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# Demystifying Ponzi Schemes

## Introduction

As the saying goes, "Whether you're rich or poor, it's always good to have money". Whilst there is no debate around the fact that it is totally natural and legitimate for the poor to aspire to some form of social or financial comfort, just like the rich to strive to be richer, what the saying does not underline is the fact that the ways and means to grab this 'good-to-have-money' are as valuable as the bounty itself.

Across the decades, as the financial world became increasingly complex, in line with the sophistication of pecuniary needs of those owning or handling the cash-cows, some invested much time and ingenuity to try and uncover unbeaten paths for tapping the resources at hand. Yet, whilst resourcefulness and, the more so, success based on rightful ambition stood as the bywords of a generation of tycoons and golden boys spinning around ethics, regulatory obligations and compliance, the old trick of 'robbing Peter to pay Paul' emerged as an efficient way to get people to shell out money by using as a lure the promise of an extremely high return on investment.

As the realm of finance evolved, so did the old concept of Peter and Paul with new 'names' being added as devilishly innovative schemes were crafted to defraud those seeking to enrich themselves quickly. To the old Peter and Paul story, one Charles Ponzi added his name… Not to steal and pay anyone else but simply to keep all the money. Despite, solid regulatory frameworks have been designed to prevent such fraud from taking place, promoters of such schemes often find their way in trapping investors and Mauritius was not immune to the abuse and has recently witness probably the first Ponzi scheme on the island.

## What is a Ponzi scheme?

A Ponzi scheme is a fraud designed to convince the public to place their money into an investment promising higher returns than other investments carrying little or no risks. The scheme being a scam, there is actually no investment being made by the promoter but the lure is high profits that the investment process generates within a relatively short span.

The modus operandi is in fact very simple: to pay early-stage investors either with an initial fund raised by the fraudsters or with the money collected from early-stage or subsequent investors. The hitch is that perpetuation of the high returns requires an ever-increasing flow of money to keep the scheme going until the day comes where the payment pyramid becomes so huge that it crumbles as the promoter can no longer raise money fast enough to pay back the investors.

## History

The Ponzi scheme got its name from Charles Ponzi who, in the 1920s, became notoriously famous for developing an embezzlement scheme in the United States. His concept was to defraud individuals by inciting them to invest in a seemingly flawless business with guaranteed high returns. He imagined a scam around the contemporary practice that whenever a person would send a mail overseas, he or she would enclose a reply coupon to cover the costs of the reply postage. Ponzi's idea was that he would buy the coupons overseas at a much cheaper price than in America and sell them back on the American market with an interesting profit margin. The profit made would then be shared amidst those who had invested in his business venture.

That appeared as a legitimate investment and the promise of 50 percent returns within 3 months did not raise any suspicion. Soon, the word spread about this clever, innovative, quick and profitable investment opportunity and investors stepped forward in ever-increasing numbers. People mortgaged their houses and invested the savings of a lifetime in the scheme.

Soon, the market started smelling a rat; the scheme began to raise eyebrows as people started wondering how Ponzi could possibly buy and sell what must have been 160 million reply coupons out of the 27,000 that existed in the world. Things only got worse when the Postal Service reported that there was not a huge flow of the coupons from one country to the other. Eventually, regulators raided Ponzi's office and discovered that he did not have a huge quantity of postal reply coupons. Ponzi was arrested and charged with 86 counts of mail fraud. He pleaded guilty and spent 14 years in prison. Collectively, his investors lost an estimated $20 million and the collapse of the scheme brought down six banks with it.

## The biggest Ponzi scheme ever

Charles Ponzi was not the first to set up such schemes and he is definitely not the last. Over the years many have been able to defraud others by using similar methods. One name however, comes to mind when talking about Ponzi schemes, that is Bernard Madoff. Madoff founded a market-making firm Bernard L. Madoff Investment Securities in the 1960s and was the former chairman of the National Association of Securities Dealers Automated Quotations (NASDAQ) and sat on its board of governors.

At one point, Madoff Securities was the largest market maker at the NASDAQ and in 2008 was the sixth-largest market maker on Wall Street. Madoff enticed wealthy and influential businessmen in New York City and Palm Beach to invest with him after befriending them and paid them handsome returns and used their positive recommendations to attract more investors. His close relationship with the Regulators also helped strengthening his reputation. To attract serious investors, Madoff did not take in any investor and did not promise high returns but rather offered modest but steady returns. Soon it became a mark of prestige to be admitted in Madoff's fund and no one could imagine that the whole scheme is a Ponzi. The more so, who would doubt that the credibility of the former chairman of the second largest stock market? However, when the financial analyst and whistleblower, Harry Markopolos, looked at a marketing document which he received from one of Madoff's investors showing the revenue streams, he immediately understood that it was a Ponzi scheme and later discovered that among the investors were renowned organizations and high net worth individuals including celebrities. Despite Markopolos' several attempts to bring Madoff's fraud to the attention of the Securities Exchange Commission (SEC), his complaints fell on deaf ears. Following the fall of financial markets at the end of 2008, some investors wished to recover their funds and when he told his sons that he could not repay them because he was running a Ponzi scheme, they reported it to the SEC and Madoff was arrested and sentenced to 150 years of imprisonment. The size of the Ponzi is estimated to be a colossal $50 billion.

## How to protect yourself?

The first rule for any investor is that they should invest their money in financial services and financial institutions that are authorized to operate because most Ponzi schemes involve unlicensed individuals or unregistered firms. Registration is important because it provides investors with access to key information about the company's management, products, services, and finances. Secondly, investment opportunities that offer returns that appear to be too high and specially investments that continue to generate regular, positive returns regardless of overall market conditions should raise a red flag. Investors should also be careful when they are told that they can earn more return from investment by introducing new investors to the scheme. They should also be suspicious if they do not receive a payment or have difficulty cashing out their investment. Usually, promoters of Ponzi schemes encourage investors to reinvest promised payments by offering even higher investment returns. Investors should also consider getting independent professional advice before making any investment decision.

In Mauritius, It is a criminal offence to conduct financial services activities without a licence. In particular, Collective Investment Schemes (CIS), which is the preferred instrument used by investors to benefit from the inherent advantages of working as part of a group, need to be authorised by the Financial Services Commission (FSC) under the Securities Act. The FSC is the integrated regulator for the financial services sector other than banking, and global business. The licensing framework provides clear sets of licensing criteria and requirements within a well-defined and consolidated framework. As part of the authorization process, the FSC will amongst others check the credentials of the promoters of the CIS, and most importantly that of its Manager. In particular, the law prescribes that as part of the application, documents have to be produced to demonstrate that the Manager has suitably qualified staff with the appropriate expertise and experience to carry out the functions of a CIS Manager. In addition, given that the value of a CIS is based on the value of the assets in which it has invested, there is a requirement that valuation reports have to be done at regular intervals and at the year end, the accounts of a CIS must also be audited and filed with the FSC.

Thus, the best way to protect oneself against Ponzi schemes is to ensure that the scheme that one is purporting to invest is a regulated scheme. Prospective investors should ensure that they conduct a proper due diligence on the scheme prior to investing. If in doubt, prospective investors should contact the regulator to determine the licensed status of the scheme.

## Conclusion

Notwithstanding the aforementioned precautions, Ponzi schemes can fool the most overly-cautious individual! In many situations, Ponzi schemes did not start with an illegal act or intention to defraud but popped up when the promoter failed to admit that an investment has gone bad and started looking for other investors to keep the ball rolling. And as more investors come in, so grows the reputation of the promoter as an aura of trustworthiness emanates from his capacity to provide high returns on a short-term basis.

Paradoxically, people who invest in such schemes often fall in the trap because they simply fail to carry out due diligence on the promoter because of the trust the market or respectable individuals put in the promoter. The Madoff case clearly illustrates this conundrum as stated by one of Madoff's victims.: "Doubt Bernie Madoff? Doubt Bernie? No. You doubt God. You can doubt God, but you don't doubt Bernie. He had that aura about him."

The characteristics of modern fraudsters are that they have the best resumes, are extremely well connected, live in posh areas and own the nicest houses and cars. Credibility is alas the very first ingredient of the embezzlement recipe and when done with style, anyone can get caught in the scheme.

By the way, have you heard about this wonderful business opportunity with a guaranteed 250% return in two weeks' time? Well, why not give it some thought...

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## About the author

Ameer Caunhye is the Compliance Officer of AXIS Fiduciary Ltd, a leading Mauritius-based independent trust company providing full spectrum of fiduciary and corporate services to an international client base. Ameer holds an LLB (Hons) from the University of Northumbria and joined the financial services sector in 2010.



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