Ponzi Fallout:
Banks' Liability for Ponzi Schemes

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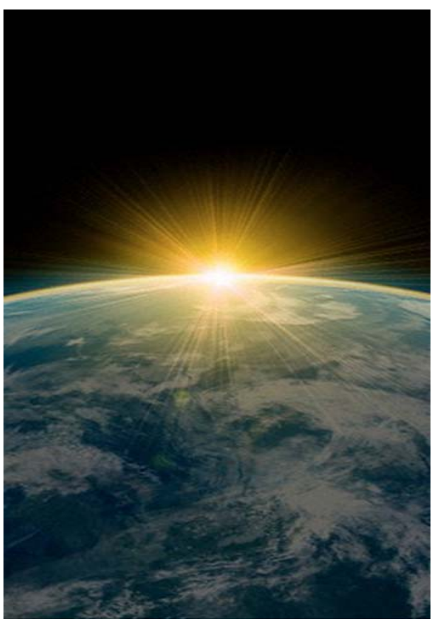

Agenda

- What is a Ponzi scheme
- How Ponzi schemes use banks
- Inevitable collapse of the scheme
- Legal fallout
- Who comes after financial institutions in the wake of collapse
- Claims against financial institutions, and defenses
- What financial institutions can do to avoid/limit liability for banking Ponzi schemes

What is a Ponzi Scheme

- Definition
- Vehicles
  - Debt
  - Equity

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How Ponzi Schemes Use Banks

- Captured relationships – relationships with only one or maybe two institutions
- Company accounts
  - Multiple corporate accounts
  - Operating accounts v. trust or restricted accounts
- Personal accounts of perpetrators and family members
- Credit card accounts

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Inevitable Collapse of the Ponzi Scheme

- **Interruption of business or portion of business that is financing the Ponzi**
- **Investor scrutiny**
- **Regulatory scrutiny**
- **Criminal scrutiny**
- **Downturn in the economy**

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Legal Fallout

- **General Chapter 7 or 11 Bankruptcy – 11 U.S.C. § 101 *et seq*.**
- **Liquidation of brokerage firms by the Securities Investor Protection Corporation (SIPC) under the Securities Investor Protection Act, 15 U.S.C. § 78aaa, *et seq*. (SIPA)**
- **Civil enforcement actions**
  - **Federal**
  - **State**
- **Criminal prosecution**

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Who Comes After Banks in the Wake of Collapse

- **Appointed fiduciaries**
- **Investors/Victims**
- **Introducing brokers**
- **Regulators**

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Claims Against Banks and Defenses: Bankruptcy Trustees and Receivers

- **Trustees only hold claims that are "property of the estate" 11 U.S.C. § 101**
- **Receivers only hold claims that are within the scope of the order appointing them**
- **Typical claims asserted against financial institutions**
  - **Questioning of validity of secured position**
  - **Avoidance of transfers made on account of unsecured debt**
  - **Assigned claims of investors**
  - **Potential other claims that are continually being tested**
- **Typical defenses:**
  - **Claim asserted is not property of the bankruptcy/receivership estate**
  - **Avoidance defenses**
  - ***In Pari Delicto* for claims of the company against third parties based on tort or contract**

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Claims Against Banks and Defenses: Investors/Victim

- Claims are to recoup investors' losses
- Claims asserted include:
  - Aiding and abetting fraud, conversion or fiduciary duty
  - Fraud by omission
  - Negligence
  - Breach of Fiduciary Duty
  - Uniform Fiduciary Act (UFA)
- Defenses
  - Lack of duty of care to investor
  - Lack of fiduciary relationship between entity and investor
  - Use of excess funds in a segregated account
  - Lack of actual knowledge of fiduciary's breach of duty to investors
  - Lack of bad faith

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Claims against financial institutions, and defenses: Regulators

- Claims are to enforce applicable law or regulation
- Remedies asserted include:
  - Civil monetary penalties;
  - Restitution to victims/protected group who have sustained losses;
  - Disgorgement of gains; and
  - Injunctive relief related to future violations of applicable law.
- Defenses
  - Regulator failed to exercise its own duties

- Role of law enforcement (criminal investigation will impact bank)

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Minimizing Risk

- KYC at opening (particularly important where investment vehicle is regulated)
- Revisit growing relationships with local branches
  - KYC is a continuing obligation
  - Employ risk benchmarks—what is normal for this business/entity
  - Require explanations for changes in account activity
- Strong internal controls
  - Insist on following all account protocols – *e.g.*, documentation and signatures
  - Managing division of labor
  - Vigilant review of trust/reserve accounts
    - CEA (Commodities Exchange Act accounts) of futures commission merchants
    - Avoid collateralization; assessing fees for other accounts to reserve account
  - Suspicious activity monitoring and reporting
  - Employee training and reporting—employment requirements

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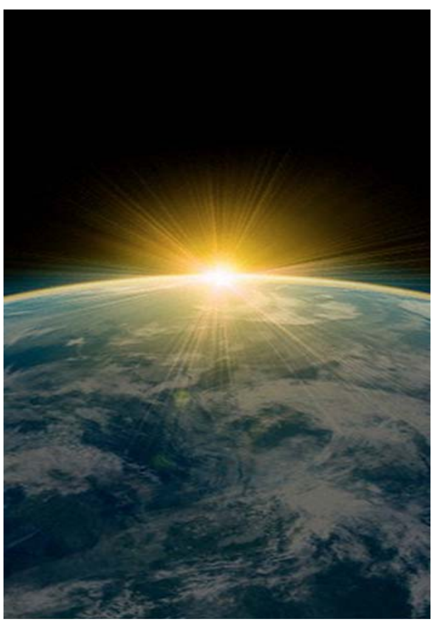

Questions?

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