, lack of registration, lack of financial information, affinity frauds aimed at religious or ethnic groups; lack of clear and detailed explanations; lack of background information on promoters; and pressure to reinvest. The Caribbean experience with fraud based on claims of foreign exchange trading is not unique: the U.S. Commodity Futures Trading Commission reports that in a recent period it filed 80 enforcement actions in which investors lost over US\$300 million.

websites on the Internet. Thus it is important that regulatory agencies develop mechanisms and tools that allow them to monitor such advertisements and websites.<sup>33</sup>

- Mechanisms to receive and act upon complaints from the public. As the recent Madoff case indicates, the public—and market participants—can play an important role as watchdogs of what is happening on the ground. Thus, regulators should develop mechanisms to allow such participation, including effective procedures for encouraging and receiving oral, written and electronic (such as email, instant messaging, web blogs, etc) complaints.

### **Seek emergency relief such as an asset freeze**

Completing a full investigation to bring civil/administrative or criminal charges against unregulated schemes can take a significant amount of time. However, the more time elapses, the greater the likelihood that scheme operators or investors' money will disappear or be relocated to other jurisdictions making repatriation difficult or impossible. Thus, once a regulatory agency has gathered sufficient evidence of the operation of a Ponzi or other fraudulent investment schemes, it should immediately seek the imposition of emergency relief, such as temporary injunctions and the freezing of assets, aimed at protecting investors' interests while the investigation aimed at bringing charges continues.

### **Bring charges (both civil/administrative and criminal)**

There should be adequate and prompt punishment of Ponzi schemes as a deterrent against future violations. As indicated above, ideally, authorities should have at their disposal both civil/administrative and criminal remedies. Civil/administrative remedies differ from criminal remedies not only with regard to the authority responsible for their prosecution and imposition, but also with regard to the burden of proof and the gravity of the sanction. Thus in addition to bringing the civil/administrative remedies directly available to them financial regulators should diligently submit the corresponding files to the criminal authorities, and be ready to assist them to build the criminal case.

### **Coordinate and cooperate locally and internationally**

Depending on the strategy used to lure investors, the operation of a Ponzi scheme can constitute a violation under several financial laws (banking, securities, commodities). For example, the operation of a scheme that allegedly utilizes the funds raised from the public to trade in foreign exchange may constitute a violation of securities laws as well as foreign exchange laws. Depending on the structure of financial regulation in a particular country, the violation might then be pursued by more than one regulator. The fact that two or more regulatory authorities might have jurisdiction over the same misconduct is not necessarily a drawback except when it leads to a situation in which neither authority acts. Thus it is

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<sup>33</sup> For example, the scheme in St. Lucia mentioned above was identified through an Internet search.



important that local regulators keep a close dialogue with regard to Ponzi schemes and when necessary coordinate actions to tackle specific schemes. Such close dialogue is also extremely important with respect to the criminal authorities since a coordinated strategy can lead to more effective enforcement.

Finally, as the Madoff case and the schemes in the Caribbean suggest, these allegedly illegal activities do not recognize local boundaries. Operators of unregulated schemes can act from several jurisdictions, taking money from investors in different jurisdictions and hiding money in others. Thus, financial regulators should be in close dialogue with regulatory agencies from relevant jurisdictions to share information and to coordinate action. Financial regulators should have in place effective mechanisms for the exchange of information and cooperation in relation to curbing unregulated schemes. The IOSCO's MoU is becoming an important tool for countries to achieve this objective.<sup>34</sup>

### **Keep the public informed**

The development of private capital markets rests on the assumption that the public understands how financial markets work, the role of financial regulators, and their rights and responsibilities as investors. Thus, in the long run, broad financial literacy programs can help to diminish the problem of unregulated schemes. In addition, it is crucial that regulators keep the public informed of the existence of unregulated schemes as well as the actions that are being taken by them to stop particular schemes. Tools to raise investor awareness include:

- **General warnings** regarding the methods used to defraud investors (red flags) and the need to ask questions regarding a potential investment's financial viability and to invest only through licensed entities.
- **Notices and lists of individuals or entities** that hold or do not hold a license to carry out financial activities.
- **A database of actions taken** against specific individuals and entities (for example, cease and desist orders, monetary penalties, etc). For this purpose the regulatory agency should have a clear policy regarding publicity of enforcement actions.

## **V. CONCLUSION**

The case history demonstrates that Ponzi and pyramid schemes are phenomena that can occur in any financial market, industrialized or developing. The business opportunities that they claim to offer and "legal structures" that they use to operate are diverse. Schemes have offered returns based on foreign exchange trading, real estate investment, and financial instruments, under structures such as joint-stock company, hedge funds, commercial banks,

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<sup>34</sup> The Caribbean jurisdictions which are signatories to the IOSCO MoU are Bermuda and the British Virgin Islands.

or simple pools of assets. At the same time, promoters employ many similar techniques to pitch their scheme, to identify target groups, to obtain publicity, and to build credibility. Experience also shows the pervasive effects that such schemes can have if left undetected, from lack of trust in financial institutions to large-scale economic, social, and political damage. Thus, there is a need for a strong governmental response to stop them and protect investors.

There are lessons to be learned from the regulatory response of industrialized countries vis-à-vis more developing countries. In the majority of industrialized countries, regulators have a wide range of tools at their disposal to deal with unregulated and/or fraudulent schemes and use them effectively to stop their operation. The ability to impose precautionary measures, such as freezes of assets, as soon as a scheme is discovered is essential in successfully dealing with UIS. The judiciary has supported such measures and a body of jurisprudence has been developed, making the prosecution of future cases easier. All these measures are complemented with active financial literacy programs that work on the side of investors to help them to understand better how financial markets work and the role of regulation. As a result, while large and long-lasting schemes still can appear, as the Madoff case reminds us, they are more likely to be stopped as soon as they are discovered.

That has not been the case for some developing countries, where unregulated investment schemes, including fraudulent schemes, have been able to flourish. The lack of a strong regulatory response, along with underdeveloped formal financial institutions, have been at the heart of the ability of unregulated and fraudulent schemes to develop. The experience shows that the lack of such response is a reflection of a broader problem, which is the challenge faced by regulators in many developing countries to develop credible enforcement programs. Many regulators in developing countries lack the necessary tools, resources and sometimes political independence to cope with financial misconduct, including the operation of Ponzi schemes. Moreover in a global financial market, effective enforcement requires the ability of regulators to exchange information and cooperate with one another. Such cooperation and exchange of information has proven critical in combating unregulated schemes, given their demonstrated ability to relocate from one jurisdiction to another. However, for many developing-country regulators such cooperation is still an aspiration, given legal limitations to their authority to exchange critical information and cooperate with foreign regulators.

This paper has provided a basic action toolkit in the hope that it will help governmental authorities determine the best course of action in their respective jurisdictions, including if necessary the pursuit of legal and institutional reforms to strengthen their enforcement frameworks to cope with unregulated schemes.

## **Annex I. Other Recent Investment Schemes**

### **A. United States**

#### *Description of schemes*

Perpetrators of fraudulent schemes in the United States have marketed a wide variety of “business opportunities” to lure investors, and the schemes have taken a wide variety of forms. Over time the U.S. SEC has developed red flags for investors to identify different forms of investment frauds, including Ponzi schemes.

During the period October 2008–January 2009 alone, the U.S. Securities and Exchange Commission obtained court orders against alleged Ponzi schemes as follows:

- US\$342 million taken in claiming returns of 11–12 percent per month for hedge funds.
- US\$370 million taken in claiming returns of 14 percent in less than 3 months to finance bridge loans.
- US\$50 million taken in claiming returns of 19–38 percent per year from securities futures trading in January 2009.
- US\$25 million for currency trading promising a return of 10 percent every 30 days in January 2009.
- US\$23 million affinity fraud targeting Haitian-Americans in December 2008. Investors were promised a 100 percent return in 90 days.
- US\$25 million for trading mortgages with reported returns of 10–17 percent in November 2008.
- US\$30 million for an export business in October 2008.
- US\$60 million for bridge loans in October 2008. The case was heavily reported because the principal Norman Hsu had, according to the SEC, made contributions to prominent politicians.
- US\$19 million in October 2008 for commodity futures contracts.

The most recent cases which have caught the attention of public and the media are two large scale alleged investment frauds, operated by Bernard Madoff (as described below) and Sir Allen Stanford (as described above).

## **Bernard Madoff Investment Securities LLC**

The Madoff case is allegedly the largest investor fraud ever committed, with losses estimated as US\$50 billion. According to the SEC's complaint, Madoff admitted to two employees of Bernard Madoff Investment Securities (BMIS) that he had been conducting a Ponzi scheme through his firm's investment adviser for many years. The SEC's civil investigation and the Department of Justice's (DoJ) criminal investigations are ongoing.

Madoff was a prominent member of the securities industry, serving on the board and in leadership positions of both the National Association of Securities Dealers and the NASDAQ Stock Market. According to the complaint in the criminal case, Madoff has confessed that he and Bernard Madoff Investment Securities, a broker dealer and investment adviser registered at the SEC, ran a Ponzi scheme for many years using the investment adviser services of the firm. The firm's purported investment strategy consisted of purchasing blue chip stocks and taking option contracts on them. Madoff has allegedly acknowledged that he never undertook those transactions. His fund offered attractive and unusually steady returns to an exclusive clientele, especially targeting prominent Jewish executives and organizations.

### ***Legal and Regulatory Framework***

At least three different governmental agencies have jurisdiction over investment fraud: the SEC, the CFTC, and the Department of Justice (DoJ).

The Securities Act of 1933 and Securities Exchange Act of 1934 provide the framework for regulation of the U.S. securities industry. According to this framework, the public offering of securities and collective investment schemes requires registration by the SEC. In addition, securities intermediary must be licensed by the SEC. There are also antifraud provisions. Breaches of such obligations and provisions constitute an offense.

The SEC has the authority to directly investigate breaches of such provisions. The SEC has civil and administrative remedies at its disposal. Civil remedies are sought in civil courts, while administrative cases are heard by an administrative law judge.

Civil remedies available include emergency relief, which allows the SEC to protect the status quo while the final decision on a case is being considered. Emergency relief can include measures such as temporary injunctions, freezes of assets, appointment of receivers. In some circumstances, such emergency measures do not require prior notification to the plaintiff. On final judgment, the SEC can seek the imposition of civil monetary penalties, disgorgement of ill-gotten benefits, and orders to bar an individual from the securities industry. Persons who violate a court order may be found in contempt and be subject to further monetary penalties or imprisonment.

Remedies available in an administrative proceeding are very similar to those described above. For example an injunction in federal court has a similar effect than a cease and desist order granted by an administrative law judge. The only important exception is the imposition of monetary penalties in non-regulated entities which can only be pursued as a civil violation in federal courts.

The CFTC has at its disposal similar tools to the SEC, and the two may act in conjunction to seek actions. In practice, the SEC accounts for a large proportion of enforcement actions, as almost all of the schemes have a “high yield” component and fall under securities laws.

Securities fraud also constitutes a criminal offense, and as such can also be prosecuted by the DoJ. Parallel proceedings, in which the SEC and the DoJ conduct independent civil and criminal investigations are common, and the SEC is authorized by statute to provide evidence to the DoJ.

### ***Regulatory Response***

The SEC has taken action against a large number of Ponzi and pyramid schemes. Schemes may come to the SEC’s attention through a variety of sources, including market surveillance, investor complaints, self-regulatory organizations and other industry sources, and media reports. The SEC staff conduct an investigation, and may subpoena witnesses once the Commission issues a formal order of investigation. The staff present their case to the Commission for review, which may then authorize the staff to take action.

In practice, the authorities most often address Ponzi schemes through civil action, based on the breaches of several provisions of the securities laws and regulations, mainly those requiring registration of public offerings, registration/licensing of broker dealers and the antifraud provisions. The SEC usually seeks first emergency relief including temporary restraining orders, freezes of assets, an appointment of receivers. Courts hear the cases immediately and in practice are very receptive to SEC requests. However, any orders entered at the outset are temporary, and final relief is dependent on an eventual trial or summary judgment on the merits (unless a defendant defaults). The development of a large amount of jurisprudence has in fact helped to ease the prosecution of these cases. Once it has a court order, the SEC then issues a press release announcing the court order and providing information on the alleged fraud and perpetrators—who may not have been aware of an investigation or complaint to the court. On final judgment the SEC usually seeks a permanent injunction, the imposition of civil penalties, and disgorgement of ill gotten benefits. However, the vast majority of cases are settled before trial.

In cases where the damage is particularly high it is usual also that criminal charges be brought in parallel with the civil remedies.

### **Madoff Investment Securities**

Madoff’s broker-dealer and, more recently, his investment adviser arm were registered with the SEC. The SEC has been criticized for missing numerous red flags and ignoring tips on Madoff’s alleged fraud, including complaints by Harry Markopolos, a financial analyst. The SEC’s chairman Christopher Cox has stated that credible and specific allegations regarding Mr. Madoff’s financial wrongdoing, going back to at least 1999, were repeatedly brought to the attention of SEC staff. He has instructed the SEC’s Inspector General to review past allegations and why they were not found credible, policies on raising such cases to the Commission level and whether these were followed, and all staff contact and relationships

with the Madoff family and firm, and their impact, if any, on decisions by staff regarding the firm.

On December 11, 2008, the SEC brought emergency actions in the district court, alleging violations of the United States securities laws and seeking a temporary restraining order against Madoff and his firm. The court issued a preliminary injunction order, freezing of assets and granted other relief against the defendants.<sup>35</sup> On the same day, in separate but related proceedings, the DoJ filed a criminal suit against Madoff charging him with one count of securities fraud. Madoff confessed to running a Ponzi scheme on March 12, 2009. On February 9, 2009, Madoff consented to a partial judgment in the SEC's civil action in which Madoff, without admitting or denying the allegations in the complaint, consented to payment of disgorgement, penalties and prejudgment interest.

The Securities Investor Protection Corporation (SIPC) successfully petitioned the District court in the civil matter to declare that BMIS should be liquidated and to appoint a SIPC trustee to marshal out BMIS' assets to customers and other claimants. The SIPC is funded by its member securities broker-dealers and maintains a special reserve fund to help investors at a failed brokerage. The reserve fund is available to satisfy remaining claims of investors of up to US\$500,000 for cash and securities.

### ***Size and Impact***

Ponzi schemes in the United States have rarely had a significant macroeconomic impact. Madoff's scheme was 0.3 percent of GDP, which is small relative to the other cases shown in Table 1 above.

## **B. Colombia**

### ***Description of schemes***

During November 12–13, 2008, the collapse of a scheme called DRFE (the Spanish initials for “Fast, Easy Money in Cash”) led to rioting and violent protests in 13 cities in Colombia. DRFE was one over 200 schemes promising returns of up to 300 percent within 6 months. Although the schemes initially drew funds from the poor, their appeal broadened over time and eventually included high-profile businessmen and politicians. Some local government councils invested in the schemes.

### **Grupo DMG**

One of the largest schemes, Grupo DMG, had been in operation for three years, and had over 60 branches in Colombia as well as offices in Venezuela and Ecuador. DMG distributed pre-paid credit cards which investors could use to buy appliances and consumer electronics from selected retailers. Customers could also collect points which could be redeemed for cash after several months. The scheme offered a return of 150–300 percent on this

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<sup>35</sup> SEC v. Madoff, et. Al., No. 8 Civ. 10791 (LLS) (Docket No. 8).

investment. Customers also became salesmen. It remained current on its obligations for three years, even after other schemes collapsed.

The founder of DMG, David Murcia Guzman, worked as a door-to-door salesman in a multi-level marketing company prior to opening DMG. As the head of DMG, he reportedly live a lavish lifestyle, with a private jet, and a fleet of expensive cars.

DMG allegedly provided financial support to political campaigns, particularly for regional offices. According to law enforcement authorities, a taped conversation indicates that DMG set aside US\$322,000 to obtain parliamentary support for a law beneficial to DMG and also sought to buy favorable media coverage.

### ***Legal and Regulatory Framework prior to the declaration of emergency***

The legal framework for financial institutions in Colombia subjects certain financial activities including deposit taking, securities intermediation and the public offering of securities to authorization by the Superintendencia Financiera (SF). In addition, Decree 1981 of 1988 states that collecting money from the public in a massive and habitual manner (*captacion masiva y habitual de recursos del publico*) without the proper authorization by the SF through a regulated entity, is an administrative and criminal offense (Article 1). Decree 1981 established the requirements to consider that such misconduct has taken place.

The *Estatuto Organico del Sistema Financiero* (EOSF) provides the SF with the authority to conduct on-site inspections on unregulated entities, as well as to examine their records, when there was evidence that the entity was undertaking a financial activity without authorization (Article 326). In addition, it provides the SF with the authority to impose certain precautionary measures on entities that undertake financial activities without authorization, although it required that the evidence meet the standards set by Decree 1981. Such measures included: (i) immediate suspension of the activities undertaken; (ii) liquidation of the entity; and (iii) fast and progressive liquidation of the operations undertaken illegally. Failure to comply with the order of suspension carried an administrative penalty of up to 61 million pesos (Decree 2269 of 1987, which regulates Article 65 of the Administrative Code).

According to Article 316 of the Law 599 of 2000 taking money from the public in a massive and habitual manner without authorization constituted an offense punishable with up to six years in prison.

### ***Regulatory response***

In 2006, the SF issued public warnings in newspapers regarding DMG. At a later stage, the SF imposed precautionary measures on specific schemes. The first resolutions date back to September 2007 when the SF imposed precautionary measures on DMG. Subsequently, in 2008, it also imposed precautionary measures on Corporacion Superservi, Grupo Network Inversiones Ltda; and DRFE. Such measures mainly included an order to cease the illegal activities and return the money collected from the public based on a restitution plan to be submitted by each entity to their regulatory agency or to the district court.

According to the authorities, the imposition of such resolutions proved to be a challenge for the SF, since some of the standards prescribed in Decree 1981 were based on accounting information, which was difficult and time consuming to collect given the unreliability of the accounting records of the perpetrators and the intensive use of cash that prevailed in such schemes, preventing any traceability of transactions. In addition, in many cases sophisticated schemes were designed to resemble legal activities, and this complicated the collection of evidence. Finally, the authorities commented that even in cases where the SF was able to impose precautionary measures, some of the schemes continued to operate by creating new vehicles different from the ones initially penalized.

### **Grupo DMG**

The first actions undertaken by the SF date back to April/May 2006 when the SF received telephone calls requesting information on whether DMG was authorized to collect money from the public. Such requests for information prompted the SF to undertake an *in situ* inspection on DMG; however according to the authorities the SF did not get sufficient information to determine whether the requirements set in Decree 1981 were met. In July and October 2006, the SF received six written requests asking if DMG was a regulated entity. Based on those requests the SF conducted a second inspection in November 2006. Subsequently, the SF issued public warnings in a local newspaper, stating that DMG was not a regulated entity and was not authorized to take money from the public.

In February 2007, the SF requested DMG to submit updated financial statements. Such information was received in April 2007. The SF carried out a third inspection during May and June 2007. Based on all the information gathered in the course of these inspections, including testimony of members of the organization, in September 2007 the SF issued resolution 1634 whereby it determined that DMG was taking money from the public and ordered it to suspend such activity and return the money it owed to the public. For that purpose, DMG had to present a restitution plan. The SF also passed the file to the Prosecutor's office, specifically to the unit in charge of money laundering crimes. It also sent the resolution to the Companies Registry in order to have it annotated in the record of the company and made publications in newspapers informing the public about the measures taken against the company.

DMG appealed such measures before the SF, however according to the legal framework the appeal did not suspend its effects.<sup>36</sup> By resolution 1806 of October 8, 2007 the SF confirmed the initial order. However, DMG continued to operate by creating a new company, and modified its modus operandi in an effort to circumvent the administrative order. In the authorities' view by the end of 2007, there was evidence that the illegal financial activity was in fact a mechanism to disguise other crimes, such as money laundering. Therefore, it was agreed among the relevant authorities to work and cooperate closely to address the case in an integral manner. According to the authorities this group met regularly throughout 2008 to discuss this matter in detail and define a coordinated action against DMG. As a consequence,

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<sup>36</sup> Technically it was a "reposicion" since it was heard by the same authority that issued the initial resolution.



the SS issued several administrative orders, and in November 2008, the General Prosecutor brought criminal charges against David Murcia and several DMG officers for money laundering and other related criminal activities.

### ***Government intervention***

Starting in 2008 other governmental authorities warned the public against UIS. In January 2008, the head of the SS informed the press that it would intervene against entities taking money from the public without authorization. Such intervention would take place on those entities that were not under the supervision of another entity.

In February 2008, the Minister of Finance issued a public warning against UIS and encouraged people to inform the authorities of the existence of UIS. In September 2008, the President of the Republic warned the public about the dangers of pyramid schemes and requested the head of the SF to develop a plan to dissuade Colombians from investing in pyramid schemes. Similar warnings were made by the President in the following months. On November 15, 2008 the President asked Congress to expedite the approval of a bill to criminalize pyramid schemes in Colombia, which had been presented by the government in September.<sup>37</sup>

Also on November 15, 2008 the President announced that the government was preparing emergency legislation. On November 17, the Government declared a state of emergency by Decree 4333. Colombian police sealed the offices of over 200 UIS, including DMG, and the government declared a nighttime curfew in the affected cities. The head of the SF resigned.

The government issued three other decrees to strengthen its ability to deal with UIS, stop their operation and recover funds.

Decree 4334 provides the government, via the Superintendencia de Sociedades (SS), the authority to intervene in the operations of any entity that undertakes the collection of resources or cash from the public without authorization. Administrative intervention<sup>38</sup> (*intervencion administrativa*) encompasses a wide range of administrative measures aimed at immediately stopping the operation of unregulated schemes and establishing an organized procedure to return money to the public. Thus, it allows the SS to take control of the entity and possession of all its assets, order the freeze of assets, and return funds to the public. All those measures can be imposed by the SS directly, without the need for court approval.

Decree 4335 provides the heads of local governments (*alcaldes*) with the power to impose certain precautionary measures (closing of the establishments) on entities that they suspect are undertaking financial activities without authorization.

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<sup>37</sup> The bill increased the penalty for collecting money from the public in a massive and habitual manner and made the failure to report to the regulatory agency by non financial institutions a criminal offense.

<sup>38</sup> Administrative intervention is a legal mechanism similar to conservatorship.

Finally Decree 4336 imposes the sanction of imprisonment of 10 to 20 years and pecuniary sanction of up to 50,00 minimum legal monthly wages<sup>39</sup> for those who undertake, promote, induce, finance, collaborate or carry out any other act to collect money from the public without authorization. In addition failure to make restitution of the money owed to the public constitutes an offense punishable with imprisonment of 8 to 15 years and a pecuniary sanction of 13,333 to 15,000 times the minimum legal monthly wage.

### *Size and Impact*

According to press reports, it is estimated that as many as 4 million Colombians invested over US\$1 billion in the schemes and that 85 percent of adults in one city had invested. However, it is very difficult to estimate how many people and resources were really affected in these schemes, and reports from the liquidation officers are still pending.

Commercial banks had expressed concern that their depositors were withdrawing funds to invest in schemes. The collapse of the schemes is not expected to have a significant impact on economic growth. In addition, it is not expected to affect commercial banks, as there were limited linkages.

The government announced that it would not bail out investors and that they might not get their money back despite the government's best efforts to recover funds. It did provide credits through public banks to those who lost money in the schemes. Some investors continue to insist it was a legitimate business and that the government's intervention caused its collapse. The founder of DMG fled the country to Panama, but was subsequently extradited back to Colombia. Several DMG officials have already been sentenced for money laundering.

## **C. Lesotho**

### *Description of the scheme*

An investment scheme in Lesotho originated from an initially legitimate and viable company.<sup>40</sup> The MKM Burial Society/Star Lion Group offered a pre-paid funeral service product. Members of the society paid subscriptions entitling them to fully paid funeral services regardless of whether their subscription was fully paid at the time of death. One of the entities involved in the scheme was a licensed insurance company. While the burial society may have been a viable financial structure at its inception, MKM proceeded to use its membership base to offer a series of deposit-like financial products with very high returns.

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<sup>39</sup> Rather than establishing a specific amount for the monetary penalties, Colombian law uses an index, the "minimum legal monthly wage", as a way to keep their value. This is a practice common in countries that have faced inflation.

<sup>40</sup> Central Bank of Lesotho (2008).

The first scheme offered a 60 percent annual rate of return for a fixed term of twelve months. Payment was pledged at the end of the term. The scheme was successful and became widely subscribed. The scheme's owner became well known for his charitable activities. By the end of 2006, however, cash flow problems emerged, subscribers were urged not to take their cash owed but to rollover their "deposits." In addition, a new financial product was introduced with a 10-year maturity which helped address the scheme's cash flow. The new product promised to pay one million maloti (about US\$100 thousand) after ten years of monthly payments of 300 maloti, which an implicit yield to maturity of about 55 percent per annum. It appears that this scheme was initiated to cover the cash flow of the initial scheme. By mid-2007, the scheme began offering other products—one with features of a pyramid for membership recruitment and expansion, and another with a larger payout for a longer term.

### ***Regulatory Framework***

The Central Bank of Lesotho (CBL), operating under the authority of and the Financial Institutions Act of 1999, is responsible for the supervision of banks.

According to the FIA financial institutions are subject to licensing by the CBL. While the law prescribes what comprises a financial institution under several categories, the process of stopping the operation of an unlicensed financial institution requires the CBL to first send auditors to make an assessment of an alleged illegally operating financial institution. Only once the audit is completed or the entity thwarts the audit can the CBL take action to suspend operations.

### ***Regulatory Response***

The CBL issued a general warning to the public in September 2007 on pyramid schemes. In November, the CBL applied to the High Court seeking an order that MKM was conducting banking and insurance business contrary to relevant law, as a first step toward suspending its operations and taking control of its assets. The application noted the CBL's view that it represented a systemic threat to the financial sector and that the entity was unable to pay claims on time. The Court granted an order suspending its operations and freezing its assets. The order also transferred control of assets to PricewaterhouseCoopers, which was also charged with investigating and auditing MKM. The government agreed to make insurance payouts, while investors would be repaid only from seized assets, which are believed to be minimal.

Protracted litigation followed, and the liquidation of MKM is still pending. In December 2008, MKM petitioned the High Court to prevent it from being liquidated.

### ***Size and Impact***

The MKM scheme took in funds representing about US\$42 million (Maloti 400 million) from around 100,00 investors, according to a published summary of a report by its receiver. The economic impact of the scheme's collapse was felt primarily through the loss of incomes. The investment scheme had few links to the banking sector, as it operated chiefly in cash.

## **D. Albania**

### ***Description of the schemes***

Shortly after transition to a market economy in the 1990s, Albania suffered severe consequences from the collapse of several “pyramid schemes” (Jarvis, 2000). In its transition to a liberalized market economy, the financial system was converting from one which was chiefly state owned. An informal sector formed to fill in gaps in financial services. One feature of the crisis was that individual schemes had sizable deposits in the banking system. Another key feature of the Albanian pyramid scheme crisis was the number of schemes that operated independently of each other. These schemes competed with each other increasing interest rates and impeding cash flows of the schemes. Competition among schemes is cited as the trigger in the collapse.

### ***Regulatory Framework***

At the time the pyramid schemes emerged, Albania had not yet put in place a regulatory framework for the financial sector. Banking supervision and regulation were rudimentary. Furthermore, the responsibility for supervising the informal market was in dispute. The Law on the Banking System of 1996 provided the Bank of Albania the power to close illegal deposit taking institutions. The law stipulated that “no person other than a bank shall accept household deposits, demand deposits, and deposits with an initial maturity of 12 months or less.”

### ***Regulatory Response***

Regulators intervened with the fraudulent schemes too late. Although the Bank of Albania viewed the schemes as illegal deposit taking institutions, this view was not shared by the Chief Prosecutor, and the Ministry of Justice refused to give an interpretation. Senior government officials frequently appeared at functions and parties organized by the companies. Aside from civic disruption and government collapse, much time was required for resolution of the failed institutions. In addition to introducing anti-pyramid legislation, reliance was placed on foreign administrators to work-out and liquidate or otherwise resolve the schemes. This was challenging given that the public distrusted foreign intervention.

Albania did not bail out investors in the scheme. As part of their intervention, they also resorted to freezing assets of the schemes in the formal banking sector.

### ***Size and Impact***

The Albania pyramid scheme crisis of 1996-1997 was unprecedented in terms of the size and impact. At their peak, the nominal value of the schemes’ liabilities amounted to almost half of GDP. When the schemes collapsed, there was uncontained rioting, the government fell, and the country descended into anarchy and a near civil war in which some 2,000 people were killed.

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