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August 1993
Volume 62
Number 8

United States
Department of Justice
Federal Bureau of
Investigation
Washington, DC 20535

William S. Sessions,
Director

The *FBI Law Enforcement Bulletin* (ISSN-0014-5688) is published monthly by the Federal Bureau of Investigation, 10th and Pennsylvania Avenue, N.W., Washington, D.C. 20535. Second-Class postage paid at Washington, D.C., and additional mailing offices. Postmaster: Send address changes to *FBI Law Enforcement Bulletin*, Federal Bureau of Investigation, Washington, D.C. 20535.

Cover photo by
Larry Wallery, FBI

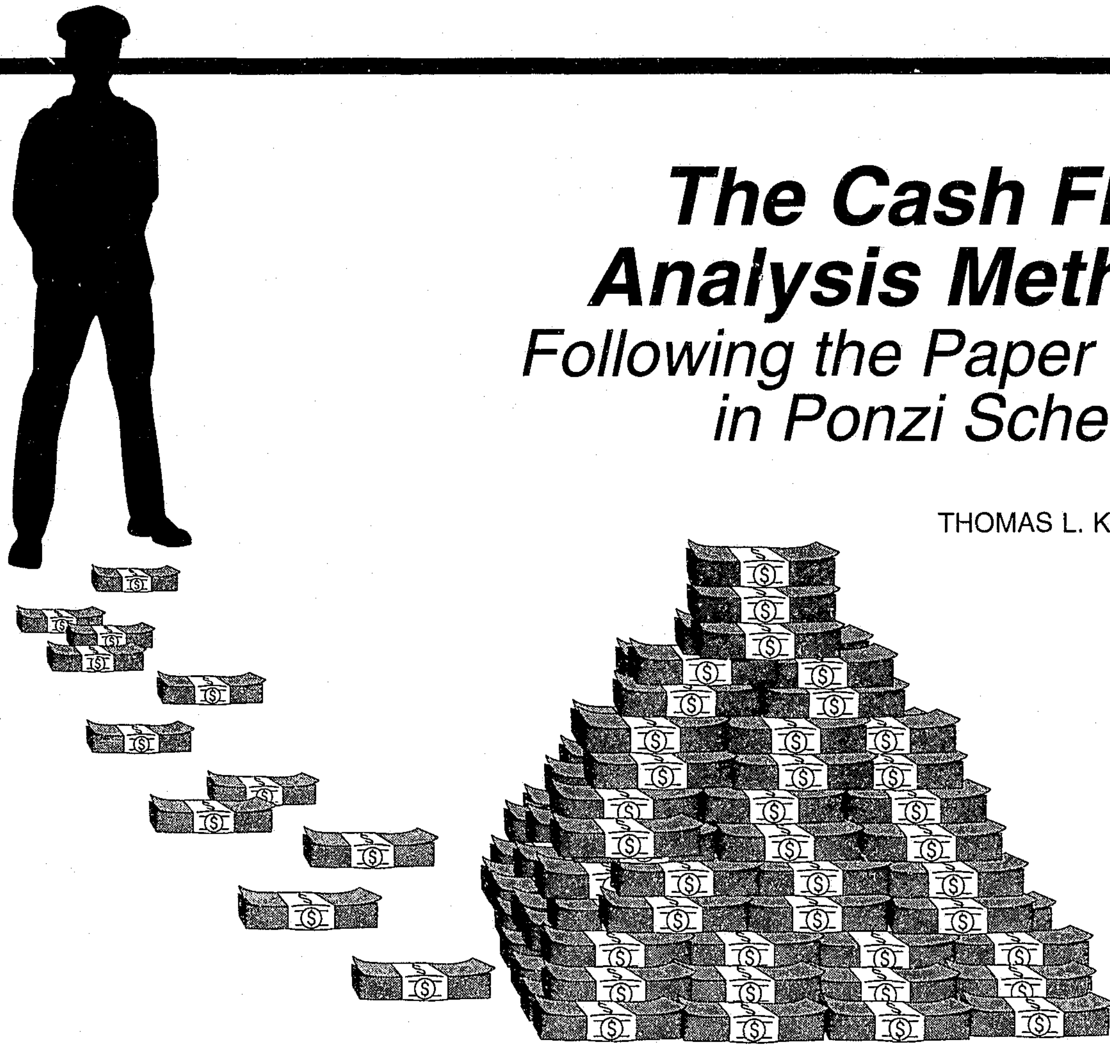
FBI Law Enforcement BULLETIN

Features

Departments

ISSN 0014-5688
USPS 383-310

144711



The Cash Flow Analysis Method
Following the Paper Trail in Ponzi Schemes

By
THOMAS L. KITCHENS

Among criminals, Charles Ponzi—a diminutive swindler who emigrated from Italy to the United States in the early 1900s—was afforded a rare distinction. A specific category of financial scam was named in his honor.

Today, Ponzi schemes continue to flourish throughout the United States. In a typical scam, an offender lures unsuspecting investors with claims of unusually high yields on their investments. While the offender provides contributors with vague background information on the firm or venture to be backed, no such entity actually exists. Instead, the offender attracts more and more investors, using their new money to make interest payments to previous investors—in other words, "robbing Peter to pay Paul." In reality, the offender uses the bulk of the immense cash reserves to finance an expensive lifestyle and pay personal bills.

For a number of reasons, these types of "pyramid schemes" have traditionally been among the most difficult cases for law enforcement agencies to detect. The investigations invariably involve multiple victims and witnesses—often from numerous jurisdictions—as well as thousands of documents and court exhibits. In the past, these cases generally took several years to investigate and prosecute. However, the Ventura County, California, District Attorney's Office now employs an investigative technique that, when appropriately applied, significantly reduces the time required to investigate Ponzi cases.

Accountants and auditors have long used cash flow analysis to trace the flow of funds into and out of particular bank accounts. The overall objective of the cash flow analysis method with regard to Ponzi scheme investigations is to establish how offenders illegally received and spent their victims' money, the total amount of money stolen, and the number of victims involved. Each of these considerations becomes an important issue when courts render punishment to convicted offenders.

A TYPICAL PONZI SCHEME

Using the cash flow analysis method, the Ventura County District Attorney's Office has successfully prosecuted a number of complex pyramid scams. The following case demonstrates many of the characteristics of a typical Ponzi scheme.

Charles Stephen Hodson presented himself as an investment banker. In reality, he stole nearly $10 million from victims—many of whom were family members and acquaintances—over a 6-year period.

Hodson told his victims that through connections with several "Fortune 500" companies, he could offer investment opportunities guaranteeing 18- to 25-percent interest returns on privately borrowed funds. He went on to inform some investors that he also had connections in Switzerland, where he could deposit their money in major banks that paid high interest rates. Hodson further informed investors that the terms of their investments would generally be from 60 to 90 days.

While these types of arrangements—known as commercial paper transactions—can be legitimate, Hodson possessed none of the "connections" he claimed. In fact, he never intended to invest his victims' money. Hodson simply used the funds to support his own lavish lifestyle.

Still, once the victims invested, most received timely interest payments, as Hodson had promised. However, these payments did not come from dividends on investments; they came from funds drawn against Hodson's own business checking account.

Hodson's scheme began to crumble when he stopped making monthly interest payments to his victims. Several filed reports with the local police agency, prompting an investigation into Hodson's business dealings. A cash flow analysis of relevant bank account records clearly revealed that Hodson did not invest any of his victims' money into major corporations or Swiss banks.

Hodson was convicted of several counts of grand theft and income tax evasion and is currently serving a 7-year sentence in a California State prison. Many of his victims suffered financial devastation.[1]

> ***"[The cash flow analysis method] significantly reduces the time required to investigate Ponzi cases."***

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CASH FLOW ANALYSIS METHOD

The cash flow analysis method is a two-step process. The first step for investigators is to obtain all relevant records—such as checks, deposit slips, and monthly bank statements—from the financial institution(s) in which the suspect placed the victims' money. The second step involves turning over these financial records to a forensic accountant for the cash flow analysis.

Step One

Since most victims make their investments by personal or cashier's check, the Ponzi artist usually deposits these funds (if only temporarily) into a bank account. This makes each investment a traceable transaction. After investigators become confident that they have amassed sufficient probable cause, they can obtain a search warrant and secure the relevant records.

Generally, in an investment fraud case, courts base the probable cause necessary to obtain a search warrant on multiple factors. Several individuals must have given money to a suspect for purposes of making an investment; these investors relied

Charles Ponzi

Born in Parma, Italy, in the late 1800s, Charles Ponzi immigrated to the United States in 1903. Destitute, he eventually settled in Boston, Massachusetts, where, in 1919, he founded the Securities and Exchange Company. From his location in the heart of the financial district, Ponzi sold 45- and 90-day promissory note investments to the unsuspecting public, to whom he guaranteed 50- to 100-percent interest rates. He informed investors that he was purchasing International Postal Reply Coupons from Spain and could sell them in the United States at a substantial profit due to the excessive differences in exchange rates following the First World War.

The investment opportunity became popular instantly. Crowds lined up daily outside Ponzi's office. The money came in so fast that Ponzi's office clerks began hiding it in desk drawers, wastebaskets, and file cabinets. In just 7 months of operation, it was estimated that Ponzi accumulated over $9 million from more than 30,000 investors. His reputation for paying exorbitant interest rates made this an even more attractive investment. At the same time, Ponzi enjoyed a lavish lifestyle at the expense of his investors.

In July 1920, a local newspaper reporter began investigating Ponzi's claims. The newspaper published an article exposing the investments as a scam. Soon after, the district attorney in Boston initiated an audit of the Securities and Exchange Company's financial records. While the audit proceeded, Ponzi agreed to cease accepting new investors, but he continued to pay interest payments on the existing investments.

Meanwhile, the audit revealed that Ponzi had merely taken new investor funds to pay off previous investors. His "magic" had been to amass large numbers of "Peters" to pay off the "Pauls." In reality, the audit showed Ponzi to be insolvent from the first day of the swindle. In the end, he owed investors nearly $14,375,000. At the conclusion of the audit, he admitted that it was all a scam. Ponzi was prosecuted and convicted in both Federal and State courts for the fraud.

While on appellate bond, Ponzi fled to Florida, where he orchestrated a real estate swindle. After serving a 1-year sentence in county jail for this scheme—which involved selling underwater plots to unsuspecting customers—he was returned to Massachusetts to serve lengthy Federal and State sentences. Upon his release, Charles Ponzi was deported from the United States. He died in 1949, a patient in the charity ward of a South American hospital.

This information was drawn from Francis Russell, "Bubble, Bubble—No Toil, No Trouble," *The Boston Post*, August 12, 1920, 74-80, 86; J. Nash, *Bloodletters and Badmen*, (1973), 448-451.

on the suspect's promise that their funds would be invested for a specific purpose and for a limited period of time; and the time period has since expired without repayment to the investors or a reasonable explanation from the suspect.

Investigators should be aware that because grand juries possess the authority to subpoena all information relevant to matters under their investigation, financial records may also be obtained through a grand jury subpoena duces tecum.[2] However, for a cash flow analysis, securing a search warrant is generally preferable.

By securing a search warrant, investigators receive the relevant bank records directly, which can then be given to the forensic accountant. If the financial records are obtained through a grand jury subpoena duces tecum, auditors must complete the cash flow analysis while the grand jury hears the case. This may prolong the time required for an indictment.

Step Two

The second step for investigators in this process is to turn over all of the financial records obtained through the search warrant or subpoena to a forensic accountant for the cash flow analysis. The forensic accountant then analyzes the bank account records and prepares cash flow compilations of these records in financial statement form. This statement shows all of the known receipts of a particular bank account during a specified period of time. Accordingly, this report demonstrates the flow of funds into and out of a Ponzi artist's account.

When completed, the compilation also assists investigators to determine whether the suspect accurately represented the investments to contributors. If investigators determine that a crime may have been committed, the compilation can then be introduced at subsequent court proceedings as demonstrative evidence of theft. The cash flow analysis compilation allows prosecutors to provide juries with a tangible record of how the suspect committed the crime and spent the victims' money.

USE OF FORENSIC ACCOUNTANTS

Investigators traditionally underuse forensic accountants in white-collar crime cases. This is an unfortunate and potentially damaging oversight.

In other types of major crime cases, investigators employ such specialists as pathologists, serologists, psychiatrists, fingerprint and document examiners, and criminalists to aid in analyzing evidence. Similarly, in many major white-collar fraud cases, forensic accountants should be called on to apply their training and expertise to legal matters and to testify in court as expert witnesses.

OBSTACLES TO INVESTIGATION

In a Ponzi scheme, investigators face the arduous task of determining the validity of suspects' claims to victims regarding their investments. In addition, prosecutors must then demonstrate *how* offenders spent the victims' money. These two elements make Ponzi schemes especially difficult to investigate and prosecute, since Ponzi artists generally "cover their bases" well.

> "...by using this approach, investigators can aggressively combat a type of crime that prosecutors once had difficulty proving beyond a reasonable doubt."

Often, in order to limit victims' inquiries, offenders represent investment opportunities as being highly technical and sophisticated in nature. Further, many white-collar crime victims hesitate to cooperate with investigators, fearing that when the offender becomes aware of an investigation, investors will never be repaid. Or, victims may simply be embarrassed because they made a foolish investment.

While victim reluctance to cooperate hampers many white-collar crime investigative techniques, it has little effect on the cash flow analysis method. Because this approach traces suspected illegal activity through financial records, it relieves investigators and prosecutors from basing cases predominately on the testimony of victims.

CONCLUSION

Ponzi artists operate in nearly every jurisdiction throughout the United States. They often rob unsuspecting victims of their life savings and lead them to financial ruin.

The cash flow analysis method allows investigators in Ventura County to address this crime by reducing the number of workhours required to investigate Ponzi schemes. It does so by providing an easy-to-follow approach to what is traditionally a time-consuming and research-intensive process.

The cash flow analysis method also uses forensic accountants to audit suspects' financial records so that prosecutors can call upon these expert witnesses to trace the trail of the stolen funds. Perhaps most important, by using this approach, investigators can aggressively combat a type of crime that prosecutors once had difficulty proving beyond a reasonable doubt. ✦

Endnotes

[1] *People* v. *Hodson* (Superior Court, Ventura County, 1987, No. CR-22899).

[2] This is a writ that requires a party summoned to appear in court to bring along a document or other piece of evidence for examination by the court.