Lesson of a Ponzi Scheme: Know Your Customer

Scott Rothstein needed a big financial institution to keep his scam going. TD Bank should have managed its risks better

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The senior management of Canada's big Toronto-Dominion Bank learned a valuable lesson recently about the risk of having the wrong customer.

An American subsidiary of the bank, TD Bank, agreed to pay $52.5 million to settle accusations that it had helped a Florida lawyer, Scott W. Rothstein, commit a Ponzi scheme estimated at $1.2 billion.

Rothstein's scam involved persuading investors to put money into "structured settlements." Investors were told that these were settlements of cases that involved sexual harassment, workplace discrimination and other complaints against certain companies.

He explained to investors that these companies had agreed to pay money over time to his clients in return for their silence. Those clients would sell the right to the payments in return for an upfront payment from the investor. He assured each investor that all the money was paid into escrow accounts he administered.

To pull off such a scheme, Rothstein needed a financial institution to set up bank accounts so he could move money around. At the time the Ponzi scheme began, Rothstein was using a small bank, Gibraltar Private Bank and Trust.

He later testified to investigators that he had "protection" from officers at that bank, but as the Ponzi scheme expanded, Gibraltar employees started asking more due-diligence questions about Rothstein's account. He realized that to attract larger investors,

including hedge funds, he needed to use a larger bank to assure investors that there was protection from a possible bank failure while the bank held their money.

Rothstein's solution was to move his account to Commerce Bank, which was later acquired by Toronto-Dominion. But he needed an ally at the bank to keep his Ponzi scheme alive. Dangling a carrot in front of TD Bank regional vice president Frank Spinoza, the lawyer bragged to him that he could introduce him to some large clients.

Spinoza was so star-struck by Rothstein's influence and wealth that he made material misstatements and omissions to investors and prepared false and misleading documents that he knew Rothstein would provide to investors.

As the Ponzi scheme began to unravel, Spinoza lied to investors concerning the safety of the investment. For example, he allegedly told them that the funds were locked into their bank accounts and could not be transferred when they could.

He also told at least two investors that the trust accounts held balances totaling "hundreds of millions of dollars," when, in reality, the SEC claimed that "the settlements Rothstein sold to investors did not exist and the purportedly 'locked' accounts generally held no more than $100."

The lawsuits against those companies, in fact, weren't real. Rothstein fabricated the cases using forged documents and elaborate ruses, such as having an accomplice pose as a bank officer.

The Ponzi scheme fell apart just after Halloween in 2009 when Rothstein couldn't lure enough new investors to pay earlier ones. After fleeing to Morocco, Rothstein returned to the United States. Two years ago, he pleaded guilty to five federal counts of racketeering, money laundering and wire fraud and is now serving a 50-year prison sentence.

Beware Having the Wrong Customer

The big lesson that TD Bank has had to learn from this messy situation is the importance of knowing your customer and understanding their business. Just because a customer is large doesn't mean you should be doing business with them.

First, there's the instability inherent in relying on one big account. For example, say a big customer pulls an order and you fall short of your plan for the year.That could lead

to your company having to cut expenses, lay people off, cut executive and employee pay or all three. Big customers also have a way of using their size to justify slow payments, changes in delivery terms or renegotiated prices.

Some entrepreneurs build their company around keeping that one big customer happy. Then, however, they take resources and customer service away from smaller accounts that together provide more diversified revenue.

Some organizations start to chase revenue that creates financeable receivables, instead of chasing profitable customers. If that large customer suddenly turns away, it effectively destroys the business's working capital.

Cutting Your Customer Risks

Here's are some risk management tips about how your company should build sound business relationships with potential customers:

1) *Know your potential customer base and your customer's industries and figure out what factors would cause a customer not to pay*. If you don't know if your customers are close to bankruptcy or have other financial trouble, you've got a problem. It's wise to have credit checks on some of your larger accounts.

2) *Establish your company as an organization needed by your customers, not merely a "nice to have."* Build yourself into your customer's supply by creating various kinds of stickiness to make it harder for the customer to leave you. Think of supplying the one essential part that their largest-earning product can't do without, for instance.

3) *Look hard at your contracts and the length of engagement*. Both can provide good opportunities to mitigate risk. If a customer has contracted with you over a longer time period or has kept buying from you even when the economy has turned sideways, you've got a bit less to worry about.

4) *Diversify within a customer as soon as possible*. Don't tie your relationship to any single contact or buyer. You need multiple champions inside a client company who can be counted on to advocate for you. You might consider selling multiple products and services to different units of a large customer rather than always selling into the same silo.

5) *Most importantly, focus on profitability rather than revenue.* Revenue can be all-consuming for a small company. Measuring the profitability of a relationship — the real value created for your business — will in the long run serve you best. The risk you take by catering to a huge primary customer should be rewarded with greater profitability from that account.

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