Ponzi Schemes and Tips to Avoid Them

By Anthony F. Fata

"Ponzi scheme" is part of the American lexicon. Sometimes the phrase is misapplied to describe suboptimal financial transactions. Recurring monthly fees from oversubscribed health studios and 11-month advance deposits for summer camps may reflect sharp capitalism, but they are not Ponzi schemes. Ponzi schemes are investment scams. The scammer pays investors fictitious profits from the very money they paid the scheming enterprise. And the scammer returns existing investor money from new investor money. And so on until a pyramid of investors builds, with the bottom left holding the (empty) bag.

Any investor could fall for a Ponzi scheme. Finance professionals can fall for them when they do not do proper diligence (look no further than Bernie Madoff's victims). Even legitimate enterprises sometimes convert to Ponzi schemes when operational profits cease. The only way to eliminate theoretical exposure to Ponzi schemes is to abstain from investing. But that is not realistic.

This article discusses the original American Ponzi scheme, how modern-day Ponzi schemes operate, the presence of such schemes in Chicago, the role of wealth managers in the schemes, practical tips for avoiding scams, and remedies should a problem arise.

Original Ponzi Scheme

In the 1920s, Charles Ponzi discovered that the Universal Postal Union was selling "International Reply Coupons" to immigrants to the U.S. and to those traveling abroad. The idea was simple: buy a coupon in Europe, travel or immigrate to the U.S., and trade in the coupon for U.S. stamps. World War I had tanked Europe's economy, which meant the coupons could be purchased in Europe at a discount relative to the cost of U.S. stamps.

Example of an Original Ponzi Scheme Coupon

Ponzi told investors he would purchase coupons in large quantities and sell them for a premium in the U.S. "Buy low, sell high." Ponzi promised investors a 50% return on investment in 45 days. He did pay early investors the promised returns. Word of Ponzi's success, and the success of his investors, spread. And demand for investment in his company– "Securities Exchange Company" – blossomed.

The basic math was true: coupons bought in Europe were selling at a discount to U.S. stamps. But the quantity of coupons that Ponzi said he was trading was a lie. There were not enough coupons to go around for Ponzi to make good on his promises of profit. And so, from the start, Ponzi paid investors the fictitious returns with money that was coming in from new investors. More investors wanted in. And Ponzi started paying these investors with money coming in from the yet-newer investors, and so on. Eventually, U.S. postal inspectors figured out the scam. Bad publicity ensued. Investors demanded their money, but it was long gone. Ponzi was arrested, tried, sentenced, imprisoned, and ultimately deported to Italy in 1934.

Even after the multi-billion-dollar Madoff fraud unraveled in 2008, the pyramid investment scheme still bears Ponzi's name.

Ponzi Schemes in Chicago

Chicago's agricultural and manufacturing roots fueled the city's rise as a world-class financial center, home to mega futures and options markets such as the CME and Cboe. Smart, honest wealth managers abound to steer clients in the right direction. Business is done based on trust. But none of this has made Chicago immune to Ponzi schemes. Here are just a few recent examples:

- 2021: The DOJ charged conspirators from Skokie and Lincolnwood with a scheme that defrauded several clients of millions. Their scheme involved near-foreclosure mortgages that they claimed to own, with their ownership validated through phony "certificates of ownership" crafted by a lawyer co-conspirator. The schemers did not really buy the mortgages with the investor proceeds. They converted the funds to their own use and paid old investors with new investor money.

- 2018: The SEC charged a father and son with operating a $135 million scheme involving real estate on the South Side. The duo promised double-digit annual returns, and made some profits, but quickly began losing money. With the actual returns not as promised, the partners began showing fictitious returns to investors and paying existing investors with new investor money.

- 2016: The DOJ charged a Wilmette financial advisor with bilking clients, including friends and retirees, out of millions. Rather than invest in high-yield stocks and futures as promised, he spent the money on personal expenses and gambling. He hid the scheme by sending phony account statements to investors.

Mechanics of a Ponzi Scheme

What separates a Ponzi scheme from other investment fraud is a structure in which fictitious investor profits and return of initial investment principal is paid from other investor money. The enterprise does not generate real profits. The schemer touts a particular investment strategy or other means of generating revenue. The strategy can range from the tangible (postage coupons, cattle, or real estate) to the intangible (buy-sell strategy, foreign currency trade).

Schemers tout attractive investment returns to get the investors away from conventional investments such as stocks, bonds, mutual funds, and ETFs. They may brag about high returns. They may guarantee safety: a 7.5% or 10% annual return does not seem too out of line, particularly if guaranteed along with return of principal.

At some point, though, the scammers need to bring in new investor money to pay old investors because the enterprise is generating no (or insufficient) real profits. So, a second wave of investors is needed, and a third, and so on, until there are no new investors coming in and the bottom falls out.

In a simplified example, assume schemers take in $100 from initial investors on the promise of a 25% annual profit and return of 100% of initial principal at the end of the year. The schemers will owe $125 to the initial investors at the end of Year One. So they start off $25 in the hole. And if they spend $25 of the investor money on themselves, they are $50 in the hole. Thus, they need to raise money from a second round of investors heading into the next year

In Year Two, they raise $200 on the same promise of a 25% return for a one-year investment; $125 of that raise goes to the initial investors (principal plus profit). The scammers have only $75 to pay the second-round investors. But the scammers' pledge has grown to $250 (the 25% return on $200 is $50, plus the $200 investment principal). The scammers are now $175 in the red. They need to cast a wider net for the big payout at the end of the second year.

In Year Three, the scammers offer financial advisors a kickback of 12.5% to refer new investors to them. They raise $400; $175 is already earmarked for the second wave of investors, $50 (12.5% of $400) must go to the referring financial advisors for the kickbacks, the third wave investors will be paid a total of $500 ($400 return of principal plus $100 for the 25% profit). There are now $725 in total liabilities with only $400 (the third raise) to pay it. The scammers are now $325 in the hole. At this point, they are unable to raise new money, and the bottom falls out on

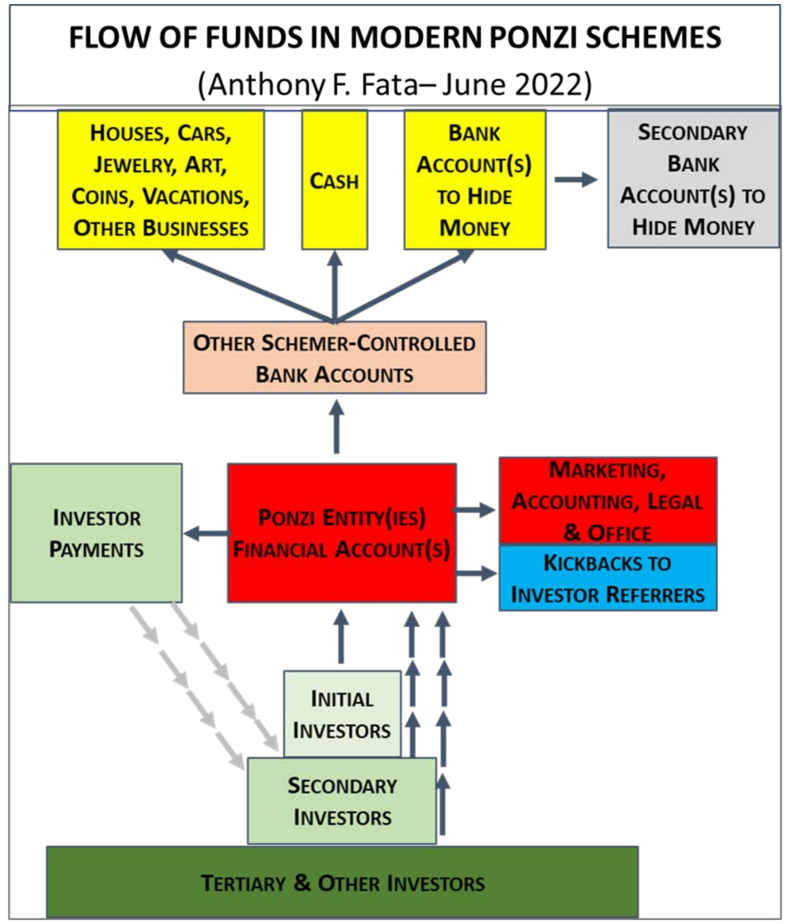
the third set of investors.

Some initial, second or third round investors may choose to stay in the investment longer, which delays doomsday for the scammers. On the flip side, administrative and marketing costs may increase, or the scammer may need to promise higher return rates or shorter lock-up periods, all of which speed up doomsday.

Where Does the Money Go?

Ponzi schemes concoct elaborate webs to recruit new money and to hide the money they get from investors. They may need to start new funds or corporate entities to take in new money, which will require law firms. They may need to be audited to lure sophisticated investors, which will require accounting firms. They will have to hire employees to keep track of the paperwork and communications from investors. And their office space and trappings will need to grow in size and image.

Typically, the investor funds are paid into a Ponzi entity bank account. It may be a "custodial" account in the name of customers. From it, the schemers pay their operational costs, kickbacks to referring advisors and brokers, and some funds to investors. The remainder goes to the schemers' personal bank accounts, personal expenditures, bank accounts used to hide the money, and secondary bank accounts used to further obscure the money. The accompanying diagram illustrates this flow of funds.



When Ponzi Schemes Unravel

Ponzi schemes unravel when the schemers cannot recruit sufficient new investors to pay existing investors actual dollars for fictitious returns or a refund on the principal investment. Many schemes benefit from word of mouth: a neighborhood, employee community, church group, or social network. Once that is tapped, new money stops. In a more elaborate scheme with a wider range of investors, new money stops flowing when the broader economy tanks. The scheme will lose ground to safer havens such as cash, bonds, or large cap stocks. The downward economy may also lead to an increase in redemption demands from existing investors, accelerating the need for new money that is not there. Once many investors demand their money and do not get it, they will ask questions and contact authorities. The jig will be up.

Paperwork discrepancies may become apparent to investors or their advisors. As the scheming enterprises grow without corresponding personnel to support them, errors are made in principal statements, returns owed, etc. Someone reading the investor statements may notice this and start asking questions. Or they may report their findings to the SEC or other regulators.

Occasionally, a regulator gets wind of a Ponzi scheme in its early stages. And sometimes, employees or vendors who figure out what is going on blow the whistle. But schemers are good at hiding things internally. So early stops are rare.

Target Industries for Ponzi Schemes

Most schemes are predicated in some form of reality: some truth and common sense lend a great deal to fraud. Scams are limited only by the creativity of the minds that devise them, and schemes span business sectors. They've included government issued instruments, life insurance, and oil and mineral rights.

Some scammers tout trading strategies in stocks, options, futures, or foreign currency or cryptocurrency. See, e.g., *Gonzalez v. Lloyds TSB Bank, PLC*, 532 F. Supp. 2d 1200 (C.D. Cal. 2006). They use terms associated with legitimate financial firms– "buy-sell," "market neutral," "arbitrage," and "cross-market"– to add a veneer. They may be unwilling to describe specifics, claiming proprietary methods (which often is true in legitimate trading environments), and avoiding the discussion that the trades do not exist or are losers.

Other fraudsters use tangible or commonly understood goods or instruments, such as livestock, real estate, mortgages, or lease agreements. Familiarity makes the investment seem plausible. Schemers will typically claim that they can buy these items at a discount for some reason, and then quickly sell them at a premium, and the spread is delivered to investors. See, e.g., *Breeden v. Kirkpatrick & Lockhart, LLP,* 268 B.R. 704, (S.D.N.Y. 2001), aff'd sub nom. In re *Bennett Funding Grp., Inc.*, 336 F.3d 94 (2d Cir. 2003)

Another popular area is non-conventional lending. One schemer represented that it financed retailer-to-retailer sales transactions for old inventory. See In re *Petters Co.*, 550 B.R. 457 (Bankr. D. Minn. 2016). The seller would not ship until it received payment, and the buyer would not pay until it received shipment. The lending enterprise would pay the seller to get the shipment going and receive a payment of the purchase price plus interest from the buyer upon delivery. This sounds logical, and, indeed, there is a legitimate financing practice known as "factoring."

Types of "Interests" Issued

Ponzi schemes offer a variety of interests. It will usually be some form of "security" which includes stocks, bonds, investment contracts, certain promissory notes, and a host of other ownership instruments. Limited partnership interests or limited liability company interests are common among Ponzi schemes (and legitimate investments).

Ponzi schemes also use other interests like "trading accounts." The Madoff scheme, for example, involved "discretionary trading accounts." In re *Bernard L. Madoff Inv. Sec. LLC*, No. 08-99000 (SMB), 2014 WL 5106909 (Bankr. S.D.N.Y. Oct. 10, 2014).

Finally, Ponzi schemes use generic sounding terms, such as "investment programs." It is not clear what the investor is getting in exchange: an ownership interest, an investor account, or something else.

Marketing Ponzi Schemes to Investors

Schemers use personal connections and word of mouth. Early investors (bragging about gains) reach out to a broader community or social circle that "wants in." Often, multiple members of the same family or employees of the same company will invest in the same Ponzi scheme.

Scammers also use social media and advisors. See FINRA Warns Investors of Social Media-Linked Ponzi Schemes, High-Yield Investment Programs (July 15, 2010). They recruit brokers and advisors to sell their investment products, often in exchange for a referral fee. See In re *Evergreen Sec., Ltd.*, 319 B.R. 245 (Bankr. M.D. Fla. 2003). The advisors' early investors receive profit distributions from the Ponzi scheme, which encourages the advisor to continue selling to other clients. Advisors play a vital role when the word-of-mouth circuit runs its course.

Questions to Ask before Investing

There is no sure-fire way to detect a Ponzi scheme in advance. The key is to ask questions of the promoters (if investing directly) or the brokers and advisors (if investing through them).

Rarely are Ponzi schemes registered with federal or state authorities or publicly traded. Therefore, alternative, non-registered investments should be scrutinized heavily (even if they are not Ponzi schemes) because they usually involve investment lock-up periods and are illiquid. Many such investments may be perfectly legitimate, but nonetheless appear shaky. Others may seem non-speculative but turn out to be frauds.

The more time spent talking, the more likely any cracks will begin to emerge. Some information cannot be given even in legitimate investment environments (commercial sensitivity, financial privacy, etc.). But the reason for non-disclosure, and the way it is conveyed, can say a lot. Does the person know why they cannot divulge the information? Generic "corporate policy" is not enough. Are they frustrated by the question? Is the reason given plausible?

The investment opportunity should include a prospectus, offering a memorandum or some other paperwork for investors. The advisor (or investor if investing directly) should read them carefully.

Below are some key topics to address and questions to ask if investing directly with the investment promoter (versus through a broker or advisor):

1. **Registration.** Is the company registered with the SEC, the Illinois Secretary of State Securities Department, or another state regulator? Does the company have articles of incorporation or other corporate documents filed with a state? Which state? Why was that state chosen?
2. **Regulation.** Do any federal or state regulators, or non-governmental self-regulatory organizations, examine the company's books and records? Does the company or its personnel have any licensure with federal, state, or self-regulatory organizations?
3. **Auditing.** Does the company have an outside auditor examine its books and records and communications with investors? If not, why not? If so, who are they? How long have they been auditing the company's books? (Too long may suggest captivity, and too short may suggest naivete). Does the company share their audit with investors?
4. **Attorneys.** Does the company have attorneys? Who are they? Are they located in the same state as the company? What do they do?
5. **Banking.** Where will my funds go? Will I have an individual account at a financial institution? Is this a "custodial" account? Does it independently verify the nature of transactions going into and out of the account? Will my funds be commingled with other investor funds? If commingled, why? How was this institution selected? Where is it located? Who is the relationship manager? Can I speak with them? Where is the company's operating bank account? Is it at the same bank? Will the company send me payments directly? If not, where will the payments come from? Why is it a different entity?
6. **Business Model & Financial Performance.** How does the company business operate? What does it do? Can you put it in simple terms? Is the business description in writing? Who are the company's chief competitors? Why are you able to do it better

than them? What have the company's returns been over the last five years? If they are consistently the same, high, or always trending up, how is that possible given ebbs and flow in the economy? If the company grows, is there enough of a market out there for it to sustain these returns? What are the biggest economic threats to the company's business model?

7. **Personnel.** How many employees does the company have? Who are its senior managers or chief officers? How were they selected? Does the company have a board of directors? How long have you known the chief officers? Do you have a compliance officer, investor relations officer or financial officer? Are you friends with these individuals or have you had a previous relationship with them (e.g., college, etc.)?
8. **Offices.** How many offices does the company have? Where are the company's headquarters? Can I visit the headquarters? Does the company host investor meetings?
9. **Transactions.** The company's business depends on underlying transactions. Who are your biggest counterparties? If you cannot tell me, why not? What happens if one of them takes its business elsewhere? How are the company's transactions recorded? Are there agreements reflecting the transactions? Does the company have UCC filings or other documents reflecting interests in the transactions or subject property? Are there intermediaries to the company's transactions, such as exchanges? Could I see copies of underlying transaction documents?
10. **Other Investors.** Where do your investors live? Are many in this area? How did the company learn about them, or how did they learn about the company? Have all of them received proceeds? Have any of them requested their money back and not received it? Why? Has the company ever paid any of its investors directly from the proceeds of new investors? If so, why?
11. **Referring Sources.** Does the company get investors through advisors, brokers or other referral firms? Does the company pay fees to these entities? Why does it need to do so if this is an attractive investment? Does the company pay fees to other investors for soliciting new investors? What are the fee structures?
12. **Redemptions and lockups.** Does the company require me to be invested for a set period of time? Why? What is the process for getting it back? What will I get when I request it back? Is there a period of time between requesting a return of principal and getting it back? What is the time period? Has it ever changed, i.e., been made longer? What was the reason for requiring investors to wait longer to get their money back?

What to Do if a Ponzi Scheme Unravels

If a Ponzi scheme unravels, the investor should obviously seek legal counsel. The attorneys and investor should contact the SEC, the Commodity Futures Trading Commission (if commodity or futures-contract related), the Financial Industry Regulatory Authority, the FTC (if one of the financial regulators does not cover the transaction), the Illinois Secretary of State Securities Department, the DOJ, and state or local police. Sometimes, a police report for fraud should be filed. The investor should also keep in mind insurance policies that may help cover losses.

Culpable parties will (or may) include the following:

1. The Ponzi scheme enterprise and its organizers (securities fraud, common law fraud, breach of contract, etc.);
2. The financial professional who recommended the investment (breach of fiduciary duty, potential securities fraud, negligence, breach of contract, etc.);
3. The bank that received the investors' funds (potential aiding and abetting, failure to warn, etc.);
4. Accountants for the Ponzi scheme (potential malpractice, aiding and abetting, etc.); and
5. Attorneys for the Ponzi scheme (potential aiding and abetting, etc.).

The circumstances dictate the legal propriety and economic feasibility of bringing civil claims. Early investors in Ponzi schemes who receive more than they invested from the schemers may also be liable (and have to return funds) to other investors who lost some or all of their principal investment.

Parallel criminal and civil enforcement proceedings may ensue. Regulators may set up victim compensation funds. Finally, receiverships and bankruptcies are common, with traceable assets returned pro rata to aggrieved investors.

Ponzi schemes are frequent occurrences in the investment world. Awareness and diligence are critical. More questions before investing reduces risk. Investors who learn they are in a Ponzi scheme should act quickly to report to appropriate authorities and bring action against responsible parties. ■

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