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Economic Downturn Accelerates Collapse of Ponzi Schemes

By Del Quentin Wilber
Washington Post Staff Writer
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The great recession has decimated many industries; home builders, automakers and bankers are obvious casualties.

Now, add Ponzi schemers to the list.

Ravaged by the same fiscal turbulence pounding the nation's legitimate businesses, Ponzi operations have been collapsing at a record clip, exposing prolific, rampant and colossal frauds that have bilked investors of billions of dollars.

The FBI, which is handling about 20 such cases in the Washington region, has almost 500 open Ponzi investigations nationwide -- up from about 300 in 2006, bureau officials said. Law enforcement officials with other agencies have noticed similar trends, and authorities said they expect to turn up many more cases in coming months.

"We have more open Ponzi scheme cases than at any time in FBI history," said Special Agent David G. Nanz, chief of the FBI's economic crimes unit. "We anticipated a spike, but the numbers we are seeing are even greater than expected. . . . There is an old saying, though: 'When the tide goes out, you can see who isn't wearing a bathing suit.' And that definitely applies to Ponzi" operators.

Pyramid schemes like those named after Charles Ponzi, a notorious rip-off artist who stole millions in 1920, involve investors who are told that they are buying real estate, securities and other assets. But no investments are ever made, and the flow of new money is used to pay "returns" to earlier investors. Eventually, the flow of new money dries up and everything collapses.

Authorities said the schemes blossomed during good times. But their very nature -- the constant solicitation of new investors to pay off old ones -- makes them vulnerable to the harsh economic climate. Federal officials said they also have become more aggressive in trying to uncover schemes before they implode and the assets evaporate.

The cases range from the $65 billion fraud orchestrated by Bernard L. Madoff, a former chairman of the Nasdaq stock exchange, to what is now considered a relatively minor rip-off -- a $23 million fraudulent hedge fund run by a Jacksonville, Fla., man guaranteeing a 50 percent rate of return.

In the Washington region, federal prosecutors recently charged five people in a $70 million mortgage fraud Ponzi scheme that targeted many in Prince George's County. Last week, they announced that they had charged a Vienna man with stealing $17 million in a sophisticated Internet Ponzi operation that led investors to believe that he had offices in the District, New York and London. In reality, the man rented a box from Mailboxes Etc., prosecutors said, and spent investors' money on expensive cars such as a Bentley and Ferrari.

"It has been a flood," said veteran postal inspector James H. Tendick, who supervises the Justice Department fraud team. "We don't have to go out scouring for these things. They are all just coming in the door."

As recently as a few decades ago, most Ponzi schemes were relatively small, relying on word of mouth, direct mail and advertisements in magazines. They generally burned out after two or three years. But through the Internet and modern communications, Ponzi schemes have grown in size, scope and sophistication.

During the economic boom years, many schemes lured investors -- including huge hedge funds and financial firms -- into putting up billions of dollars. Smaller investors, drawing on home equity loans, also flooded Ponzis with cash.

The largest operations were the one run by Madoff, who is scheduled to be sentenced this month on fraud charges, and what authorities say was an $8 billion scheme managed by R. Allen Stanford, a prominent Texas businessman.

Then the housing bubble burst, and the stock market began to sag and the financial markets went into cardiac arrest. Soon, Ponzi operators couldn't find new investors to keep their wheels spinning. Investors began screaming for their money back. When their calls were not returned or they were blown off, they started calling authorities. Cautious potential investors, bombarded with news reports about Madoff, quickly alerted regulators and federal agents to deals that seemed too good to be true.

"A lot of investors have become more aware of the risks and are asking harder questions," said Scott Friestad, deputy director of enforcement at the Securities and Exchange Commission, adding that he was "surprised that there are so many instances where people have raised hundreds of millions of dollars from thousands of investors and been ripping them off as pervasively as they have."

With the walls crashing down, insiders even started reporting each other, and some Ponzi operators surrendered to federal agents, hoping to cut deals.

That is what happened to Joseph S. Forte, 54, of Broomall, Pa., federal prosecutors said.

Authorities said that over 12 years, Forte collected $80 million from at least 80 investors who believed that he was putting their cash into Standard & Poor's index futures contracts.

By 2008, Forte's revenue dried up because he could no longer find anyone willing to invest with him, authorities said. Then he couldn't pay off redemption requests, and he turned himself in to authorities, postal inspectors wrote in court papers. Forte has pleaded guilty to fraud charges.

Federal agents uncovered what they allege is a $3 billion pyramid operation allegedly operated by one of Minnesota's most prominent businessmen, Thomas Petters, after an employee tipped them off to the operation.

The employee reported the fraud, her attorney has said, because she had lost confidence in Petters's ability to pay back investors. Petters has pleaded not guilty.

And in April, a California man was indicted on charges of operating a $40 million scam that promised investors, many of whom he met at church, huge returns in a hedge fund. Suspicious about the firm's financial performance, a potential investor approached federal authorities, court records show.

"This kind of climate is death on Ponzis," said William K. Black, a law and economics professor at the University of Missouri-Kansas City School of Law and a former executive director of the Institute for Fraud Prevention.

But Black said the same trends that pumped up the Ponzi industry and then tore it apart will eventually lead to new opportunities for scam artists who manage to escape the law and financial carnage. The crooks know that potential investors, some desperate for a quick return, will not always be so wary.

Staff researcher Meg Smith contributed to this report.

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