

Understanding a Ponzi Scheme: Victims' Perspectives

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ABSTRACT

Ponzi schemes have received significant media coverage lately, due in large part to the Bernard Madoff scandal; however, there is limited academic research exploring investors' decision-making processes when investing in what ultimately is discovered to be a Ponzi scheme. We conducted semi-structured interviews of 17 investors in a Ponzi scheme to better understand the investors' decision-making processes, their perceptions of the fraud, and the mechanics of the fraud. Overall, the interviews reveal a fraud with the following characteristics: (a) older, educated victims; (b) a plausible story that traveled by word of mouth among people who knew each other well; (c) demonstrated returns over several months (people often watched others get checks for a few months before investing themselves); (d) low pressure (no urgency to invest); and (e) a "good guy" promoter who did charitable works. We discuss avenues for future research.

Keywords: Fraud, Ponzi, decision-making, investment.

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FBI agents, doctors, and lawyers invested in it...a relative suggested I invest...He [the promoter] was very charismatic. You don't really assume someone is going to take you for a ride. It's hard but with 20/20 hindsight, you look back and reevaluate everything, and he was obviously a crook. He appeared to be very spiritual. He brought up God a lot and prayed a lot. Very confident, he didn't try to convince you... He said he was just very successful... and wanted me to get in on the action.

I. INTRODUCTION

Ponzi schemes (pyramid schemes) are fraudulent investments where earlier investors' returns are paid from the contributions of later investors. As the quote above indicates, people can be drawn into Ponzi schemes without a "hard sell," as long as the perpetrator can create the impression of credibility, often through personality and charisma.

Ponzi schemes have received significant media coverage lately, due in large part to the Bernard Madoff scandal, and enforcement efforts are increasing (Anderson, 2009). However, there is limited academic research exploring investors' decision-making processes when investing in what ultimately is discovered to be a Ponzi scheme. One notable exception is recent work by Lewis (2010, 2011a, 2011b) that examines issues related to Madoff's fraud victims – the victims' efforts to recover their losses, how Madoff committed the fraud, and the victims' responses to the aftermath of the fraud. Those studies examine perhaps the largest Ponzi scheme in history.

The focus of this study is on a more typical Ponzi scheme, where the losses are in the millions, rather than billions, and the life of the fraud is short, rather than 10-20 years. We conducted semi-structured interviews of 17 investors in a Ponzi scheme involving several hundred investors who collectively lost tens of millions of dollars in a little over a year to better understand the investors' decision-making processes, their perceptions of the fraud, and the

mechanics of the fraud. Among the issues examined in the investor interviews are: (1) how the investor learned about the investment, (2) any professional advice received, (3) investment characteristics, (4) influences on the decision to invest, (5) investment promoter communication, and (6) overall reflections on their personal experience.

Overall, the interviews reveal a fraud with the following characteristics: (a) older, educated victims; (b) a plausible story that traveled by word of mouth among people who knew each other well; (c) demonstrated returns over several months (people often watched others get checks for a few months before investing themselves); (d) low pressure (no urgency to invest); and (e) a “good guy” promoter who did charitable works.

The next section of the paper provides background information on Ponzi schemes. The following sections present the research method, results, and conclusion.

II. BACKGROUND

Ponzi schemes are named after Charles Ponzi, who in 1920 promised investors he would double their money in 90 days by purchasing foreign postal coupons. His investments originally appeared successful as he paid earlier investors their promised returns; however, the scheme ultimately unraveled when he was unable to pay later investors (Tsai, 2009). Despite decades of media attention on Ponzi schemes, Mr. Ponzi’s methods continue to be used today. For example, in 2009, investors lost approximately \$16.5 billion in Ponzi schemes (Anderson, 2009), and the Madoff fraud alone appears to far exceed that amount. In addition, in early 2009, the SEC charged R. Allen Stanford for a “multi-billion dollar investment scheme” (SEC 2009), further evidence of the continuing prevalence of such frauds.

Elements of a Ponzi scheme include (1) investor deposits, (2) little or no legitimate business operations, (3) little or no business profits or earnings, and (4) the source of returns to investors is from cash received from new investors (Tsai, 2009). Investors in a Ponzi scheme not only lose principal invested when the scheme is discovered, but they may have to repay amounts received from the investment (i.e., clawbacks) before discovery that the investment was a fraud (Tsai, 2009; Benson, 2009). In addition, if the investor wants to recover any funds lost, a formal public claim of loss is required to be filed with the bankruptcy court exposing the investor to numerous legal notices, lawyer solicitations, and public identification.

In-depth research on the victims of Ponzi schemes appears to be limited. Recently, Lewis (2010, 2011a, 2011b) performed a series of studies on the victims of the Bernard Madoff fraud. Lewis found that Madoff used the art of impression management to ingratiate himself with potential or current investors. In fact, almost randomly, Madoff turned down potential clients to create an atmosphere whereby his investors felt special, unique, and part of a club. Similar to our study, Lewis found that Madoff investors had a great deal of anger not only at Madoff for swindling them, but also at the government-appointed trustee who is overseeing the liquidation and recovery of Madoff assets. In fact, the Madoff trustee has become a primary target of the investors' anger, as a result of the fees paid from recovered Madoff assets to cover the costs of the administration of the bankruptcy, as well as the methods used by the trustee to calculate victim losses.

III. METHOD

The 17 interviewees were among the several hundred investors in a Ponzi scheme, which court documents indicate lasted for over one year.¹ The perpetrator of the fraud, who was new to the community, represented to investors that he was an experienced trader in foreign currency. In fact, the perpetrator led training seminars in foreign currency investing, which often led to seminar participants investing funds with the perpetrator. The perpetrator lived an extravagant lifestyle and communicated to potential investors that he was “called” to share his success with others.

Investors were solicited to participate by their friends, neighbors, fellow church members, and business associates. Often, the solicitors were paid a commission by the perpetrator for each new investee. These commissions leveraged the existing community relationships of the solicitors, resulting in a large inflow of investee dollars in a relatively short time frame.

The investors deposited cash or transferred cash from an existing retirement account into the scheme and typically received a signed promissory note from the perpetrator guaranteeing their invested funds would be returned at the end of three years. In addition, a 5 percent monthly return on investment typically was guaranteed. When the scheme unraveled, the investors had lost tens of millions of dollars in a little over a year.

A list of the defrauded investors was obtained through court records. Potential investors were asked to participate in the study by phone and/or mail. Eighty-eight phone calls were made to solicit investors’ participation in the research. In addition, follow up letters were mailed to investors who did not respond to initial requests or whose phone numbers were unavailable to explain the potential benefits of the research and further solicit their participation. If the investor agreed to participate, a face-to-face interview or conference call time was set up to conduct the

¹ We have intentionally not provided details of the specific case, so as to further protect the victims’ privacy.

interview. Nine interviews were conducted face to face, and eight were conducted over the telephone.²

The investors were interviewed during September through December of 2010. The average length of the interviews was 55 minutes; the shortest was 15 minutes and the longest was 120 minutes. We used a list of questions, but encouraged the interviewees to discuss their experiences related to the investment and the impact of the investment on their future. All interviews were conducted by two co-authors or by a co-author and honors research assistant, and both researchers took notes during the interview either on paper or a laptop computer – attempting to capture the exact words spoken by the interviewee. After each interview (typically within 48 hours), the notes were reconciled by the two researchers into a final data version. The differences between the two researchers’ notes were minimal.

Using the final data version of the reconciled notes, a research assistant coded all of the data in a spreadsheet, creating categories of responses and frequencies. An interviewing co-author reviewed the assistant’s coding and data set and compiled key “quotes” from all of the interviewees. There were only insignificant and minor differences, which were reconciled.

IV. RESULTS

Interviewee Demographics

As shown in Table 1, many of the investors interviewed were older, retired, and had low to average investing experience, although those investors who agreed to participate in the interviews may have been those with more available time to participate (i.e., older and retired). The investors typically had some college education, with nine graduating from college, including

² Such a mix of face-to-face and telephone interviews is consistent with other studies (e.g., Beasley *et al.*, 2009).

two with a doctorate. The demographics appear to be consistent with typical nonprofessional investors, who are generally educated and older (Loyle, 2007).

Table 1
Interviewee Demographics
(n = 17)

Gender:	
Male	11
Female	6
Age:	
Mean age (range of 24-91; median = 59; standard deviation = 15.79)	61
Employment:	
Retired	8
Business owner	6
Professional	3
Investing Experience:	
Low	6
Average	10
High	0
Did not answer	1
Education:	
Bachelor's	6
Master's	1
Doctorate	2
Some college	5
Did not answer	3

How Interviewee Learned About the Investment

We asked the interviewees how the promoter identified them as potential investors (see Table 2). All 17 interviewees learned of the investment by word of mouth, which is consistent with findings in Shiller (1990). Shiller found that the actions and opinions of others often influence investment decisions. In fact, Shiller (1984) suggests that nonprofessional investors do not have clear objective evidence when investing in speculative assets; therefore, the investors tend to rely on the judgment of trusted others when making investment decisions.

Nine of the interviewees became aware of the investment opportunity through friends, four through relatives, three through advisor recommendations, and one through business interactions. Three interviewees describe how they learned of the investment, in each case highlighting the word of mouth introduction:

A real good friend of mine, had a really, really good friend who was connected with it [the investment]. Now she [friend of the friend] didn't know what was going on. [My friend] was a church-goer and was trying it and it was working. We didn't think she would get into something that wouldn't be ethical.

We had a meeting one night and the lady who was leading it, a prayerful friend... she mentioned that [the investment] paid a 5 percent return [per month]. We asked how she knew about it. It was from another prayer partner. I trusted them...

A friend invested, and she knew quite a few people in our community so she actually got many people involved in it through just knowing her and through business association already.

Table 2
How Investor was Targeted
(Open-ended Questions)
(n = 17)

<i>How were you identified as a potential investor?</i>	
Word of mouth	17
<i>By whom?</i> Most commonly mentioned items.	
Friend	9
Relative	4
Advisor	3
Other	1
<i>Did you have prior personal or professional ties to other investors in the Ponzi investment?</i>	
Yes	17
No	0
<i>Did you seek any advice from others prior to making the investment?</i>	
Yes	11
No	5
Did not answer	1
<i>Did you perform any other due diligence relating to the investment?</i>	
Private investigator	1

None of the interviewees had prior ties to the investment promoter, but all had prior personal and/or professional ties to other investors. Thus, the interviewees were introduced to the investment by someone they knew. At times, the introduction to the investment was made by a friend or relative, who received a commission from the promoter if the interviewee invested. Often this “commission” was not disclosed to the investor, but even when it was, the interviewees did not seem to hold this person responsible for their investment. The following two interviewees discuss the investment, with limited evidence of animosity toward those who introduced them to the investment:

We just believed what the insurance agent said. He was sorry that it happened. He was working with [the promoter] part time, not employed, signing people up for it. He told me several people who signed up, even his sons. He’s an honest guy.

I was upset with the broker, but my husband was good friends with him. They play golf together, and he said the broker was just as shocked as we were.

Professional Advice

Eleven interviewees sought advice or counsel prior to investing, but often did not follow the advice given (see Table 2). Three interviewees describe how they either avoided getting professional advice, or explicitly disregarded advice they had received:

I knew the investment was risky. I felt accountants were too conservative and would try to talk me out of it. I watched it six months or more, and the people I was talking to were receiving checks.

Yes, we spoke with our financial advisor. To stay away from it was the advice given. We discounted the advice.

I talked to a friend of mine, and he said don’t do it. He dialed the number of a banker who said it wasn’t possible, but I went ahead with it.

Most of the interviewees did not perform any background checks or securities license due diligence. One interviewee did hire a private detective to do a background investigation on the promoter, but the private detective did not uncover a prior criminal background even though one existed. The same interviewee was warned by another potential investor that the promoter may have a criminal background, but the interviewee was unable to determine if the prior criminal arrest record actually belonged to the promoter or another person with the same name.

Investment Characteristics

As shown in Table 3, fourteen of the interviewees received a promissory note from the perpetrator upon investing. The rate of return promised was typically 5 percent per month, but some were promised 2 to 3 percent per month, and one investor was promised 10 percent per month. The interviewees did not seem to recognize that 5 percent per month annualized was a 60 percent rate of investment return and represented a “too good to be true” rate. The promoter specified the rate of return on a monthly basis to all investors, apparently framing the investment return as plausible. Three interviewees describe the investment and how it seemed reasonable at the time:

The investment strategy was foreign currency exchange. It made sense to me that he could make what I consider now to be too high of a return.

There was a videotape of a seminar showing how he made trades and set up groups as traders. Made sense, seemed reasonable. High leverage ... making big money with small amounts.

Currency trading can be lucrative and can also be a disaster; all depends on what you buy and what you sell. And so he claimed to have a track record ...

The interviewees had mixed expectations about the investment risk. Twelve investors indicated they were told the investment had little or no risk, while four investors understood there was risk involved. As noted above, in return for giving funds to the perpetrator, investors

often received a signed promissory note guaranteeing that their invested funds would be returned within three years as well as typically a 5 percent monthly return on investment. Most of the interviewees referred to their promissory note as a “guarantee” of their investment. The interviewees apparently did not realize a signed promissory note with no collateral relies upon the good faith and success of the borrower to repay the principal invested. Five interviewees comment on their understanding of the risk involved, which most viewed as low:

The investor was issued a promissory note, which was like a lender of a house. There was no way to lose investment was what I was told. You could take the note as a document to a court of law just as you would if you foreclose on a house.

They said there was a risk to put money in anything, even in a bank. The risk would be 1: 1 millionth ratio. The risk was miniscule, they said.

I don't think we were aware of the potential to lose it all. In fact, his promissory note promised payback.

Yes, but [risk] was downplayed.

Anything would be a risk. We were not misled there.

Table 3
Investment Characteristics
(Open-ended Questions)
(n =17)

<i>Describe what the investors received upon investing:</i>	
Promissory note	14
<i>What were the investment risks (if any) stated by the Ponzi promoter?</i>	
Little risk	12
Risk involved	4
Unknown	1

Influences on Decision to Invest

Interestingly, the promoter of the Ponzi scheme did not seem to use pressure or a sense of urgency to persuade the interviewees to invest (see Table 4). Rather, a soft approach was used, as three interviewees describe:

Actually it was almost just the opposite [of urgency], because it was like, "This is what I do. You don't have to get in on it."

No, that is why I watched it for four months.

[The promoter] was very kind and he never pushed. None of them did. Did not try to fast talk me...

In addition, the promoter did not insist the investors keep their investment confidential or secret. The promoter did not rely on media advertising to promote the investment, but gained additional investors from current investors spreading the news about their investment and returns promised.

The interviewees mentioned charitable works most often as an influence on their decision to invest. A significant number also mentioned religion, charisma, special expertise in trading foreign currency, and an appearance of wealth or credibility. Two interviewees discuss the role of charitable giving:

He spent money on people, and a guy I know was about to sink in his business and he gave him money. That was pretty impressive. The guy did not have to pay it back.

I did know that he had done charitable works. He bought houses and drove big cars. It made it look like, well, he must know what he was doing because he was making the money.

However, the most significant influence mentioned by the interviewees was the other people who invested (see Table 2, role of word of mouth). They assumed since their friends and relatives were receiving their promised returns, the investment must be legitimate, even though originally

the interviewees may have had some doubts. Three interviewees describe how they watched the returns materialize for others, often over a few months, before they decided to invest:

I had a couple of guys I know that invested...I kinda investigated it for something like four months... I decided after watching a couple of people get 5 percent on their money... I would invest.

I knew people who were investing in it. A friend's daughter-in-law's uncle worked for the FBI, and he invested in it and thought it looked ok. I went down to the offices and it all looked legitimate... I thought about it for a couple of months before investing, but finally decided to invest.

The second friend invested ... and I watched his investment for four months... four months it [the check] came in like clockwork. Once I made the investment, I later learned that I was the last investor before he decided to run ... Therefore, if I had watched it for five months, then I would be richer.

Table 4
Influences on Decision to Invest
(Open-ended Questions)
(n =17)

<i>Was there an urgency to the investment decision? Act now or miss out?</i>	
No	17
<i>Did the promoter of the Ponzi investment insist on confidentiality or secrecy?</i>	
No	17
<i>What did the promoter of the Ponzi scheme use in his appeal to persuade you to invest? Discuss all that apply. Most commonly mentioned items:</i>	
Charitable works	13
Religion	8
Promoter's charisma	8
Special expertise/proprietary strategy	7
An appearance of wealth/living large	7
Credibility	3
Patriotism	2
Family	1

Communication

As shown in Table 5, the promoter of the Ponzi scheme or his employees primarily used face-to-face conversations, phone, and mail/FedEx to communicate with investors. The investors

were mixed about their recollections of whether or not the promoter had a website. The vast majority of the investors did not receive official IRS forms reporting tax information regarding their investment. Most of the investors participated in the investment for a matter of months before communication with the promoter became strained or difficult. Communication broke down when promised returns were not received, and the scheme quickly dismantled. Investors would call, go by the offices, and threaten lawsuits or bodily harm in efforts to obtain their invested funds. Four interviewees describe their efforts to contact the promoter once their checks stopped coming. The investors' rage is apparent in some of these quotes:

They were slow about paying the last one [payment]. I called and said I wanted my money back. ... If I could have found him, I would have gotten my gun and got my money back.

I went to the offices ... to the traders, and I walked in past the security guards and everyone. I told them I wanted answers to what was going on and why I wasn't getting my check.

I called, well, they gave a bunch of excuses ... I said I wanted my money back, and they wouldn't give it to me. I called several different people about it. I never saw him... Then we looked in the paper one day, and we saw he was arrested.

Late in the game, that is when he started going out of town, I knew we were hooked. I tried to force him to give me back my money, and he didn't.

Table 5
Communication with Promoter
(Open-ended Questions)
(n = 17)

<i>How did the Ponzi investment promoter communicate with you?</i> Most commonly mentioned items:	
Face-to-face	5
Phone	3
Mail/FedEx	2
Through relative	1
Broker	1
Email	1

<i>Did the Ponzi promoter have a website?</i>	
Yes	5
No	4
Did not know	3
Did not answer	5
<i>Was the investment income reported to you on official IRS tax forms?</i>	
Yes	1
No	11
Did not know	2
Did not answer	3
<i>How long before you discovered the investment was a Ponzi did communication with the promoter become strained or difficult?</i>	
Less than a month	3
One-two months	5
Several months	5
Did not answer	3
Does not know if it was a Ponzi	1

Overall Reflections

The interviewees were greatly impacted financially and psychologically by their experience in the Ponzi scheme. Four interviewees discuss the personal impacts of this investment, which include financial loss, guilt, shame, regret, and depression:

We still have no money saved. Loss of confidence and, well, guilt because I did tell [a relative] that it worked.

We never told anyone we lost that money. We did tell [a relative] recently. We were embarrassed by it. It was a dumb thing to do...

My [relative] went into a little depressed state. He felt he did not do research like he should have...

I hurt everyday over the fact that [a relative] worked so hard, and all of the investment is gone...

Amazingly, some of the interviewees apparently still believe that the purported investment returns were possible, even after the fraud was exposed:

His investing strategies were sound. He had a good method for investing in this market. Even after everything blew up, I talked to two people who worked very

closely with him, and in fact, spent a week with one of them, and both of them said everything else aside, his investment strategies worked...I still think that what he was promising was possible...

It didn't start as a Ponzi because different from Madoff, currency trading is a legitimate business...and that was his gift, and it would never have been classified as a Ponzi except for greed...I sat down with him and he was good at trading...

He seemed to have around him several very experienced and knowledgeable traders who were actually going to be trading the currency for us...and he introduced them at a seminar.

Well, I looked it up on the Internet as far as foreign exchange goes. It checked out; it made sense to me. I'm an engineer, but it made sense.

While the interviewees obviously are disappointed that their investment was a fraud, they also are also angry about the legal process of unwinding the fraud. The investors are reminded of their poor investment each time the mail comes and another legal document arrives. In addition, the legal documents describe the investors' funds recovered and amounts spent on legal fees and investigations. The investors realize that as time goes on, the fees continue to add up, which ultimately reduces the possibility they will ever see any of their investment funds recovered. The investors also are angry that some investors who received substantial sums of money prior to the discovery of the Ponzi scheme are settling with the bankruptcy trustee for small amounts.

Some of their reflections are detailed below, many of which express anger with investors apparently being last in line to collect:

To date, they've recovered ...million in cash and assets, which have been turned into cash. All of the trustees and lawyers have been paid, but none of the investors have gotten their money.

I don't like the way it was handled; I don't even like the way the government handled it. They charge exorbitant fees to look into this guy. They are as big a crook as this guy...

We get letters all of the time, at least two or three a week...and it's annoying to us, because we are getting nothing back. It would cost too much money to bring people to court, so they make a settlement out of court so they don't waste court

fees...so people are making settlements and what little is paid back the trustee gets paid...

The lawyer and legal system is out for themselves, not to help us. The lawyers won't even look after the consumers. I still don't know if I'll ever get any of that money back. The only winner is the law firm and investigators.

The trustee has found some [of the promoter's] money and supposedly sold his property to get our money back... It would be such a small percentage. I don't know who gets paid back and who gets very little [relative] to what they invested....Attorney fees are so high there won't be any funds for investors. I don't live everyday expecting information. And no, I don't think it should take this long, I think it's terrible ... I may be dead and gone.

V. CONCLUSION

Our research suggests that individuals model their actions, particularly under conditions of uncertainty, to behaviors of others in their social network. The interviewees were all influenced by individuals they trusted (relatives, friends, and advisors) who were knowledgeable about the investment or invested themselves. Thus, the often-stated red flag “if it’s too good to be true, it probably is” may not prevent or curtail future frauds. The investors interviewed did not realize until the investment unraveled that their promised return was unreasonable; in fact, some still believe the promised return was possible even after the discovery of the fraud.

We found that the victims of the Ponzi scheme were typically older and educated. Even if they originally had doubts about investing, as they watched their friends, neighbors, and relatives receive the promised returns, they became more inclined to invest. The investors also were influenced through impression management techniques used by the perpetrator, such as charitable giving, appearance of wealth, and demonstrated or described investment expertise. The perpetrator did not use high-pressure sales techniques; instead, he relied on impression management and word-of-mouth to entice new investors.

One limitation of this study is that we examine only one Ponzi scheme, and within that scheme, we interview 17 victims. This approach has the benefit of allowing us ample time to explore the perceptions of these 17 victims. However, the decision processes used by these 17 investors interviewed may not be representative of the entire population of smaller Ponzi scheme victims. Despite this limitation, we found many of the experiences and perceptions to be fairly consistent across individuals.

We call for additional research to determine behavioral influences on investor decision-making, particularly as it relates to fraudulent investments. Research to understand the influences may lead to the development of methods to minimize future investor participation and/or losses in fraudulent investments. We also recommend additional research to examine the implementation and underlying equity of the current law requiring bankruptcy trustees to track down fraudulent and preferential transfers, which results in forcing some victims of Ponzi schemes to repay amounts received prior to discovery of the fraud (clawbacks). For example, is the desired result of clawbacks, a more equitable division of the perpetrator's assets amongst all the creditors, actually being attained? Are there ways to enhance the effectiveness and/or efficiency of clawbacks? Overall, we encourage additional research into the contributors to and resolution of Ponzi schemes, which continue to victimize investors.

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