Warding off the Ponzi Trap: Eschewing the Quick Buck Promise that can Dupe You

Saloni Gupta

Associate Professor, Bharti College, University of Delhi, Delhi
Email Id: salonigupta0609@gmail.com

Abstract. A Ponzi scheme is an investment fraud that involves illegal, unregistered pooling of investment. Ponzi schemes are named after Charles Ponzi, an Italian who duped thousands of US investors in 1920s by promising to double their money in 90 days. The Ponzi operators entice investors by offering unusually high returns in a very short time or/& guaranteed returns consistently over a long period of time. Understanding how scam artists operate a Ponzi and ticking some basic check-boxes can help you to side-step the Ponzi trap, protect your hard money and reach your financial goals.

Keywords: Ponzi schemes, collective investment schemes

1 Introduction

'Ponzi'! Does this word ring a warning bell? It should, it must. In recent times, many instances of naïve investors getting duped by dubious investment schemes have come to light in India, bringing the menace of Ponzi schemes to the forefront. Lakhs of unsuspecting and hapless small investors lost their life's savings with the falling apart of the Saradha Group. The collapse of Saradha Group has revealed the archetypal tale of a money pooling scam in which the gullible investors are enticed to part with their hard earned money by luring them with the promise of exorbitant returns on their investment in a very short time. By all estimates, savings aggregating to more than Rs 4800 crore, collected by Saradha fraudsters from around 17 lakh customers by promising them returns as high as 24% annually, vanished in one of the biggest financial frauds in Indian history. In a classical play out of a Ponzi scheme, the Saradha Chit Fund scam was carried out using a complicated maze of 338 bank accounts and 224 companies that made up the Saradha Group and ran a wide variety of collective investment schemes (CIS) or chit fund throughout East India, especially in West Bengal, Odisha, Assam.

The scary news is that the Saradha scam is not a one-off case. There has been a spate of Ponzi scheme bust-ups in recent times. Speak Asia, a Ponzi scheme that made headlines a few

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years back promised that an initial investment of Rs 11,000 would grow into Rs 52,000 in a year's time i.e. @ 373% return in one year. Stock Guru, Rose Valley Hotels & Hospitality, Pearls Agrotech Corporation Ltd (PACL), Sahara Group etc are all part of the list of such dubious and fraudulent Ponzi-like investment schemes. Since May 2013, India's capital market regulator Securities and Exchange Board of India (SEBI) has launched crackdown against 47 illegal collective investment schemes, with funds totaling at least Rs 64,000 crores.

One can keep guessing as to how many others are still thriving, under **innovative new garbs like earning pyramids, plantations and orchards, time share holiday resorts, multi state cooperative credit societies** etc. They sell the fiction of some esoteric investment strategy generating exceptional returns to the gullible, and often greedy, investors. According to a recent report of the Financial Stability Board India is World's third largest growing market for 'shadow financing' i.e. financial/investment activity outside the banking system, after China and Argentina. Gullible investors become easy victims of shadow banking, read Ponzi schemes, because the interest rate offered by the formal banking system in India is abysmally low and doesn't even cover for inflation rate. "Where there is money, there are bound to be some sharks", the finance minister had observed in Lok Sabha in August 2014, while empowering SEBI with greater powers to regulate CISs where the amount involved is more than Rs 100 crore and to clampdown on unregistered/illegal money collecting schemes i.e. Ponzi schemes.

2. Decoding a Ponzi scheme

A Ponzi scheme is an investment fraud that involves illegal, unregistered pooling of investment. Ponzi schemes are named after Charles Ponzi, an Italian who duped thousands of US investors in 1920s by promising to double their money in 90 days. The Ponzi operators entice investors by offering unusually high returns in a very short time or/& guaranteed returns consistently over a long period of time. The fraudsters do not actually invest the money so pooled from gullible investors. Instead, they use it to pay a so called 'return' to those who invested earlier and siphoning off the rest for themselves.

A Ponzi scheme is based on the modality of paying the promised "return" (or even refund of principal) to the existing investors, from the funds contributed by (hopefully ever increasing number of) new investors and not out of profits. The operators take advantage of lack of investor knowledge or competence and solicit new investors by promising to invest funds in legitimate but unique business opportunities/ideas claimed to generate very high returns with little or no risk. They back their claims by delivering the promised returns to some of the early investors to create a false impression that investors are profiting from a legitimate business. In reality these returns are delivered not out of some genuine business profits but out of fresh pooling of investments from new investors. Invariably the fraudsters successfully convince the unsuspecting investors to leave their compounded money in the scheme itself, with promise of even higher return on ‘rolled-over’ investments. Thus the operators do not have to actually pay out much, they merely send the statements of how much the investors have earned (notionally!). This perpetuates the deception that the investment scheme is indeed a high return proposition. With very little or no legitimate investment and earning, Ponzi schemes collapse when it becomes difficult to solicit new investors or when a large number of investors wish to withdraw their money. The collapse causes turmoil as the fraudsters vanish with the money or at least the money belonging to hapless investors vanishes even if they are caught and jailed, as in the case of Sudipta Sen of Saradha scam or Subrata Roy Sahara of Sahara group case.

3. Warning signs

One has to be careful in order to ward off the Ponzi trap and to save oneself from being duped. There are some tell tale signs or the red flags to look for, while investing your hard earned money. Typically, a Ponzi scheme would promise returns that are too good to be true - beware of such lure and eschew such greed. The scamsters would use fancy phrases like ‘once in a life time opportunity’, ‘hedge funds opportunities’, ‘off-shore incredible gains’ etc, and would promise exceptional returns through complex and secretive strategies - don’t believe in them. In a Ponzi, the money is often transferred multiple times through multiple bank accounts and entities, sometimes involving overseas accounts, to hide the fraud from investors and authorities, so keep a tab on the trail of past investments before committing yours. The promise of ‘Guaranteed returns’ is another reason to be highly suspicious, because there’s no such thing! Ponzi schemes typically try to take advantage of regulatory loopholes and do not get themselves registered with regulators like SEBI, so ask for registration as this will provide you with access to key information about the company’s management, projects, finances etc. You can protect yourself from being a fraud victim. Understanding how scam artists operate a Ponzi and ticking some basic check-boxes can help you to side-step the Ponzi trap, protect your hard money and reach your financial goals.