In the High Court of New Zealand
Wellington Registry

I Te Koti Matua o Aotearoa
Te Whanganui-A-Tara Rohe

	CIV- 2012-485-2591
Under	The Companies Act 1993 and the High Court Rules
In the matter of	Ross Asset Management Limited (in liquidation) and related entities
Between	**John Howard Ross Fisk and David John Bridgman**, as Liquidators of Ross Asset Management Limited (in liquidation), Dagger Nominees Limited (in liquidation), Bevis Marks Corporation Limited (in liquidation), United Asset Management Limited (in liquidation), McIntosh Asset Management Limited (in liquidation), Mercury Asset Management Limited (in liquidation), Ross Investments Management Limited (in liquidation) and Ross Unit Trusts Management Limited (in liquidation) each being Chartered Accountants of Wellington and Auckland respectively Applicants
And	**Eoin David Fehsenfeld** Respondent

Affidavit of Barrington John Prince

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I, Barrington John Prince, of Waikanae, Retired, swear:

1. I have been serving as a member of the Price Waterhouse Cooper ("PCW"), Ross Asset Management ("RAM") liquidation committee ("the Committee"), for over five years and I am a victim of the RAM fraud. I made no withdrawals from the scheme along with around 400 other investors. After 5 years many of these investors are now dying, and in many cases their widows are now living in bedsits and left trying to support themselves on the old age pension, all because the RAM process to date has delivered such unfair outcomes.

2. I seek the leave of the Court, as a creditor of RAM and its related entities, to appear and to be heard on the matters which are the subject of this affidavit.

The Purpose of This Affidavit

3. The purpose of this affidavit is to provide the Court with reasons why the use of the "Alternative Distribution Model" ("the ADM"), as opposed to use of the "Net Distribution Model' ("the NDM"), would be fairest way to distribute assets that the liquidator, PCW, is in the process of recovering.

4. I understand that the NDM is supported by current law in the form of the Companies Act 1993 ("the CA"), and the Property Law Act 1952 ("the PLA").

5. In order to provide the Court with reasons why the use of the NDM would be neither fair or Just, I feel that it is necessary to go back to the beginning to explain why I consider that the process which has been executed to date through the use of the CA and associated laws, has been neither fair nor just.

The Reasoning in Support of the Alternative Distribution Model

6. I believe that the assets which are recovered by PCW should be distributed according to the ADM for the reasons which are set out in the paragraphs below.

7. I believe that our laws are designed to enable those in authority to maintain the principles under which our society exists.

8. I would ask the Court to consider whether they agree that the following two principles are relevant to the RAM Ponzi:

   (a) no participant in a crime however innocent should benefit from the crime;

   (b) when a crime is committed that results in financial losses, all participants however innocent, should bear their fair share of those losses.

9. I would also ask the Court to bear in mind that, to date, through the rigid use of the CA and the PLA, neither of the above principles have been achieved in the liquidation process used by PWC. This development has resulted in a large number of investors recovering all their capital investment, some have made withdrawals that have enabled them to minimise their losses, leaving a minority who made no withdrawals left to shoulder most of the losses.

10. I do not consider this result to be either fair, or just, and I believe that such an outcome is diametrically opposed to the principles which are referred to above.

How the Liquidation of RAM Should Have Been Processed

11. I believe that if the above principles had been applied to the liquidation process, the losses incurred as a result of the Ponzi could have been shared out equitably amongst all investors.

12. I believe that the liquidator should have been empowered to attempt to claw back all of the payments which were made by David Ross to all investors, and that the money which was subsequently recovered should have been paid

back to all investors at a rate in the dollar that represented the amount recovered to that lost.

13. Based on similar crimes committed overseas, I do not think that it would have been unreasonable to expect that a rate in excess of 60 cents in the dollar could have been recovered had the aforementioned approach been taken. Instead, through the rigid use of inadequate laws the recovery rate, at best, may end up in the region of 20 cents in the dollar, or less.

14. I believe that the principles which are enunciated in paragraph 8 above are completely in line with the pari passu principle, and the law of Equity. Has the law of Equity been considered and/or applied to date? The answer seems to be "no".

Why the Liquidation Process Went So Wrong

15. I believe that the Financial Markets Authority ("FMA") erred in applying to the High Court to appoint PWC to liquidate RAM in accordance with the CA.

16. I do not believe that the FMA ever considered what principles should be applied to enable a fair and just outcome for all RAM investors, or whether the CA would be the correct legal tool to facilitate such an outcome.

17. I believe that the FMA failed to take into consideration that it was not RAM that perpetrated the fraud, but David Ross who broke investors' trust by using his company as a tool with which to defraud his investors.

18. The FMA's blasé approach to the issue of RAM was summed up by a public comment made by the then CEO, Sean Hughes, during the course of a Firstline television interview on 20 November 2012. Mr Hughes made the analogy between investing in the share market, and losing a bet on a horse. He said that investors took similar risks when investing in the share market. I believe that Mr Hughes's analogy was seriously flawed, as he completely

missed the point that when betting on a horse, one does not expect the TAB to be run by a bunch of crooks.

19. I do not believe that there is anything wrong with using the CA to liquidate a company that has foundered due to adverse commercial circumstances. However, I believe that the CA was the completely the wrong tool to use to endeavour to sort out the finances of a company that has been used to effectively commit theft.

20. I would like it to be recorded that this view has been proffered by the Ministry of Business Innovation & Employment ("MBIE") in the discussion paper which it released in May 2018 titled "A new regime for unravelling Ponzi schemes". A copy of the discussion paper is **annexed** hereto and marked "**A**".

21. A major aspect that I would ask the Court to take into consideration is that, unlike many people currently involved and affected by the RAM Ponzi, the MBIE discussion paper was compiled by people who have no vested or financial interest in the outcome of the substantive hearing. These people share my and around 399 other victim's viewpoint, in that losses incurred as a result of a Ponzi should be shared equitably amongst all investors.

22. I understand that the High Court was involved in the appointment of PWC. I do not believe that the High Court considered what would be a fair and just outcome for those who invested in RAM, and which laws would empower PWC to produce such a result, when it sanctioned the FMA's request that PWC be appointed as liquidator. No recourse appears to have been had to the laws associated with the recovery of stolen goods, breach of Trust and Equity.

23. David Ross broke the trust of all his investors, yet PCW does not appear to have invoked or attempted to use other legal avenues, such as breach of Trust and Equity, to enable them to reach a fair and just outcome for all investors.

24. I believe that the best way to illustrate the magnitude of the fraud is by way of example. Prior to 2010 RAM had over 1200 investors. A large number have made substantial profits from the fraud, many have recovered all of their capital investments, and around 250 made withdrawals that did not exceed their capital investment, and have incurred varying degrees of loss. Whatever happens, as far as which distribution model is used, the remaining investors (around 400) who made no withdrawals will still bear the brunt of the financial losses.

25. I believe that PWC and its legal advisor, Bell Gully, knew that rigid adherence to the CA and PLA would not enable them to reach a fair and just outcome for all investors.

26. [redacted]

27. I do not believe that PWC ever contacted those who had appointed them, the FMA and the High Court, for guidance as to how to proceed and or to make suggestions to the Court as to how the most fair and just outcome might be achieved. [redacted]

[redacted] Instead, PWC have effectively stuck to the instructions given to them by the FMA through the auspices of the High Court and have rigidly adhered to the provisions of the CA during the liquidation process.

28. It is my view that a plea made to the FMA and the High Court, based on Common Law, Breach of Trust and Equity, would have had a very good chance of success, thus enabling PWC to attempt to issue a blanket claim to all investors and ensuring that more investors bore their fair share of the losses.

29. I respectfully request that the Court gives consideration to the fact that, to date, the liquidation process has taken over 5 years and 5 months, (a period of time which just happens to coincide with the minimum prison sentence which David Ross will have to serve if he behaves himself).

30. I understand that it takes time to draft and enact new legislation. However, I doubt that it would have taken five years for a motivated FMA, PWC and legal system to pressurise the government to have a new law introduced which enabled a fair and just outcome to be achieved for all investors of Ponzi schemes, and possibly similar frauds such as pyramid schemes.

31. I believe that PWC decided to implement three test claims using different aspects of the law such as "Voidable Transactions", because it didn't know which laws under the CA and PLA would have the greatest success in enabling them to claw back money from investors who made a profit from the Ponzi.

32. The first test case, *MacIntosh v Fisk and Bridgman* [2017] NZSC 78, involved the liquidator represented by John Fisk of PWC, to initially claim back the profits made by an investor called Mr McIntosh, then as the case progressed from the High Court to the Supreme Court, PWC attempted to make a counter claim in an effort to claim back the capital which Mr McIntosh invested as well.

33. I do not believe that the majority of Judges of the Supreme Court in *McIntosh v Fisk and Bridgman* considered what ramifications their ruling would have on RAM investors who made little or no withdrawals. The ruling stated that as Mr McIntosh had provided value to the scheme he was entitled to keep the capital he had withdrawn, but had to return the fictitious profits. All but one Judge seems to have omitted to consider that all investors gave value to the scheme. The Court made no effort to ensure that the losses inflicted as a result of the Ponzi scheme, would be shared equitably amongst all investors.

34. Within the discussion paper which is referred to in paragraph 20, MBIE states that it does not support the ruling which was made by the Supreme Court in this matter. I respectfully request that this fact be placed on the record.

35. With further reference to *McIntosh v Fisk and Bridgman*, I believe that the Court made another serious mistake when it supported the concept that withdrawals made by RAM investors were to be considered as capital first, and fictitious profits second. This effectively prevented PWC from being able to claw back all of the fictitious profits which David Ross paid out to investors. Without such a ruling, I believe that it would have been possible for PWC to claw back sufficient money to enable a distribution in the region of 30 to 40 cents in the dollar to investors who lost all or part of their capital investment. I believe that in this way, some semblance of equity would have been achieved by enabling the losses to be shared amongst a greater number of investors. However, it still wouldn't have prevented over half of the investors getting away with most of the money and not having to bear any share of the losses which, as previously stated, are now left to be borne by the minority.

36. There is another critical aspect of the fraud which I believe the Supreme Court, and investors who made withdrawals, have ignored or failed to understand, which is the mathematics associated with the mechanics upon which a Ponzi scheme works.

37. In *McIntosh v Fisk and Bridgman*, the Supreme Court ruled that withdrawals made by investors are to be considered as being the withdrawal of their capital first, and fictitious profits second. This clearly infers that when an investor made a withdrawal they were recovering some or all of their own capital. This is not the case, as an equity tracing exercise or forensic analysis would have revealed. At the time investors made withdrawals, their money was long gone, as it had been used by David Ross to pay fictitious profits and capital reimbursement to other investors who have got away without bearing their fair share of the losses.

38. It is a mathematical fact that when an investor made a withdrawal, that withdrawal was funded using money stolen from recent investors, mostly from investors who made no withdrawals.

The Distribution of Liquidated Assets

39. I believe that, to date, the way in which the FMA, PWC and the Courts have allowed the RAM liquidation process to evolve through the use of the CA and PLA, makes it impossible to ensure that all investors bear their fair share of the losses.

40. However, I believe that there is still time to ensure that those who made no or minimal withdrawals, don't have to suffer further financial losses if the ADM is used, as opposed to the NDM or any other compromise.

41. To support the above statement, I would like to bring the Court's attention to an example that clearly reveals how unfair the NDM is.

42. To ensure that the record is correct, I understand that the NDM would mean that if an investor lost money due to the RAM Ponzi, then regardless of the level of withdrawals which the investor previously made, they were eligible for a share of any distribution based on the size of their loss.

43. The Supreme Court ruled that all payments which were made by David Ross to investors are to be considered as a re-imbursement of capital first.

44. I do not believe that the Supreme Court's ruling was correct, but as far as the manner in which assets are distributed it is very significant in that the Supreme Court has ruled that the majority of investors have already recovered all or part of their capital investments. Unfortunately for the minority of investors left to bear the brunt of the financial losses, other investors who closed their account years ago or have claimed 'Change of Circumstance' have been allowed to keep their fictitious profits as well.

45. If, for example, investor 1 originally invested $100,000.00 with RAM, then over the years withdrew $90,000.00, they would have made a loss of $10,000.00, and then based at the rate of 10 cents in the dollar, they would be eligible for a further recovery of $1,000.00, to add to the $90,000.00 they had already withdrawn. This would result in a total receipt of $91,000. In other terms this represents a recovery of 91 cents in the dollar.

46. I wish to bring the Courts attention to the fact that the only source of funds with which to pay a share of the liquidated assets to investor 1 would have be made by taking further funds away from investors who made no or minimal withdrawals.

47. On the other hand, if investor 2 originally invested $100,000.00 with RAM, then over the years made no withdrawals, they would have made a loss of $100,000.00. As with investor 1. this investor would also be eligible for a share of the distribution based on 10 cents in the dollar. However, they would receive a much smaller amount totalling only $10,000.00. In other words, investor 1 would have recovered a total of $91,000.00 which would be $81,000.00 more than investor 2 would recover.

48. I do no believe that the NDM can be called fair, just and equitable, if it allows one investor to recover 91 cents in the dollar and let another investor who

made exactly the same level of investment to recover only 10 cents in the dollar.

49. If the ADM were to be used, it would mean that only those who have made no or minimal withdrawals that total under the number of cents in the dollar recovered, would receive a share of the liquidated assets. This asset distribution would of course be after PWC's fees are deducted. These fees have now escalated to over $5M.

Submissions for Eoin David Fehsenfeld – 15 June 2018

50. According to the payment schedule which is contained within the Submissions for Eoin David Fehsenfeld dated 15 June 2018, Dr Fehsenfeld invested $6,867,585.83, and withdrew $1,894,306.48. Irrespective of the language which you use, this represents a recovery of 28 cents in the dollar.

51. However, the information which is contained within the schedule is misleading and incomplete.

52. There is no way that David Ross would allow an investor to withdraw more funds than were in the investor's account. According to the schedule, in 2002 Dr Fehsenfeld was supposedly $285,155 in the red.

53. The schedule does not show what Dr Fehsenfeld's account looked like to him. The fictious profits are missing.

54. I refer the Court to the revised schedule which I have prepared to show the hypothetical position of Dr Fehsenfeld's account based on an average return of 12%. A copy of the Revised Payments Schedule is **annexed** hereto and marked "**B**".

55. The Revised Payments Schedule shows that the account never went into the red. I believe that David Ross realised that he couldn't challenge such a picture without admitting that he was running a Ponzi scheme, so he had to allow Fehsenfeld to withdraw $100,000.00 in 2001, and a further

$250,000.00 in 2002, even though he had to use other investor's capital to do so.

56. It may seem that the ADM is unfair to someone who made withdrawals years ago but who then didn't make any withdrawals for several years. However, when you consider that other investors made exactly the same investments, in the same timescale, but made no withdrawals, it is clear to see that the adoption of the ADM is the fairest and most just means of distributing funds recovered by the liquidator in the present case.

Where Liquidated Assets Currently Reside

57. I have been informed that where the liquidated assets currently reside has a legal impact on how the money may be distributed. This seems to be another legal quirk in the way of a fair and just outcome.

58. I would like to draw the Court's attention to the fact that all of the money originally came from one, and only one, source - it was all effectively stolen from investors. It was then either found by PWC in RAM's bank accounts or other assets, or clawed back from investors by PWC and put into another account.

59. I would like to make a plea that the Court takes into consideration that all of the liquidated assets were originally stolen, mainly from investors who have made no withdrawals.

Use of Liquidated Assets

60. I understand that PWC are using liquidated assets to pay their solicitor, Bell Gully, to advocate on behalf of the NDM. I believe that they are also using liquidated assets to cover the cost of appointing an Amicus Curie to advise the Court on the pros and cons of the ADM and the NDM, plus any asset distribution methods which they may feel are relevant. A minority of the members of the Committee made the point that the hearing scheduled for

the 22nd June 2018 would be out of balance if no-one was employed to advocate on behalf of the ADM. Subsequently, this minority requested that PWC use liquidated assets to employ a legal representative to advocate on behalf of the ADM. This request was denied.

Costs

61. I would like to make a plea that Court rule that the costs associated with the preparation and filing of this affidavit be paid from RAM assets liquidated by PWC.

Summary

62. What has occurred to date is without doubt in my mind, a gross miscarriage of justice. If it is ruled that the NDM has to be used to distribute the RAM liquidated assets, then this miscarriage of justice will continue until the liquidation has been completed.

63. The miscarriage of justice I refer to is that if the Court rules that the NDM has to be used, then the Court will be by default, continuing to condone a situation where hundreds of investors have been allowed to make a profit out of a crime and will also continue to allow the majority of investors to elude bearing their fair share of the losses inflicted as the result of a crime.

64. It is my plea that the Court makes a judgement based on justice and fairness not just based on the administration of inadequate laws. The experience gained over the last 5 years and 5 months have clearly revealed that adherence to the CA and PLA did not enable the Courts or the liquidator to make fair and just rulings in circumstances where it was the criminal who committed the crime, not the company he used as a tool with which to misappropriate hundreds of people's savings.

65. To this effect I further plea that the Court make a ruling that the ADM is used to distribute all RAM assets that have been, and remain to be, liquidated by

PWC. In this way at least a small portion of the losses would be shared amongst a few more investors.

66. I believe that the widows of the investors who were referred to at the beginning of this affidavit are much worse off than the majority of investors who made withdrawals, and I believe that they need all the help that they can get. In light of the same I ask the Court to make a ruling which is fair and just for all investors.

67. I apologise to the Court for the sometimes informal language which has been used in this affidavit. However, I feel that it is extremely important that the viewpoint which is expressed herein is brought to the Court's attention.

Right to Appeal

68. If I am granted leave to be heard on the matters which are the subject of this affidavit I wish to formally reserve my right to appeal any decision which may be made by the Court in respect of the substantive proceedings which are currently before it.

Signature of the deponent: BJ Pence

Sworn at Paraparaumu this 19th day of June 2018

Before me:

Emily Jane Sutton
Solicitor
Paraparaumu

A Solicitor of the High Court of New Zealand

"A"

MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HIKINA WHAKATUTUKI

Discussion paper

A new regime for unravelling Ponzi schemes

May 2018

EXHIBIT NOTE
This is the annexure marked "A" referred to within the Affidavit of Barrington John Prince and sworn at Paraparaumu this 19th day of June 2018 before me
Signature EMILY JANE SUTTON
A Solicitor of the High Court of New Zealand

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How to have your say

Submissions process

The Ministry of Business, Innovation and Employment (MBIE) seeks written submissions on the issues raised in this document by 5pm on **6 July 2018**.

Your submission may respond to any or all of these issues. Where possible, please include evidence to support your views, for example references to independent research, facts and figures, or relevant examples.

Please use the submission template provided at: ***http://mbie.govt.nz/info-services/business/business-law/insolvency-law-working-group/ponzi-schemes***. This will help us to collate submissions and ensure that your views are fully considered. Please also include your name and (if applicable) the name of your organisation in your submission.

Please include your contact details in the cover letter or e-mail accompanying your submission.

You can make your submission:

- By sending your submission as a Microsoft Word document to corporate.law@mbie.govt.nz.
- By mailing your submission to:

  Business Law team
  Building, Resources and Markets
  Ministry of Business, Innovation & Employment
  PO Box 1473
  Wellington 6140
  New Zealand

Please direct any questions that you have in relation to the submissions process to ***corporate.law@mbie.govt.nz***

Use of information

The information provided in submissions will be used to inform MBIE's policy development process, and will inform advice to Ministers. We may contact submitters directly if we require clarification of any matters in submissions.

Release of information

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The Privacy Act 1993 establishes certain principles with respect to the collection, use and disclosure of information about individuals by various agencies, including MBIE. Any personal information you supply to MBIE in the course of making a submission will only be used for the purpose of assisting in the development of policy advice in relation to this review. Please clearly indicate in the cover letter or e-mail accompanying your submission if you do not wish your name, or any other personal information, to be included in any summary of submissions that MBIE may publish.

Contents

Glossary

FMA	Financial Markets Authority
FMCA	Financial Markets Conduct Act 2013
Insolvency practitioner	An insolvency practitioner is someone who is licensed to act in that capacity.[1]
Insolvency professional	An individual, whether an insolvency practitioner or other professional, experienced in insolvency law.
IWG	The Insolvency Working Group
MBIE	Ministry of Business, Innovation and Employment
SFO	Serious Fraud Office

[1] The government decided in 2016 to introduce a regime for the licensing of insolvency practitioners

Executive summary

1. A Ponzi scheme is a fraudulent investment scheme in which investors are paid fictitious profits from the amounts invested by new investors. Usually, the initial investors are promised and paid large returns. This attracts new investors. However, Ponzi schemes eventually collapse because total losses grow and the promoter is unable to attract the expanding amount of new investments needed to keep the scheme operating.
2. At present, there is no targeted regime providing for the recovery of investor funds lost in a Ponzi scheme. When unwinding a Ponzi scheme, the courts and insolvency professionals often find themselves in the position of trying to apply the insolvency regime in the Companies Act 1993 (Companies Act) and, in some cases, the prejudicial dispositions regime in the Property Law Act 2007 (Property Law Act). Neither of those regimes was designed for recoveries where the purpose of the business was to defraud investors.
3. While various courts have grappled with the application of these rules to various Ponzi schemes, it is not certain that future courts will follow these approaches. This is because the analysis is highly fact dependent. This creates uncertainty around the proper application of the law.
4. The insolvency regime generally results in distinctions being made between investors in a Ponzi scheme based on:
    a. whether any funds withdrawn from the Ponzi scheme are able to be clawed back by the liquidator
    b. whether investors have been able to withdraw any money from the Ponzi scheme before it collapsed
    c. whether investors are able to establish claims on any specific assets held within the Ponzi scheme.
5. These differences should not be relevant to the sharing of losses between investors in a Ponzi scheme. In most instances they reflect differences in timing – they do not suggest that any investor is more blameworthy or should bear a greater share of losses for any other reason.
6. The provisions in the governing documents for most managed investment schemes dealing with the winding up of those schemes and the apportioning of losses result in similar distinctions being made between investors.
7. The uncertainty surrounding the application of the insolvency regime to Ponzi schemes also results in:
    a. Expenses being incurred by insolvency professionals in order to clarify the application of the insolvency regime to the facts of a particular Ponzi scheme. These costs ultimately reduce the amount available to be distributed to investors, increasing the losses investors suffer.
    b. Delays to the distribution of funds to victims of a Ponzi scheme. The resulting uncertainty can itself inflict additional harm on defrauded investors.

Objectives

8. We consider that the regime for unwinding Ponzi schemes should:
    a. provide consistent outcomes for investors

b. share losses among investors as fairly as possible

c. minimise the cost to investors of unwinding that scheme.

For the reasons set out above, we do not think the law is currently achieving these objectives.

Criteria for designing a better system

9. Drawing on the problems identified with the current insolvency framework, we consider that the system to allocate losses to investors in a Ponzi scheme should:

   a. Recognise that investors have all been the victims of fraud.

   b. Apply equally to all common investment scheme structures so that investors are not treated differently based on the legal structure of the Ponzi scheme they have invested in.

   c. Provide a structure-neutral mechanism for funds to be recovered from investors who have received funds from the Ponzi scheme for the benefit of investors collectively.

   d. Make distinctions between investors, as far as possible, based on relevant criteria.

   e. Provide certainty to investors with regards to the likelihood that they will be required to repay funds they have received and the possibility that they will receive any further distributions from the Ponzi scheme.

   f. Be simple to administer.

   g. Provide hardship grounds for investors to be able to avoid returning money fraudulently paid to them.

Our proposal

10. We propose that a new liquidation mechanism be incorporated within the Financial Markets Conduct Act 2013 (FMCA) for resolving Ponzi schemes relating to financial products and certain types of financial services.

11. This proposal is intended to provide more balanced outcomes for investors in a Ponzi scheme. It would do so by:

    a. increasing the pool of total recoveries for redistribution to investors – this is intended to even out the burden of losses as among individual investors

    b. providing principled reasons where it is considered appropriate for some investors to bear a smaller share of the losses suffered by investors collectively.

12. This regime would apply to any 'investment scheme' which purports to be a:

    a. managed investment scheme

    b. discretionary investment management service

    c. derivative

    d. client money or property service in respect of a financial product,

    (collectively referred to as investment schemes in this document).

13. Alternative proposals we considered are also discussed below.

The courts declare that an investment scheme is a Ponzi scheme

14. We consider that the following parties should be able to seek a declaration that an investment scheme is a Ponzi scheme and seek the appointment of a liquidator:
    a. the Financial Markets Authority (FMA)
    b. the Serious Fraud Office (SFO)
    c. a liquidator, administrator or receiver of the operator of the Ponzi scheme
    d. in the case of a managed investment scheme, either the manager, the supervisor (or where there is no supervisor a trustee), an administration manager, a custodian, an auditor, or an actuary
    e. in the case of a discretionary investment management service, the discretionary investment management service licensee or any custodian in respect of that service
    f. any other person with the leave of the court subject to any conditions which the court may consider it is appropriate to impose (eg an investor).
15. The proposals in this document do not envisage that any one party will be primarily responsible for identifying and resolving Ponzi schemes. Rather, they seek to empower a broad group to act, for the benefit of consumers, where a Ponzi scheme is uncovered.

Responsibilities of the liquidator

16. The liquidator's responsibilities would be:
    a. to identify or estimate the date at which the Ponzi scheme began or became a Ponzi scheme
    b. to recover amounts claimable from the scheme operator and third parties
    c. to recover funds withdrawn and fictitious profits paid to investors
    d. after meeting the liquidator's reasonable costs and expenses, to distribute all amounts available to investors.

Clawback

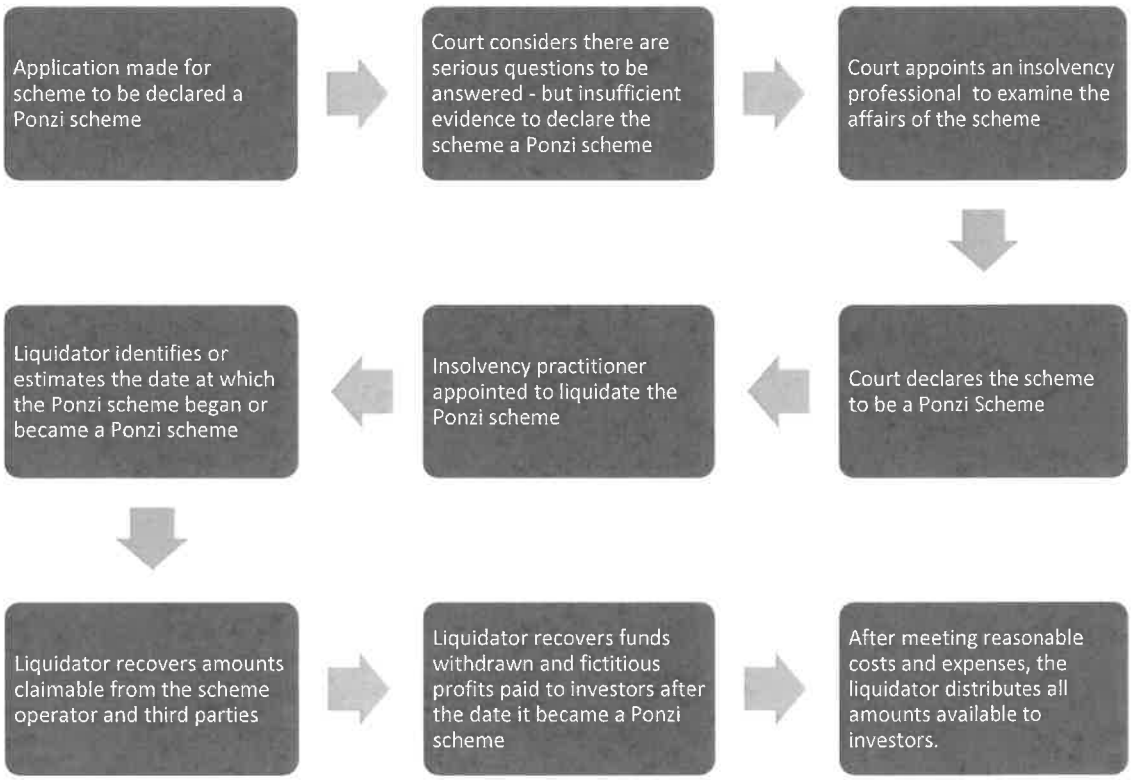
17. The liquidator would be able to recover from investors any withdrawals made (whether of principal or profit) after the scheme became a Ponzi scheme. This recovery power will be subject to a four year recovery window. Investors would not be required to repay any payments made before this period.

Distribution to investors

18. MBIE's initial view is that, in the case of all Ponzi schemes, a proportional distribution of assets is preferable to trying to identify the assets specifically attributable to individual investors.
19. However, it is important to provide clarity around what is meant by proportional. We have identified a number of models for doing this. These are discussed in greater detail in Part 5 of Chapter 3.
20. In some cases, this may have the effect of overturning the contractual basis on which investors have agreed to apportion gains and losses amongst themselves. However, we

feel this is an appropriate outcome where the basis on which investors have invested is a sham.

Overview of process to unwind a Ponzi scheme



How to use this document

21. **This document is structured in three parts, as outlined below. We have included suggested questions throughout the document but we would welcome any other relevant information that you wish to provide. All paragraphs are numbered for ease of reference.**

Chapter	Part	Description
Chapter 1: Introduction	Part 1	Purpose and context of this discussion document
	Part 2	What is a Ponzi scheme?
Chapter 2: Summary of the current position	Part 1	Liquidation is the most common method for unwinding a Ponzi scheme
	Part 2	Recovery of investor funds
	Part 3	Distribution of funds to investors
Chapter 3: Potential reforms	Part 1	Insolvency law is not designed for schemes designed to defraud investors
	Part 2	Defining a Ponzi scheme
	Part 3	Process for identifying a Ponzi scheme and appointment of a liquidator
	Part 4	Identifying the assets available for distribution to investors
	Part 5	Distribution of assets to investors

List of questions

1	Are there currently any other methods for resolving a Ponzi scheme which officials should keep in mind? If so, what are they?
2	Do you agree with Glazebrook J's statement that "an accident of timing as to when funds are withdrawn should not favour one defrauded investor over another"?
3	Do governing documents ordinarily cover the scenario where an investor is overpaid? If so how is this provided for?
4	Do you consider that, where investors are all the subjects of fundamentally the same fraud, the strict legal form of a Ponzi scheme should not impact the outcomes of investors?
5	Do you agree with the objectives we have identified for the regime for unwinding Ponzi schemes?
6	Do you agree with problems identified with the status quo? Are there any additional issues which we should seek to address?
7	Do you agree with the preferred option we have chosen?
8	Do you agree with our design goals? Are there any other goals which the system should be designed to achieve?
9	Are there any other factors which you think should be treated as indicating that an investment scheme is a Ponzi scheme?
10	What are your views on our proposed definition of a Ponzi scheme: • Do you consider that our definition of a Ponzi scheme might capture any investment structures or products which it should not? • Do you consider that the definition of a Ponzi scheme should seek to capture any other investment structures or products?
11	Do you consider that the third limb of the proposed definition of a Ponzi scheme should be expanded to capture investments more generally?
12	Are you aware of any cases in which our proposed definition would have failed to capture a Ponzi scheme?
13	Do you agree with the criteria for identifying when an investment scheme should be able to be declared a Ponzi scheme?
14	Do you consider that there are any additional or alternative criteria which should need to be met in order for a scheme to be declared to be a Ponzi scheme?
15	Do you consider that proving fraudulent intent on the part of the operator of an investment scheme should be a necessary requirement to establish that that scheme is a Ponzi scheme?

16	Do you consider that the test for whether an investment scheme is a Ponzi scheme should be: • based on a set of fixed criteria? • At the absolute discretion of the courts? • a combination of limited discretion by the courts based on a set of criteria?
17	Is it appropriate for the liquidator of a Ponzi scheme to have the same duties and powers of the liquidator of a company under the Companies Act?
18	Do you agree that a liquidator should be able to exercise all powers, rights, and privileges that the operator of the Ponzi scheme had prior to that liquidation – notwithstanding that any arrangements contemplate that those powers, rights, and privileges would end on the appointment of a liquidator?
19	Do you think that liquidation is an appropriate model for resolving a Ponzi scheme? If you think a different model is more appropriate please explain why you consider this to be the case.
20	Do you agree that the process for appointing a liquidator is an appropriate model on which to base the process for declaring an investment scheme is a Ponzi scheme?
21	Do you agree that that in order to declare an investment scheme to be a Ponzi scheme the High Court must be satisfied on the balance of probabilities that it is in fact a Ponzi scheme?
22	What are your views on the list of parties that would be able to seek a declaration that an investment scheme is a Ponzi scheme?
23	Do you agree that where the courts consider that a scheme may be a Ponzi scheme, but lack sufficient evidence to make an order to that effect, that the court be able to appoint an insolvency professional to examine the affairs of the scheme?
24	What level of certainty that a scheme may be a Ponzi scheme should be required to make such an appointment?
25	How long would it take, and what do you think the cost would be, for an insolvency professional to examine the affairs of a scheme and advise the court whether, in their professional opinion, there is sufficient evidence to conclude that that scheme is in fact a Ponzi scheme?
26	Where an investor seeks a declaration that an investment scheme is a Ponzi scheme should the Crown be required to fund the appointment of the relevant insolvency professional if it is found that the scheme is not a Ponzi scheme? If not who should bear that cost and why?
27	Should there be a set period for which an insolvency professional should be able to be appointed?
28	Do you consider that investment schemes which are invested in only by investment businesses, large persons and government agencies should not be able to be declared to be Ponzi schemes?
29	Do you consider that it may be in investors' interests for investment schemes, which have invested substantially in a Ponzi scheme, to be able to be wound up as if they were a Ponzi scheme themselves?

30	Do you think that measures are needed to minimise or mitigate the consequences for an investment scheme or its operator of a failed attempt to have it declared to be a Ponzi scheme?
31	Should there be a limit placed on the ability of investors to bring proceedings to have a scheme declared to be a Ponzi Scheme?
32	Should a defence be available to investors who in good faith bring a proceeding that a scheme is a Ponzi scheme from claims for damages brought by the operator of the investment scheme?
33	Do you consider that there should be a presumption that a Ponzi scheme was a Ponzi scheme for all time (so there is no need to identify when the scheme became a Ponzi scheme unless there is evidence to the contrary)?
34	Do you think that there should be a statutory default (say 5 years) for how far back a scheme is a Ponzi scheme in cases where a liquidator is not able to identify a point (or period) at which the scheme became a Ponzi scheme?
35	Do you agree that, in the case of Ponzi schemes, tracing is an inappropriate remedy to resolve investors' claims?
36	If you favour keeping tracing as a potential remedy in the case of Ponzi schemes how would you address the issues identified with its application?
37	Do you agree that investors should not be able to retain any fictitious profits paid to them?
38	Do you agree that there should be a limit on the period of a clawback?
39	Do you agree that four years is a reasonable period for a clawback to operate? If not what alternative would you propose?
40	Do you think that the liquidator of a Ponzi scheme should be able to apply to the courts to extend the period of vulnerability, in respect of specific investors, where it can be shown that the investor received distributions in bad faith?
41	Do you agree that in order to have the benefit of a defence against the clawback powers of the liquidator investors should be required to demonstrate that *a reasonable person in their position would not have suspected, and they did not have reasonable grounds for suspecting, that a Ponzi scheme existed*? If not, what alternative test would you propose?
42	Do you agree that significant financial hardship is an appropriate criterion for determining whether an investor merits retaining funds received from a Ponzi scheme?
43	Do you consider that alternative criteria should be used for determining whether an investor merits retaining funds received from a Ponzi scheme?
44	Do you consider that a whistle blower safe harbour should be provided to investors in a Ponzi scheme? If there is to be a safe harbour, do you consider that this should be available to all investors or just the first investor to 'blow the whistle'?

45	Do you think that a defence should be provided for investors who substantially alter their position in the reasonably held belief that a distribution or withdrawal was valid and would not be set aside?
46	Do you agree that recovery against trade creditors of a Ponzi scheme should continue to be dealt with under the ordinary principles of insolvency law?
47	Do you agree that a proportional distribution of assets is preferable in the case of all Ponzi schemes regardless of the legal structure of the Ponzi scheme?
48	Do you have any information about the cost to find out whether the losses specifically attributable to individual investors are able to be identified?
49	Do you agree that investors in a Ponzi scheme should not be entitled to the benefit of any fictitious profits allocated to them when deciding their proportional entitlements to the assets of a Ponzi scheme?
50	What is the most appropriate model for distributing assets?
51	Are there any additional models which we should consider?
52	Should investors' losses be able to be adjusted to take account of inflation or any other factors?
53	Are there any additional or alternative criteria which we should use to assess the various models for distributing assets to investors?

Chapter 1 - Introduction

Part 1 - Purpose and context of this discussion document

22. A Ponzi scheme is a fraudulent investment scheme in which investors are paid fictitious profits from the amounts invested by new investors. Usually, the initial investors are promised and paid large returns. This attracts additional investors. However, Ponzi schemes eventually collapse because the total losses grow and the promoter is unable to attract the expanding amount of new investments that are needed to keep the scheme operating.

23. While relatively rare in New Zealand, Ponzi schemes can cause significant losses for defrauded investors and can impact the confidence of businesses, investors and consumers in participating in New Zealand's financial markets. A number of recent financial market reforms, including the FMCA, were designed to make it harder for Ponzi schemes to operate without being detected. However, the experience of other countries with similar requirements shows that Ponzi schemes are still able to be perpetrated.

24. Unwinding a Ponzi scheme is a complex process - typically the exercise only begins once a Ponzi scheme ends, at which point investor losses are revealed. Once exposed, the operator of a Ponzi scheme often finds themselves the subject of insolvency proceedings.

25. In these situations, the courts and insolvency experts find themselves in the position of trying to apply insolvency law provisions in the Companies Act, including the voidable transaction provisions. These provisions were designed for balancing the interests of trade creditors, not circumstances where the purpose of the business was to defraud investors. While various courts have grappled with the application of these rules to various Ponzi schemes, it is not certain that future courts will follow these approaches. This is because the analysis is highly fact dependent.

26. This can result in arbitrary outcomes for defrauded investors. In addition to the statutory provisions, the rules in the governing documents for most managed investment schemes dealing with the winding up of those schemes and the apportioning of losses can result in similarly arbitrary outcomes for investors.

Scope and context of this discussion document

27. The Insolvency Working Group (IWG) was formed in late 2015 to provide advice to the government on aspects of corporate insolvency law. One matter the IWG was asked to provide advice on was whether any changes could be made to company or investment law to aid the recovery of funds, and obtain compensation for lost funds, by Ponzi scheme investors. The IWG reported on this issue in its second report in May 2017. A copy of that report is available ***here***.[2]

[2] http://www.mbie.govt.nz/info-services/business/business-law/insolvency-law-working-group/report-no-2-voidable-transactions-ponzi-schemes-other-corporate-insolvency-matters/consultation-document-report-no.2-review-of-corporate-insolvency-law.pdf

28. In Chapter 4 of its second report, the IWG outlined a number of potential changes to better protect the interests of investors and to speed up recovery processes in the case of Ponzi schemes, based largely on law in the United States.

29. However, the IWG made no firm recommendations because a Supreme Court decision (*McIntosh v Fisk*) was pending before that report was completed. This case related to a clawback claim made by the liquidator against an investor who withdrew his investment from the Ross Asset Management Ponzi scheme nine months prior to its collapse and was also paid a fictitious profit.

30. The law as clarified by this decision is that, an investor who withdraws the amount of their initial investment can keep that amount. They are, however, required to return any fictitious profits paid to them by the scheme.

31. The effect of this decision is that investors who were lucky enough to withdraw from the scheme at the right time are able to keep their capital, while other investors receive little if anything. This has the effect of causing other investors to suffer proportionally higher losses because the amount of the withdrawn capital is not available to be distributed to other investors in the Ponzi scheme.

32. MBIE's preliminary view is that the law, as clarified by the Supreme Court, is inconsistent with public policy settings for the following reason given in a minority judgment by Glazebrook J:

> *The operation of a Ponzi scheme cannot... in any way be described as an ordinary commercial transaction. The only purpose of the scheme is to defraud investors. I accept that Mr McIntosh was an innocent investor who had no knowledge of the fraud. However, this was the same for all investors. In policy terms an accident of timing as to when funds are withdrawn should not favour one defrauded investor over another.*[3]

Problems with the status quo

33. In Chapter 4 of its second report, the IWG identifies that:

> *... it is essential, under insolvency law and other legislation, to provide a fair and efficient procedure for liquidating Ponzi schemes, recover whatever funds might remain and distribute them among investors. This is particularly important for investors who have retired from the work force and have invested most or all of their retirement savings into a scheme which, unknown to them, is a Ponzi scheme. The current processes are not as efficient as they could be.*

We agree with this summary.

34. MBIE's view is that the current insolvency law framework does not adequately address the issues which arise in the context of a Ponzi scheme. The current insolvency framework can result in differing outcomes for investors in Ponzi schemes based on:

    a. **Structure**: Investors can face different outcomes depending on how a Ponzi scheme is legally structured (for example, a single trust vs a series of trusts).

    b. **Recovery**: The ability of a liquidator or trustee to recover assets fraudulently paid to investors can be highly fact dependent.

    c. **Timing**: Investors' rights to keep money they have withdrawn from a Ponzi scheme and their overall rate of recovery on the winding up of a Ponzi scheme can be affected by when they withdrew their money from that Ponzi scheme.

[3] *McIntosh v Fisk* [2017] NZSC 78 at para 275

d. **Tracing**: Some investors are able to establish claims to specific assets or amounts of money held by a Ponzi scheme (this process is called tracing). An investor's ability to establish a tracing claim reduces the overall pool of assets available to all investors on the winding up of that scheme.

35. Such distinctions are irrelevant to the question of how to apportion losses among investors in a Ponzi scheme. In most instances they reflect either:
    a. differences in when an investor happened to deposit or withdraw their investments
    b. the actions of other investors in depositing or withdraw their investments
    c. the actions of the operator of the Ponzi scheme
    d. the legal structure of the Ponzi scheme.
36. We do not consider that these factors suggest that any investor is more blameworthy than any other or should bear a greater share of losses caused by a Ponzi scheme for any other reason.
37. We also consider that the uncertainty surrounding the application of the corporate insolvency regime to Ponzi schemes results in:
    a. Expenses being incurred in order to clarify the application of the corporate insolvency regime to the facts of a particular Ponzi scheme. Such costs ultimately reduce the amount available to be distributed to investors exacerbating the losses they have suffered.
    b. Delays in the distribution of funds to victims of a Ponzi scheme. The resulting uncertainty can itself inflict additional harm on defrauded investors.

What does this document do?

38. This document:
    a. outlines MBIE's analysis of various issues identified with the application of New Zealand's insolvency regime as it applies to Ponzi schemes
    b. tests our criteria for assessing an optimal regime for the sharing of losses amongst investors in a Ponzi scheme
    c. seeks input on certain solutions to the problems identified.
39. This document also contains a number of key questions, informed by initial discussions with government agencies, industry groups and professional advisers. We seek your responses to these questions and other relevant feedback to:
    a. improve our understanding of the issues with the application of corporate insolvency law to the unwinding of Ponzi schemes and opportunities for change
    b. inform the development of a regime for the sharing of losses amongst investors in a Ponzi scheme.

Part 2 – What is a Ponzi scheme?

40. The main features of a Ponzi scheme are identified in the following descriptions from two court decisions, one from the United States and the other from New Zealand:

a. A Ponzi scheme is a fraudulent investment scheme in which money contributed by later investors is used to pay artificially high dividends to the original investors.[4]

b. Ponzi schemes do not generate profits sufficient to yield their promised profits but rather use new investor money to pay 'profits' and to repay existing investors, with each payment exacerbating the scheme's financial position. That is their distinctive characteristic.[5]

41. The U.S. Securities and Exchange Commission similarly defines a Ponzi scheme as:[6]

> *A Ponzi scheme is an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors. Ponzi scheme organizers often solicit new investors by promising to invest funds in opportunities claimed to generate high returns with little or no risk. In many Ponzi schemes, the fraudsters focus on attracting new money to make promised payments to earlier-stage investors to create the false appearance that investors are profiting from a legitimate business.*

42. The following three more detailed descriptions identify several additional characteristics that may be commonly observed in a Ponzi scheme but are not necessary conditions:

a. *A Ponzi scheme is a fraudulent investment scheme where the operator, whether an individual or an entity, pays returns to investors from new capital paid to the operators by new investors, rather than from profit earned by the operator.* ***The scheme will usually lack substance and will not usually be a genuine business undertaking. Operators of Ponzi schemes entice investors by offering returns that are much higher than market rates of return****. They often promise a consistent return from one period to the next.*[7]

b. *The promoter promises investors a return on investment and says it is secure, but there is no real 'investment'. The promoter convinces people to invest with their scheme.* ***They then use the money deposited by early investors to pay the first 'dividend' until investors feel comfortable and decide to invest more. Some investors then encourage their family and friends to join.*** *Eventually the scheme falls apart because the promoter starts to spend the money too quickly or the pool of investors dries up.*[8]

c. *A 'Ponzi' scheme is a term generally used to describe an investment scheme which is not really supported by any underlying business venture. The investors are paid profits from the principal sums paid in by newly attracted investors. Usually those who invest in the scheme are promised large returns on their principal investments. The initial investors are indeed paid the promised sizeable returns. This attracts additional investors. More and more investors need to be attracted into the scheme so that the growing number of investors on top can get paid.* ***The person who runs this scheme typically uses some of the money invested for personal use.*** *Usually this pyramid collapses and most investors not only do not get paid their profits, but also lose their principal investments.*[9]

43. While there is no agreed definition of what a Ponzi scheme is, in this document, when we refer to a Ponzi scheme we are referring to a fraudulent investment scheme that involves the payment of investment returns to existing investors, from funds contributed by new investors.

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[4] *In re the Bennett Funding Group Inc* 439 F.3d 155 (2d Cir 2006) at 157.
[5] Miller J's minority opinion in *McIntosh v Fisk* [2016] NZCA 74 at [107].
[6] U.S. Securities and Exchange commission website ***here***
[7] *Report No. 2 of the Insolvency Working Group, on voidable transactions, Ponzi schemes and other corporate insolvency matters*, May 2017, para 136.
[8] Australian Securities and Investments Commission's MoneySmart website ***here***
[9] *Martino v Edison Worldwide Capital (In re Randy)* 189 BR 425 (Bankr ND III 1995) at 437.

Chapter 2 – Summary of the current position

Part 1 – Unwinding a Ponzi scheme

44. At present, there is no targeted regime providing for the recovery of investor funds lost in a Ponzi scheme. In Chapter 4 of its second report, the IWG outlined the purpose of corporate insolvency law as follows:

    The purpose of corporate insolvency law is to provide a legal mechanism to address the collective satisfaction of the outstanding claims from assets (both tangible and intangible) of the debtor company. Its purpose is not [...] to prevent or address investment fraud.

45. For this reason the outcomes which the corporate insolvency regime arrives at in the case of a Ponzi scheme are not necessarily appropriate. However, because of the broad powers of liquidators, liquidation is often used as a way to recover and distribute any remaining assets of the operator of a Ponzi scheme to investors. For example:

    a. A liquidator can, in some cases, take action against an investor who received a payment prior to a Ponzi scheme's collapse under the voidable transactions regime under the Companies Act, or the prejudicial dispositions regime under the Property Law Act. This makes the amount of those payments available for distribution to the other defrauded investors in the Ponzi scheme.

    b. A liquidator may take action against the owner or operator of a Ponzi Scheme to seek restitution for knowing receipt of funds in breach of trust, dishonest assistance to a trustee to disperse trust funds in breach of trust and, possibly, unjust enrichment.

46. These remedies are primarily used where the Ponzi scheme is structured as, or through, a company. However, this is not always the case. Some Ponzi schemes are trusts. In such scenarios, statutory managers are in some cases appointed under the Corporations (Investigation and Management) Act 1989.

47. In addition, investors can try to recover their investment in a Ponzi scheme directly from the assets held by the liquidator of the scheme through a process called tracing. This process is discussed in more detail below.

48. There are other avenues available to recover misappropriated funds, namely:

    a. Investor funds appropriated by the perpetrator of the Ponzi scheme may be subject to forfeiture under the Criminal Proceeds (Recovery) Act 2009.

    b. Common law remedies may assist either individual investors or the liquidator on behalf of all investors to try to recover funds which have been paid away in breach of trust.

49. However, these remedies respectively fall within the ambit of the criminal law or within the general discretion of the courts and therefore fall outside of the scope of this discussion document.

50. It is also possible to argue that the insolvency of a Ponzi scheme is not a requirement for an investor to be able to bring a common law claim to try to recover funds which have been paid in breach of trust. However, we note that in practice where any investor is

seeking to bring such a common law claim in respect of a Ponzi scheme that case is likely to push the scheme to the point of collapse by:

a. spurring other investors to withdraw their own contributions and fictitious profits

b. bringing regulatory scrutiny to bear on the scheme.

1	Are there currently any other methods for resolving a Ponzi scheme which officials should keep in mind? If so, what are they?

Part 2 - Recovery of investor funds

51. Ponzi schemes have many different legal forms. The specific remedies available to investors in a Ponzi scheme and the powers available to unwind Ponzi schemes and recover money paid to investors will differ based on how a Ponzi scheme is structured. This can produce inconsistent outcomes for investors in different schemes in circumstances where they are all the victims of the same type of fraud.

52. A liquidator may take action against investors to claw back payments made prior to a Ponzi scheme's collapse under the voidable transactions regime in sections 292-296 of the Companies Act or the prejudicial dispositions regime in sections 344-350 of the Property Law Act. However, the powers of a liquidator are more limited where a Ponzi scheme is a trust.

53. Alternatively, a statutory manager is able, under narrow circumstances described in section 54 of the Corporations (Investigation and Management) Act 1989, to seek court orders requiring the return of property improperly disposed of or a payment of a sum for the value of that property.

54. Finally, where there is a trustee (independent of the operator of a Ponzi scheme) they may bring claims against the operator of a Ponzi scheme for breach of trust.

55. Investors also have the option to try to trace their beneficial interest in specific assets which they have invested in a Ponzi scheme and try to recover those assets or the proceeds of those assets.

56. Each of these methods of recovery is discussed in more detail below.

57. There may also be causes of action available to any liquidator, statutory manager, or trustee under common law to seek restitution for knowingly receiving funds in breach of trust, dishonestly assisting a trustee to disperse trust funds in breach of trust and possibly unjust enrichment.

Recovery of investor funds under the Companies Act

58. Under the voidable transactions regime in the Companies Act, payments made by a company in the two years prior to the commencement of its liquidation can be clawed back by the liquidator as long as the company was insolvent at the time the payment was made (the IWG has recommended that the period of vulnerability be reduced to six months for unrelated parties and increased to four years for related parties). It is also arguably possible to liquidate a trust under the Companies Act.

59. However, creditors (including the investors in a Ponzi scheme) have a defence under s296(3) of the Companies Act which provides that the High Court must not order a recovery under the Companies Act or any other enactment if the person from whom the recovery is sought proves that:

a. they acted in good faith

b. a reasonable person in their position would not have suspected and did not have reasonable grounds for suspecting, that the company was or would become insolvent

c. they gave value for the property, or altered their position in the reasonably held belief that the transfer of the property was valid and would not be set aside.

60. A clarification of the law by the Supreme Court in 2015 (*Allied Concrete v Meltzer*[10], which related to three cases involving trade creditors) had the effect of making the "gave value" test relatively easy to meet. This makes the alternative "altered position" test in s296(3)(c) irrelevant in many cases.

McIntosh v Fisk

61. The Court of Appeal and Supreme Court needed to apply the "gave value" test in *McIntosh v Fisk*[11], a case that related to the Ross Asset Management (RAM) Ponzi scheme. In this case an investor in RAM, had withdrawn a $500,000 investment in RAM about nine months prior to its collapse. The investor was also paid a fictitious profit of about $450,000. The liquidator had sought to claw back both amounts under the voidable transactions regime in the Companies Act.

62. The case came down to whether the investor could meet the "gave value" test under limb (c) of the creditor's defence. By 4-1, the Supreme Court ruled that the investor met the test in relation to the $500,000 of capital, but not in relation to the fictitious profit of $450,000. Glazebrook J agreed with the majority in relation to the fictitious profit but disagreed in relation to the amount invested. Her Honour stated that the provision of funds by an investor into a Ponzi scheme delivered no value to RAM.[12]

The implications of *McIntosh v Fisk*

63. The Supreme Court decision means that any investor in a Ponzi scheme can retain all invested funds that were withdrawn before a liquidator is appointed because the Court ruled that capital contributions to a Ponzi scheme meet the "gave value" test. This means that investors who withdraw funds from a Ponzi scheme before it collapses gain an advantage over those who do not. To illustrate, we understand that RAM investors who made no withdrawals will probably receive less than 20 cents for every dollar invested, compared with 100 cents for every dollar invested for investors who withdrew everything prior to that scheme's collapse.

64. Had Glazebrook J's minority opinion prevailed, then almost all investors would have received the same percentage. The only exceptions would have been investors who withdrew funds before RAM collapsed which could have met all three requirements of the creditor's defence in s296(3) of the Companies Act, including the requirement to prove that they altered their position in the reasonably held belief that the transfer was valid and would not be set aside.

The outcome in McIntosh v Fisk leads to seemingly unjust outcomes

65. Glazebrook J summarised the arguments for asserting that the current law is unjust in *McIntosh v Fisk*:

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[10] *Allied Concrete Limited v Meltzer* [2015] NZSC 7.
[11] *McIntosh v Fisk*, [2017] NZSC 78.
[12] *McIntosh v Fisk* [2017] NZSC 78 at [266].

[275] The operation of a Ponzi scheme cannot... in any way be described as an ordinary commercial transaction. The only purpose of the scheme is to defraud investors. I accept that Mr McIntosh was an innocent investor who had no knowledge of the fraud. However, this was the same for all investors. In policy terms an accident of timing as to when funds are withdrawn should not favour one defrauded investor over another. This is particularly the case as the very essence of a Ponzi scheme is that investment by new investors is used to pay out those investors who wish to withdraw their funds. As the liquidators submit, the very purpose of the payments made to Mr McIntosh was to defraud other investors.

66. Our initial view is that treating investors equally is important for distributive justice reasons. Accidents of timing should not favour one defrauded investor over another.

2	**Do you agree with Glazebrook J's statement that "an accident of timing as to when funds are withdrawn should not favour one defrauded investor over another"?**

Recovery of investor funds under the Property Law Act

67. The court may make an order under section 348 of the Property Law Act clawing back property disposed of by a debtor where the debtor:

    a. was insolvent at the time of that disposal, or became insolvent as a result of that disposal of property

    b. was engaged, or was about to engage, in a business or transaction for which their remaining assets were, given the nature of the business or transaction, unreasonably small

    c. intended to incur, or believed, or reasonably should have believed, that they would incur, debts beyond their ability to pay,

    and disposed of that property with the intent to prejudice a creditor, as a gift, or without receiving reasonably equivalent value in exchange.

68. This test is likely to be able to be met where, in the case of a Ponzi scheme, the operator of the scheme distributes money to investors.

69. The Property Law Act contains two protections for third parties in these circumstances:

    a. a third party can defend any application to the court if they can show that they acquired the property for valuable consideration and in good faith without knowledge of the fact that it had been a prejudicial disposition,[13] or

    b. the court can decline to make a clawback order, or make an order of limited effect, if:

        i. the person received the property in good faith and without knowledge of the fact that it had been a prejudicial disposition

        ii. the circumstances of the person who received the property have so changed since they received it that it would be unjust to require them to return the property or pay compensation.

[13] Or they acquired the property through a person who acquired it in those circumstances

Tracing

70. Tracing is a process available to a beneficiary of a trust, or to anyone to whom a fiduciary obligation in respect of property is owed (like a defrauded investor) under which that person can:

    a. try to locate the property which was the subject of that trust or duty

    b. try to recover that original trust property or anything it has been turned into (eg shares contributed to a Ponzi scheme might be sold by the operator of the Ponzi scheme, turning them into cash or vice versa).

71. The ability of some investors in a Ponzi scheme to bring tracing claims can result in those investors being able to recover a greater proportion of their investment than others.

Recovery where a Ponzi scheme is structured as a trust

72. Where a Ponzi scheme is structured as a managed investment scheme (which is not a company or limited partnership) recovery of funds from investors is often a matter of the terms of the governing document (typically a trust deed) and general rules of law. There is no separate statutory mechanism for recovery of money paid to investors.

73. Whether any governing document contains express provisions requiring repayment of any amount paid in breach of that document is a factual question.

74. In the absence of an express ability to recover funds, any trustee or replacement manager is left to take general claims against investors (for example for unjust enrichment). Whether such a claim is possible is a question of fact in each case. This process is a more complex, and therefore expensive, process than for recovery of voidable transactions under the Companies Act or the Property Law Act.

3	**Do governing documents for managed funds ordinarily cover the scenario where an investor is overpaid (eg based on a mistaken unit price)? If so how is this provided for?**

Recovery of investor funds under the Corporations (Investigation and Management) Act 1989

75. Section 54 of the Corporations (Investigation and Management) Act 1989 allows the court to make an order that:

    a. property should be transferred or delivered to a statutory manager

    b. that any person who acquired or received the property should pay to the statutory manager a sum not exceeding the value of that property,

    where that person:

    a. acquired property in circumstances which cause it to be just and equitable that they should hold it on trust for any corporation that has been placed in statutory management

    b. acquired property that has been improperly disposed of, whether or not the property has become subject to a trust.

76. Relevantly however, a statutory manager is, in some circumstances, able to exercise their powers in relation to a trust.

77. While statutory management has been used to resolve some Ponzi schemes, it is intended to enable an entity to be managed where normal legal procedures are inadequate and preserve the interests of beneficiaries and creditors. However, once a Ponzi scheme is uncovered, particularly an advanced one it is too late to do this – significant losses have already been incurred. At that stage what is required is a process to allocate those losses across investors.

Part 3 - Distribution of funds to investors

78. The usual approach to the distribution of assets on the liquidation of a company or the bankruptcy of an individual is that all creditors are treated equally, based on the amount of their claim against the company or the bankrupt individual at the date of liquidation or bankruptcy.

79. In the event that the assets of the company or individual are not sufficient to meet all of their debts then the shortfall is shared among creditors on a proportional basis - based on the amount of their claim.

80. Similarly, we understand that the trust deeds of many managed investment schemes provide that after trade creditors are paid most investors participate in the remaining assets of the scheme on a proportional basis – typically based on the number of 'units' allocated to them.[14]

81. In addition, in some cases:

    a. Investors are able to bring a claim for specific assets to be returned to them.

    b. Investors are able to keep some of the amounts they have withdrawn from a Ponzi scheme before its collapse.

82. This can result in these investors suffering a smaller overall loss than other investors.

83. The current insolvency framework results in differing outcomes for investors in Ponzi schemes based on:

    a. whether they are able to establish claims on any specific assets held within the Ponzi scheme

    b. whether they have been able to withdraw any money from the Ponzi scheme and the impact of those withdrawals on their effective recovery rate.

84. In most instances these factors reflect differences in timing or the legal form of the Ponzi scheme. They do not suggest that any investor is more blameworthy or should bear a greater share of losses for any other reason.

Inconsistent outcomes between investors who are able to trace a claim to specific assets and those who are not

85. Tracing claims can effectively allow impacted investors to get back what they invested or the investments notionally held for them. This means that they do not suffer any of the losses which have been caused to investors generally or they can greatly reduce this loss. Their only losses are in respect of the assets they have not been able to get back. This can result in a proportionally much higher recovery rate for those investors than investors generally.

[14] We are aware that some defined benefit schemes provide for separate hierarchy as between pensioners and active members.

86. This can have the effect of concentrating losses among those investors who are not able to bring tracing claims.

Inconsistent outcomes between investors who withdrew some of their initial investment before the collapse of the scheme and those who did not

87. In the event that the assets of a company or an individual are not sufficient to meet all of their debts the shortfall is typically shared among creditors, including investors, in proportion to the amounts they are owed. Investors' entitlements are calculated by taking into account all deposits and withdrawals made by the investor and calculating a running balance to the date of the unwinding of the Ponzi scheme.

88. Various commentators, and a number of investors, have raised the issue that this method results in unfair outcomes. This is because it does not take into account previous payments which an investor may have received and how that impacts on their overall rate of recovery. This effectively prefers investors who received payments prior to the collapse of the scheme.

Example

An investor deposits $5,000 with a Ponzi scheme. The investor subsequently withdraws $2,000. This brings their reference debt to $3,000. Assuming a recovery rate of 10 cents in the dollar, the investor will receive a distribution of $300. The investor accordingly makes an overall recovery of $2,300 (their initial withdrawal of $2,000 plus the distribution of $300). This represents an overall recovery of 46 cents in the dollar.

In contrast, an investor who makes an identical $5,000 deposit on the same day but does not make any withdrawal before the collapse of the Ponzi scheme and will be entitled to recover at the same rate of 10 cents in the dollar. This means they would receive a distribution of $500 which represents an overall recovery of 10 cents in the dollar.

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89. This issue is currently being considered by the courts in the context of the Ross Asset Management Ponzi scheme.

90. Investors in RAM have proposed an alternative model which seeks to take into account payments received by an investor when calculating their claim. This model is discussed in greater detail in Part 5 of Chapter 3. However, in summary, under the "alternative model":

    a. There is no set rate of recovery – the rate at which an investor is eligible to recover the amount of their initial investment will depend both on their withdrawals and those of other investors.

    b. Preliquidation withdrawals are effectively treated as voidable transactions – albeit that any shortfall is not recovered from impacted investors. The consequences of this are that, to the extent that investors have already withdrawn more than they would otherwise be entitled to recover, they are not entitled to receive any further distribution.

91. Similar issues can arise on the winding up of a managed investment scheme which is found to be a Ponzi scheme. Some investors will have had the benefit of withdrawals based on a fraudulent or mistaken understanding of the asset position of the scheme. However, once the true asset position is uncovered, the interests of all remaining investors are typically proportionally reduced in value to reflect that true position.

4	Do you consider that, where investors are all the subjects of fundamentally the same fraud, the strict legal form of a Ponzi scheme should not impact the outcomes of investors?

Chapter 3 – Potential reforms

Part 1 - Insolvency law is not designed for schemes designed to defraud investors

Objectives

92. We consider that the regime for unwinding Ponzi schemes should:
    a. provide consistent outcomes for investors
    b. share losses among investors as fairly as possible
    c. minimise the cost to investors of unwinding a Ponzi scheme.

    For the reasons set out below, we do not think the law is currently achieving these objectives.

The law does not apply fairly to investors in Ponzi schemes

93. In Chapter 4 of its report no. 2, the IWG identifies that

    > *... it is essential, under insolvency law and other legislation, to provide a fair and efficient procedure for liquidating Ponzi schemes, recover whatever funds might remain and distribute them among investors. This is particularly important for investors who have retired from the work force and have invested most or all of their retirement savings into a scheme which, unknown to them, is a Ponzi scheme. The current processes are not as efficient as they could be.*

94. We agree with this summary. MBIE's initial view is that the current insolvency law framework does not adequately address the issues which arise in the context of a Ponzi scheme:
    a. We do not consider it is relevant whether a Ponzi scheme is insolvent when an investor receives a payment. Ponzi schemes rely on attracting new investments in increasingly large amounts as time passes, so they inevitably collapse.
    b. Whether an investor gave value should have no bearing on whether or not a liquidator should be able to claw back payments made to one group of investors when the funds that were used for those payments were obtained by defrauding other investors.
    c. The absence of a statutory ability to easily recover fraudulent payments in regards to some investment structures creates arbitrary outcomes for investors based on the legal form of a Ponzi scheme.
    d. The IWG recommendation to reduce the period of vulnerability for insolvent transactions from two years to six months prior to the commencement of the liquidation is too short in the context of investment fraud.
95. The current insolvency framework results in differing outcomes for investors in Ponzi schemes, based on whether:

a. any funds withdrawn from the Ponzi scheme by investors are able to be recovered by a liquidator, statutory manager or trustee

b. investors have been able to withdraw any money from the Ponzi scheme and the impact of those withdrawals on their effective recovery rate

c. investors are able to establish claims on any specific assets held within the Ponzi scheme.

96. Such distinctions are arbitrary between investors in a Ponzi scheme. In most instances, these factors reflect differences in timing – they do not suggest that any investor is more blameworthy or should bear a greater share of losses for any other reason.

97. We also consider that the uncertainty surrounding the application of the corporate insolvency regime to Ponzi schemes results in:

a. Expenses being incurred by liquidators in order to clarify the application of the corporate insolvency regime to the facts of a particular Ponzi scheme. Such costs ultimately reduce the amount available to be distributed to investors exacerbating the losses they have suffered.

b. Delaying the distribution of funds to victims of a Ponzi scheme. The resulting uncertainty over an extended period can inflict additional harm on defrauded investors.

98. Similarly, the lack of a regime to deal with the insolvency of managed investment schemes results in inconsistent outcomes between investors in different schemes based on the specifics of their governing documents and a lack of recovery powers to recover funds inappropriately paid to investors.

99. In addition, there is no public enforcement mechanism under the current insolvency framework, nor is there a need for one in relation to trade creditors. By contrast, there is a case to be made for a broad group to be empowered to intervene in order to assist the victims of a fraud including a regulator where the public benefit of intervention outweighs the cost of doing so.

5	**Do you agree with the objectives we have identified for the regime for unwinding Ponzi schemes?**
6	**Do you agree with problems identified with the status quo as outlined in paragraphs 89 to 95 above? Are there any additional issues which we should seek to address?**

Options for achieving objectives

100. We have identified two options for achieving the objectives set out above.

Create a bespoke, Ponzi-specific, insolvency regime (preferred option)

101. It would be possible to create a bespoke, Ponzi-specific, insolvency regime outside (and as an alternative) of the current insolvency regime. This could be incorporated in the FMCA, as one of its purposes is to:

> *promote the confident and informed participation of businesses, investors, and consumers in the financial markets*

Pros	Cons
The FMCA is intended to be the cornerstone piece of financial markets legislation. Any financial markets-specific insolvency framework would logically be found in that statute.	There is currently no insolvency regime in the FMCA. This would be a novel inclusion in that Act.
The types of investment structures which are the most likely to be used as a Ponzi schemes are already regulated under the FMCA.	To the extent that there are no remaining assets within the Ponzi scheme and no ability to recover assets from investors, this approach would not be able to redistribute losses between investors.
No regulator has an enforcement role under the corporate insolvency regime. There is a case for a regulator to intervene in Ponzi schemes in order to assist the victims of fraud. The FMCA has existing mechanisms for regulators to play an enforcement role.	

Modify the current insolvency regime

102. It would be possible to make a series of discrete amendments to the current insolvency regime contained in the Companies Act and the Property Law Act, to address the problems identified with the applications of that regime to Ponzi schemes.

Pros	Cons
The current regime is already in place and is understood by insolvency professionals.	The insolvency regime in the Companies Act and in the Property Law Act is intended to apply to ordinary commercial arrangements - not investment fraud.
	In order to address the issues identified above, without impacting on ordinary insolvencies, a substantially parallel insolvency regime would need to be created in the Companies Act and the Property Law Act. This could confuse the operation of those Acts.
	There is no public enforcement mechanism under the voidable transactions regime, nor is there a need for one in relation to recoveries from trade creditors. There is however a good case for a regulator to intervene in order to assist the victims of fraud.
	The government is considering its response to recommendations made by the IWG in relation to the corporate insolvency regime. This could require changes to this regime which are inconsistent with the objectives above.

Pros	Cons
	To the extent that there are no remaining assets within the Ponzi scheme and no ability to recover assets from investors, this approach would not be able to redistribute losses between investors.

Options discarded

103. We also considered the establishment of a compensation scheme for investors in a Ponzi scheme. This option was discarded as, while it could address many of the objectives set out above, it would also have a number of unintended consequences. In particular:

    a. If a compensation programme were to provide meaningful compensation to investors, this could reduce the incentives for investors to invest prudently. They might disregard risks knowing that they would be held harmless through the compensation regime.

    b. If the compensation scheme was primarily funded by the financial services industry (eg by the imposition of a levy on all transactions):

        i. That funding model could impose significant transaction costs on financial markets. This risks distorting market forces. Market participants could reasonably be expected to take the impacts of any levy into account when deciding what transactions to undertake and to structure their affairs to reduce that levy as far as possible.

        ii. Participants in the financial markets could reasonably be expected to pass the cost of any funding levied directly from the industry on to investors. This risks imposing a barrier to investors' participation in the financial markets.

        iii. That would effectively transfer losses suffered by the investors in a Ponzi scheme to the financial services industry and ultimately to other investors who have not invested in a Ponzi scheme.

    c. Even if any compensation scheme was primarily funded by the industry it could require a government contribution or underwriting – transferring losses onto the Crown balance sheet.

Preferred option

104. Our preferred option for achieving the objectives in paragraph 92 is to establish a bespoke, Ponzi-specific, insolvency regime under the FMCA.

105. This option can:

    a. provide consistent outcomes for investors in a Ponzi scheme

    b. share losses among investors as fairly as possible

    c. minimise the cost to investors in a Ponzi scheme of unwinding it.

106. This option also has the fewest negative impacts associated with it.

7	Do you agree with our choice of preferred option?

Designing a better system for unwinding Ponzi schemes within the FMCA

107. Drawing on the problems identified with the current insolvency framework, we consider that the system to allocate losses to investors in a Ponzi scheme should:

    a. Recognise that investors have all been the victims of fraud.

    b. Apply equally to all common investment scheme structures so that investors are not treated differently based on the legal structure of the Ponzi scheme they have invested in.

    c. Provide a structure-neutral mechanism for funds to be recovered from investors who have received funds from the Ponzi scheme for the benefit of investors collectively.

    d. Make distinctions between investors, as far as possible, based on relevant criteria.

    e. Provide certainty to investors with regards to the likelihood that they will be required to repay funds they have received and the possibility that they will receive any further distributions from the Ponzi scheme.

    f. Be simple to administer.

    g. Provide hardship grounds for investors to be able to avoid returning money fraudulently paid to them.

8	Do you agree with our design goals? Are there any other goals which the system should be designed to achieve?

Part 2 - Defining a Ponzi scheme

108. As set out above, the scope of any bespoke regime for addressing Ponzi schemes is intended to be limited to the potential establishment of a regime for the sharing of losses (and any residual surplus) among investors in a Ponzi scheme. It is not intended to provide a regime for the sharing of losses among the victims of fraud more generally or to liquidate managed investment schemes in other circumstances.

109. In order to confine the application of any regime purely to Ponzi schemes it is necessary to define precisely what is meant by that term. However, there are various complexities in attempting to define a Ponzi scheme.

110. In its end phase a legitimate business may take on the appearance of a Ponzi scheme as the debtor transfers incoming receipts to meet outgoings rather than applying them to formerly profitable business activities.[15]

111. There is also a time element. As was noted in submissions on second report of the IWG a Ponzi scheme that has run its course and collapsed will be easy to recognise. However:

    a. Many Ponzi schemes are not Ponzi schemes at the outset. They may begin as a legitimate business but if investment returns deteriorate the operator may come under pressure to use new investor funds to pay 'returns' to withdrawing investors.

    b. Where a Ponzi scheme is caught early, it may share many of the characteristics of a legitimate business that has overextended itself and is temporarily using money deposited by new investors to pay amounts to exiting investors, pending an improvement in cash flows.

[15] Mark McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers* (1998) 72 American Bankruptcy LJ 157 at 174.

112. We also note that:

a. Where a Ponzi scheme is caught early, some of the assets of the 'scheme' may not yet have been appropriated by the operator of the scheme and it may still be possible to identify discrete pools of money held on trust for identifiable investors.

b. For managed investment schemes it is common practice for outgoing investors to be repaid from the capital contributions of incoming investors so as to minimise the costs of buying and selling investments. Hence, one of the potentially important issues in determining whether or not a scheme is a Ponzi scheme is to assess whether the use of new investments to pay withdrawing investors is permitted by terms of that scheme.

113. United States courts have found that to establish that a Ponzi scheme exists it must be shown that:

a. deposits were made by investors

b. the operator of the Ponzi scheme conducted little or no legitimate business operations as represented to investors

c. the purported business operations of the operator of the Ponzi scheme produced little or no profits or earnings

d. the source of payments to investors was from cash infused by new investors.[16]

114. Numerous other factors have been identified by the US courts as weighing in favour of establishing that an investment scheme was in fact a Ponzi scheme. These include:

a. The operator of the scheme in question does not have any legitimate business operation to which the investment scheme was connected.

b. Investors' money was commingled.

c. The operator of the scheme failed to invest all of the investors' funds in the promised investments.

d. The operator of the scheme used investor funds for unauthorised purposes unrelated to the scheme.

115. Where a legitimate investment scheme becomes a Ponzi scheme as a result of incremental changes in the operation of the scheme it can also be difficult to identify exactly when the scheme became a Ponzi scheme.

9	Are there any other factors which you think should be treated as indicating that an investment scheme is a Ponzi scheme?

Statutory definition of a "Ponzi scheme"

There is a risk that a prescriptive statutory definition of a "Ponzi scheme" could be too narrow or too wide

116. MBIE is concerned that there is a risk that a statutory definition of "Ponzi scheme" could be either too narrow or too wide. This would introduce arbitrariness to the outcomes faced by investors in different fraudulent schemes.

117. If the definition of a Ponzi scheme was drawn too narrowly then investors in what is, in substance, a Ponzi scheme would be left to rely on the corporate insolvency regime.

[16] In Re Canyon Systems Corp., 343 B.R. 615 (Bankr. S.D. Ohio 2006)

118. Alternatively, if the definition of a Ponzi scheme was drawn too broadly then schemes which are not, in substance, Ponzi schemes could be brought into any Ponzi regime resulting in gains and losses being inappropriately shared among investors.

119. However, we consider that any overly detailed distinctions will in many cases be matters of fact and degree. This risks introducing arbitrariness into any Ponzi regime.

Proposed definition

120. As a starting position, we consider that a Ponzi scheme should be defined in legislation as a scheme which is, or purports to be, either:

    a. a *managed investment scheme* as defined in the FMCA

    b. a *discretionary investment management service* as defined in the FMCA

    c. the offer of a *derivative*

    d. the provision of a *client money or property service* in respect of a *financial product* as defined in the Financial Services Legislation Amendment Bill and the FMCA respectively.

121. These structures were chosen because:

    a. they currently each attract a level of consumer protection under the FMCA

    b. of existing investment structures under the FMCA they are the most likely structures to be used as a Ponzi scheme.

122. It should also meet certain other criteria indicating that it is a Ponzi scheme, as discussed in more detail below.

123. In summary terms, a *managed investment scheme* is a scheme to which each of the following applies:

    a. The purpose or effect of the scheme is to enable investors taking part in the scheme to contribute money, or to have money contributed on their behalf, to the scheme to acquire interests in the scheme.

    b. Those interests are rights to participate in, or receive, financial benefits produced principally by the efforts of another person under the scheme.

    c. Investors do not have day-to-day control over the operation of the scheme.

124. A *discretionary investment management service* is a service in which:

    a. A person decides which financial products to acquire or dispose of on behalf of an investor.

    b. In doing so is acting under an authority granted to them to manage some or all of that investor's holdings of financial products.

125. In high level terms a *derivative* is an agreement in which:

    a. One party is, or may be, required to make a payment (or provide other consideration) at a future time.

    b. The amount of the payment, or the value of the agreement, is set by reference to the value or amount of something else.

126. A *client money or property service* in respect of a *financial product* is a service involving:

    a. the receipt of

        i. client money being money:

1. received in connection with acquiring, holding, or disposing of a financial product (ie a debt security, an equity security, a managed investment product or a derivative) or otherwise in connection with a financial product
2. received from, or on account of, that client (and not on that person's own account)

ii. client property being property (other than money) to which the following applies:

1. the property is a financial product, a beneficial interest in a financial product, or is received in connection with a financial product
2. the property is received from, or on account of, that client (and not on that person's own account)

b. the holding of that client money or client property by a person in trust for, or on behalf of, the client, or another person nominated by that client, under an agreement between that person and the client or between that person and another person with whom the client has an agreement.

127. Investment schemes which are managed investments, discretionary investment management services, derivatives or client money or property services in respect of a financial product were chosen as the basis for this regime on the grounds that:

a. they currently each attract a level of consumer protection under the FMCA

b. of existing investment structures under the FMCA they are the most likely structures to be used as a Ponzi scheme.

128. A notable omission from the list of structures which could be a Ponzi scheme is debt securities. These are rights to be *repaid* money or paid *interest* on money that is, or is to be, deposited with, lent to, or otherwise owing by a person. These have been excluded on the basis that they are loans. This means that any money invested in a debt security is no longer the property of the investor – they have given it to the person borrowing it. Any failure to pay on the part of the borrower is to that extent appropriately dealt with by the law relating to trade creditors.

129. The consequences of structuring the definition of a Ponzi scheme in this way is that any Ponzi scheme which:

a. does not conform to one of these structures

b. in the case of client money or property services does not deal or purport to deal in financial products (for example because it purports to acquire land),

would not be able to be dealt with using any Ponzi specific insolvency regime.

10	What are your views on our proposed definition of a Ponzi scheme: • Do you consider that our definition of a Ponzi scheme might capture any investment structures or products which it should not? • Do you consider that the definition of a Ponzi scheme should seek to capture any other investment structures or products?

Financial product vs security

130. We also considered linking the client money or property service definition of a Ponzi scheme to the acquisition of a "security" as defined in the FMCA instead of a "financial product". Security is a more expansive term.

131. We do not favour using this term as it would result in the client money or property service limb of the definition expanding to cover Ponzi schemes involving types of investments which do not currently attract investor protection under financial markets legislation (eg bloodstock or real property).

132. We recognise that investors investing in such a scheme could be investing in a substantially identical type of fraud as a Ponzi scheme (as defined above). However, the aim of this paper is not to seek views on recoveries from all forms of fraud. The aim is to deal with a problem with Ponzi schemes as they are commonly understood. In addition, to the extent that a managed investment scheme was investing in such products that would be captured.

11	Do you consider that the third limb of the proposed definition of a Ponzi scheme should be expanded to capture investments more generally?
12	Are you aware of any cases in which our proposed definition would have failed to capture a Ponzi scheme?

Characteristics for an investment scheme to be a Ponzi scheme

133. We consider that an investment scheme should be able to be declared a Ponzi scheme in circumstances broadly analogous to those used in the United States (as described in paragraph 113).

134. In particular we consider that the courts should be able to declare that an investment scheme is a Ponzi scheme where it can be shown that:

    a. Deposits were made by investors to the investment scheme for the purposes of investment (or in the case of a scheme which purported to be a derivative managing a financial risk).

    b. The operator of the Ponzi scheme conducted little or no legitimate business or investment operations, as represented to investors, as part of the investment scheme.

    c. The purported business or investment operations of the operator of the Ponzi scheme produced little or no profits or earnings as represented to investors.

    d. The source of payments to investors was from cash infused by new investors in breach of the terms on which investors invested in the scheme.

13	Do you agree with the criteria for identifying when an investment scheme should be able to be declared a Ponzi scheme?
14	Do you consider that there are any additional or alternative criteria which should need to be met in order for a scheme to be declared to be a Ponzi scheme?

135. While it would be possible to incorporate fraudulent intent, on the part of the operator of a scheme, as a necessary precondition of the criteria above, doing so could unnecessarily impede the process for declaring a scheme to be a Ponzi scheme. Specifically it would be necessary to prove, or infer, such a motive on the part of the operator of the scheme in question and this could raise evidentiary questions which are not appropriately able to be dealt with at a preliminary stage.

136. While it may be appropriate to infer a fraudulent motive to the actions of the operator of an investment scheme once that scheme is declared to be a Ponzi scheme, we do not consider that such an inference is appropriate in the first instance. The rationale for not needing to prove intent to defraud was explained as follows in a United States court case:

One can infer an intent to defraud future [investors] from the mere fact that a debtor was running a Ponzi scheme. Indeed, no other reasonable inference is possible. A Ponzi scheme cannot work forever. The investor pool is a limited resource and will eventually run dry. The perpetrator must know that the scheme will eventually collapse as a result of the inability to attract new investors... He must know all along, from the very nature of his activities, that investors at the end of the line will lose their money... a debtor's knowledge that future investors will not be paid is sufficient to establish his actual intent to defraud them.[17]

137. The difficulties in drawing up a list of clearly defined parameters when an investment scheme should be found to be a Ponzi points to the need to leave it to the court to make case-by-case judgments based on observable facts.

15	Do you consider that proving fraudulent intent on the part of the operator of an investment scheme should be a necessary requirement to establish that that scheme is a Ponzi scheme?
16	Do you consider that the test for whether an investment scheme is a Ponzi scheme should be: • based on a set of fixed criteria? • At the absolute discretion of the courts? • a combination of limited discretion by the courts based on a set of criteria?

Part 3 - Process for identifying a Ponzi scheme and appointment of a liquidator

Declaration that a scheme is a Ponzi scheme and appointment of a liquidator

138. We consider that the process for identifying that an investment scheme is a Ponzi scheme should be modelled on the process for liquidating a company. That is persons or organisations with standing to do so should, as a first step, be required to apply to the High Court to seek a declaration that the investment scheme is a Ponzi scheme.

139. The appointment by the court of an insolvency practitioner[18] to liquidate the Ponzi scheme would then be a second step.

140. We consider that the liquidation regime in Part 16 of the Companies Act is an appropriate model for the unwinding of a Ponzi scheme. Our reasons for forming this view is that liquidation, while commonly thought of in the company context, is conceptually able to be applied in a way which is neutral as to the legal structure of a Ponzi scheme and its purpose is appropriate for winding up a Ponzi scheme. The principal duty of a liquidator of a company is:

    a) *to take possession of, protect, realise, and distribute the assets, or the proceeds of the realisation of the assets, of the company to its creditors in accordance with this Act; and*

    b) *if there are surplus assets remaining, to distribute them, or the proceeds of the realisation of the surplus assets, in accordance with section 313(4)—*

    in a reasonable and efficient manner.[19]

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[17] *Merrill v Abbott (In re Independent Clearing House Co)* (1987) 77 BR 843 at 860.
[18] The Government has decided to proceed with the licencing of insolvency practitioners
[19] Section 253 of the Companies Act

141. Liquidators also have a number of other duties under the Companies Act relating to the performance of their role. Liquidators have broad powers under the Companies Act including:

    a. the powers necessary to carry out the functions and duties of a liquidator under that Act as well as a number of specific powers such as powers to:

        i. make a compromise or an arrangement with creditors

        ii. enter into contracts in the name and on behalf of the company[20]

    b. the power to obtain necessary documents and information[21]

    c. the ability to apply to the courts to seek an order that:

        i. a company that is, or has been, related to the company in liquidation should pay the whole or part of any or all of the claims made in the liquidation

        ii. where two or more related companies are in liquidation, the liquidations in respect of those companies should go forward together as if those companies were a single company[22].

142. MBIE considers that providing the liquidator of a Ponzi scheme with similarly broad powers is essential to the effective and efficient winding up of a Ponzi scheme and distributing the proceeds in accordance with the statutory rules. A more prescriptive approach could tie the liquidator up in technicalities (including the threat of legal action) to the detriment of the collective interests of the innocent investors that the regime is intended to protect.

143. We also consider that in light of the fact that Ponzi schemes often involve complex contractual arrangements that a liquidator should be able to exercise all powers, rights and privileges that the operator of the Ponzi scheme has under any contract or otherwise prior to that liquidation – notwithstanding that those arrangements may be drafted so as to remove those powers, rights and privileges on the appointment of a liquidator.

17	**Is it appropriate for the liquidator of a Ponzi scheme to have the same duties and powers of the liquidator of a company under the Companies Act?**
18	**Do you agree that a liquidator should be able to exercise all powers, rights and privileges that the operator of the Ponzi scheme had prior to that liquidation – notwithstanding that any arrangements contemplate that those powers, rights and privileges would end on the appointment of a liquidator?**

144. We also considered whether statutory management was an appropriate model to use in the context of a Ponzi scheme but concluded that it was inappropriate. Statutory management is intended to enable an entity to be managed where normal legal procedures are inadequate and preserve the interests of beneficiaries and creditors. However, once a Ponzi scheme is uncovered, particularly an advanced one, it is too late to do this – significant losses have already been incurred. At that stage what is required is a process to allocate those losses across investors.

Ability to seek a declaration

[20] Section 260 and Schedule 6 of the Companies Act
[21] Section 261 of the Companies Act
[22] Section 271 of the Companies Act

145. We consider that the following parties should be able to seek a declaration that an investment scheme is a Ponzi scheme and, if successful, apply to the High Court to appoint a liquidator to that scheme:

    a. the Financial Markets Authority (FMA)

    b. the Serious Fraud Office (SFO)

    c. a liquidator of the operator of the Ponzi scheme (appointed under Part 16 of the Companies Act)

    d. a receiver of the operator of the Ponzi scheme

    e. in the case of a managed investment scheme either the manager, the supervisor (or where there is no supervisor a trustee), an administration manager, a custodian, an auditor, or an actuary

    f. in the case of a discretionary investment management service the discretionary investment management service licensee or any custodian in respect of that service

    g. any other person with the leave of the court subject to any conditions which the court may consider it is appropriate to impose (eg an investor).

146. We consider that in order to declare an investment scheme to be a Ponzi scheme the courts must be satisfied *on the balance of probabilities* that the investment scheme is a Ponzi scheme.

147. Where an individual investor is granted leave by the courts to seek, and obtains, a declaration that an investment scheme is a Ponzi scheme their reasonable costs in obtaining that declaration would be treated as expenses of the liquidation. This reflects that those expenses were incurred for the collective benefit of investors in the Ponzi scheme.

Scope of any declaration

148. The scope of any declaration that an investment scheme (or schemes) is a Ponzi scheme would be at the discretion of the courts. For example the courts could declare that notionally separate services offered by the operator of a Ponzi scheme (such as a discretionary investment management service and a client money or property service) formed part of the same Ponzi scheme.

149. The liquidator of a Ponzi scheme would also be able to apply to the courts to seek further declarations that other investment schemes formed part of the same Ponzi scheme.

Liquidator's role

150. The liquidator's responsibilities would be:

    a. To establish, or where that is not reasonably possible to estimate, a date when the investment scheme became a Ponzi scheme (the significance of this is discussed below).

    b. To recover amounts claimable from the scheme operator and third parties.

    c. To recover funds withdrawn and fictitious profits paid to investors.

    d. After meeting the liquidator's reasonable costs and expenses, to distribute all amounts available to investors.

Liquidator's fees and expenses

151. As is the case for the liquidation of companies, we consider that the liquidator's reasonable costs and expenses should be treated as costs of the liquidation and met from the assets of the Ponzi scheme.

152. While a liquidator is entitled to be paid for their work on the liquidation of the Ponzi scheme, they can only be paid if there are assets available. To the extent that there are insufficient assets to pay a liquidator, the liquidator will not be paid.

153. This is the current position for liquidators appointed to companies.

19	Do you think that liquidation is an appropriate model for resolving a Ponzi scheme? If you think a different model is more appropriate please explain why you consider this to be the case.
20	Do you agree that the process for appointing a liquidator is an appropriate model on which to base the process for declaring an investment scheme is a Ponzi scheme?
21	Do you agree that that in order to declare an investment scheme to be a Ponzi scheme the High Court must be satisfied on the balance of probabilities that it is in fact a Ponzi scheme?
22	What are your views on the list of parties that would be able to seek a declaration that an investment scheme is a Ponzi scheme?

Appointment of an insolvency professional to advise the courts if there is evidence that a scheme may be a Ponzi scheme

154. As noted above, MBIE's preliminary view is that the decision for an investment scheme to be declared to be a Ponzi scheme should be a case-by-case judgment based on observable facts.

155. However, such evidence will not necessarily be available to the courts when such an application is first made. Accordingly, we consider that where the courts consider there are serious questions to be answered as to whether an investment scheme is a Ponzi scheme, the court should be able (but is not required) to appoint an insolvency professional[23] to examine the affairs of the scheme and advise the court of their findings.

156. This person would be required to advise the court whether in their professional opinion there is sufficient evidence to conclude that that scheme is in fact a Ponzi scheme. Any such appointment should be for a fixed term to avoid the uncertainty associated with any such investigation – though it should be able to be extended by court order.

157. We consider that the costs of the appointment of an insolvency professional to advise the court should, in the event that the investment scheme is found to be a Ponzi scheme, be treated as an expense of the liquidator - to be met from the remaining assets of the Ponzi scheme.

158. Alternatively, if the investment scheme is found not to be a Ponzi scheme then the costs of the appointment of that insolvency professional should, in the majority of cases, be met by the person seeking to have the investment scheme be declared to be a Ponzi scheme.

159. This would act as a deterrent to parties seeking to have a scheme to be declared to be a Ponzi scheme without having sufficient evidence.

[23] This party would not have to be an insolvency practitioner eg a lawyer or forensic accountant.

160. We consider that where an individual investor seeks a declaration that an investment scheme is a Ponzi scheme that they should not be required to fund the appointment of any insolvency professional. We do not consider that it would be in the public interest to place an additional barrier to investors from bringing such a matter before the courts. Provided that they have been able to meet the threshold for the appointment of an insolvency professional it is appropriate that that cost be met by the Crown.

23	**Do you agree that where the courts consider that a scheme may be a Ponzi scheme, but lack sufficient evidence to make an order to that effect, that the court be able to appoint an insolvency professional to examine the affairs of the scheme?**
24	**What level of certainty that a scheme may be a Ponzi scheme should be required to make such an appointment?**
25	**How long would it take, and what do you think the cost would be, for an insolvency professional to examine the affairs of a scheme and advise the court whether, in their professional opinion, there is sufficient evidence to conclude that that scheme is in fact a Ponzi scheme?**
26	**Where an investor seeks a declaration that an investment scheme is a Ponzi scheme should the Crown be required to fund the appointment of the relevant insolvency professional if it is found that the scheme is not a Ponzi scheme? If not who should bear that cost and why?**
27	**Should there be a fixed period for which an insolvency professional should be able to be appointed?**

Ponzi declarations in the case of wholesale schemes

161. We have not formed a preliminary view about whether it should be possible for wholesale investment schemes to be declared to be Ponzi schemes.

162. We recognise that the policy decision has been made in the FMCA and the Financial Advisers Act 2008 that investment schemes, in which all of the investors fall within one or more of the following categories:

    a. investment businesses within the meaning of clause 37 of Schedule 1 of the FMCA

    b. large persons within the meaning of clause 39 of Schedule 1 of the FMCA

    c. government agencies within the meaning of clause 40 of Schedule 1 of the FMCA

    d. entities that are under the control of a person referred to in any of paragraphs (a) to (c) above (where control has the same meaning as in clause 48 of Schedule 1 of the FMCA),

    do not require independent third party custody of assets or (in some cases) the provision of audits with regards to the custody of assets.

163. We note that the lack of statutory protections for such investors is based on the fact that they are:

    a. able to require such protections as a matter of contract or by investing in a retail product if they want those protections

    b. are sufficiently sophisticated to understand the consequences to them of the fact that such a scheme cannot be declared to be a Ponzi scheme.

However, we do not consider that these factors make wholesale investors immune from the effects of fraud.

164. In addition, excluding wholesale schemes from any Ponzi regime:

    a. would require an in-depth analysis to be undertaken to find out whether a scheme is able to be declared to be a Ponzi scheme – during which investors losses could increase

    b. perpetuates the flaws with the current system for resolving Ponzi schemes.

28	**Do you consider that investment schemes which are invested in only by investment businesses, large persons and government agencies should not be able to be declared to be Ponzi schemes?**

Interfunding

165. We understand that it is common practice for investment schemes to invest in other investment schemes. This is a reasonably common method to enable investors to obtain exposure to investment products which they might not otherwise qualify to invest in or to diversify investment holdings.

166. In some cases investment schemes wholly invest in other investment schemes. In such cases where the 'investee' investment scheme is declared to be a Ponzi scheme the investors in the 'investor' scheme have also, in substance, been investing in a Ponzi scheme.

167. By this we mean that the returns paid to the investors in the 'investor' scheme have also ultimately been funded fraudulently and any investors who have successfully withdrawn their investment have done so to the detriment of other investors. Accordingly, the policy rationale for unwinding Ponzi schemes could also apply equally to that 'investor' investment scheme.

168. For this reason we are considering letting the operator of an investment scheme, which has invested all or nearly all of its assets in a Ponzi scheme (whether in New Zealand or offshore), to apply for that investment scheme to be wound up on the basis that it too is a Ponzi scheme.

169. A person seeking to make use of this facility would be required to file an affidavit with the High Court stating that they considered that winding up that investment scheme on the basis that it is a Ponzi scheme is in the best interests of investors generally.

29	**Do you consider that it may be in investors' interests for investment schemes, which have invested substantially in a Ponzi scheme, to be able to be wound up as if they were a Ponzi scheme themselves?**

Consequences for schemes of failed applications

170. There is a significant risk that a mistaken application for a declaration that an investment scheme is a Ponzi scheme could result in the winding up of that scheme. For example a mistaken claim could see concerned investors seeking to recover all their funds at the mere suggestion that they might be lost – whether this is a real risk or not. This could result in significant losses for the operator of that scheme including:

    a. lost revenue from the operation of the scheme

    b. loss of their costs associated with the setup of that scheme

c. considerable reputational damage.

171. This risk could be minimised by the sealing of any proceedings seeking to declare that a scheme is a Ponzi scheme. However, sealing proceedings raises questions of procedural fairness for those investors whose position with regards to the investment scheme will be substantively overturned if it is declared to be a Ponzi scheme, without them having the opportunity to be heard.

172. However, if proceedings are public then that provides a tool for aggrieved investors to use against the operators of schemes. For example an aggrieved investor could threaten to take proceedings to have an investment scheme declared to be a Ponzi scheme as leverage in a dispute. If these proceedings were public then that could result in reputational damage for the scheme in question.

173. The risk of being sued by the operator of an investment scheme may act as a deterrent to investors making accusations in bad faith that a scheme is a Ponzi scheme. However, the potential losses to the operator of an investment scheme could be greater than could reasonably be recovered from any investor.

174. The possibility also needs to be accounted for that an investor may reasonably, and in good faith, but mistakenly believe that an investment scheme is a Ponzi scheme. In such circumstances it may not be in the public interest to prevent those persons from bringing such a matter before the courts.

175. Our initial thinking is that the best balance between these competing concerns is struck by limiting the parties who are able to bring a claim that an investment scheme is a Ponzi scheme as of right to those listed in paragraph 145 a-f above. These parties are either government agencies, owe a statutory duty of care, and/or perform a statutory function in respect of that investment scheme.

176. While investors are not prevented from taking such claims they would be required to seek the leave of the court to do so and the courts would be empowered to place any procedural safeguards they deem appropriate to protect the interests of the operator of the investment scheme.

30	**Do you think that measures are needed to minimise or mitigate the consequences for an investment scheme or its operator of a failed attempt to have it declared to be a Ponzi scheme?**
31	**Should there be a limit placed on the ability of investors to bring proceedings to have a scheme declared to be a Ponzi Scheme?**
32	**Should a defence be available to investors who in good faith bring a proceeding that a scheme is a Ponzi scheme from claims for damages brought by the operator of the investment scheme?**

Identifying when the Ponzi scheme began

177. Evidence suggests that some Ponzi schemes begin as legitimate businesses and only become Ponzi schemes later. The consequences of this are that distributions or investment returns received before this date are not tainted by any element of fraud. This means that any distributions should not be able to be clawed back or any profits treated as fictitious on the liquidation of the Ponzi scheme.

178. We propose that once a Ponzi scheme has been identified, and a liquidator appointed, that one of the tasks of the liquidator should be to identify the date at which the Ponzi scheme

began or became a Ponzi scheme. The identification of this date will provide certainty to investors as to the status of any withdrawals or investment returns received before this date - which will be protected from being able to be clawed back.

179. We recognise that, except where an investment scheme has been a Ponzi scheme since the beginning, it may not be possible to identify with certainty the exact date on which an investment scheme became a Ponzi scheme.

180. To that end we propose that a liquidator should only be required to identify the date on which a scheme became a Ponzi scheme. We are conscious that this standard raises risks that distributions or profits may be improperly characterised as falling on one side of the line or the other. However, given the potential impossibility of concluding with absolute certainty the exact date on which a scheme became a Ponzi scheme a lower standard needs to be set. In addition, setting a higher standard risks imposing additional costs on investors (in liquidators fees) to try and identify such a date and would extend the process for resolving the liquidation.

181. Where a liquidator is not able to identify a specific date on which an investment scheme became a Ponzi scheme but can identify a period of time (eg between two dates) we propose that the liquidator be permitted to take the midpoint of those two dates.

33	Do you consider that there should be a presumption that a Ponzi scheme was a Ponzi scheme for all time (so there is no need to identify when the scheme became a Ponzi scheme unless there is evidence to the contrary)?
34	Do you think that there should be a statutory default (eg 5 years) for how far back a scheme is a Ponzi scheme in cases where a liquidator is not able to identify a point (or period) at which the scheme became a Ponzi scheme?

Part 4 – Identifying the assets available for distribution to investors

Dis-applying tracing of investors claims to assets in a Ponzi scheme

182. MBIE's initial view is that, in the case of Ponzi schemes, the ability of investors to trace their investments to specific assets is inappropriate.

183. Our reasons for forming this view are that tracing differentiates between defrauded investors in a Ponzi scheme based on criteria beyond their control rather than any merit on the part of the investor and results in losses being disproportionately borne by some investors. For example:

    a. A classic characteristic of Ponzi schemes is the commingling of investors' funds. All investors invested in a fraudulent scheme. The fact that a specific investor's funds have not been so commingled or depleted so as to make a tracing claim impossible is largely an accident of timing and the decisions of the operator of the Ponzi scheme.

    b. A Ponzi scheme is a fraud – any segregation between investors' funds is fictional. The decision of the operator of a Ponzi scheme to steal assets notionally held for one (or a subset of) investor(s) rather than another is not a reason that only one or some investors should bear the losses caused by a Ponzi scheme. At the point an investment scheme has become a Ponzi scheme, rather than merely a fraud, the distinction between different groups of investors is no longer justified.

c. Tracing relies on the availability of reliable records. These will often not be available in the case of a Ponzi scheme or might only be available for some investors.

d. The ability of some investors to bring tracing claims can depend on the actions of other investors. For example if the bank account of a Ponzi scheme is overdrawn then any investor depositing money in it cannot trace their investment (it is generally accepted that it is not possible to trace money through an overdrawn account). However, if an earlier investor brings such an overdrawn account back into credit then a later investor could bring a tracing claim. We consider that this outcome is unfair.

184. We also consider that tracing particularly in the context of large Ponzi schemes:

a. with numerous investors

b. in which many simultaneous or near simultaneous transactions were being undertaken,

would be an expensive and time consuming exercise. The expenses associated with such an exercise would further deplete the assets available to be distributed to investors increasing the magnitude of their losses. In addition, the time involved in undertaking such an exercise would delay distributions to investors and prolong the uncertainty associated with this process. Finally, at the end of such a process it may be necessary to conclude that there are insufficient records to enable such a process to be undertaken.

185. For many of the reasons above, the parties responsible for unwinding many Ponzi schemes in New Zealand often seek court orders dis-applying tracing for some if not all investors.

186. However, we are conscious that:

a. investors currently have a right to apply to the courts to trace their investments in a Ponzi scheme – which this proposal would be taking away

b. if this right were taken away then those investors who would otherwise be able to bring a tracing claim would essentially see the value of their tracing claim shared among other investors.

187. We considered the possibility of preserving tracing claims for simpler or smaller Ponzi schemes where tracing would not be impractical. However, we ultimately reached the view that an exercise to identify whether tracing was a practical option in the resolution of a Ponzi scheme would preserve many of the flaws of the current model - potentially for no gain to any investors if it was found that tracing was not possible.

35	**Do you agree that, in the case of Ponzi schemes, tracing is an inappropriate remedy to resolve investors' claims?**
36	**If you favour keeping tracing as a potential remedy in the case of Ponzi schemes how would you address the issues identified with its application?**

Recovery of funds withdrawn and fictitious profits paid to investors

188. We propose that similar to the current corporate insolvency regime that the liquidator of a Ponzi scheme be empowered to recover any funds withdrawn and fictitious profits paid to investors from the Ponzi scheme.

189. Importantly, these powers would only operate after the scheme had become a Ponzi scheme. This means that withdrawals and profits paid before the scheme became a Ponzi scheme (as determined by the liquidator) would not be able to be clawed back.

190. To the extent that profits have been earned prior to the date a scheme became a Ponzi scheme (as determined by the liquidator) we propose that they be treated the same as deposits. Our rationale for this distinction is that these profits represent the value of actual investments and accordingly requiring that they be disregarded would effectively be taking legitimate profits from some investors for the benefit of others.

191. This will be a significant change from the status quo as clarified by the Supreme Court in McIntosh v Fisk.

37	Do you agree that investors should not be able to retain any fictitious profits paid to them?

Clawback

192. Our initial view is that the process for recovering funds withdrawn and fictitious profits paid to investors from a Ponzi scheme should follow the process for voidable transactions in s294 of the Companies Act. In summary terms, we propose that a liquidator wishing to set aside a distribution would be required to:

    a. file a notice with the court that details the distributions to be set aside and informs the recipient of their ability to object

    b. serve that notice as soon as practicable on:

        i. the relevant investor

        ii. any other party from whom the liquidator intends to recover.

193. The period of time during which distributions to investors are able to be set aside by a liquidator needs to strike an appropriate balance between the collective interests of investors and fairness to individual investors who received what appeared to be normal payments from the scheme prior to the liquidator being appointed by the court. These are competing objectives. The collective interests of investors are fully protected if all transactions are avoided without exception. The interests of individual investors are fully protected if no transactions are ever re-opened.

194. The six month period of vulnerability recommended by the IWG under the voidable transactions regime reflects the following circumstances:

    a. Although companies often trade while insolvent for some time before the liquidator is appointed, our understanding from insolvency practitioners is that it is unusual for that period to be more than 2 years.

    b. A payment made by a debtor company to a preferred creditor is not derived from money obtained through fraud.

195. Neither of these statements is true in relation to Ponzi schemes. They can operate for several years before they are detected.

196. Any period of vulnerability is inevitably arbitrary. However, our view is that four years from the date the application was made for a scheme to be declared a Ponzi scheme would provide a reasonable balance between the collective and individual interests of investors, subject to there being a defence available to investors from whom recovery is sought where that would cause significant hardship — discussed in more detail below.

197. In addition, to the extent that the inability to recover withdrawals by some investors results in a higher overall rate of recovery by those investors, we consider that it is possible to take account of this at the distribution phase.

198. We have also considered whether the period of vulnerability should be longer in the case of related parties of the operator of the Ponzi scheme – potentially going back to the

beginning of the scheme. We concluded that this is inappropriate on the basis that many of the first victims of a Ponzi scheme are often the friends and family of the operator of the Ponzi scheme.

199. If there is a concern that the operator of a Ponzi scheme could collude with investors to transfer misappropriated funds to them to the detriment of others, then this can be specifically addressed (for example by the inclusion of a specific power for the liquidator to extend the period of vulnerability in relation to specific investors who received distributions in bad faith).

38	Do you agree that there should be a limit on the period of a clawback?
39	Do you agree that four years is a reasonable period for a clawback to operate? If not what alternative would you propose?
40	Do you think that the liquidator of a Ponzi scheme should be able to apply to the courts to extend the period of vulnerability, in respect of specific investors, where it can be shown that the investor received distributions in bad faith?

Defence to recovery by liquidator

200. We consider that the current defences in the Companies Act and the Property Law Act do not provide an appropriate basis for investors in a Ponzi scheme to challenge the setting aside of any distributions made to them. In particular:

    a. Whether an investor gave value should have no bearing on whether or not a liquidator should be able to claw back payments made to one group of investors when the funds that were used for those payments were obtained by defrauding other investors.[24]

    b. All investors who seek to withdraw money from an investment scheme for a specific purpose (eg to purchase a house) can be expected to argue that they have altered their positon in the reasonably held belief that that withdrawal was valid and would not be set aside. However, this ultimately has no relation to their position with regards to other investors and the general fairness of them receiving the benefit of those funds if they are able to repay them.

201. For these reasons we propose that investors in a Ponzi scheme have a defence available to them against any attempt by a liquidator to recover funds or property from them where:

    a. they received the relevant assets in good faith

    b. a reasonable person in their position would not have suspected, and they did not have reasonable grounds for suspecting, that a Ponzi scheme existed

    c. that returning the funds or property which are the subject of the order to the liquidator, in part or in full, would result in significant financial hardship for the investor.

Good faith and knowledge

202. The good faith and knowledge tests are essential elements in establishing that the recipient is an innocent investor and, therefore, merits obtaining the protection that the defence would provide.

[24] The IWG recommended repealing the "gave value" test. The government is considering its response to this recommendation.

203. In addition, the knowledge element needs to be modified to guard against wilful blindness. Hence, we consider that where the court has declared that a scheme is a Ponzi scheme the knowledge test would only be met if a reasonable person in that person's position would not have suspected that they received the property in furtherance of a Ponzi scheme.

204. Consideration was given to requiring investors having to instead demonstrate that a reasonable person in that person's position *after making reasonable enquiry* would not have suspected that they received the property in furtherance of a Ponzi scheme. However, it was considered that this placed an unwarranted onus on investors to look behind all transfers in order to ensure that they meet this standard. It was felt that this:

    a. Would impose costs on investors for no gain in the majority of cases (because the relevant investment scheme is not a Ponzi scheme)

    b. Would privilege sophisticated investors over other investors as they would be the only ones adequately resourced to look behind transfers and other reporting provided by an investment scheme.

41	**Do you agree that in order to have the benefit of a defence against the clawback powers of the liquidator investors should be required to demonstrate that *a reasonable person in their position would not have suspected, and they did not have reasonable grounds for suspecting, that a Ponzi scheme existed*? If not, what alternative test would you propose?**

Significant financial hardship

205. The significant financial hardship test is intended to establish that the recipient of funds from a Ponzi scheme would suffer sufficient harm from the return of them that they merit keeping them. It is intended that this test impose a high bar for investors as an investor successfully making out this defence has the effect of transferring losses from one investor to investors collectively in circumstances where they are all the victims of the same fraud.

206. We propose that significant financial hardship be defined, non-exhaustively, in a similar way to clause 11 of the Schedule 1 in the KiwiSaver Act 2006. In particular we consider that significant financial hardship be defined to include significant financial difficulties that arise because of an investor's inability to meet:

    a. minimum living expenses

    b. mortgage repayments on his or her principal family residence resulting in the mortgagee seeking to enforce the mortgage on the residence

    c. the cost of medical treatment for an illness or injury of the investor or an investor's dependant

    d. the cost of palliative care for the investor or an investor's dependant.

42	**Do you agree that significant financial hardship is an appropriate criterion for determining whether an investor merits retaining funds received from a Ponzi scheme?**
43	**Do you consider that alternative criteria should be used for determining whether an investor merits retaining funds received from a Ponzi scheme?**

Whistle blower defence

207. A possible additional defence or 'safe harbour' from clawback by a liquidator could also be provided for those investors who 'blow the whistle' on a Ponzi scheme either:

a. to the FMA or the SFO before the scheme is declared to be a Ponzi scheme

b. by bringing independent proceedings against a scheme to have it declared to be a Ponzi scheme.

208. Such a defence could encourage investors – especially sophisticated and sceptical investors – who have some level of suspicion to alert authorities.

209. Any such defence or safe-harbour would be subject to an exception for fraud. This would prevent the operator of a Ponzi scheme from transferring profits to an investor who is colluding with them or is a related party of the Ponzi scheme, then encouraging them to exit with their gains.

210. However, it is possible that such a safe harbour could have unintended consequences. In particular:

a. Sophisticated investors may be able to identify that an investment scheme is a Ponzi scheme before less sophisticated investors. This could incentivise sophisticated investors to withdraw their funds which would then reduce the amount available to unsophisticated investors. The extent to which such a safe harbour would impact on remaining investors could be minimised by only giving its benefit to the first investors to "blow the whistle". However, to the extent that the second investor to blow the whistle to FMA, the SFO or the courts was not aware of the actions of the earlier investor it is difficult to point to a distinction between them which justifies one investor receiving the benefit of the safe harbour over another.

b. Aggrieved investors may use any such facility as leverage in a dispute with the operator of a legitimate investment scheme.

211. We are not aware of any evidence substantiating either of these risks.

44	**Do you consider that a whistle blower safe harbour should be provided to investors in a Ponzi scheme? If there is to be a safe harbour, do you consider that this should be available to all investors or just the first investor to 'blow the whistle'?**

Alteration of position

212. We have considered providing a defence where an investor can show that they altered their position in the reasonably held belief that a distribution or withdrawal was valid and would not be set aside. This would substantively replicate the current defences in the Companies Act or the Property Law Act.

213. Our preliminary view is to not include such a defence for the following reasons:

a. As set out above, all investors who seek to withdraw money from an investment scheme for a specific purpose (eg to purchase a house) can be expected to argue that they have altered their positon in the reasonably held belief that that withdrawal was valid and would not be set aside.

b. Whether an investor altered their position in the reasonably held belief that a distribution or withdrawal was valid and would not be set aside ultimately has no relation to their position, with regards to other investors, and the general fairness of them receiving the benefit of those funds if they are able to repay them and that would not cause them significant financial hardship.

c. An investment in an investment scheme is, in some respects, analogous to a bank account. Many investors may not alter their positon on the basis of a distribution but rather on the reasonable belief that they will be able to obtain a distribution in the future. Requiring actual reliance creates an arbitrary distinction between investors.

45	**Do you think that a defence should be provided for investors who substantially alter their position in the reasonably held belief that a distribution or withdrawal was valid and would not be set aside?**

Recovery of payments to trade creditors

214. The operator of a Ponzi scheme will in many instances also make payments to innocent third parties from the assets of the Ponzi scheme. These could include payments to:

    a. providers of utilities such as power and water

    b. business service providers such as information technology

    c. share brokers and custodians in respect of any investment activities undertaken by the operator of the Ponzi scheme.

215. We do not propose that ordinary trade creditors should be subject to the same recovery regime as investors. Rather, any amounts paid to trade creditors should be subject to recovery under the ordinary principles of insolvency law applicable to the operator of the Ponzi scheme. Amounts owed to the Ponzi scheme by its operator will then rank in the insolvency of the operator of the Ponzi scheme as unsecured creditors. However, we would expect the level of the operator of the Ponzi scheme's indebtedness to the Ponzi scheme to eclipse amounts owed to trade creditors so that the Ponzi scheme will ultimately recover a significant proportion of the money available to unsecured creditors.

216. Our reason for forming this view is that ordinary trade creditors, in most instances, will not owe a duty to determine whether their customers are operating a fraudulent business. However, making them subject to the greater clawback powers proposed in this document will effectively penalise trade creditors for not making such enquiries.

217. To the extent that a trade creditor might owe a duty to investors to look behind the business (such as the supervisor of a managed investment scheme), then investors or the liquidator can seek to recover against that creditor separately for breach of the relevant duty.

46	**Do you agree that recovery against trade creditors of a Ponzi scheme should continue to be dealt with under the ordinary principles of insolvency law?**

Part 5 – Distribution of assets to investors

218. The liquidator of a Ponzi scheme is ultimately required to distribute the assets recovered from the scheme to investors. However, the process for doing this can be fraught and needs to balance a number of competing objectives. For example:

    a. The need to balance fairness to individual investors needs to be balanced against the collective interests of all investors.

    b. Simple solutions may result in unfair outcomes for some investors but complex and nuanced solutions could incur significant costs — reducing the overall pool of assets available to all investors.

219. It also needs to be kept in mind that each investor's recovery comes from the same pool of assets. This means that where there are not enough assets to repay each investor in full, as is often the case, each investor's returns come at the cost of lower returns for other investors.

Sharing of losses

220. Under the law as it stands the starting point in the case of bank accounts in which trust monies have been mixed is that the first money paid into the mixed fund is treated as being the first money drawn out. This is referred to as the rule in Clayton's Case.

Example

If three investors each invest $100,000 on successive days into an account maintained by a Ponzi scheme (on the basis that it will be held on trust for them) and $100,000 is misappropriated from that account by the operator of that scheme, then that loss is treated as coming entirely from the investment of the first investor.

221. The application of this rule can result in earlier investors in a Ponzi scheme bearing a disproportionate share of any losses. The rule in Clayton's Case is however merely a presumption and can be displaced.

222. Where the Clayton's Case approach has not been followed, especially when this is due to the impracticality of applying the rule, a form of proportional sharing has often been applied.[25]

223. In the case of a Ponzi scheme we do not consider that distribution to investors following the rule in Clayton's Case would be appropriate. Such a model has the potential to disproportionately penalise earlier investors for the benefit of later investors in circumstances where they have all been victims of the same fraud.

224. While it is possible to set aside the rule in Claytons Case this can be the subject of court proceedings. This has cost implications for the unwinding of a Ponzi scheme and can ultimately reduce the pool of assets available to be distributed to investors.

Should different types of Ponzi schemes have different distribution methods?

225. There are four types of common investment structures which could fall within our proposed definition of a Ponzi scheme. These are:

    a. a managed investment scheme

    b. a discretionary investment management service

    c. trust accounts in respect of derivatives investor money

    d. a client money or property services in respect of a financial product.

226. In each of these cases the nature of investors' claims to recover assets is slightly different.

227. Investors in a managed investment scheme invested on a pooled basis. On this basis the courts have found, in the context of Ponzi schemes, that investors invested on the basis of a proportional sharing of losses.

228. In contrast, investors in a discretionary investment management service, derivatives or a client money or property service have invested on the basis that their investments (or money) will be kept separate and they will each receive the gains (or losses) attributable to

[25] Re International Investment Unit Trust CIV 2004-404-1868

their own investments.[26] In addition, section 77T of the Financial Advisers Act 2008 provides that client money or client property that is received or held by a 'broker' on trust for a client:

a. is not available for the payment of the debts of any other creditor of the broker

b. is not liable to be attached or taken in execution under the order or process of any court at the instance of another creditor of the broker.[27]

This could be used to support the idea that investors receiving a discretionary investment management service or a client money or property service in respect of a financial product have agreed that they would each bear the losses specifically attributable to them.

229. However, in the case of derivatives regulation 246 of the Financial Markets Conduct Regulations 2014 imposes a collective trust on investor money and property. Such a collective trust could be used to support the idea that investors invested on the basis of collective sharing of losses on insolvency.

230. MBIE's view is that, pro rata distribution of assets is to be preferred in the case of all Ponzi schemes to identifying the assets specifically attributable to individual investors. We consider that:

a. A Ponzi scheme is a fraud - any segregation between investors' funds is fictional from the perspective of the operator of the Ponzi scheme. The decision of the operator of a Ponzi scheme to steal assets notionally held for one (or a subset of) investor(s) instead of another is not a reason that only one or some investors should bear the losses caused by a Ponzi scheme.

b. At the point an investment scheme has become a Ponzi scheme, rather than merely a fraud perpetrated on a few investors, the distinction between different groups of investors is no longer justified as they have all been robbed of all of their investment.

c. Individual allocation of losses favours later investors over earlier investors as there has been less time for the amounts they invested to be dispersed.

d. Having each investor bear the losses specifically attributable requires reliable records to be available to quantify those losses. These records will often not be available at all, might only be available for some investors or for certain periods. However, we expect that the cost of examining records to identify whether the individual allocation of losses to investors is even possible would be an expensive exercise. The expense of doing this will reduce the pool of assets generally available to pay to creditors.

For these reasons we do not think there are good reasons to allow investors in a Ponzi scheme to claim that each investor should bear the losses specifically attributable to them.

47	**Do you agree that a proportional distribution of assets is preferable in the case of all Ponzi schemes regardless of the legal structure of the Ponzi scheme?**
48	**Do you have any information about the costs to find out whether the losses specifically attributable to individual investors are able to be identified?**

Treatment of profits

[26] Investors receiving a discretionary investment management service may however be invested in the same products as each other due to the fact that they have invested using the same investment strategy.
[27] Section 77T will be substantively replicated in the FMCA as section 431ZG by the Financial Services Legislation Amendment Bill.

231. The inclusion of profits (whether real or fictional) can have a material impact on an investor's proportional entitlement to the distribution of assets in a Ponzi scheme.

232. MBIE's view is that when calculating an investors' proportional entitlement to the distribution of assets in a Ponzi scheme investors should not receive the benefits of any fictitious profits allocated to their accounts.

233. To do so would allow those investors to shift losses on to other investors based on an arbitrary amount allocated to them which has no relation to reality.

234. In contrast we consider that profits earned before an investment scheme becomes a Ponzi scheme should be treated the same way as deposits in the scheme. Our reason for forming this view is that these profits represent a real asset of the investor which has been stolen by the operator of the Ponzi scheme.

49	**Do you agree that investors in a Ponzi scheme should not be entitled to the benefit of any fictitious profits allocated to them when deciding their proportional entitlements to the assets of a Ponzi scheme?**

How to work out what is a fair proportion

235. We have identified four broad methods for proportionally allocating losses in a Ponzi scheme. These methods differ in:

    a. the way they calculate the amounts owed to investors

    b. the measure they use to rebalance investors losses (eg rate of recovery or amount lost).

    These differences can result in large differences in the amount ultimately paid to specific investors.

236. We note that our description of some of these models differs from the international understanding as to how these models operate in some respects. This is a result of tailoring to reflect the New Zealand insolvency regime and necessary changes to account for the effect of some of our other proposals.

Reported Balance

237. Under this method investors recover in proportion to their last recorded balance in the Ponzi scheme as compared to other investors. This model would only be an option if it was decided to give investors the benefit of any fictitious profits (discussed above).

238. To our knowledge this approach has not been favoured by the New Zealand courts in any recent decisions. However, it has been argued for in the United States of America on the basis that:

    a. it recognises both changes in the value of money (inflation) and the opportunity cost to investors of having invested in a Ponzi scheme

    b. it gives investors the benefit of any genuine profits that were earned for their benefit before the scheme was a Ponzi scheme rather than appropriating those for the benefit of investors collectively. [28]

[28] Kathy Bazoian Phelps and Hon, Steven Rhodes, The Ponzi Book: A Legal Resource for Unraveling Ponzi Schemes, section 20-06 (Lexis Nexis, 2012).

239. This option gives investors the benefit of any fictitious profits that have been recorded in their "account". As these profits never existed our view that giving investors the benefit of them results in shifting some of the losses of earlier investors to more recent investors who have earned lower or no (fictional) returns.

240. We also note that while some of the reasons identified for using this method are valid there are better ways to address them. In particular:

    a. If it is felt that changes in the value of money should be recognised then a multiplier can be applied to investors' deposits to reflect the effect of inflation since that money was deposited.

    b. If it is felt that it is appropriate to give investors credit for the opportunity cost of having their funds within a Ponzi scheme then this could similarly be achieved by applying a notional rate of return to investors' deposits to reflect their opportunity cost.

    Finally, we note that while concerns about the appropriation of returns earned before an investments scheme became a Ponzi scheme are legitimate they are already addressed by the fact that under our proposal only fictitious profits "earned" after the scheme became a Ponzi are disregarded.

Pros	Cons
Gives investors credit for any returns actually earned before the scheme became a Ponzi scheme	Gives investors the benefit of fictitious profits, favouring earlier investors over later investors
Is straightforward to calculate level of returns	It is possible to give investors credit for any returns actually earned before the scheme became a Ponzi scheme without allowing them the benefit of fictitious profits.

Net investment

241. Under the net investment model each investor's deposits and withdrawals into the Ponzi scheme are taken into account to calculate a running balance to the date of the liquidation. This enables a distinction to be made between:

    a. those investors who were able to withdraw more than they contributed (overpaid investors)

    b. those who received less than they contributed (underpaid investors)

242. Only underpaid investors are eligible to recover anything under this model and receive a distribution in proportion to the size of their running balance in the Ponzi scheme.

243. This approach is the conventional approach to distributing assets to investors in Ponzi schemes in New Zealand and is the approach favoured by the liquidators in the Ross Asset Management Ponzi scheme.

Example

An investor deposits $5,000 with a Ponzi scheme. The investor subsequently withdraws $2,000. This brings their debt to $3,000. Assuming a recovery rate of 10 cents in the dollar, the investor will receive a further distribution of $300.

244. In the event that sufficient assets are recovered to enable all investors to recover at least as much as their initial investment in the Ponzi scheme (subject to any adjustments discussed below) then the remaining assets recovered would be distributed to investors proportionally.[29]

245. This model has been criticised by investors in the RAM Ponzi scheme on the basis that it results in those investors who were able to make a withdrawal receiving a higher effective level of recovery from that Ponzi scheme in the event that there are insufficient assets to allow for the full recovery of investors' funds.

Example

Investor 1 deposits $5,000 with a Ponzi scheme. The investor subsequently withdraws $2,000. This brings their debt to $3,000. Assuming a recovery rate of 10 cents in the dollar, the investor will receive a distribution of $300. Investor 1 makes an overall recovery of their initial contribution of $2,300. This represents an overall recovery of 46 cents in the dollar.

Investor 2 makes an identical $5,000 deposit on the same day as Investor 1 but does not make any withdrawals before the collapse of the Ponzi scheme. Investor 2 will be entitled to recover at the same rate of 10 cents in the dollar. This means they will receive a distribution of $500 dollars which represents an overall recovery of 10 cents in the dollar.

Pros	Cons
Is straightforward to calculate level of returns	Results in an uneven level of total recovery across investors
Targets returns at those investors who have lost their initial capital investment	Does not take account of the differing levels of loss investors have suffered.

246. A variant of the net investment method has been considered by the courts in the United States of America. This variant lets investors keep the returns that they received and participate in a proportional distribution based on their initial investment combined with the fictitious profits they never received, less the fictitious profits they already received.[30]

247. This model is intended to place those investors who had the opportunity to withdraw their investment but chose to roll them over in the same position as those investors who chose to withdraw their funds.

[29] Based on their net investment in the Ponzi scheme as at the date it was declared to be a Ponzi scheme.
[30] United States Commodity Futures Trading Comm'n v. Barki LLC, No. 3; 09CV106-MU, 2009 WL 3839389 (W.D.N.C. Nov. 12, 2009) and S.E.C. v. Byers. 637 F.Supp.2d at 171–72

248. The rationale of the courts in SEC. v. Byers in approving this model was focussed on the fact that ignoring reinvestment would result in injustice between investors who chose to withdraw funds and those who did not.

249. The court in this case felt that ignoring the reinvested amount would penalize those investors who chose to roll over their investments rather than receive them in cash.

250. We disagree. In particular we consider that it fails to adequately address the fact that distributions on the insolvency of a Ponzi scheme are funded from the same pool as all other investors some of whom may not have received the benefit of any distributions. This creates a transfer of losses from earlier investors who had the benefit of fictitious distributions to later investors who have not received distributions.

251. In addition, the only reason that an investor would be entitled to keep any distributions under our model is that it is considered unduly harsh to require that they be returned due to the hardship that would cause or because of practical difficulties due to the time that had passed since those distributions were received.

Pros	Cons
Is straightforward to calculate level of returns	Results in an uneven level of total recovery across investors
Targets returns at those investors who have lost their initial capital investment	Does not take account of the differing levels of loss investors have suffered.
	Transfers losses from earlier investors to later investors

Alternative model

252. Some investors in the RAM Ponzi scheme have put forward a variant of the net investment model which seeks to take into account payments received by an investor when calculating their entitlement to be repaid. The model proposed:

    a. calculates a provisional debt for each investor based only on their contributions to the Ponzi scheme, then

    b. applies a provisional distribution rate to those debts

    This allows a provisional gross entitlement to be calculated for each investor. This figure can then be compared to the total payments received by the investor from the Ponzi scheme:

    a. If the payments previously received by the investor are less than the provisional gross entitlement then the investor is entitled to the balance.

    b. If the payments previously received by the investor are more than the provisional gross entitlement then the investor is not entitled to any distribution.

253. This approach results in those investors who have not withdrawn any funds being entitled to a full distribution at the relevant rate.

254. Investors who have withdrawn funds but less than their provisional gross entitlement would receive a distribution at a lower distribution rate (as their pre liquidation withdrawals are taken into account). Investors who have withdrawn more than they would be entitled to receive at the provisional distribution rate are not entitled to receive any

further distributions and the amount which they would receive is then redistributed among the other investors.

255. Under this model there is a relationship between the distribution rate, the varying amounts of previous distributions received by investors and whether or not an investor is ultimately entitled to receive a distribution. Accordingly, applying this model requires many iterations of the distribution model to be calculated with differing distribution rates in order to arrive at a position where the full amount available is distributed. However, we expect that given advances in technology that this is not an overly onerous process.

256. Under the "alternative model":

    a. There is no set rate of recovery – the rate at which an investor is eligible to recover the amount of their initial investment will depend both on their withdrawals, and those of other investors.

    b. Pre liquidation withdrawals are effectively treated as voidable transactions – albeit that any shortfall is not recovered from impacted investors. While such withdrawals may not be recoverable, they are counted against any entitlement an investor might have to a claim.

257. The table below illustrates the range of effects the use of either the net investment model or the alternative model can have on investors.

	Investor A	Investor B	Investor C	Investor D	Investor E
Contributions	$7,800,000	$628,000	$349,000	$2,448,000	$627,000
Withdrawals	($2,185,000)	($146,000)	($25,000)	($31,000)	$0.00
Net Contributions	$5,615,000	$482,000	$324,000	$2,417,000	$627,000
Distribution: Net investment Model					
Reference Debt	$5,615,000	$482,000.00	$324,000	$2,417,000	$627,000
Distribution Rate	11.23%	11.23%	11.23%	11.23%	11.23%
Distribution	$631,000	$54,000	$36,000	$271,000	$70,000
Distribution: Alternative model					
Reference Debt	$7,800,000	$628,000	$349,000	$2,448,000	$627,00
Maximum distribution rate	18.23%	18.23%	18.23%	18.23%	18.23%
Maximum distribution	$1,422,000	$114,000	$63,000	$446,000	$114,000
Pre liquidation capital returns	($2,185,000)	($146,000)	($25,000)	($31,000)	$0.00
Distribution	$0.00	$0.00	$38,000	$415,000	$114,000
Positive/(negative) impact of the alternative model					
	($631,000)	($54,000)	$2,000	$144,000	$44,000

258. In the event that sufficient assets are recovered to enable all investors to recover at least as much as their initial investment in the Ponzi scheme (subject to any adjustments discussed below) then the remaining assets recovered would be distributed to investors proportionally based on their net investment in the Ponzi scheme as at the date it was declared to be a Ponzi scheme.

Pros	Cons
Is straightforward to calculate level of returns	Results in an uneven level of total recovery across investors
Targets returns at those investors who have suffered higher losses	

Rising tide

259. The rising tide method, similar to the alternative model discussed above, calculates a provisional debt for each investor based only on their contributions to the Ponzi scheme.

260. Based on each investors' returns from the Ponzi scheme, a provisional loss is then able to be calculated based on the proportion of the amount withdrawn to the amount invested.

261. Distributions are then made first to those investors with the greatest percentage of loss. When all of those initial creditors reach a plateau with other creditors then all creditors with that level of loss are eligible to receive distributions in proportion to their remaining debt. This process will continue until all investors have suffered the same losses (measured in percentage terms) at which point the remaining assets would be distributed in proportion to each creditors remaining debt until the assets available to be distributed are exhausted.

262. The rising tide method has the potential to concentrate recoveries to a very small group of investors — resulting in all other investors receiving nothing.

263. The worked example below illustrates some of the outcomes which the rising tide model can create:

	Investor A	Investor B	Investor C	Investor D	Investor E
Contributions	$7,800,000	$628,000	$349,000	$2,448,000	$627,000
Withdrawals	($2,185,000)	($146,000)	($25,000)	($31,000)	$0.00
Distribution: Rising tide					
Reference Debt	$7,800,000	$628,000	$349,000	$2,448,000	$627,000
Pre liquidation returns	28.01%	23.25%	7.16%	1.27%	0%
Provisional loss	71.99%	76.72%	92.84%	98.73%	100%
First distribution	$0.00	$0.00	$0.00	$0.00	$8,000
Provisional loss	71.99%	76.72%	92.84%	98.74%	98.74%

	Investor A	Investor B	Investor C	Investor D	Investor E
Second distribution	$0.00	$0.00	$0.00	$144,000	$37,000
Final loss	71.99%	76.72%	92.84%	92.84%	92.84%
Distribution	$0.00	$0.00	$0.00	$144,000	$45,000

264. Investor E, because they had not made any withdrawal from the Ponzi scheme (and so suffered a 100% loss) would receive the first distribution.

265. Investor E's distribution would be in the amount necessary to equalize their loss with that of the investor with the next highest losses - Investor D.

266. Investors E and D would then receive a distribution in the amount necessary to equalize their losses with that of investor C. At this stage the funds available for distribution are exhausted.

267. Investor C is considered to have been treated equally to Investors E and D because they have suffered the same proportional loss – even though investor C received no distribution on the insolvency of the Ponzi scheme.

268. Investors A and B receive no additional distribution from the Ponzi scheme because their previous recoveries are treated as already having resulted in them achieving a greater rate of recovery than other investors.

269. In the event that sufficient assets are recovered to enable all investors to recover at least as much as their initial investment in the Ponzi scheme (subject to any adjustments discussed below) then the remaining assets recovered would be distributed to investors proportionally based on their net investment in the Ponzi scheme as at the date it was declared to be a Ponzi scheme.

Pros	Cons
Targets returns at those investors who have suffered the greatest level of losses	Potentially concentrates returns to a very small group of investors
Provides the most even distribution of losses relative to the other models	

50	What is the most appropriate model for distributing assets?
51	Are there any additional models which we should consider?

Other adjustments of investors' losses

270. An issue which has been raised with us is the appropriateness of providing an adjustment to investor's debt to account for inflation and for their opportunity cost (interest).

271. Such adjustments could have a significant impact on each investor's entitlements on the unwinding of a Ponzi scheme. For example, where an investor has invested a substantial amount in a Ponzi scheme for an extended period, this can result in a large adjustment in absolute terms. Because of the limited assets available to be distributed in the case of a

Ponzi scheme this will need to be funded from the assets available to be distributed to all investors.

272. While we have not formed a concluded view as to the appropriateness of this, some parties with which we have consulted have raised questions as to the appropriateness of this. In particular, questions have been raised as to the fairness of this to more recent investors. While the dollar value of recent investors losses has not yet been magnified by inflation they will be in due course. To only give an adjustment to earlier investors therefore unfairly punishes later investors because their losses have not yet been magnified by time – even though they will be in due course.

52	Should investors' losses be able to be adjusted to take account of inflation or any other factors?

Criteria for assessing models

273. We have not formed a view on which of the alternative approaches to distribution is the most appropriate. We propose assessing each of the models for distributing the remaining assets in a Ponzi scheme to investors (ie the reported balance, net investment, alternative method and rising tide models) against the status quo using the following criteria:

    a. Certainty
    b. Predictability
    c. Principled
    d. Cost
    e. Fairness

Certainty

274. Uncertainty over the appropriate method for distributing assets results in a need for court orders. The cost of seeking such orders reduces the amount available to be distributed to investors. The model arrived at should be sufficiently certain to avoid the need to incur such costs.

Predictability

275. The uncertainty surrounding the application of the current regime makes predicting likely outcomes difficult. For example it is difficult for investors to predict the extent to which they might be entitled to recover any of their investment. This prolonged uncertainty can prevent investors moving on with their lives.

276. Under any new model it should be possible for investors to readily assess the extent to which, based on expected rates of recovery, they will be entitled to participate in any distribution and the likely extent of that distribution

Principled

277. Whichever model is picked to distribute assets to investors will create winners and losers. To the extent that distinctions are made between investors, which result in different treatment and therefore different outcomes, these should not be based on arbitrary criteria.

Cost

278. The expenses associated with allocating returns to investors will ultimately be borne by investors as a cost of the liquidation. Accordingly, which ever model is selected should be sufficiently simple that the cost associated with it does not outweigh the benefit to investors.

Fairness

279. All investors in a Ponzi scheme have been the victims of fraud and it is important that they be treated as fairly as possible. However, because the distribution of assets ultimately becomes a mathematical exercise it is important to quantify what we mean by this. We propose measuring fairness by the extent to which each model is able to equalise investors' losses.

53	**Are there any additional or alternative criteria which we should use to assess the various models for distributing assets to investors?**

"B"

EXHIBIT NOTE
This is the annexure marked "B" referred to within the Affidavit of Barrington John Prince and sworn at Paraparaumu this 19th day of June 2008 before me
Signature EMILY JANE SUTTON
A Solicitor of the High Court of New Zealand

DR Fehsenfeld's Hypothetical Investment Portfolio with Ross Asset Management

Year	Evisaged portfolio value carried over to next year	Deposits	Envisaged portfolio value before interest	Fictitious Profits at **12.0%**	Envisaged portfolio value after interest but before withdrawals	Withdrawals	Envisaged portfolio value after withdrawals
1994		166,022	166,022	19,923	185,945		$185,945
1995	185,945	35,453	221,398	26,568	247,965	32,020	$215,945
1996	215,945	65,390	281,335	33,760	315,096		$315,096
1997	315,096		315,096	37,811	352,907		$352,907
1998	352,907		352,907	42,349	395,256	120,000	$275,256
1999	275,256		275,256	33,031	308,287	50,000	$258,287
2000	258,287		258,287	30,994	289,281		$289,281
2001	289,281		289,281	34,714	323,995	100,000	$223,995
2002	223,995		223,995	26,879	250,874	250,000	$874
2003	874	174,155	175,029	21,004	196,033	22,000	$174,033
2004	174,033		174,033	20,884	194,917		$194,917
2005	194,917	830,392	1,025,309	123,037	1,148,346		$1,148,346
2006	1,148,346	1,842,089	2,990,435	358,852	3,349,287		$3,349,287
2007	3,349,287	1,024,069	4,373,356	524,803	4,898,159		$4,898,159
2008	4,898,159		4,898,159	587,779	5,485,938	1,092,074	$4,393,864
2009	4,393,864	212,818	4,606,683	552,802	5,159,484	228,212	$4,931,272
2010	4,931,272	1,450,198	6,381,470	765,776	7,147,247		$7,147,247
2011	7,147,247	198,264	7,345,511	881,461	8,226,972		$8,226,972
2012	8,226,972	868,717	9,095,689	1,091,483	10,187,172		$10,187,172
Totals		$6,867,568				$1,894,306	$10,187,172
				Withdrawals as a percentage of deposits		27.6%	