



# ROBBING PETER TO PAY PAUL

## Ponzi Schemes Throughout History

By Becky Laughner

PONZI SCHEMES HAVE captured the public's attention recently with the fall of Bernard Madoff's investment fund, which, at approximately \$36 billion, is the biggest financial fraud in history. The principle behind a Ponzi scheme is simple. The Securities Exchange Commission defines it as investment fraud involving the payment of returns to existing investors from funds contributed by new investors, with the organizer usually focusing on soliciting new investors in order to provide promised payouts to earlier investors instead of engaging in legitimate investment activity. Since no legitimate profits are generated, Ponzi schemes are not sustainable and inevitably collapse because they require more and more deposi-

tors to support the fictitious returns. The Museum's new exhibition, "Scandal! Financial Crime, Chicanery and Corruption that Rocked America," focuses on the most infamous Ponzi artists: Charles Ponzi, Ivar Kreuger and Bernie Madoff.

### The Original Ponzi Artist

The eponymous Charles Ponzi gained his notoriety when he coaxed approximately \$7 million from investors in 1920. Ponzi began making a name for himself in Boston, promising a 50% return in 45 days with the purchase of his "Ponzi notes." An Italian immigrant and self-made businessman, Ponzi set up a firm with a seemingly officious and legitimate name, the Securities Exchange Company, and sold fake securities to investors. His many investors did not realize that his company made no actual profit.

Instead, Ponzi paid dividends on his notes with money collected from subsequent investors, which in turn required him to find yet more investors to cover his increasing liabilities. Ponzi realized that such a plan is not an easy undertaking, but he had confidence and cunning in spades. He also concocted a plausible investment strategy.

To attract his initial investors, Ponzi advertised his high returns, explaining that investment money was being used for the "lucrative" arbitrage of International Reply Coupons (IRCs). The Universal Postal Union introduced IRCs in 1906 as a way for people to purchase postage for someone in another country, particularly necessary in that era due to the explosion of immigration across Europe and in America. IRCs could be purchased in one country and then redeemed in another for standard letter postage

*Ponzi artists (left to right): Ivar Kreuger, Bernie Madoff and Charles Ponzi.*

to a foreign country. Although the rate of exchange was set by regulations, the devaluation of currencies across Europe following World War I wreaked havoc with rates, creating a potential arbitrage opportunity. In theory, the trade of International Reply Coupons could produce a profit, but there have never been enough coupons in circulation to support the scale of Ponzi's scheme. Most investigators never probed deeply enough to realize that his IRC plan was a hoax, and if they attempted to do so he claimed he could not reveal his source for the coupons for fear that a competitor would steal his methods. Most of all, his impressive knowledge of the intricacies of the postal system was enough to convince anyone who questioned his tactics.

Ponzi's scheme was eventually exposed. The editors and reporters

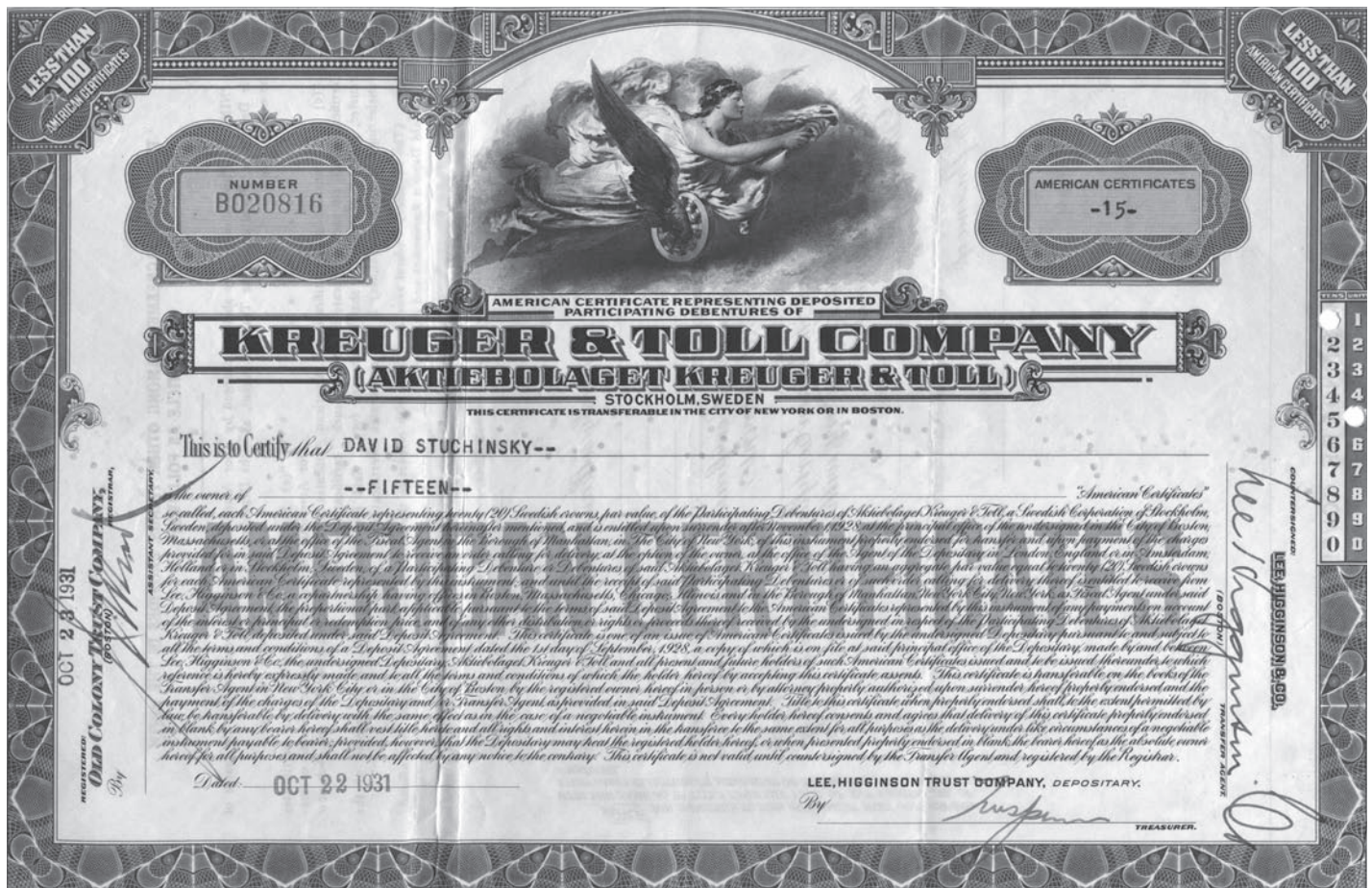
of the *Boston Post* (now defunct, but which won a Pulitzer in 1921 for its coverage of Ponzi and his crimes) became suspicious and brought the scheme to the attention of financial reporter Clarence Barron (founder of *Barron's*) to look into Ponzi's operations. Barron determined that Ponzi was most likely a fraud but the final straw came after the *Boston Post* revealed Ponzi's dubious history and criminal past in its pages. The news triggered runs by investors to exchange their notes, causing the scheme to unravel. When an audit was conducted to determine how much money had been lost, the final tally was almost \$4 million. Six Boston banks were also ruined, and Ponzi's investors received only about 30 cents on the dollar for their investments.

For his crimes, Ponzi served almost 10 years in federal and state prison

and was eventually deported back to Italy. He lived there briefly until he got a job through a cousin in the airline industry and moved to Brazil. He worked there quite successfully until World War II disrupted the airline's service between Italy and Brazil. Despite his innate genius and charismatic personality, he spent his life trying to get rich quickly and ultimately died penniless in Rio de Janeiro in 1949 at the age of 67.

### The Match King

Ivar Krueger was known as the "Match King" because his factories produced more than two-thirds of the world's matchsticks at the height of his reign in the 1920s. Although famous for his matchstick making, Krueger was actually a financial genius who mastered several industries. Using his experience in finance, he was able to utilize



Stock certificate for shares in Ivar Krueger's company, Kreuger & Toll, dated October 22, 1931.



*International reply coupons like this formed the basis for Charles Ponzi's money-making scheme.*

creative accounting practices without getting caught, and move money around via off balance sheet liabilities and inter-company holdings and raise massive capital by introducing complex hybrid securities.

Kreuger's life reads like a movie script. Born in Sweden to a family with a small match factory, Kreuger actually got his start in business in the engineering and construction industry. After finishing school in Sweden, he left for the US to make a name for himself and spent several years floundering, attempting to set himself up in different regions of the country. Eventually Kreuger got a lucky break that enabled him to pursue engineering. He spent much of his life as a young adult traveling the world assisting in major construction projects including the stadium for the 1912 Olympics, the Stockholm city hall, the Metropolitan Life Tower, the Flatiron building, The Macy's building, Syracuse University's stadium and many beautiful hotels around the world including the Plaza and St. Regis hotels.

After stumbling across "Kahn Iron," an innovative new reinforced

concrete building material used primarily in America, Kreuger came up with the idea of introducing it to Europe. Partnering with Paul Toll, a fellow Swede and Kahn's representative in Europe, the two pioneered new construction methods and formed the extremely successful Swedish engineering firm Kreuger & Toll. With Kreuger's business savvy, the company quickly developed a near-monopoly in construction in Europe and Scandinavia. Soon, though, Kreuger set his sights on bigger things and parted ways with Toll. Leaving him to run the construction company, Kreuger established and ran a spin-off holding firm bearing the same name as his construction company.

Kreuger began pursuing a different industry: matches. Due to its abundance of natural resources, especially timber, Sweden had long been a major player in the matchstick market. Beginning with the takeover of his family's match factory and then with other factories in the region, Kreuger quickly came to dominate the Swedish matchstick industry. Unlike Ponzi, Kreuger produced actual profits and was quite

a successful entrepreneur and financial manager. It would not be until later that Kreuger would begin his scheme.

In 1922 Kreuger made a triumphant return to America to court the prominent investment bank Lee, Higginson & Co. With his extensive knowledge and ability to recite facts and statistics on even the most arcane financial topics, Kreuger impressed the Lee, Higginson & Company board, and a partnership was formed. Together they introduced numerous securities to the American public over the next 10 years until Kreuger's death in 1932. Securities were issued for Kreuger & Toll, International Match and Swedish Match Company, the largest of Kreuger's companies, though it is believed that Kreuger supervised over 400 different corporations worldwide, some of which were legitimate and others that only existed on paper.

Because Kreuger was incredibly secretive and he alone controlled his businesses, he treated his companies as one giant corporation and freely moved funds between them, often to the confusion of his accountants. This provided him liquidity and the ability to pay consistently high dividends, usually 20–25%, even on his failed ventures. (One of Kreuger's unsuccessful endeavors included a try at the film industry, which he loved. He is credited with discovering Greta Garbo, a fellow Swede and long-time friend.) Kreuger realized that he could use the capital raised from International Match securities to negotiate loans to foreign governments in exchange for match monopolies. He then turned around and used profits of his monopolies to pay returns on his securities and negotiate the issuance of new securities. Playing on the incredible confidence US investors had in him, Kreuger would occasionally issue securities before the negotiations with national governments for match monopolies that funded the securities were finalized.

Kreuger was remarkable in that he

existed as a sort of private financier to the world, negotiating complex loans with governments. He essentially achieved what the Dawes Plan did by himself; in a little over a decade, Krueger negotiated loans with match deals to Peru, Poland, Ecuador, Estonia, France, Greece, Hungary, Latvia, Portugal, Romania, Yugoslavia, Germany, Bolivia, Bulgaria, Guatemala, Lithuania, Turkey and after extensive negotiations without a resolution, he fabricated a deal with Italy, even forging the Minister of Finance's signature on fake bonds. He was able to cover his liabilities *and* support new business endeavors by collecting funds from new security issues by Kreuger & Toll and its subsidiaries in a giant, complex Ponzi scheme.

After the Crash of 1929, Kreuger's companies appeared to weather the stormy economic climate better than most. Not believing that the crash would continue, Kreuger continued paying out false dividends and even extended his liabilities by negotiating a \$125 million loan to Germany. It was impossible to raise sufficient funds in the aftermath of the crash to keep up with his obligations. Eventually, Kreuger began to falter on his payments. Realizing he would soon be discovered, he committed suicide in March 1932. A financial crisis ensued almost immediately after Kreuger's death, but it would not be for another couple of years that the full extent of his deception would be known.

### **Bernard Madoff**

In 2008, the largest Ponzi scheme in history was revealed by the mastermind behind it: Bernard Madoff. Unlike Ponzi and Kreuger's pasts, Madoff's background provided no indication of his capacity to commit fraud. A co-founder and former chairman of NASDAQ, he served on the board of the National Association of Securities Dealers, was active in philanthropic circles, and his firm was

at one time the largest market-maker in NASDAQ securities. Founded in 1960, Bernard L. Madoff Investment Securities LLC was mostly known for market making and acting as the middle man in the transaction of buying and selling stocks. He was a pillar in the securities industry, providing solid advice for almost 50 years. When he turned himself in, he caught the world off-guard, including the Securities Exchange Commission.

It is estimated that Madoff's fraud began sometime in the 1980s or early 1990s, meaning he collected between \$10–17 billion in bogus investments in only 20 years. Estimated losses with fabricated gains are thought to be approximately \$65 billion. There are many similarities between Ponzi, Kreuger and Madoff's schemes. Like Kreuger, Madoff's legitimate activities acted as a cover for his fraudulent dealings. Madoff oversaw a secretive, guarded arm of his renowned firm that provided wealth management services. Keeping it separate from the rest of his business, even physically segregating it on another building floor from the rest of his operations, it was under this secret division that Madoff ran a Ponzi scheme with money from his wealthier clients. Madoff did not openly advertise his special private wealth management services, creating the illusion of exclusivity. The fund consistently paid out a steady return of 12% (less ostentatious than Ponzi's 50% or Kreuger's 20–25%). Once granted the privileges of investing with Madoff's fund, depositors were reluctant to question the details of his methods or strategy.

As a well-respected financial manager, a man who had testified before Congress and who had also worked alongside the SEC in the regulation of NASDAQ in its early days, the SEC found it unnecessary to interrogate his operations as well. His swindle was not actually discovered until he turned himself in, revealing everything and

taking sole credit for the entire scheme. It is curious that a serious investigation was never made. In hindsight, the signs are all there and we know that a handful of people had picked up on the suspicious nature of Madoff's profits. In May 2001, both *Barron's* and a trade publication called *Mar/Hedge* published investigative reports on his hedge fund, both citing the impossible annual returns, Madoff's decision to charge a paltry commission instead of collecting management fees, and *Mar/Hedge* additionally noted the unlikelihood of Madoff's hedge fund being one of the largest in the world while remaining virtually unknown. Harry Markopolos also vociferously proclaimed Madoff to be a fraud, picking up on suspicious behavior as early as 1999 and even reported his misgivings to the SEC on more than one occasion.

At age 71, Madoff went to trial and pled guilty to 11 federal offenses, possibly sparing his family and those around him from admitting responsibility. He was sentenced to 150 years in prison, the maximum allowable sentence with no possibility for parole.

None of these three stories have happy endings. Between severe prison sentences and death, each financier paid duly for their crimes. Even if they believed their schemes were only a temporary means to an end, they all ultimately proved that fraud does not pay (for very long) and that a Rob-Peter-to-Pay-Paul scheme is never sustainable. Despite these three examples, which vividly illustrate this important lesson, Ponzi artists continue to practice their art. Just as Kreuger ignored Ponzi's fate and Madoff disregarded them both, small scale Ponzi schemes are still amazingly still being revealed even with Madoff's name still in newspaper headlines. ■■

*Becky Laughner is the Museum's Assistant Director of Exhibits and Archives.*