What’s a Ponzi Scheme?

It is amazing how situations, terms and titles can exist for years with little notice and, then, in a moment’s notice become a household term.

Such has been the case of the “Ponzi Scheme.” This bit of financial slight-of-hand has been with us for almost a century. Yet, it wasn’t in our vocabulary until recently, after our nation’s economic free-fall.

Readers of this website need to be made more aware of such activities because of how this basic scheme is still with us today, only mixed into more digestible marketing programs, known as Multi-Level-Marketing or simply called “Networking.”

A Ponzi scheme is a fraudulent investment operation that pays returns to investors from their own money or money paid by subsequent investors, rather than from profit. The term "Ponzi scheme" is used primarily in the United States, while other English-speaking countries do not distinguish colloquially between this scheme and other pyramid schemes.

The Ponzi scheme usually offers abnormally-high, short-term returns in order to entice new investors. The perpetuation of the high returns that a Ponzi scheme advertises and pays requires an ever-increasing flow of money from investors in order to keep the scheme going.

The system is destined to collapse because the earnings, if any, are less than

Con man Ponzi circa 1910
March 3, 1882–January 18, 1949

the payments. Usually, the scheme is interrupted by legal authorities before it collapses because a Ponzi scheme is suspected or because the promoter is selling unregistered securities. As more investors become involved, the likelihood of the scheme coming to the attention of authorities increases.

The scheme is named after Charles Ponzi, who became notorious for using the technique after emigrating from Italy to the United States in 1903. Ponzi did not invent the scheme, but his operation took in so much money that it was the first to become known throughout the United

States. His original scheme was in theory based on arbitraging international reply coupons for postage stamps, but soon diverted investors' money to support payments to earlier investors and Ponzi's personal wealth. Charles Dickens' 1844 novel Martin Chuzzlewitt described a Ponzi scheme decades before Ponzi was born.

Knowingly-entering a Ponzi scheme, even at the last round of the scheme, can be rational in the economic sense if a government will likely bail out those participating in the Ponzi scheme.

Hypothetical example:

Suppose an advertisement is placed that promises extraordinary returns on an investment — for example, 20% on a 30-day contract. The objective is to deceive lay-people who have no in-depth knowledge of finance or financial jargon. Verbal constructions that sound impressive but are essentially meaningless will be used to dazzle investors: terms such as "hedge futures trading", "high-yield investment programs", "offshore investment" might be used. The promoter will then proceed to sell investors — who are essentially victims of a confidence trick — stakes, by taking advantage of a lack of investor knowledge or competence.

Without the benefit of precedent or objective prior information about the investment, only a few investors are tempted, usually for smaller sums. Thirty days later, the investor receives the original capital plus the 20% return. At this point, the investor will have more incentive to put in additional money and, as word begins to spread, other investors grab the "opportunity" to participate, leading to a cascade effect deriving from the promise of extraordinary returns. However, the "return" to the initial investors is being paid out of the investments of new entrants, and not out of profits.

One reason that the scheme initially works so well is that early investors — those who actually got paid the large returns — commonly reinvest their money in the scheme (it does, after all, pay out much better than any alternative investment). Thus, those running the scheme do not actually have to pay out very much (net) — they simply have to send statements to investors showing them how much they earned by keeping the money, in order to maintain the deception that the scheme is a fund with high returns.

Promoters, also, try to minimize withdrawals by offering new plans to investors, often where money is frozen for a longer period of time, in exchange for higher returns. The promoter sees new cash flows as investors are told they could not transfer money from the first plan to the second. If a few investors do wish to withdraw their money in accordance with the terms allowed, the requests are usually promptly processed, which gives the illusion to all other investors that the fund is solvent.

The catch is that at some point one of three things will happen:

1. The promoters will vanish, taking all the remaining investment money (minus the payouts to investors) with them;

2. The scheme will collapse under its own weight, as investment slows and the promoters start having problems paying out the promised returns (the higher the returns, the greater the chance of the Ponzi scheme collapsing). Such liquidity crises often trigger panics, as more people start asking for their money, similar to a bank run;

3. The scheme is exposed because the promoter fails to validate their claims when asked to do so by legal authorities.

What is not a Ponzi scheme:

A multilevel pyramid scheme is a form of fraud similar in some ways to a Ponzi scheme, relying as it does on a disbelief in financial reality, including the hope of an extremely high rate of return. However, several characteristics distinguish these schemes from Ponzi schemes:

In a Ponzi scheme, the schemer acts as a "hub" for the victims, interacting with all of them directly. In a multilevel scheme, those who recruit additional participants benefit directly (in fact, failure to recruit typically means no investment return).

A Ponzi scheme claims to rely on some esoteric investment approach, insider connections, etc., and often attracts well-to-do investors; multilevel schemes explicitly claim that new money will be the source of payout for the initial investments.

A multilevel scheme is bound to collapse a lot faster, due to the necessity of exponential increases in participants to sustain it. By contrast, Ponzi schemes can survive simply by persuading most existing participants to "reinvest" their money, with a relatively small number of new participants.

A bubble. A bubble relies on suspension of disbelief and an expectation of large profits, but it is not the same as a Ponzi scheme. A bubble involves ever-rising (and unsustainable) prices in an open market (be that shares of a stock, housing prices, the price of tulip bulbs, or anything else). As long as buyers are willing to pay ever-increasing prices, sellers can get out with a profit, and there doesn't need to be a schemer behind a bubble. (In fact, a bubble can arise without any fraud at all — for example, housing prices in a local market that rise sharply, but eventually drop sharply because of overbuilding.) Bubbles are often said to be based on the "greater fool" theory. Although, according to the Austrian Business Cycle Theory, bubbles are caused by expanding the money supply beyond what genuine capital investment supports, and in this case would qualify as a Ponzi scheme, with expanded credit taking the place of an expanded pool of investors.

Although non-fraudulent in intent, a pension fund can share some of the characteristics of a Ponzi scheme in that, except during the final period of the fund's life-span, the outgoing cash used in any month to pay pensions is usually taken from the incoming contributions of the active members of the pension scheme. In a year of poor equity returns such as 2008, a pension fund can often perform worse for its members than a Ponzi scheme.

Robbing Peter to pay Paul. When debts are due and the money to pay them is lacking, whether because of bad luck or deliberate theft, debtors often make their payments by borrowing or stealing from other investors they have. It does not follow that this is a Ponzi scheme, because from the basic facts set out there is no indication that the lenders were promised unrealistically high rates of return via claims of unusual financial investments. Nor (from these basic facts) is there any indication that the borrower (banker) is progressively increasing the amount of borrowing ("investing") to cover payments to initial investors (as, again, Ponzi was not the first to do).

The eponymous Ponzi scheme was coordinated by Charles Ponzi, who went

from anonymity to being a well-known Boston millionaire in six months using such a scheme in 1920. Profits were supposed to come from exchanging international postal reply coupons. The purpose of the postal reply coupon was to allow someone in one country to send it to a correspondent in another country, who could use it to pay the postage of a reply. IRCs were priced at the cost of postage in the country of purchase, but could be exchanged for stamps to cover the cost of postage in the country where redeemed; if these values were different, there was a potential profit.

Inflation after the First World War had much decreased the cost of postage in Italy expressed in U.S. dollars, so that an IRC could be bought cheaply in Italy and exchanged for U.S. stamps to a higher value. The process was: send money abroad; have IRCs purchased by agents; send the IRCs to the U.S.A.; redeem the IRCs for stamps to a higher value; sell the stamps. Ponzi claimed that the net profit on these transactions, after expenses and exchange rates, was in excess of 400%. This was a form of arbitrage, or profiting by buying an asset at a lower price in one market and immediately selling it in a market where the price is higher, which is not illegal.

Ponzi canvassed friends and associates to back his scheme, offering a 50% return on investment in 45 days. The great returns available from postal reply coupons, he explained to them, made such incredible profits easy. He started his own company, the "Securities Exchange Company", to promote the scheme. He promised 50% interest (return) on investments in 45 days or "double your money" in 90 days.

About 40,000 people invested about $15 million all together; in the end, only a third of that money was returned to them.[2] By July 1920 he had made millions. People were mortgaging their homes and investing their life savings. Most did not take their profits, but reinvested. Ponzi was bringing in cash at a fantastic rate, but the simplest financial analysis would have shown that the operation was running at a large loss. As long as money kept flowing in, existing investors could be paid with the new money. In fact, new money was the only source Ponzi had to pay off those investors, as he made no effort to generate legitimate profits.

Ponzi lived luxuriously: he bought a mansion in Lexington, Massachusetts with air conditioning and a heated swimming pool, and brought his mother from Italy in a first-class stateroom on an ocean liner.

By this time Ponzi was seeking another deal to get him out of the golden trap he had built for himself, but time was running out. On July 26 the Boston Post started a series of articles that asked hard questions about the operation of Ponzi's money machine. The Post contacted Clarence Barron, the financial analyst who published the Barron's financial paper, to examine Ponzi's scheme. Barron observed that though Ponzi was offering fantastic returns on investments, Ponzi himself wasn't investing with his own company. Barron then noted that to cover the investments made with the Securities Exchange Company, 160,000,000 postal reply coupons would have to be in circulation. However, only about 27,000 coupons were actually circulating.

The United States Post Office stated that postal reply coupons were not being bought in quantity at home or abroad. The gross profit margin in percent on buying

and selling each IRC was colossal, but the overhead required to handle the purchase and redemption of these items, which were of extremely low cost and were sold individually, would have exceeded the gross profit.

The stories caused a panic run on the Securities Exchange Company. Ponzi paid out $2 million in three days to a wild crowd outside his office. He canvassed the crowd, passed out coffee and donuts, and cheerfully told them they had nothing to worry about. Many changed their minds and left their money with him.

In the short term, Ponzi had hired a publicity agent, James McMasters. However, McMasters quickly became suspicious of Ponzi's endless talk of postal reply coupons, as well as the ongoing investigation against him. He went to the Post, calling Ponzi a "financial idiot". The paper offered him five thousand dollars for his story, and ran a headline on August 2 declaring Ponzi hopelessly insolvent. On August 10 federal agents raided the Securities Exchange Company and shut it down. There was no large stock of postal reply coupons. The Post continued its articles, with one revealing Ponzi's jail record and publishing his (smiling) Canadian mugshots.

On August 12, 1920, Ponzi was under arrest, with a Federal indictment. His liabilities were estimated at $7 million.

In two federal indictments, Ponzi was charged with 86 counts of using the mails to defraud the public. It was an ironic charge — Ponzi's only use of the mails was to send postcards to his "investors", telling them their notes were due and to come get their money, which until the very end he happily paid. On November 1, 1920, Ponzi pleaded guilty to a single count of mail fraud before Judge Clarence Hale, who declared before sentencing: "Here was a man with all the duties of seeking large money. He concocted a scheme which, on his counsel's admission, did defraud men and women. It will not do to have the world understand that such a scheme as that can be carried out ... without receiving substantial punishment." He was sentenced to five years in federal prison. He was released after three and a half years to face 22 Massachusetts state charges of larceny.

Ponzi was eventually released in 1934 following other indictments, and asked for a full pardon from Joseph Buell Ely, the Massachusetts Governor. He was deported to his homeland, Italy, as he hadn't ever become an American citizen. His charismatic confidence had faded, and when he left the prison gates, he was met by an angry crowd. He told reporters before he left: **"I went looking for trouble — and I found it."**

Mug shot of Charles Ponzi, Boston financial wizard, taken during his arrest for forgery under the name of Charles Bianchi.

Bernard Madoff
Born April 29, 1938
How could you not trust this man?

On December 10, 2008, Bernard Madoff, the former non-executive chairman of the NASDAQ Stock Market, allegedly told his sons that the asset management arm of his firm was a massive Ponzi scheme — as he put it, "one big lie." The following day he was arrested and charged with a single count of securities fraud — but one that accuses him of milking his investors of $50 billion. This may be the largest Ponzi scheme ever perpetrated, as well as the largest investment fraud ever committed by a single person. One of Madoff's biggest investors, René-Thierry Magon de la Villehuchet of Access International Advisors, committed suicide around December 23, 2008, following the disclosure of the losses of $1.5 billion.

Madoff's scheme was typical of a Ponzi in its structure, but differed in its pace and marketing. Rather than offer (suspiciously) high returns to all comers, Madoff offered modest, but steady returns to an exclusive clientele, produced in both up and down markets. Although the investment method was marketed as a "too complicated for outsiders to understand" combination of stock purchases tracking some index and related puts and calls (contrary "bets" on the index's direction), the true secret to Madoff's success was his lifetime involvement with non-profit charities, and the tax law knowledge he gleaned from that experience over many decades.

Charitable foundations were the basis, as well as the side-victims, of his surreptitious strategy. He exploited his own social networks, and over time, received implicit entree into new venues to promote himself and his company among his clientele. He invested their significant funds consisting of educational foundations and social charities, as directed by them. The slow pace and ongoing cliquish "insider" word-of-mouth marketing enabled the deception to survive for several decades. It grew beyond the expectations of a common Ponzi.

All was quite successful until the autumn market meltdown in 2008 and extraordinary demands for cash by other investors in early December overwhelmed his system. Some investors were unknowingly exposed through multiple fund investments that they had believed to be diversified in some of Madoff's hedge funds investments and/or through investments in third party hedge funds with unreported investments in various Madoff programs.

Ultimately, charities and foundations which invested with Madoff lost millions, in what has been characterized as a form of affinity fraud. Mitchell Zuckoff, professor of journalism at Boston University, author of Ponzi's Scheme: The True Story of a Financial Legend, explained "the 5%

payout rule", a federal law requiring foundations to pay out 5% of their funds each year. As long as a foundation's principal earns 5% a year - not always possible in a given year, but a reasonable goal over time - a foundation endures, and so does its sponsor, Madoff's vision. Madoff knew the "Rule" well.

Zuckoff noted, "For every $1 billion in foundation investment, Madoff was effectively on the hook for about $50 million in withdrawals a year. If he wasn't making real investments, at that rate the principal would last 20 years. By targeting charities, Madoff could avoid the threat of sudden or unexpected withdrawals." Zuckoff suggests that years ago, Madoff "solved the two interlocking puzzles that usually prevent Ponzi schemes from becoming perpetual money machines: sustaining growth, while maintaining stability."

Comparison to Social Security

Detractors of Social Security systems often draw parallels between those programs (where investors are paid off by future investors) and Ponzi schemes. See Social Security debate (United States).

See also:

Fraud
Multi-level marketing
High-yield investment program
Bucket shop (stock market)
Pyramid scheme
Get-rich-quick schemes
Matrix scheme
Reed Slatkin
Double Shah

Terminology: Confidence trick — Mark —Shill — Sucker list

Notable confidence tricks: Advance fee fraud — Badger game — Black money scam — Bogus escrow — Clip joint — Drop Swindle — Embarrassing cheque — Employment scams — Hustling — Mock auction — Penny-and-dime scam — Pig in a poke — Pigeon drop — Reloading scam — Shell game — Slavery reparations scam — Spanish Prisoner — Thai gem scam — Thai tailor scam — Three-card Monte — White van speakers — Multi-level marketing — Networking.