Ponzi schemes: how do they do it

Business

A Ponzi scheme characterizes a form of investment which is fraudulent in nature, whereby investors get paid through their own invested capital. The investors in this scheme can also be paid by investments provisioned by new investors (SEC Enforcement against Ponzi schemes, 2012). The investor's earnings do not come from the institution or organization running the Ponzi operation. The scheme obtains its operating capital through enticing potential investors with higher returns on capital invested than other investments. The gains on investments are on the short term basis, but in most cases they are inconsistent.

To ensure perpetuity of earnings, a Ponzi scheme must have an ever ending flow of finances from new investors. The history of Ponzi schemes dates back to 1920s. It was started by Charles Ponzi, who convinced thousands of England residents to venture into a postage stamp scheme. The popularity of the scheme rose quickly since the return rates on investment was far above that on the banks. At the time, the periodic interest rate obtained by banks was 5 percent. Charles promised 50 percent yields within a 90 day period (Ponzi schemes – frequently asked questions, n.

d.). At the start of the scheme, Charles had bought small coupons of international mails in order to facilitate the scheme. However, after some time, he started using funds from new investors to pay off old investors. Ponzi schemes can grow to generate billions of shillings to perpetrators.

This is because the short cash out period and impressive interest rates on investments create impetus to the frenzy that follows as word leaks out.

Charles Ponzi is said to have collected about 9. 8 million U. S. dollars in 1920 from just 10, 550 men and women (Fleming, n.

d.). This number included about 75 percent of the total Boston Police Force at the time. Later, he paid out approximately 7. 8 million U.

S. dollars to initial investors within a span of only 8 months. There are 5 principal techniques that Ponzi schemers use to commit fraud to unaware investors. First, the schemers bring forth the benefit factor. This is whereby they show potential investors the advantages of investing with them. Normally, the schemers offer a promise that upon investment, rate of return is remarkably high.

The yield on the invested money is normally set high enough in order to convince investors that it is worth their while. Nevertheless, the perpetrators do not set the return rate to be extremely high so that it may not sound unbelievable to their targeted investors. The second tactic used by the schemers is the setup (Moffatt, n. d.).

This is whereby the fraudsters generate plausible arguments and explanations as to how the invested money will attain the high yields. The set up information normally used by Ponzi schemers is that they have access to viable inside information. They claim that the information is not available to the general public. They could also cheat that they have access to capital intensive investments which generates high returns, and the gains ploughed back into the scheme. The third tactic which is of key importance to the Ponzi schemers concerns the initial credibility which determines whether the fraudulent enterprise will be successful or not.

The administrators of the scheme should appear genuine enough so as to make the potentials investors trust them with their money. When schemers are convincing, they are able to trik numerous people into joining the investment. The fourth tactic that Ponzi schemers employ to achieve their success is to ensure that the initial investors obtained their yields after making their investment decision. For the first few periods, the schemers ensure that the investors in their business attain the promised earnings. Ponzi schemes generate high earnings to those who join early (Walsh, 1998).

This way, the investors will act as mediums of channeling information about the legitimacy of the scheming company to the public. The schemers may even offer some of their money to investors to ensure that the promised yield rate has been attained. In most cases, the exited first period investors reinvest their money back into business for more earnings. The fifth tactic used by schemers is the communicated success technique. Upon success attainment of yields in the first period, investors communicate about their gain to other people.

This brings more potential investors into the scheming entity. The ability of Ponzi schemers to communicate about their profit to the public determines the success of the fraudulent enterprise. More investors must come into the business so as to pay off the earlier investors. Without new investors, the Ponzi scheme fails. Despite the lucrative earnings that come from investing in a Ponzi scheme, majority of them collapses after some time.

Their failure is due to lack of legitimate sources of earnings. Their only source of funds is from new investors. If the number of interested investors

falls, or efforts to recruit them do not bear fruits, finances to pay off earlier investors subside. Eventually the schemes collapse. They can also collapse if there are large numbers of investors demanding to cash out at the same time.

National authorities’ intervention also causes Ponzi schemes to fail. Various government agencies are on the look out for such schemes which cheats investors off their money. On the other hand, Ponzi scheme promoters may run away with the investor’s money once they have collected enough. Some economic forces may also trigger the fall of Ponzi schemes. For example, in the event there is a sharp decline in the level of economy, investors may withdraw some of their earnings from Ponzi schemes destabilizing it.

Ponzi schemes are illegal and normally result in a high jail term for the perpetrators. For example, a federal judge sentenced Mr. Doug Vaughan, a Ponzi scheme perpetrator in U. S. to 12 years in prison (In brief: Ponzi scheme leads to 12-year sentence, 2012).

Among the many cases of Ponzi schemes recorded across the globe, is that of Bernard Madoff. At the moment, he is serving a jail term of one hundred and fifty years. Mr. Madoff created a multi billion dollar scheme which cheated money off thousands of investors across the globe. Rather than promising exceptionally high returns on investments to investors, he used faked account statements. The falsified bank statements were used as evidence of legitimacy of his business, which seemed to remain stable even at the time of economic crisis.

Ponzi schemes are at times mistaken with pyramid schemes. Despite the fact that both pay earlier members with the new participants funds, they are different. Whereas Ponzi schemes recruit new members to obtain funds, pyramid schemes earn profits through obtaining distributors who sell a perceived product. The product in the context dooes not exist, or it is claimed to be sold inside the pyramid group. Pyramid schemes normally collapse more quickly than Ponzi schemes. This is because the earlier participants of a Ponzi scheme may reinvest their money in the scheme for a second time.

The U. S. Securities and Exchange Commission (SEC) investigates and prosecutes the founders of Ponzi schemes, thereby protecting unaware investors from being robbed off their money. They also help investors to recover their investments and assets lost in the fraudulent schemes. In the event the SEC suspects that a business is a Ponzi scheme, they may result into emergency control measures.

The measures may entail freezing of the entity' s assets until a thorough investigation on legitimacy of the business is performed. Numerous people wonder how they can avoid being preys to Ponzi schemes. There are various ways that people can employ to avoid wrong investment decisions and losses with Ponzi schemes. People should be cautious when advised to join investments promising high returns over small risks. Naturally, a business which yields much profit is faced with a high level of risk.

Investors should also be cautious with entities which promise exceptionally consistent returns. Normally, due to various economic conditions, businesses

tend to have upward and downward trends in their earnings. Legitimate entities should have a license. However, due to the nature of Ponzi schemes operations, none of them are licensed. Potential investors should make sure that investments have the legitimate government licenses for their operations. Investments should also have licensed sellers as mandated by state security and federal laws.

Ponzi scheme management individuals do not posses any form of license to show their legitimacy. Investors should not engage in any trade with unlicensed individuals. Investors should also avoid businesses which offer comprehensive, secretive, and complex strategies. As a rule, it is essential to avoid such business since in most cases they are out to trick unaware investors. Moreover, if an investment has issues when it comes to paperwork, it is reasonable to avoid it. A smart investor should always read an investment's disclosure statement as well as its prospectus.

If there are issues with the account statements, it is a clear indication that the finances are not put to use as promised. Ponzi Schemes have been around for almost a century. Despite the massive public cautioning on its prevalence by the governments, people continue to invest in them. Due to public ignorance, investors continue to be ripped off millions of shillings by these scams. Often, investors are sophisticated people who are well aware of pitfall available when investing in the Ponzi schemes (Touryalai, 2012). For this reason, Ponzi schemes will continue to be evident in the investment platforms.

In conclusion, Ponzi schemes cause phenomenon destruction to investors across the globe annually. Many investors globally lose millions of shillings through wrong investment decisions. The harsh economic conditions have made people search for quick returns for their investments. This has triggered an increase in the number of Ponzi and pyramid schemes across the globe. In order to avoid losses through these fraudulent scams, investors should be ready to conduct a thorough research on any business opportunity to determine its legitimacy.