Recognizing and responding to red flags: The *Stanford* Ponzi scheme

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ABSTRACT

What red flags that would – and should – come to the attention of managers and other employees, as well as directors, outside auditors, feeder fund managers, direct investors and others who typically interact with an organization involved in a Ponzi scheme? How are those red flags recognized? If someone becomes aware of such a red flag, how should they respond?

This case study allows for a consideration of the various signals and significant circumstances that surrounded the billion-dollar Ponzi scheme operated by Robert Allen Stanford and the Stanford Financial Group. Facts are drawn from pleadings, affidavits and other court documents, as well as from fact summaries that included as part of published court opinions. These facts and circumstances, in turn, are considered from the perspectives of various parties who would have become of aware of them.

This case study is designed for undergraduate and graduate students studying such topics as business law, business ethics, corporate social responsibility, personal finance, financial planning, financial services, corporate governance, organizational behavior, auditing, forensic accounting or other similar courses of study. Case study questions invite students to consider what it means to become aware of red flags that point to possible fraud, and how to respond to – and properly investigate – these red flags. Specific skills and tactics that include both financial auditing and forensic investigations are recommended by the authors of this case study.

Keywords: Ponzi schemes, red flags, forensic investigation, corporate governance, corporate responsibility

INTRODUCTION

It is estimated by federal prosecutors that the Ponzi scheme orchestrated by Bernard Madoff amounted to approximately $65 billion of fraud, making it the largest investment scandal on record. In the wake of the Madoff scandal, several books and hundreds of articles have been written to analyze how he had been able to fool so many people to such an extent, for such a long time. Harry Markopolos' book, *No One Would Listen*, serves as an excellent example of such an analysis.[1] In his book, Markopolos describes the many signals and signs of the impending collapse Madoff's operation which were ignored by the financial services industry, the U.S. Securities and Exchange Commission (SEC) and others.

Madoff's was not the only Ponzi scheme that flourished over the last two decades, even if it was the largest. Among a second tier of investment frauds, was that of the Stanford Financial Group. This organization, which was founded, owned and managed by Allen Stanford, collapsed in 2009 when it was discovered that it was yet another massive Ponzi scheme. To date the best estimates are that the Stanford fraud involved $7 to $8 billion.

The Stanford Ponzi scheme has not been the subject of as many books and articles as has been Madoff Ponzi scheme, even though there is a plethora of financial statements, court documents, business records, and other materials available for analysis. In fact, one difference between the Stanford scheme and other recent Ponzi scams (including the Madoff fiasco), is that in the Stanford case one of the key co-conspirators, James M. Davis, entered in to a plea agreement. In that plea agreement, Davis acknowledged many of the details that took place behind the scenes, along with his first-hand involvement with that scandal.[2]

This case serves as an invitation for students to look beneath the surface of the Stanford investment operation, and to ask themselves how a massive fraud like Stanford could have been sustained for nearly a decade. Wasn't anyone paying attention? Why didn't anyone blow the whistle? Weren't there any ethical parameters in place? Didn't anyone notice that something was wrong? If they did notice, why did they remain silent?

As part of the process of considering what really happened at Stanford, students are invited consider the various signals and significant circumstances that surrounded the scheme. Detailed facts in the case, drawn from a rich treasure trove of pleadings, affidavits and other court documents, as well as from fact summaries that included as part of published court opinions, are provided. Students can limit their investigation to the facts as presented here, or can explore the original pleadings, reports and court documents for a close look at the machinations that produced a $7 to $8 billion fraud.

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[1]Harry Markopolos and Frank Casey, No One Would Listen: A True Financial Thriller (Hoboken, N.J.: Wiley, 2010).

[2]See United States v. Davis, Criminal Case No. H-09-335 (U.S. District Court, S.D. Tex., August 27, 2009) "Plea Agreement," at http://blogs.chron.com/stanford/Davis%20Plea%20Filed%20Version.pdf (Last retrieved February 26, 2011) and also at http://www.lpf-law.com/UserFiles/File/2010%20Docs/09-724/Doc468-1_Receiver_Appx_Part2_ReMagnessMJS_062210.pdf (Last retrieved February 26, 2011). See also, United States v. Davis, 2010 U.S. Dist. LEXIS 91305 (S.D. Tex. June 18, 2010). The original indictment of Davis is available at http://www.justice.gov/usao/txs/initiatives/Stanford%20Information.pdf (Last retrieved February 26, 2011).

This case study is designed for undergraduate and graduate students studying such topics as business law, business ethics, corporate social responsibility, personal finance, financial planning, financial services, corporate governance, organizational behavior, auditing, forensic accounting or other similar courses of study. The case study questions encourage students to consider what it means to become aware of red flags that point to possible fraud, and how to respond to – and properly investigate – these red flags. Specifically, students are provided the opportunity to determine what types of red flags that would – and should – come to the attention of managers and other employees, as well as directors, outside auditors, feeder fund managers, direct investors and others who typically interact with an organization involved in a Ponzi scheme. Recognition of these red flags is only half of the battle; the more interesting challenge is for students to determine and articulate what should be done about the red flags that have been recognized.

CASE SYNOPSIS

Ponzi Schemes: Robbing Peter to Pay Paul

In February 2009, the Securities and Exchange Commission filed a Complaint against the Stanford Financial Group and several affiliates, along with R. Allen Stanford and several other individuals, alleging violations of U.S. securities laws in connection with a worldwide Ponzi scheme[3]. Among the other named individuals was James M. Davis. As stated in Paragraph 1 of the Second Amended Complaint:

> For at least a decade, R. Allen Stanford and James M. Davis executed a massive Ponzi scheme through entities under their control, including Stanford International Bank, Ltd., ("SIB") and its affiliated Houston-based broker-dealers and investment advisers, Stanford Group Company ("SGC") and Stanford Capital Management ("SCM"). Stanford and Davis, acting in concert with the other defendants, misappropriated billions of dollars of investor funds and falsified SIB's financial statements in an effort to conceal their fraudulent conduct.[4]

Ponzi schemes, as such, originated much earlier. They bear the name of Charles Ponzi, an engaging con man who perpetrated a massive fraud in the 1920s. Ponzi began trading and redeeming postal reply coupons. Postal reply coupons had been created to allow a person in one country to pre-pay postage for mail sent back from another country. For a time after World War I, fluctuations in currency exchange rates created a disparity between the cost and redemption value of postal reply coupons in various countries thereby creating the potential to make a profit in these transactions. Ponzi claimed he could earn 400% by trading and redeeming postal reply coupons and he promised investors that he would give them a 50% return on their money in 45 to 90 days if they invested with him. Initially Ponzi did purchase and redeem postal reply coupons, but he soon discovered it was too much work for the amount of return that he could actually

[3]See "SEC Charges R. Allen Stanford, Stanford International Bank for Multi-Billion Dollar Investment Scheme" (SEC Press Release 2009-26), at http://www.sec.gov/news/press/2009/2009-26.htm (Last retrieved February 26, 2011).
[4]See "SEC Charges Two Accountants and Antiguan Regulator for Roles in Stanford Ponzi Scheme" (SEC Press Release 2009-140), at http://www.sec.gov/news/press/2009/2009-140.htm (Last retrieved February 26, 2011).

receive.

Although he stopped trading postal reply coupons, Ponzi kept telling his investors that he was doing so and because he paid early investors the promised 50% return, many new investors gave him their money. He paid his earlier investors with the new investors' money, rather than with any investment returns. In effect, Ponzi was "robbing Peter to pay Paul". Because of this fact, Ponzi scams are also known as "Peter-Paul" scams. As the money continued flowing in, Ponzi used his investors' money to pay for a lavish lifestyle and he even invested in a bank. All Ponzi scams will eventually collapse of their own weight because it is impossible to continually attract new investors.[5]

The Players at Stanford Investment Group

At the center of the Stanford Ponzi scheme was Robert Allen Stanford, who at the height of his "success" was one of the richest men in the world. A flamboyant jet-setter and a citizen of the United States and Antigua and Barbuda, West Indies, he was involved in charity and sporting events and was knighted by the Antiguan government. Stanford was born in Mexia, Texas, near Dallas. He attended Baylor University in the 1970s. While at Baylor, he met James M. Davis, another of the Stanford defendants. In or about 1985, Stanford founded the Guardian International Bank, whose name was later changed to the Stanford International Bank, Ltd., a private, offshore bank in Montserrat. In or about 1989, the bank's principal banking location was moved to Antigua. Stanford's company, the Stanford Financial Group, was the parent company of the Stanford International Bank and a host of other affiliated financial services companies.[6] According to the company's website, the Stanford Financial Group was a privately-held group of companies that had in excess of $50 billion of assets "under advisement."[7]

The Stanford Financial Group and its affiliated companies were controlled by R. Allen Stanford. Stanford was the Chairman of the Board of Directors for the Stanford International Bank and a member of its Investment Committee. With respect to the Stanford International Bank, Stanford received regular updates and financial reports on the bank's investment activities; made hiring decisions; directed what revenue and asset numbers to report to investors, regulators and others; made investment decisions; updated employees, investors and others and approved reports on the financial condition and activities of the bank; authorized and made loans to himself and authorized property transactions between the bank and other Stanford affiliated companies.

Other individuals deeply involved in the Stanford Financial Company affiliates (and named as defendants in the Securities and Exchange Commission case) were: James M. Davis,

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[5]See “Pyramid Schemes,” Prepared Statement of Debra A. Valentine, General Counsel for the U.S. Federal Trade Commission presented at the International Monetary Fund's Seminar on Current Legal Issues Affecting Central Banks, Washington D.C., May 13, 1998, at http://www.ftc.gov/speeches/other/dvimf16.htm (Last retrieved February 26, 2011).
[6]See U.S. v. Davis, supra note 3.
[7]See SEC v. Stanford Int'l Bank, Ltd., Case No. 3:09-cv-0298-N (N.D. Tex. Mar. 12, 2009) (Memorandum of Law in Support of Motion for Ex Parte Temporary Restraining Order, Preliminary Injunction and Other Emergency Relief), at http://online.wsj.com/public/resources/documents/stanfordmemorandumoflaw20090217.PDF (Last retrieved February 26, 2011).

Laura Pendergest-Holt, Gilberto Lopez, Mark Kuhrt and Leroy King. James M. Davis attended Baylor University in the 1970s, where he met Robert Allen Stanford. Davis appeared to be a "religious" man and led prayers before bank business meetings. He'd also started his own church in Mississippi. Davis was the Chief Financial Officer for Stanford Financial Group and Stanford International Bank. He also served as a member of Stanford International Bank's Investment Committee. Davis regularly consulted with Stanford about the financial status of the Stanford International Bank and what revenue and asset numbers to report to investors and others. He made investment decisions for the bank and regularly received updates on the bank's revenue and loss records; updated investors and others about the financial status and operations of the bank, and approved reports to investors and others about the financial condition of the bank. Davis, in his guilty plea, admitted that he intentionally and knowingly participated in a scheme to defraud purchasers of the bank's CDs, and that he created or caused to be created false and misleading accounting books and records.

Laura Pendergest-Holt was born in 1974 and grew up in Baldwin, Mississippi. As a teenager she met James M. Davis at the Baptist church where they both attended. She joined Stanford Financial Group in 1997, after graduating from Mississippi State University with a master's degree in mathematics. Prior to joining the Stanford Financial Group in 1997, Pendergest-Holt had no experience in financial services or securities. She was the Chief Financial Officer of Stanford Financial Group and in 2005 she was appointed to the Stanford International Bank's Investment Committee. She held herself out to investors, employees of the bank and Stanford Financial Group, and others as managing the entire investment portfolio of the bank (although, in fact, she only oversaw less than 10% of the portfolio). She also supervised research analysts of Stanford Financial Group; updated investors, employees of the bank and Stanford Financial Group, and others about the financial status of the bank; and provided information about the bank's investment portfolio to Stanford Financial Group and Stanford Group Company financial brokers. She represented that the Stanford International Bank’s investments were liquid and safe, even though she knew that Tier 3 always had real estate investments in it and that Tier 3, which represented the bulk of the bank’s investments, was primarily invested in private equity and real estate. During at least 2006 and 2007, when investors questioned whether Allen Stanford could run off with the money, Pendergest-Holt instructed the bank’s senior investment officer to say that the Stanford International Bank had sufficient controls and safeguards in place to protect its assets. She also instructed the senior investment officer to not divulge too much about oversight of the bank’s portfolio because that information wouldn’t leave an investor with a lot of confidence.

Leroy King was the Administrator and Chief Executive Officer for Antigua's Financial Services Regulatory Commission. He facilitated the Ponzi scheme by looking the other way and conducting sham audits and examinations of Stanford International Bank's books and records. He also accepted bribes from Stanford and provided Stanford with access to the Financial Services Regulatory Commission's confidential files, including requests by the U.S. Securities and Exchange Commission for information regarding the bank. He obstructed the Commission's investigation by allowing Stanford to dictate the substance and content of the Financial Services Regulatory Commission's responses to the Commission's requests.

Gilberto Lopez was the Chief Accounting Officer of Stanford Financial Group Company. He provided "‘overall supervision of the accounting reports and budgetary process'" and "‘supervisory and managerial duties for the accounting process'." Lopez was Mark Kuhrt's supervisor. From 2007 to 2009, Kuhrt held various positions, including Account Manager,

Assistant Controller and Controller at Stanford Financial Group Company and Global Controller for Stanford Financial Group Global Management, another Stanford affiliate.

The Stanford International Bank was operated by a close-knit circle of Stanford's family and friends. Its board of directors included Stanford, Davis, Stanford's father (James A. Stanford), and O.Y. Goswick, a family friend, cattle-rancher and car salesman from Mexia, Texas. Stanford, Davis, Stanford's father, Goswick and Laura Pendergest-Holt, another of the Stanford defendants, were the bank's investment committee. The Stanford Investment Bank was a wholly owned subsidiary of the Sanford Financial Group, which maintained offices in Houston, Texas; Memphis, Tennessee; and Miami, Florida, among others.

The Stanford International Bank's assets were monitored by a small group of Stanford Financial Group employees who maintained offices in Memphis, Tennessee and Tupelo, Mississippi. Ken Weeden, the Managing Director-Research and Investments, in charge of this group reported to Pendergest-Holt, his sister-in-law. Further, Davis' son, and at least one of his college classmates, were research analysts who oversaw a portion of the bank's assets.

In addition to the close-knit group operating the Stanford International Bank, the chief Antiguan regulator was a close friend of Stanford. In fact, according to testimony by Davis in his plea agreement, in 2003 Stanford and Leroy King became "blood brothers" in a "brotherhood ceremony". Further, when two Antiguan regulators who worked for King became too aggressive and suspicious in examining the bank, they were reassigned or replaced. In 2004, Stanford paid $8,000 for tickets to the Super Bowl game in Houston for King and King's girlfriend. In June, 2005, King showed Stanford a confidential letter he'd received from the U.S. Securities and Exchange Commission seeking information about the Stanford International Bank's CDs and noting it might be involved in a Ponzi scheme. Stanford and an aide drafted a false and misleading response to the S.E.C.'s letter.

Stanford International Bank told its investors that the Antiguan regulator responsible for the oversight of the bank's investment portfolio, the Financial Services Regulatory Commission, audited its financial statements. However, the Financial Services Regulatory Commission did not audit or verify the assets the bank claimed in its financial statements. Instead, C.A.S. Hewlett & Co., a small accounting firm operating in Antigua, was responsible for auditing the bank's multi-billion dollar investment portfolio. The Stanford International Bank chose C.A.S. Hewlett & Co. to audit its books even though at least two of the big four multinational accounting firms had locations in the Caribbean.[8]

The Stanford House of Cards

One of the Stanford Financial Group's subsidiaries was the Stanford Group Company, a Texas corporation which had been incorporated in 1995. The Stanford Group Company was registered with the Securities and Exchange Commission as an investment advisor and broker-dealer. Stanford Group Company and its financial advisor employees promoted the sale of Certificates of Deposit (CDs) in the Stanford International Bank. These CDs were not insured by the U.S. Securities Investor Protection Corporation (SIPIC) or the Federal Deposit Insurance

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[8]See Pendergest-Holt v. Certain Underwriters at Lloyd's of London, 2010 U.S. Dist. LEXIS 108920 (S.D. Tex. Oct. 13, 2010), at http://www.jenner.com/files/tbl_s69NewsDocumentOrder/FileUpload500/8735/Pendergest_Holt_v_Lloyds.pdf (Last retrieved February 26, 2011).

Corporation (FDIC). A "Regulation D" notice dated November 13, 2001 and signed by Frans P. Vingerhoedt, President and Chief Executive Officer of Stanford International Bank Limited, indicated the minimum investment which would be accepted from investors in the bank's CDs was $50,000. The notice also indicated that the CDs would be sold in all states in the United States of America. No sales were to be made to non-accredited investors and the aggregate offering price was $150 million of which $37,202,166.55 had been already sold by the date of the notice. In connection with marketing the CDs in the United States several Regulation D notices were filed.

Disproportionately large commissions were paid to the Stanford Group Company for the sale of the CDs. The Stanford Group Company received a 3% trailing fee from the bank on the sales of the CDs by its advisors. Stanford Group Company advisors received a 1% commission upon the sale of a CD and were eligible to receive as much as a 1% trailing commission throughout the term of the CD. In 2006 the Stanford International Bank paid Stanford Group Company and its affiliates approximately $211 million in management fees and CD commissions. In 2007, the management fees and commissions paid to Sanford Group Company and its affiliates totaled more than $291 million.

The Stanford Group Company also sold a proprietary mutual fund wrap program called the Stanford Allocation Strategy to investors, including non-accredited, retail investors. This program grew from less than $10 million in around 2004 to over $1 billion. The Stanford Allocation Strategy generated fees for Stanford Group Company and Stanford Capital Management, LLC in excess of $25 million. The Stanford Allocation Strategy program was used to recruit registered financial advisers with significant books of business, who were then rewarded for re-allocating their clients assets to the Stanford International Bank's CD program. To generate interest in the Stanford Allocation Strategy, Stanford Capital Management used pitch books from 2005 through 2009 that used fictional and/or inflated performance results. For example, in 2006, the pitch book reported the following Stanford Allocation Strategy (SAS) results compared to the S&P 500 (S&P): 2005 – SAS, 12.09%; S&P 4.91%; 2004 – SAS 16.15%; S&P 10.88%; 2003 SAS 32.84%, S&P 28.68%; 2002 SAS -3.33%, S&P -22.10%; 2001 SAS 4.32%, S&P -11.88%; 2000 SAS 18.04%, S&P -9.11%.

However, actual client returns, gross of advisor fees ranging from 1% to 2.75%, ranged from: -7.5% to 1.1% in 2000; -2.1% to 10.7% in 2001; -8.7% to 26.6% in 2002. By November 2006 financial advisers were questioning why their clients were not earning the returns represented in the pitch books. In response, Stanford Capital Management hired an outside performance expert to review some of its results. In late 2006 and early 2007, the expert informed Stanford Capital Management that its performance results for the twelve months ending on September 30, 2006 were inflated by as much as 3.4%. In March of 2008, the expert reported that the performance results for 2005 were also inflated by as much as 3.25%.

The Stanford International Bank was not an ordinary commercial bank with checking accounts and general lending services. Its primary investment product and principal source of funds was its CDs. These CDs were marketed to investors promising substantially higher rates of return than were available at banks in the United States. For example, on November 28, 2008, the Stanford International Bank quoted 5.375% on a 3-year Flex CD, while comparable U.S. banks' CDs paid under 3.2%. In fact, for almost fifteen years, the Stanford International Bank represented that it had experienced consistently high returns on its certificates of deposit (ranging from 11.5% in 2005 to 16.5% in 1993). In turn, its CD deposits increased from $3.8 billion in 2005, to $5 billion in 2006 and $6.7 billion in 2007. As of November 28, 2008, the bank reported

$8.6 billion in total assets.

In its 2007 Annual Report to investors the bank had reported approximately $6.7 billion worth of the CD deposits and over $7 billion in total assets. In its December 2008 Monthly Report, it purported to have over 30,000 clients from 131 countries representing $8.5 billion in assets. For 2008, in the midst of the global financial crisis, Stanford International Bank claimed its diversified portfolio of investments lost only $110 million or 1.3%, while the S&P 500 lost 39% and the Dow Jones STOXX Europe 500 Fund lost 41%. In addition to this improbable performance, for 1995 and 1996, the Stanford International Bank reported identical returns of 15.71%, even though it purportedly had a "globally diversified portfolio" of "marketable securities."

The Stanford International Bank marketed the sale of its CDs by claiming it invested in "marketable" global securities and that "maintaining the highest degree of liquidity" was a "protective factor" for its clients. In its 2007 annual report it reported that its portfolio allocation was 58.6% equity, 18.6% fixed income, 7.2% precious metals and 15.6% alternative investments. The bank's annual reports also claimed that it did not expose its clients to the risks associated with commercial lending and that it only loaned monies on a cash-secured basis. The bank's annual reports contained a section entitled "Related-Party Transactions" that supposedly disclosed all related party transactions. In its Annual Reports from 2004 to 2008 no mention was made of any loans to Stanford. Further in the bank's quarterly reports to the Financial Services Regulatory Commission no loans to Stanford were disclosed. In contrast to these representations, the bank's internal records disclosed more than one-half of the bank's investment portfolio (approximately $3.2 billion) was in undisclosed "Private Equity Real Estate".

There were also numerous loans to Stanford (totaling approximately $1.6 billion) many of which were documented by promissory notes created after Davis had wired funds to Stanford or his designees. $400 million of these funds Stanford had used to purchase personal real estate and more than $36 million had gone to subsidize Stanford 20/20, an annual cricket tournament with a $20 million purse. These unsecured, personal loans to Stanford were disguised in the bank's financial statements as "investments."

Using predetermined return on investment numbers, typically provided by Stanford or Davis, Lopez and Kuhrt reverse-engineered the bank's financial statements to report investment income the bank did not actually earn. Stanford International Bank's financial statements and annual reports to investors were prepared, drafted and approved by Stanford, Davis, Lopez and Kuhrt and signed by Stanford and Davis. Although the bank's assets were purportedly invested in conservative, multi-national corporate and government securities, fixed-income investments and other liquid assets, whose returns would have typically been easily ascertainable, Davis provided no documentary backup for the investment numbers. Despite this, Lopez and Kuhrt deliberately and knowingly, month after month for years, engaged in this reverse-engineering process based on estimates and revenue projections to prepare the bank's investment revenue reports.

Did Anyone Notice?

Employees of Stanford's companies and others raised questions regarding returns and investments at various times. According to an Associated Press release posted on February 20, 2009, in early 2003, a top performer at Stanford's bank, Charles Hazlett, was fired for asking too many questions about investment details. His concerns about the bank's investments and lack of

forthrightness were raised in an arbitration hearing shortly thereafter.[9]

In December 2007, two Stanford Group Company financial advisors, D. Mark Tidwell and Charles W. Rawl, left the company either because they were fired or forced to resign. In early 2008, these advisors filed suit in a Texas state court alleging that they were constructively discharged by the Stanford Group Company for refusing to engage in unethical and illegal business practices. The alleged illegal practices included the company's: "(1) prohibiting its financial advisors from filing mandatory securities forms for clients possessing IRA accounts containing Stanford International Bank, Ltd. certificates of deposit ; (2) neglecting to notify holders of such IRA accounts of the civil and criminal penalties associated with the failure to file the mandatory securities forms; (3) violating FINRA regulations by overstating the asset value of individuals in a manner designed to mislead potential investors; (4) ordering the removal or destruction of information contained in client or company files in response to an ongoing SEC investigation into Stanford Group's certificate of deposit sales practices; and (5) purging electronic data from its computer in response to the SEC investigation."[10]

Tidwell testified that Stanford Group Company financial advisors were trained to market CDs to clients as safe and secure investments; that "the funds from the CDs were placed in a highly liquid investment portfolio consisting mainly of marketable securities". He further testified that when he asked for further details about the Stanford International Bank's investment portfolio he was told "the information was proprietary and confidential, and was given no information."

In late 2008 a financial analyst, Alex Dalmady, reviewed the Stanford International Bank's reports as a favor for a friend who was considering investing in the bank's CDs. He concluded that it was not possible for the bank to produce the returns it claimed based on its reported investments and that it could not fund the dividends that it was continuing to pay its investors. He shortly thereafter published his findings in a Venezuelan magazine.[11]

Pershing Limited is an affiliate of Pershing LLC, a subsidiary of The Bank of New York Mellon Corporation. Stanford International Bank used Pershing as its clearing broker. In 2008, Pershing, which had sent Stanford International Bank $517 million in 1,635 wire transfers from 1,199 customer accounts between 2006 and December 12, 2008, refused to process any further wire transfers to Stanford International Bank. Since the spring of 2008, Pershing had been attempting to obtain an independent report regarding Stanford International Bank's financial condition. On November 28, 2008, it was informed by Stanford Group Company's president that "obtaining the independent report was not a priority."

In fact, as disclosed in internal records, the Stanford International Bank divided its portfolio into three tiers of investments. In early December 2008, Tier 1, which represented

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[9]Tim Elfrink, “SEC Says Texas Financier Sir Allen Stanford Swindled Investors Out of Billions,” Dallas Observer(Texas), April 9, 2009, at http://www.dallasobserver.com/2009-04-09/news/sec-says-texas-financier-sir-allen-stanford-swindled-investors-out-of-billions/ (Last retrieved February 26, 2011).

[10]Stanford Group Co. v. Tidwell (In re Stanford Group Co.), 273 S.W.3d 807 (Tex. App. Houston 14th Dist. 2008), at http://tx.findacase.com/research/wfrmDocViewer.aspx/xq/fac.%5CTX%5C2008%5C20081209_0010139.TX.htm/qx (Last Retrieved February 26, 2011).

[11]Alex Dalmady, “Duck Tales,” VenEconomy Monthly (January 2009), pp. 11-15, at http://www.scribd.com/doc/12737973/0901Duck-Tales (Last Retrieved on February 26, 2011).

approximately 9% ($800 million) of the portfolio, was invested in cash and cash equivalents. Tier 2 was designated as investments with "outside portfolio managers (25+) that are monitored by Analysts" and represented 10% of the portfolio. Tier 3, which was managed under the direct control of Stanford and Davis, represented 80% of the bank's investment portfolio.

On December 15, 2008, Pendergest-Holt met with her analysts by teleconference after the Stanford International Bank decided to liquidate more than 30% of the Tier 2 investments (approximately $250 million) in light of increasing redemptions. At least one analyst questioned why it was necessary to liquidate Tier 2, rather than Tier 3 assets, to increase the bank's liquidity. Pendergest-Holt informed the analyst that Tier 3 was primarily invested in private equity and real estate and that Tier 2 was more liquid than Tier 3.

THE COLLAPSE OF THE HOUSE OF STANFORD

On February 16, 2009, after several weeks of investigation, the SEC initiated its lawsuit against Stanford financial group and its top officers.[12] The next day, US marshals raided the Houston offices of Stanford financial group, and at the same time, the SEC froze all of Stanford's assets. Nine days later, Laura Pendergest-Holt was arrested for lying to the SEC. On June 19, 2009, the U.S. District Court for the Southern District of Texas unsealed a 21-count indictment returned by a federal grand jury on June 18, 2009, against defendants Robert Allen Stanford, Laura Pendergest-Holt, Gilberto Lopez, Mark Kuhrt, and Leroy King, charging each of them with wire fraud, mail fraud, money laundering, and conspiracy, as well as, in the cases of some of the defendants, obstruction of justice.[13] Stanford was arrested and held without bail.

The corporate assets have been placed into receivership, and investors filed a class action lawsuit.[14] Other lawsuits have been initiated, including a lawsuit against the law firms that represented the Stanford Financial Group. As the extent of the Stanford fraud came to light, journalists and investigators have discovered that the Stanford “story” is one of fraud and corruption dating back to 1980s.[15]

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[12]Note 3, supra.

[13]See United States v. Stanford, Criminal Action No. H-09-342-1 (S.D. Tex. 2009), Indictment, at http://www.justice.gov/criminal/vns/docs/2009/jun/06-18-09Stanford.pdf (Last Retrieved on February 26, 2011).

[14]See Adams v. Stanford, Case No. 4:09-cv-00474 (S.D. Tex. 2009), Class Action Complaint, at http://www.stanfordfinancialreceivership.com/documents/Stanford_First_Amended_022709.pdf (Last Retrieved on February 26, 2011).

[15]See, e.g., Bryan Burrough, “Pirate of the Caribbean,” Vanity Fair, Vol. 51, No.7 (June 3, 2009), pp. 51-76, reprinted in Graydon Carter, The Great Hangover: 21 Tales of the New Recession (New York: Harper Perennial, 2010), pp. 251-275.

SUGGESTED QUESTIONS FOR STUDENTS NEEDING STRUCTURED GUIDANCE

1. **Ethics: Read through the admissions of James M. Davis as recounted in his plea bargain at footnote 2, *supra*. How does a person typically go from an idealistic, religious college student, to a books-cooking, money laundering, bribing co-conspirator in a Ponzi scheme?**

   In the factual basis for his guilty plea, James M. Davis admits to wilfully producing fraudulent investment reports and financial statements. He also admist to being aware of, if not directly participating in, such activities as paying $200,000 to buy off an Antiguan bank regulator (including paying $8,000 for two tickets to the 2004 Super Bowl). And yet Davis and Robert Allen Stanford first met as students at Baylor University, where they were both committed to their faith-based beliefs and values. In fact, Davis recruited Laura Pendergest-Holt, whom he met at his church (where he was a active member). What do you suppose helped to trigger Davis' moral decline? What can be done to help people who start out in their careers with ideals of honesty and high moral standards, keep from losing these values?

2. **Who knew: Taking into account the information in the Case Synopsis (and, as necessary, the underlying documents listed and linked in the footnotes), consider the roles played by, and activities performed by, each of the following: Robert Allen Stanfod, James M. Davis, and Laura Pendergest-Holt. For each of these three insiders, answer the following: (a) What fraudulent tasks did they perform, such that one or more other persons (outside of this inner circle), would have had at least some awareness of such tasks? (b) For each of these three insiders, how many individuals are likely to have had at least some awareness of their fraudulent behavior? (c) Give some examples of the roles or jobs of such outside individuals who would likely have been aware of the fraud; and (d) Explain why you think that none of the outsiders described in (c), above, never came forward as whistleblowers.**

   The inner circle of the Stanford Investment Group leadership were secretive, even to the point of participating in "blood oaths" to prevent disclosure of their fraud. But each day they interacted with secretaries, accountants, managers, bank tellers, and many other people in many different roles. But no one came forward to blow the whistle. Why not?

3. **Red flags: Consider again the roles played by each of the following three insiders: Robert Allen Stanfod, James M. Davis, and Laura Pendergest-Holt. For each of these three insiders, answer the following: (a) What "red flags" would have been evident from each of their activities, such that financial auditors, bank regulators and auditors, securities regulators, business journalists, savvy investors, and others should have taken notice? (b) For each such red flag (for each of these three insiders), what were the financial risks being signaled? (c) For each such red flag (for each of these three insiders), what were the ethical lapses being signaled?**

   Auditors, regulators, investors and others are properly concerned with such red flags as: a small and tightly knit group of managers, consisting mostly of family and close friends; close ties to regulators; firing/reassigning of employees for asking too many questions; the

engagement of a small public accounting firm as the auditor of a large operation; many interlocking or affiliated corporations; disproportionately large commissions paid on financial products; large fees paid to related entities; very rapid growth of programs; returns on financial products significantly above market returns; meturns for stated investments bearing no relationship to returns that were being generated by types of securities that supposedly were held; lack of disclosure of particular assets that were held by the companies even though these securities were supposedly invested in global corporations and government entities; annual statements deceptive and false; non-disclosure of related party loans; lavish lifestyle of principal insiders; lack of expertise of individuals hired into the inner circle; failure to file mandatory securities forms; failure to notify clients of penalties for failures to file forms; removal or destruction of documents to hide information from SEC, and purging of electronic data to hide information from SEC; and refusal to provide audited financial statements and reports. Most of these red flags signal some financial risk, and most reflect an ethical lapse of one kind or another.

4. **Making the connection: Select one type of outsider (from question 2 above) who would likely have become aware of a red flag (from question 3 above). What would the proper course of action of been, in response to that outside individual's awareness of the red flag? What risks would be faced by "blowing the whistle" in such a case? Why should a person be a whistleblower in such a case, despite the risks?**

   Many laws and regulations are designed to safeguard whistleblowers, but even with such protections in place most whistleblowers pay a price for doing the right thing. This question is designed to encourage some soul-searching about the ethics of being a whistleblower, the benefit to society, and the real meaning of corporate citizenship.

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