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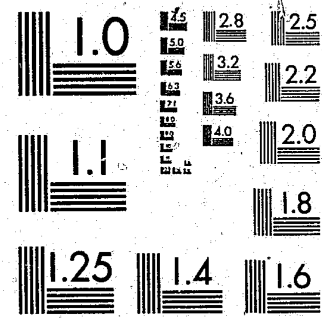

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FBI LAW ENFORCEMENT BULLETIN

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William H. Webster, Director

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Ponzi Schemes and Laundering--

How Illicit Funds are Acquired and Concealed

By
VINCENT P. DOHERTY
and
MONTE E. SMITH
Special Agents
Economic And Financial Crimes Training Unit
FBI Academy
Quantico, Va.

Historically, "crime" has been considered only in terms of acts of violence, threats of violence, and overt thefts. Our system of jurisprudence has evolved by defining as illegal certain activities directed against property and persons, and over a number of years, law enforcement agencies have developed generally accepted methods for investigating these traditional crimes.

In 1949, however, a new type of crime was brought to the attention of law enforcement when Professor Edwin H. Sutherland coined the term "white-collar crime." He defined this crime as " . . . a crime committed by a person of respectability and high social status in the course of his occupation." [1]

The definition of white collar-crime has, since 1949, expanded to include acts committed by people of less than high social status, and our appreciation for the impact of this crime has prompted law enforcement to look beyond traditional acts for illegal and criminal behavior.

Herbert Edelhertz, writing in 1970, provided a comprehensive definition of white-collar crime as " . . . an illegal act or series of illegal acts committed by nonphysical means and by concealment or guile, to obtain money or property, to avoid the payment or loss of money or property, or to obtain business or personal advantage." [2] This definition considers white-collar crime in terms of the nature and character of the wrongful activity involved rather than the offender.

This distinction is important for law enforcement officials, since a successful prosecution must show that one or more criminal statutes were violated by the activity in question. Thus, in white-collar crime investigations, efforts must be directed toward proving an illegal activity rather than concentrating on the offender. The law enforcement officer must find the crime rather than the criminal.

It is important, therefore, for the officer to understand exactly how the crime is committed and at what juncture or junctures in the activity the illegality occurs. Knowing the identity of the perpetrator of a fraud is not enough. The law enforcement officer must be able to understand, explain, and show conclusively how and why the activities are illegal.

Special Agent Doherty

Special Agent Smith

This article takes an in-depth look at two types of white-collar crime in an effort to demonstrate the complexity of the crime and to explain how the activities are fraudulent. The Ponzi or pyramid schemes and the laundering of funds activities are only two examples of dozens of bribery, kickbacks, payoffs, bankruptcy, credit card, check, consumer, and insurance frauds and schemes that occur each year. Nonetheless, analyses of these two schemes may provide the officer familiarity with the type of activity involved in any white-collar crime.

Ponzi and Pyramid Schemes

Pyramid sales schemes, otherwise known as chain referral schemes or Ponzi schemes, have mushroomed across the United States and may be operating in other countries. There is no way of calculating the exact amount of money lost by the victims of pyramid schemes, but it is estimated to be well over one-half billion dollars in the United States alone. Some officials even contend that pyramid sales schemes are the number one consumer fraud problem today. Despite the scope of the problem, many persons still do not know what pyramids are or the dangers inherent in them.

A pyramid sales scheme is a marketing program by which people buy the right to sell others the right to sell a specified product. The promoters select a product, such as household items, cosmetics, or safety devices, and sell large inventories to distributors with the added incentive of permitting the distributor to sell new distributorships. The real profit is earned primarily by recruiters developing new recruits who develop even more recruits. In all of this activity, there is little or no real concern given to direct sale of products or services to the public. Consumer distribution, therefore, becomes a sham and acts merely as a cloak of respectability.

One of the earliest known examples of a pyramid scheme appeared in 1920, in Boston, Mass. Charles Ponzi, an Italian immigrant and financial wizard, established the Securities and Exchange Company. The corporation consisted of only Ponzi, who started his company with a few hundred dollars borrowed from two silent partners. The company's prospectors promised investors substantial returns on their investments in Ponzi's company. Within 45 days an investor would receive his original investment plus 50 percent interest; in 90 days, he would double his original investment. By June 1920, Ponzi claimed to be receiving $500,000 per day and paying out $200,000 a day.

Ponzi explained to doubters that knowing how to take advantage of the varying currency exchange rates in different parts of the world was how he made his profit. He started his company upon receiving a business letter from a conspirator in Spain, who enclosed a reply coupon which, if exchanged at any U.S. Post Office, was worth 6 cents. In Spain, the cost of the coupon to a buyer was only 1 cent. Ponzi reasoned that by buying the coupon in Spain and redeeming it in the United States, he made a 5-cent profit. Thereafter, Ponzi began operations in nine different countries, with his agents traveling back and forth between these countries and the United States to take advantage of the disparity in currency value.

A *Boston Post* newspaper reporter was convinced that Ponzi had never purchased any coupons and that he was taking money from one investor to pay off another. Further investigation by this reporter turned up information that Ponzi, under his real name Charles Bianchi, had been sentenced to prison in Canada for forgery several years earlier.

By the end of 1920, Ponzi's world collapsed and he was subsequently convicted in Massachusetts. Of the $15 million that Ponzi had taken in, there was no accounting for $8 million. Such schemes became known as Ponzi schemes.

Today, another Ponzi plan, sometimes called the pyramid scheme, has hit the United States. It involves the making of $16,000 from a $1,000 investment. To play the pyramid game, one needs only a chart and $1,000 in cash. (See fig. 1.)

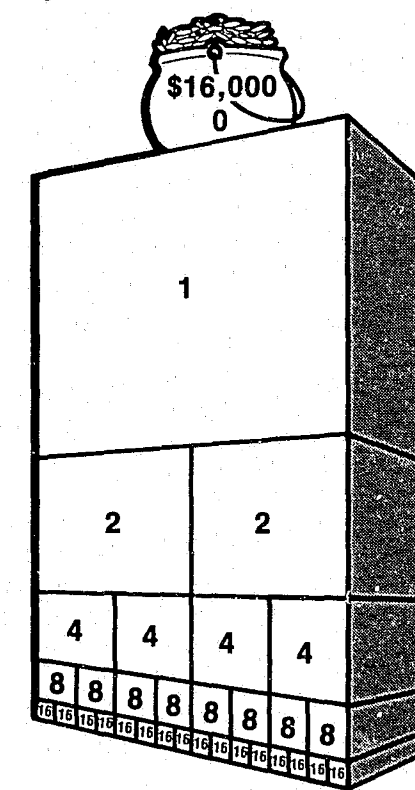
With the $1,000, you can buy a "slot" on the bottom line. This purchase is accomplished by giving $500 to each investor above you on the 8th line and to the player in the zero position. Pyramid success occurs when all the slots on your line are filled and you are able to progress up the chart. When an investor finally moves into the zero position, he or she can begin collecting up to $16,000.

At the heart of each pyramid scheme is the representation, expressed or implied, that a new participant can recoup his original investment by simply finding and inducing two or more prospects to make the same investment. Promoters fail to tell prospective participants that this is mathematically impossible, since some persons drop out of the pyramid while others recoup their original investment and then drop out. This simple misrepresentation constitutes the heart of the fraudulent scheme.

If each investor recruits two additional investors in an effort to get his money back and no one drops out, everything works according to plan. If there are 15 investors at the first meeting to start a pyramid and one person at the top level, the number of new members doubles each day thereafter until, at the end of 2 weeks, 262,143 persons are involved and at the end of 3 weeks there are 33,554,431 participants. It is obvious that the whole scheme must collapse before this is reached. Therefore, the earlier one gets in on the pyramid, the better the possibility to collect the $16,000. For everyone to win, an infinite number of investors is needed to fill the chart from the bottom up.

"One immediate answer to reducing the effectiveness of pyramid schemes is to increase the public's awareness of the impossibility of success in the schemes."

Figure 1



Problems for Law Enforcement

When corporate entities are employed, company promotions of Ponzi plans frequently take on enormous and complex proportions, making auditing difficult, expensive, and time consuming. Too many promoters in local areas make prosecution impractical. By the time informative actions are taken, most promotions have run their course, rendering restraining orders ineffective.

The overall problem of establishing criminal liability is made more difficult by the need to separate victims from promoters. Peculiarly, it is in the victim's best interest to become a promoter and transfer his loss to another. Participants who lose their entire investments do so only because they cannot convince others to invest. For this reason, useful victim testimony is limited. The prosecutor finds appealing victim testimony only from those investors who invested in the pyramid for reasons other than participation in the chain-referral recruiting.

One immediate answer to reducing the effectiveness of pyramid schemes is to increase the public's awareness of the impossibility of success in the schemes. Public education is an effective tool in combating the Ponzi schemes. Law enforcement should not rely solely upon adverse publicity, during or after disclosure of a Ponzi scheme, as the means for combating the crime.

The Laundering of Money by Organized Crime

At the end of the 19th century, most money earned by the American underworld was money gained through extortion, blackmail, and dock racketeering. By the 1920's, the chief source of income had changed to bootlegging, and some believe that it was prohibition that supplied organized crime with the funds and expertise to operate multimillion-dollar ventures.[3] Today, it is estimated that organized crime has invested more than $20 billion into between 15,000 and 50,000 business establishments in the United States.[4] It is estimated that annually, organized crime businesses take in at least $48

billion in gross revenues, with about $25 billion in untaxed profits.[5] If these figures are accurate, it becomes obvious that organized crime has historically been successful in concealing from law enforcement officials and legitimate businessmen the true nature and origin of funds invested in business enterprises.

Definition of Laundering

Alphonse Capone, the infamous gangster of the 1920's is said to have amassed a fortune of $20 million in a 10-year period through such illegal activities as bootlegging and gambling.[6] Yet, when Capone was sentenced to 11 years in prison in 1931, it was for an income tax evasion conviction, not because he had been charged with any of these illegal activities.

The conviction of Capone taught other organized crime members an important lesson: Money not reported on an income tax return is money that cannot be spent or invested without risk of detection and prosecution.

Since most monies collected by organized crime activities are from illegal sources such as loansharking, prostitution, gambling, or narcotics, the individual racketeer is understandably reluctant to report the income and its source on his tax return. Before spending or otherwise using these funds, it is necessary that these monies be given an image of legality so that they can be reported on a tax return without revealing the true nature of their origins. This process of conversion is known as "laundering."

If law enforcement officials are to combat organized crime successfully, they must have an understanding of how monies acquired from illicit sources are transformed into respectable funds that can be spent and invested without fear of discovery or prosecution.

"If law enforcement officials are to combat organized crime successfully, they must have an understanding of how monies acquired from illicit sources are transformed into respectable funds that can be spent and invested without fear of discovery or prosecution."

Domestic Laundries

While laundering money can be accomplished in a wide variety of legitimate businesses, it should be recognized that certain domestic businesses have characteristics which lend themselves to successful laundering operations. For example, the business selected as a "laundry" must be capable of absorbing a large volume of cash income, since most illicit income is received in the form of cash. The purpose of laundering funds is to commingle licit and illicit monies so that they cannot be separated, while simultaneously preventing the discovery of the introduction of illegal monies into the business. Since almost all checks and credit card receipts are traceable by law enforcement officials, businesses such as restaurants, bars, and massage parlors, which normally take in a high proportion of cash, tend to be more desirable as a potential "laundry" than a business normally receiving most of its income in the form of checks or other traceable financial instruments.

Another favorable characteristic for a "laundry" is relatively fixed expenses which do not vary with sales volume. An example of such a business is a movie theater showing pornographic films. The expenses of such a business (rent, electricity, wages) are almost constant, regardless of whether the theater is full. Illicit income can be introduced and camouflaged in this type of business quite easily, since the additional sales volume does not result in a proportional increase in business expenses. Law enforcement officials who later examine the records of such a movie theater would have a difficult time proving that the actual or "legitimate" income generated by the theater was much less than that recorded on the books and reported to the taxing authorities.

Businesses that normally experience a high rate of spoilage or other loss of goods also have a high potential for being used to launder money. Groceries and restaurants are good examples, since some spoilage of goods is expected during the normal course of business. When such a business is controlled, large blocks of illicit money are introduced into the business and recorded in the general income accounts of the grocery store or restaurant as if this money were received from customers. Fraudulent invoices for produce or other perishable items are then issued to these businesses by other mob-owned or mob-controlled companies acting as suppliers. The grocery store or restaurant either issues checks to these "suppliers" or records the transaction as a cash payment and charges the expenditure to an expense account, such as cost of goods sold. The undelivered produce or perishable items listed as spoiled and discarded are written off the books. (See fig. 2.)

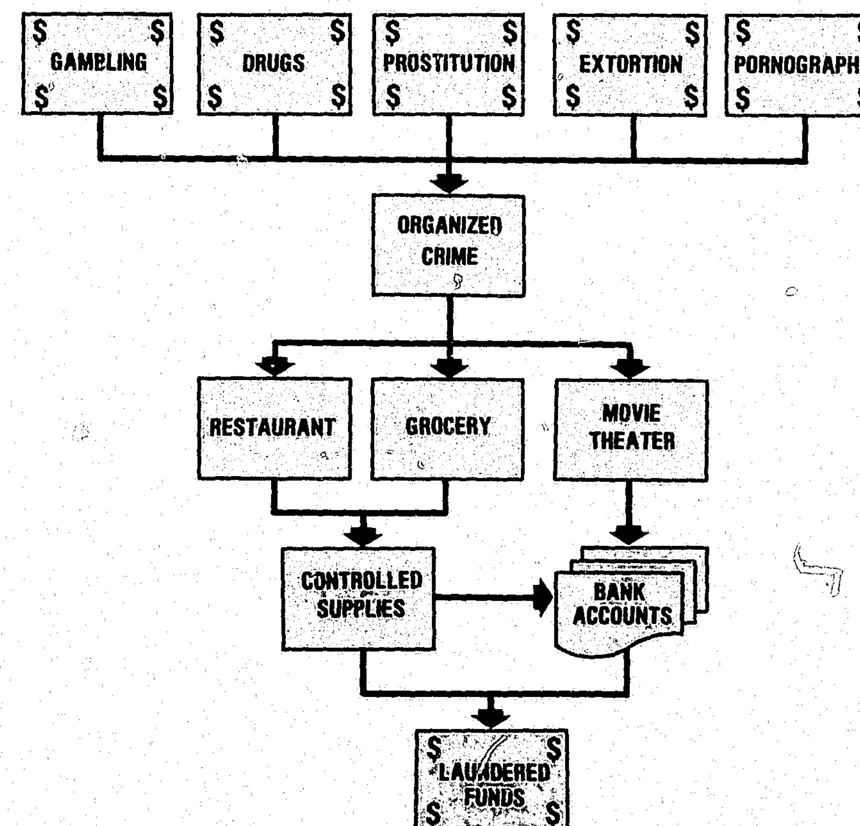
By using this method, the grocery store or restaurant avoids substantial tax liability on large blocks of illicit monies introduced into the business, since this income is offset by corresponding expenses relating to the nondelivered goods. The funds paid to the "supplier" by the grocery or restaurant have taken on an image of legality and may be spent or invested with very little risk of discovery. Within a week of this "transaction," it is almost impossible for law enforcement officials to disprove the story of the grocer or restaurant owner.

The above techniques have been used to launder funds successfully for a number of years, and large numbers of domestic businesses controlled by organized crime are still being used for this function. Recently, however, law enforcement officials have adapted new methods, such as sampling, ratio analysis, and flowcharting, to discover laundering operations and to prosecute successfully the people involved in the conversion process.

". . . law enforcement officials have adapted new methods . . .to discover laundering operations and to prosecute successfully the people involved in the conversion process."

Simply stated, "sampling" is a statistical procedure wherein the number of customers of an establishment is randomly counted, a conservative estimate is made of the amount of money spent by each customer, and a projection is made as to how much money is actually received by an enterprise in the ordinary course of operation. This procedure is similar to that used to project the outcome of an election with only a small percentage of the votes counted. If the projected income is materially smaller than that reported to taxing authorities, it is a good indication that the business is being used to launder funds.

Figure 2



The use of ratios to evaluate businesses has been used for many years by accountants, investors, and lending institutions. There are four basic types of ratios in common use:

1) Liquidity ratios, which indicate the ability of an enterprise to satisfy its immediate (short term) financial obligations;
2) Operating ratios, which indicate the efficiency of the business enterprise;
3) Profitability ratios, which indicate the effective use of assets and the return on the owner's investment in the business; and
4) Leverage ratios, which indicate the extent to which the enterprise is financed by debt.

By using ratio analysis, an investigator is able to compare the past performance of a business enterprise to that of the industry in which the business operates. This comparison is for the purpose of spotting significant deviations from the norm, which may indicate the existence of a laundering operation.

Another method used to uncover domestic laundering operations involves researching the corporate and ownership structures of both the suspected business and all the companies with which the suspected business deals. Since the ultimate success of a laundering operation is dependent upon keeping the money "in-house," there will be a commonality among the various businesses. The relationship between the various companies may be illustrated visually by the process of flowcharting, which allows investigators, prosecutors, and juries to grasp more easily the sometimes complex relationships which exist in laundering operations.

While law enforcement agencies have been relatively successful in detecting and exposing domestic laundering operations, it should be realized that underworld leaders have developed and perfected a number of international money laundering operations that have traditionally been immune from this detection and exposure. Although these international laundries vary greatly in form, organization, and complexity, the object is still to disguise the true nature and origin of funds derived from illegal activities. International laundering schemes often involve the use of dummy corporations and numbered bank accounts, or they may use securities or financial instruments issued by banks located in a country where banking regulations are lax (often referred to as "off-shore banks").

Foreign Laundries

It will come as no surprise to most law enforcement officials that much of the money invested by organized crime in legitimate businesses in the United States is first routed through secret numbered bank accounts in countries such as Switzerland, Liechtenstein, West Germany, Panama, and the Bahamas. This type of arrangement is ideal for the racketeer who wishes to clean large amounts of cash earned through illicit activities. Very often, this laundering process involves depositing illicit funds in a secret numbered account, then bringing the funds back into the United States in the form of a loan from either the foreign bank or from a dummy corporation set up under the laws of a foreign country. Not only are the illegal income and the sources of this income hidden from the Internal Revenue Service and other law enforcement agencies, but the "interest" on this supposed loan is often deducted as a business expense on the tax return of the racketeer.

In many cases, organized crime members have not been content with merely using secret numbered accounts in foreign banks. As early as the 1960's, it was recognized that numerous banks in Switzerland and the Bahamas had been taken over by Americans known to be associated with organized crime activities.[7] Not only did the American ownership protect the identity of bank customers and allow for the falsification of bank records, but it also enabled the racketeers to bring apparently legitimate monies back into the United States in the form of various financial instruments issued by these banks and by foreign governments. It did not take long for these owners to realize that controlled banks could also be used to generate other illicit income through the issuance of fraudulent financial instruments that are used in this country as collateral for loans and in other fraud schemes. Enforcement agents working for the U.S. Comptroller of the Currency now estimate that the volume of phony financial instruments issued by offshore banks is "in the hundreds of millions of dollars."[8]

Implication for Law Enforcement

The successful use of domestic businesses to launder dirty money depends upon keeping the cash flow "in-house" and creating such complexity that investigation into the operation appears to be too complicated to undertake. Experience has shown, however, that these laundering operations are not complicated and can be successfully investigated by law enforcement officers willing to use techniques such as sampling, ratio analysis, and flow-charting, combined with traditional methods of investigation.

The success of organized crime in laundering funds through secret numbered bank accounts and foreign corporations and through securities and financial instruments issued by offshore banks has, in large part, been a result of the fact that these "foreign laundries" have traditionally been beyond the jurisdiction and resources of law enforcement agencies operating in the United States. While investigating this type of a laundering operation remains expensive, difficult, and time-consuming, significant steps have been taken in providing investigators with new jurisdictional tools to combat this problem.

On January 23, 1977, a Mutual Assistance in Criminal Matters Treaty between the United States and Switzerland became effective. As a result of this treaty, U.S. law enforcement authorities are now able to obtain previously secret bank information where organized crime is involved.

Investigators are further aided by the passage of "The Currency and Foreign Transactions Reporting Act" (U.S.C., title 31, secs. 1051–1143). This act and the Treasury Department's regulations implementing its provisions set forth reporting requirements for any person importing or exporting currency or other financial instruments totaling more than $5,000. Further, banks and financial institutions must report currency transactions in excess of $10,000 to the Internal Revenue Service.[9] This act also requires all U.S. citizens having a financial interest in, or signature authority over, bank securities or other financial accounts in foreign countries to report this relationship annually to the Treasury Department.

Summary

Laundering operations evolved because members of organized crime needed a source of apparently legitimate income to invest in business enterprises and to account for excess consumption and changes in personal net worth over any period of time chosen by taxing authorities for a comprehensive investigation. These operations have continued because legitimate businesses also provide other essential services needed by organized crime, such as warehousing, transportation, and a place to do business. The concept of investing illegally derived income into legitimate businesses within America becomes most disturbing when one considers that the very methods used to obtain these illicit funds can also be applied to the marketplace to eliminate competition, compel the purchase of defective merchandise, and gain unfair business advantages over more honest businesses.

Historically, law enforcement efforts have concentrated on the illegal activities of organized crime rather than on what was done with the income derived from these activities. If investigative efforts against organized crime are to be successful, law enforcement agencies must also begin to concentrate on how these illicit funds are being converted and used to infiltrate legitimate businesses.

Conclusion

White-collar crime, like traditional crime, has existed for hundreds of years. Our system of jurisprudence has, however, concentrated on those crimes involving violence, threats to person and property, and overt theft. For this reason, laws were passed to deal with the poorer, more visible criminal element, and law enforcement agencies have concentrated their investigative efforts on these types of crimes.

Following the massive securities swindles and bank failures of the 1930's, government leaders and criminologists began to address the problem of white-collar crime and passed the first laws to deal with these crimes. Since that time, both the general public and the law enforcement community have come to perceive these activities as illegal, and studies have shown that the costs of these crimes are a threat to our economy.

Few police officers, however, have had experience and training in this subject. The two types of white-collar crime explored in this article illustrate the wide diversity of activities which qualify as this type of crime. This examination of the subject is intended to be of assistance in law enforcement efforts to combat this crime. If the rapid increase in white-collar crime is to be dealt with effectively, it is essential that law enforcement officials understand the nature of these crimes and develop new techniques to investigate these activities successfully. **FBI**

Footnotes

[1] Edwin H. Sutherland, *White Collar Crime*, (New York: Dryden Press, 1949), p. 9.

[2] U.S. Department of Justice, LEAA *The Nature, Impact, and Prosecution of White-Collar Crime* (Washington, D.C.: U.S. Government Printing Office, 1970) pp. 4–6.

[3] August Bequai, *Organized Crime, The Fifth Estate*, (Lexington, Mass.: D.C. Heath and Company, 1979), p. 183.

[4] Lawrence J. Kaplan and Dennis Kessler, *An Economic Analysis of Crime*, (Springfield, Ill.: Charles C. Thomas, 1976), p. 275.

[5] "The Mafia—Big, Bad and Booming," *Time*, May 16, 1977, p. 33.

[6] Wayne Moquin and Charles Van Doren, *The American Way of Crime—A Documentary History*, (New York, N.Y.: Praeger Publishers, Inc., 1976), p. 68.

[7] James Cook, "The Invisible Enterprise," *Forbes*, October 13, 1980, p. 125.

[8] Jim Drinkhall, "Con Men Are Raking In Millions By Setting Up Own Caribbean Banks," *The Wall Street Journal*, March 23, 1981, p. 1.

[9] Robert E. Chasen and Arthur Sinai, "Currency and Foreign Transactions Reporting Act—A New Law Enforcement Tool," *FBI Law Enforcement Bulletin*, August 1979, pp. 1–5.

15-Percent Decrease in Bombing Incidents

The number of bombings during the first 6 months of 1981 represented a 15-percent decrease when compared to those occurring in the same 6-month period of 1980. In the first half of 1981, there were 553 bombings in the United States and Puerto Rico. Of these, 369 were explosive and 184 were incendiary. Last year, during January through June, 654 bombings were reported. Explosive bombings and incendiary incidents were down 16 percent and 14 percent, respectively.

This year's bombings resulted in 11 deaths, 68 injuries, and property damage estimated over $55 million. Of the 11 fatalities, 4 were the perpetrators themselves. Five of those killed were the intended victims and two were innocent bystanders. The 11 deaths represented a decrease from the 13 deaths that occurred in the first 6 months of 1980.

The number of persons injured also declined—from 75 reported in the first half of 1980 to 68 in the same period of 1981. Of those injured this year, 25 were innocent bystanders, 22 were perpetrators, 16 were intended victims, and 5 were law enforcement officers.

Residences were the most frequent targets of the bombings, accounting for 33 percent of the incidents. Other leading targets were commercial operations and office buildings, vehicles, and school facilities. Eleven attacks were directed at law enforcement.

Regionally, the Western States recorded 209 bombings; the North Central States, 154; the Southern States, 130; and the Northeastern States, 54. Puerto Rico reported six incidents.

END