UtahStateUniversity
COOPERATIVE EXTENSION

FINANCIAL FITNESS

FACT SHEET

February 2000

PONZI SCHEMES

FL/FF-05

Barbara R. Rowe Ph.D.
Professor and Extension Family Resource Management Specialist
Utah State University

In 1920, Charles Ponzi was a $15-a-week stock clerk in Boston. He learned that he could make a small profit by buying International Postal Reply coupons (IPRCs) which in turn could be redeemed for stamps in a number of countries. If he bought the postal coupons at a low rate in a weak-currency country (as Spain was at the time) and then redeemed them at a higher price in the United States, he could make a profit because of the widely varying rates of currency exchange.

Greed, however, quickly overran his modest intentions and he began to solicit money from other people on the promise that they could expect a 50% profit from their investment in just 45 days. This was at a time when normal interest rates were only 5%. The plan might have worked had there been enough IPRCs in circulation to support large-scale purchases. But the coupons were distributed in very limited quantities for the convenience of postal customers who used international mails. By the time interest in the scheme grew and Ponzi saw orders flooding in, he was totally obsessed with the idea of making huge amounts of money. He baited the trap by giving some early investors the 50% returns promised–using the money of new investors to pay them off. He promised new investors even higher returns, eventually, up to 100%.

Within a year, Ponzi had taken in 10 million dollars from gullible investors and moved into a palatial home. Even when the scheme was exposed and Ponzi was on his way to prison, money continued to pour into his office from victims who were convinced he had a good thing going. Since then, any operation that pays off old investors with money from new investors is known as a "Ponzi scheme." It's similar to a chain letter–it works until it becomes increasingly difficult to find new players, then the whole thing collapses leaving many investors with a loss, not a profit.

Why Ponzi Scams Still Work

Although Ponzi schemes have been around for more than 80 years in one form or another, and they are one of the easiest swindles to detect, they are more prevalent today than ever before. According to North American Securities Administrators, Ponzi schemes are snaring many investors who have large sums to invest and who are supposedly experienced and financially sophisticated. The reason is the growth in financial services and sometimes bewildering new investment instruments available to the public. In a fast-changing financial marketplace, Ponzi promoters have an increasing number of ways to dress up their schemes and shield them from ready detection.

The range of Ponzi-type offerings is a tribute to the imagination and ingenuity of the promoters of these swindles. They can involve just about any kind of deal you might imagine, from gold mines and synthetic rubies to hydroponic farming, windmills, tropical islands and equipment used in outer space. One Ohio teenager realized that he could use other people's money to buy rock concert tickets and then turn around and "scalp" them for a 40-50% profit. He rounded up his friends to stand in line and buy concert tickets and then re-sell them. At first he ran his business out of the back of a van, but as the word spread, he soon raked in millions of dollars. When the bubble of this modern-day Ponzi scam burst, the teen would have had to buy every rock concert ticket in Ohio and all surrounding states in order to keep paying out the promised returns to investors. There simply weren't enough concerts and enough people willing to pay inflated prices for concert tickets. This guy's friends, and their friends, all lost money on this scheme.

The bottom line for prospective investors is always the same: the guarantee that they will receive higher-than-going-rate returns on their investment. Promoters count on investors' eagerness to leap into a get-rich-quick plan. They rely heavily, too, on what has been described as the "herd instinct." The start-up may be slow, with only a trickle of investors willing to take the bait. But once the plan builds momentum, word of mouth alone is almost enough to spin the operation into high gear. For this reason, Ponzi promoters focus their initial efforts with demography in mind. They may confine their efforts to professional football players or concentrate on a large church congregation, a single retirement community, or Air Force base.

Early participants in Ponzi scams are often rewarded with high returns on their initial investment. Promoters know that word of a few successful participants will spread rapidly to others. However, many of these early investors are so elated with their financial killings they turn right around and put their money back into the scheme, often losing almost everything in the end.

How Can You Protect Yourself?

1. *Ignore promises of high, guaranteed profits, the trademark of the Ponzi scam.* Legitimate investments not only address themselves conservatively to any discussion of profits but rigorously avoid any promise of specific percentages over any given period.

2. *Avoid any kind of investment that is not described clearly, in detail, and without hedging.* Swindlers often declare that the specifics are "too technical" to describe in layman's language. They may also avoid mentioning names on the grounds that the geniuses behind the plan "wish to remain anonymous." Why would you invest in something you don't understand by somebody who won't give his or her name?

3. *Check out the promoters' credentials and background carefully* through reliable sources that can alert you to any illegal acts or questionable practices that may color their records.

4. *Obtain information about the proposed offering from* the Utah Division of Securities, phone 801-530-6600 or, if you have Internet access, security@br.state.ut.us or the Better Business Bureau at 801-892-6009 (24 hours), http://www.saltlakecity.bbb.org. If you detect or suspect any violations of the law or securities registration, do other investors a favor by reporting your doubts to these organizations or the Division of Consumer Protection at 801-530-6601 or http://www.commerce.state.ut.us.

5. *Demand detailed information in writing.* You are well within your rights to ask for documentation. Be concerned if the promoter is reluctant or hedges by asserting that such information is "confidential." It's your money!!

6. *Just because a promoter of a plan makes a claim doesn't mean it's true!* Verify any and all claims and promises made by the promoter. Swindlers often try to imply that the offering is registered with a government agency, has Dun & Bradstreet's stamp of approval, or has been cleared through a trust company. Don't accept such claims at face value.

7. *"Seeing is believing."* Ask to visit the plant where the "fabulous new product" is being manufactured. If it's "off-limits to everyone but employees," be suspicious.

8. *Back away from plans that offer "deferred" payments,* where you have to invest today but will not see any products or evidence of ownership until tomorrow, or where you are pressured into reinvesting or letting your profits "roll over."

9. *Be on the alert for any kind of unbusinesslike conduct on the part of the promoters,* including the inability to reach them through phone calls, by mail or by e-mail. The farther along the road to disaster a Ponzi plan may be, the more impossible it becomes for investors to obtain information or get through to the promoters.

10. *Ponzi scams are not pyramid schemes*. Although closely related in the minds of many, the classic Ponzi amounts to little more than robbing an army of Peters to pay a handful of Pauls. A pyramid scheme is a plan in which people invest in the right to sell the investment. They are alike in that both are illegal and both will continue to part fools and their money.