

The Ponzi Scheme: An Old Con That's Making News

Submitted by Sean Gross

You've likely heard about some of the Ponzi schemes that have served to erode investors' trust in the financial industry. Heightened awareness of the issue—especially in light of the media storm generated by the Bernard Madoff scandal—may uncover more of these schemes in the future. But aside from knowing that these events aren't good news, many people don't really understand what a Ponzi scheme is and, more importantly, how to avoid becoming a victim of one.

Ponzi—a name that lives in infamy

In simplest terms, a Ponzi scheme is based on the idea of robbing Peter to pay Paul. It earned its name from Charles Ponzi, who, in the 1920s, stole millions from more than 40,000 people in New England in what is believed to be the first and most well-known of these crimes. The elements of Ponzi's original scam are markers for similar swindles today.

Ponzi told investors that he could take advantage of the differences in U.S. and foreign currencies used to buy and sell international mail coupons. He **claimed that he could provide a 40-percent return in only 90 days, which was dramatically greater return than the 5-percent return investors could earn in a bank savings account.** Investors jumped on the idea, inundating Ponzi with funds. He became a well-known Boston millionaire within six months.

Unfortunately, even the simplest financial analysis would have illustrated that his operation was running at a large loss. While new investors kept money coming in, that new money was the only source Ponzi had to pay off existing investors, as he **made no effort to generate legitimate profits.** Indeed, he only purchased \$30 worth of the international mail coupons he said he was working with, and he paid off a handful of early investors to make his scheme appear legitimate.

Fortunately, there are steps you can take to ensure that the professionals you align with possess the integrity that was foreign to Mr. Ponzi.

Spotting a fraud

These tips are geared toward forming relationships with financial professionals, but they can be applied to any type of engagement in which you trust someone with your money. One safety measure alone may not be enough, however—so be sure to use a combination of precautions.

1. **Remember, if it sounds too good to be true, it probably is.** This is perhaps the most important reminder for all of us. Be wary of such words as *guarantee* or *risk-free*, as well as products that promise higher than average returns. Trust your gut and avoid being influenced by “easy” profits.

2. **Be wary of high-pressure tactics designed to make you act—not think—fast.** Phrases like *once-in-a-lifetime* or *can't-miss* opportunity, as well as anything else pushing you to *act now*, can be red flags. Legitimate investment opportunities are rarely that fleeting. Investors must be given time to carefully review and investigate any proposed investment vehicles and strategies.

Ponzi did not need to use high-pressure tactics because he masked his scheme by paying other investors. Today, you're more likely to encounter would-be con artists who tout the need to act fast before opportunity passes you by.

3. **Avoid writing checks made individually payable to an investment advisor or a small, unknown company.** Although it should go without saying, **never invest with cash or traveler's checks**, and steer clear of anyone who suggests that you do so.
4. **Don't be afraid to ask questions and review legal documents.** Request a copy of the Form ADV Part II or the investment advisory agreement. Be sure to pay attention to the fine print and disclosures on these materials. This is where most of the investment assumptions and material representations can be found.

Ponzi bought only \$30 worth of the product he said he was using to make profits. Perhaps if investors had asked to see his inventory, they would have thought better of the supposedly great deal they were being offered. If someone claims that there is a product, make sure it's true!

5. **Research any affiliates.** If the advisor is associated with a broker/dealer, bank, or clearing firm, take the time to review the website and material of the affiliate organization. Most important, find out where the assets are custodied, and review the organization (bank or clearing firm) prior to investing.
6. **Check credentials.** Anyone can call himself or herself a financial planner or advisor—or claim any other designation he or she chooses—so it pays to check with national organizations that issue these credentials. AARP offers a resource that explains various financial designations; find it by going to www.aarp.org and typing “understanding financial credentials” into the Search field.
7. **Conduct a thorough background check.** Review the broker's or advisor's record on www.finra.org or www.sec.gov, paying extra attention to any customer complaints, regulatory history, and employment history. A rule of thumb is to avoid anyone who has multiple prior customer complaints or regulatory problems and to avoid brokers or advisors who have switched firms repeatedly (at least three changes in a five-year period).

Charles Ponzi was an ex-convict with a charming personality. A little digging into his background may have dissuaded investors.

8. **Check to see if the firm has a website, and review as much of it as possible.** This is a basic step you can take to ensure that you are partnering with an advisor who's put some resources into his or her online appearance. While there are plenty of scam artists who work to make their cons look legitimate, this is an easy check to combine with several, if not all, of the other steps.

9. **Rely on recommendations from friends, neighbors, and professionals**, especially when they have long-standing relationships with the individual you are considering. Feel free to bring a trusted friend or professional to the initial interview meetings. Seeking multiple opinions will give you a clearer picture of the advisor and what he or she can offer you.

Remember, some of the initial investors in Ponzi's scheme were paid off; it would have been enormously valuable for the other investors to have checked with some who did not receive funds.

10. **Get it in writing.** Be skeptical of any investment opportunity, strategy, or statements that are not backed up in writing. If an advisor has something real to offer, he or she will always put it in writing.

Your financial future is in your control—you decide who gains access to your hard-earned dollars—so be sure to choose wisely. You'll find that most financial professionals not only want to assist you with your needs, but they also want to educate you so you can make the right decisions for your situation. The time you put into vetting potential professional partners is one investment that can legitimately promise a great return.