

# Difference in Ponzi schemes between regions and times

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**Abstract:** Although there were numerous well-known Ponzi schemes in history to alert people with such kind of fraud, in the 21<sup>st</sup> century the number of victim to Ponzi scheme does not decrease. Ponzi scheme is worth studied because its system is growing to attract more people continuously to form a pyramid, in the end, the number of victims and the financial loss are significant. Past papers in the field studied variously from the operation of Ponzi schemes to the reasons for people to be swindled in such fraud. This paper will answer the change in Ponzi scheme over time and the difference in Ponzi schemes on the region bases. In the below article, a few famous and special cases of Ponzi schemes will be studied . There are limitations in the data of the numbers of victims and the value of financial loss, because some Ponzi schemes happened long time ago. The essay found out that the marketing strategies of ponzi scheme developed over time and the operation of ponzi scheme has diversified in different regions. The result may contribute to identify the development in Ponzi scheme and to help deduce the pattern of future schemes. It also acknowledges the characteristics of Ponzi schemes in different regions, which may illustrates the loopholes of policies in different regions and help to reduce such kind of defraudation.

## 1 Introduction

Ponzi scheme is also called pyramid scheme, it is any fraud using new investors' money to pay back the old investors. The system promises high rate of return which is always unreasonable, and itself does not generate any revenue. It is named after Charles Ponzi (1882-1949), who promised his investors a 50% rate of return but swindled them out of 15 million dollars in the 1920s. After he was caught, his investors only got 5 million dollars in return. A Ponzi scheme system is fragile, it will break down at anytime when the old investors claim to take back their previous invested fund, which disorganized the operation of the whole system, and the fraud is forced to shut down. For the most of them through out history, two years would be considered to be a relatively long lasting scheme. However, in a more recent and the biggest Ponzi scheme in the history, by Bernard Madoff, an American businessman and a wall street stock broker , the limit had been extended to nearly 20 years, started from 1980 to 2008, when Madoff was arrested and sentenced to jail. Information asymmetry and the use of psychology measures to control people's minds usually occur in ponzi scheme, it is worth studied because from past to 21<sup>st</sup> century, ponzi scheme is developing and endangering increasing amount of people. Ponzi schemes in nowadays become more advanced and long lasting due to the development in social network. The paper (Junru Lv, 2018) analyzed the influences of Internet on Ponzi schemes. Differences also appeared in Ponzi schemes based on different regions because of their own development. We believe in the future, when social networks are more developed, numbers of Ponzi scheme will not diminish but to increase. The aim of the article is to analyze the change of Ponzi schemes through out history and compare the difference between Ponzi schemes in America and China.

The methods used in analysis, the results, conclusions and acknowledgments will be included in the past papers.

## **2 Method**

The paper is going to analyze the change in Ponzi schemes chronologically, then base on different regions. The below contents will firstly introduce the scheme briefly and then analyze the difference between Ponzi schemes through the method of committing the scheme, length of scheme, location, scale in financial loss and the unique characteristics of each scheme.

### **2.1 Chalres Ponzi**

Basic information: Charles Ponzi as mentioned above, was a swindler who was famous of his crime and had similar kind of fraud named after himself. He was born in Lugo, Italy, in a declining family, which was short in budget. After he graduated from University of Rome La Sapienza, he had become financially challenged, and his family encouraged him to migrate to America. On November 15, 1903, he arrived in Boston, with only 2 dollars. In the following four years, he could not find any office work, and kept doing ignoble works, in his own words.

#### *2.1.1 Method*

In the spring of 1919, Charles Ponzi quitted his job and rented an office, where he started the Charles Ponzi import and export corporation, with the aim to be an import and export agent

being paid with brokerage. Soon after, his business failed because no banks wanted to lend him money, until one day he accidentally got to know international reply coupon (IRC), which was put into envelopes to prepay the postage of the letter of reply. It could be exchanged for stamps or any other objects with equivalence price. Through calculation, Ponzi found out that through buying IRCs in countries with depreciation in their currencies, then exchanged these IRCs back in Boston post office, his rate of profit could reach 230% in maximum.

In the same year, he started his own company, “Securities Exchange Company”. Ponzi claimed that anyone who spent more than 10 dollars can have promissory notes from his company, and he would use these money to buy IRC. He promised his investors an interest rate at 50% in 90 days, his investors could gain 400% of revenue in one year. With a good marketing skill, Ponzi attracted his first few investors and pay them back after 45 days, from then on, more investors invested in his business.

However, Ponzi realized the impossible of the business soon after due to the limited supply in IRC. The profit generated by each IRC was around 2 cents, Ponzi had 5 million dollars in his account, which means he needed at least two and a half hundred million of IRCs to earn this money. But the fact is the supply of IRC was not matched to the growing demand, moreover, more Postal services in different countries had limited the supply of IRC when they found out there were people speculate on it. Ponzi did not stop after he saw the impossibility in his business, and kept attracting new investors and use their money to pay back the old investors, and thought about other ways to generate profits at the same time.

On August 12 of 1920, Charles Ponzi was arrested and his scheme finally came to an end.

The main reason for the collapse was that Clarence Boron, a financial journalist hired by the Boston Post (the daily newspaper in New England) , found out the amount of postal reply coupons in circulation within the country , was far beneath the amount that could generate such profits for Ponzi because Italy, France and Romania had quitted the Universal Postal Union , and also he was not budget well as he pretended because a record showed he borrowed \$250,000 from the Hanover Trust bank of Boston , which all raised suspicion from society (Charles Ponzi, 2009).

### *2.1.2 Time and Length*

Ponzi scheme committed by Charles Ponzi had lasted less than a year. Although he started the company in 1919, the fraud began from January to the August of 1920.

### *2.1.3 Location*

His scheme was firstly set in Boston, but then developed branches in America in Maine, New jersey and so on, his customers mainly came from America and Italy.

### *2.1.4 Scale in financial loss*

The Ponzi scheme led the Hanover Trust and other 5 banks into bankruptcy.

### *2.1.5 Characteristics*

1. The success of Ponzi's fraud was based on the good marketing skills used by Ponzi. He came from Italy, and then learnt English and several other languages, which made him accessible to investors from different countries. Charles Ponzi also mentioned in his autobiography that his early jobs made he learnt many skills in dealing with people and helped him in the marketing of his "IRC" business (Charles Ponzi, 2009).

Also Ponzi invited his old investors to become his sales agent and paid them with 10% of the deal made. He taught his agents that instead of using high-pressure sales tactics, they should not spread too much details, and only advertised the high rate of return and stated the business was legal.

2. There was no limitations for the investors of Ponzi's scheme. Any people with any jobs could invest in his business as long as they paid 10 dollars or more. Ponzi's clients varied from successful business man to police man, or even the one who polished shoes. This high acceptance of investors is very different from the Ponzi scheme committed by Bernie Madoff, which created a top grade image for his business and only accept investors with strong economic background.
3. The scheme promised a significantly high profit rate, which became the symbol of typical ponzi scheme. In order to prevent being suspected by general public, ponzi schemes afterwards usually do not promise a rate of return as uncommon as the initial scheme. For example, Bernard Madoff.

## 2.2 Bernie Madoff

Basic introduction: Bernie Madoff was a well-known wall-street business man. He was born in a Jewish family in February 24, 1938. After quitted the Brooklyn Law School, he started his business in Wall street with 5000 dollars earned from being lifeguard and installing sprinklers in parks. In 1960, He set up Bernard Madoff Investment Securities, and devoted in securities brokerage business. As the inventor of “Payment for order flow” system, he became the pioneer in the electronic processing of securities trading .The beginning few years had brought Bernard Madoff a good reputation and lots of respects. However, until 2008, he had run the longest and biggest Ponzi scheme in the history (Yaxiong Zhang, 2013).

### *2.2.1 Method*

The fraud committed by Madoff started from the Palm Beach Country Club, a rich-club located in one of the most famous Jewish society in America, which only accessed to the Jewish elites in different fields and had significant high limitation for entry. As a successful business men in Wall street , and with his rich history of donations, Madoff became one of the member of the club. Because of his good reputation, Madoff attracted many clients in short time, around 100 of the total 300 members in the club became his investors. Instead of advertised his business actively to others, Madoff used an other approach. If people wanted to become Madoff investors, the level of wealth was just part of the evaluation criteria, they also needed to ask Madoff ’s old investors or friends to introduce them to Madoff. Bernard Madoff promised a rate of return at 10% to 12% annually, whatever the economic background was of that year. He kept his promises and paid his investors with constant interests each year, for 20

years. However, there was always a rule to invest in Madoff 's business, that investors could not ask any question about the content of the business.

In 2008, during the world economic crisis, a client of Madoff wanted to redeem his 7 billion dollars investment back, which was the reason for the collapse of Madoff 's scheme because there was no such amount of money in the system at all and Madoff were already close to bankruptcy. In 9 December, 2008, Madoff decided to gave the bonus earlier, which raised some suspicion. In the following day, he finally admitted to his sons that he had run a Ponzi scheme for the last twenty years, and this was the end. On that day, Madoff 's son called the police and Madoff was arrested in the 11 December, 2008. Bernard Madoff was sentenced to jail for 150 years for his crime (Yaxiong Zhang, 2013).

### *2.2.2 Length*

20 years

### *2.2.3 Scale in financial loss*

The loss from the scheme was more than 50 billion dollars in total. The highest loss was from Kingate Management (3.5 billion dollars), following by Santander Central Hispano S.A. (3.1 billion dollars), and Tremont Hedge Fund (3.0 billion dollars) (Kun Liu, 2009).

### *2.2.4 Location*

America

### *2.2.5 Characteristic*

1. Bernie Madoff only accept investors with high economic status and refuse those who did not reach the level. This is different from the initial Ponzi scheme in which Ponzi put many efforts in to the marketing. This exclusiveness in the choice of investors created vanity among people, because entering the Madoff' s club became a symbol of social status. Thus the attitude of investors changed from worry to lose money to worry to fall behind. Madoff applied this psychology to their clients well and attracted not only large number of investors, and also large amount of investment by each person (Yuhua Cong, 2008).
2. Information asymmetry occurred in every Ponzi scheme but it was the most obvious in Madoff 's scheme. In the scheme committed by Charles Ponzi, investors were told that their money was used to invest in international reply coupons, however, Bernard Madoff refused to tell his investors any details or general facts about his business. Non of his investors knew where or in which field their money was invested. Madoff separated the assets management department and the administrative department on different floor in the company, and all documentaries about investment were "locked up" by Madoff, and only accessible to himself. The asymmetry in information did not reduced but increased the amount of investors because of their speculating mentality, that they were confident with their decision because almost all elites, involving the professionals in finance, had invested in Madoff' s business (Yaxiong Zhang, 2013; Lingling Mao, 2009).

3. Bernard Madoff was good at building his personal charm and forming a good reputation. Madoff was famous from his honesty in business, and he was seen as a symbol of fair dealing, and the pursuing of perfection. Furthermore, he was also a well known philanthropist, who had established his own foundation and funded many other institutions includes Chais Family Foundation and so on. Madoff 's foundation contributed to the Jewish society by building universities, theatres and supporting the art industry. All of his behaviors earned public's respects and trust, which made the basis of his fraud.
4. The annual rate of return that Bernard Madoff promised to his investors were 10% to 12%, which was much lower than the rate in general ponzi scheme, such as the initial ponzi scheme by Charles Ponzi, which promised a profit rate at 50% in 90 days. This strategy reduced the suspicious from the public.

## 2.3 Current Chinese Ponzi scheme

Basic introduction: The history of Ponzi schemes in China can be dated back in the 1900s, different from Ponzi schemes in America, Ponzi schemes in China developed in to two types, the southern and the northern scheme. The southern Ponzi scheme is the upgraded version of the northern, so the following analysis will introduce northern scheme briefly and focus on the southern scheme. The northern Ponzi scheme was originated from TianJin, such schemes are strongly related to violence and illegal acts other than financial fraud. The southern scheme is relatively new and developed version of the northern scheme, originated from GuangXi ,which do not limit their investors compulsively and use brainwash to convince their customers that

the business is totally legal, and makes them willing to invest (Hongpeng Guo, 2013).

### *2.3.1 Method*

The northern Ponzi scheme always pretend and advertised themselves to be a formal business, attracting customers or employers through fake information, and then sell products compulsively to generate profits. It involved restraint of personal liberty , and even threat to personal safety.

The southern Ponzi schemes do not sell any products, they called themselves “special project supporting by government”, use pure “capital operation ”and advertised a high rate of profit in the long run. The investors need to pay an amount of entry fee to join in the project, sometimes apart of the fee is returned to investors as rewards, which makes investors become more certain for their investment. Compare to the northern scheme , the southern scheme never use compulsive actions to restraints their consumers and give them high level of freedom, which is not what known to be as typical Ponzi scheme by the majority of people in China, making them more confident to invest.

Both southern and northern scheme functions by a system called “five levels and three promotion”, which is widely used in the financial industries, and is not illegal by itself. It introduced 5 levels and investors should been through 3 steps to be promoted from the lowest level to the highest level. The promotion is based on the number of people “dragged in” to the scheme, once a number is reached, the person can be promoted. This is how the ponzi scheme grow (Yongsheng Zhang, 2014).

### *2.3.2 Time and length*

Normally around 1 years

### *2.3.3 Location*

China

### *2.3.4 Scale*

The biggest scheme in China being recorded is “e-zubao”. The fraud involved a scale of 500 billion yuan and 900 thousands of victims (Chaofeng Jiang, 2016).

### *2.3.5 Characteristics*

1. Ponzi schemes in China showed a wide use of brainwash. Brainwash is the only thing that keep supporting the Chinese Ponzi scheme system running. Participants have classes together which covered from Chinese literature to knowledge of capital operation. Books with the contents of how capital operation contributes to country are sold in formal book stores, but the contents were made up by a large extent. The fact of nonfeasance of the police are used by the members in the scheme to attract new members. The argument stating “capital operation” to be legal becomes more persuasive to others when the police shows ignorance on their activities.

2. There are close connections between investors in Chinese Ponzi scheme. They live in the same place where they call “home”, and call other members “family”.
3. Chinese ponzi schemes are similar with the initial scheme committed by Ponzi in the way they attract new members in to the scheme through their old members advertising. However, the people they drag in to the system in Chinese ponzi schemes are mostly relatives and close friends. The organization often suggest their participants to use the money they earnt to buy cars instead of house, which can be seen by others easily, and attract more members.

### **3 Results**

Through researching in essays about ponzi scheme committed by Charles Ponzi, Bernard Madoff and the modern Ponzi schemes in China, the essay concluded the characteristics of each scheme and reached the results of the difference between the three types of scheme. The three types of scheme share some common characteristics: Firstly, marketing and advertising played important role in their business; Secondly, information asymmetry occurred between investors and the organizers to different extent in each scheme. However, changes and development can be seen from old schemes to new schemes in the skills of marketing and the way of operation. To begin with, in the initial ponzi scheme, Ponzi’s business was faced to the general public and everyone had the chance to invest in his business. Later on, the targeting group in Ponzi schemes became more specific. In Madoff scheme, Madoff investment was only accessible to people with high social status and personal wealth, and in Chinese ponzi

scheme, the investors being found were mostly the elderly with spare assets, people with low levels of education and poor people, who are all susceptible and impulsive, making the advertising process easier. Moreover, the utilization of people's mentality increased over time. In ponzi scheme committed by Charles Ponzi, investors were informed that their money were used in the investment of IRC. Although details of the business were not exposed, the nature of the business, which was speculation, was known by all. Thus it was reasonable for investors to believe in high revenue generated from such business. People invest money was simply because of the driving force of profit. In Madoff ' scheme, because of the high limitations in the qualification of investors, the aim of investing was also proving one's social status than earning profit. This is the unique tactic used by Barnard Madoff that cannot be copied easily by other fraudsters, because they do not have the high social status and interpersonal relationship with such kind of people. In modern Chinese ponzi schemes, a more extreme method , brainwash, is used. By teaching obscure knowledge of "capital operation" to people with zero economic study background, victims are easily persuaded to believe in the effectiveness of such system to generate profit. Furthermore, the ineffectiveness of relative policies and inefficiency of police force in striking such crimes make investors believe in the legitimacy of the business. However, the results the essay did not find is the impact of development in internet on the operation in Ponzi scheme, which was demonstrated in the paper (Junru Lv, 2018). The influences of each ponzi scheme on the political aspect in different regions are also not to be found in the essay . The results of the essay may help to identify the evolution of ponzi schemes during time and introduce the characteristics of ponzi schemes in different

regions.

## **4 Discussion**

There are limitations in the essay. The information of the method used by Charles Ponzi in committing fraud came from his autobiography, so the contents might not be fully true. There are limited amount of essays introducing the Chinese ponzi scheme, so the content may be lack of details and more research is needed to illustrates the method of operation of ponzi scheme in China. The scale of financial loss caused by each ponzi scheme may only be an approximate value, because loss from individual investors may not be concluded in the data. Some data were lost for the ponzi scheme by Charles Ponzi because of time. The essay cannot provide information for the use of internet in modern ponzi scheme and for the relative policies formulated to strike such fraud.

## **5 Conclusions**

In conclusion, the way of operation of ponzi scheme has diversified over time, and there were increasing use of psychology measures in the marketing of ponzi scheme over time. When ponzi scheme was initially used by Charles Ponzi, it promised a enormously high profit rate in short time, and pretend to generate profit from speculation of IRC. Charles Ponzi recruit his investors to advertised his business as the marketing strategy. In a modern ponzi scheme committed by Bernard Madoff, which was the longest and the largest ponzi scheme in history, people's speculating mentality and vanity was used to a large extent. With a good reputation

and high social status, Madoff himself acted as advertisement for his scheme. The level of information asymmetry in Madoff's scheme was also higher than in Ponzi's scheme. By contrast, in China, a more extreme method, brainwash, is widely used in ponzi scheme and sometimes personal safety of people is threatened by the scheme. The modern Chinese ponzi scheme advertised themselves as "pure capital operation", stated that they were different from ponzi scheme and was legal and supported by government. The achievements of the essay can be used to predict the future trend of ponzi scheme and gives some helpful information for the formulation of policies orients to ponzi scheme in different regions.

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