

Ponzi or Pyramid Schemes

Source: <http://sci.tech-archive.net/Archive/sci.logic/2005-02/1861.html>

From: Immortalist (*Reanimater_2000_at_yahoo.com*)

Date: 02/23/05

Date: Wed, 23 Feb 2005 09:17:26 -0800

Ponzi or Pyramid Scheme
Charles Ponzi 1882-1949

Charles Ponzi managed to accrue an estimated \$15 million in 1920, with a mansion in Lexington to go with it, by persuading 40,000 Bostonians that he had discovered the secret of making easy money. Psychology, charm, and an indefatigable hunger to be rich were his business assets.

Sometimes called the Pyramid Scheme, or "borrowing from Peter to pay Paul," the game has many variations. In this case, Ponzi sold coupons that could be redeemed at a 50 percent profit in 90 days—and they were! As long as Ponzi could sell coupons to new investors to pay the previous group, the profits continued.

Stories about Ponzi and his financial wizardry were newspaper headlines during the summer of 1920. When the scheme was revealed, Bostonians stormed his office by the thousands to retrieve their money. Ponzi went to jail, tried another quick-money scheme in Florida, and went to jail again. He died penniless in a charity ward in Brazil. His bravado, style, and tireless efforts at amassing wealth led to the bestowal of his name on this form of fraud.

<http://www.innovationodyssey.com/ponzi.htm>

<http://www.mark-knutson.com/>

A pyramid scheme is a fraudulent system of making money which requires an endless stream of recruits for success. Recruits (a) give money to recruiters and (b) enlist fresh recruits to give them money.

A pyramid scheme is called a pyramid scheme because of the shape of a pyramid: a three dimensional triangle. If a pyramid were started by a human being at the top with just 10 people beneath him, and 100 beneath them, and 1000 beneath them, etc., the pyramid would involve everyone on earth in just ten layers of people with one con man on top. The human pyramid would be about 60 feet high and the bottom layer would have more than 4.5 billion people!

A diagram might help see this:

1
10
100
1,000
10,000
100,000
1,000,000
10,000,000
100,000,000
1,000,000,000
10,000,000,000

Thus, in very short order, 10 recruiting 10 and so on would reach 10 billion, well in excess of the earth's population. If the entire population of earth were 5 billion and we all got involved in a pyramid scheme, the bottom layer would consist of about 90 percent of the planet, i.e., about 4.5 billion people. Thus, for 500 million people to be WINNERS, 4.5 billion must be LOSERS.

In a straightforward pyramid scheme, a recruit is asked to give a sum of money, say \$100, to a recruiter. The new recruit then enlists, say, 10 more recruits, to give up \$100 each. In the simplest example, the recruiter keeps all the money he gets from his recruits. In our example, each recruit gives up \$100 in exchange for \$900 (\$100 from each of his 10 recruits minus the \$100 he gave his own recruiter). In order for no one to lose money, the recruiting must go on forever. On a planet with a limited number of people, even if the planet is as large as Earth and has almost 6 billion potential recruits, one runs out of new recruits rather quickly.

Thus, the result of all these schemes is inevitable: at best, a few people walk away with a lot of money, while most recruits lose whatever money they put into the scheme. In fact, the only way anybody can make money through a pyramid scheme or chain letter is if other people are defrauded into giving money upon a promise of getting something in return when it will be impossible for them to get anything at all in return. That is to say, in plain English, these schemes always constitute fraud. They use deception to get money. That is why they are illegal. They are not illegal because they involve recruiting people to recruit other people to recruit other people. That is perfectly legal and is done to some degree in many legitimate businesses. They are not illegal because they involve giving money to people. It is perfectly legal to give money to people. They are illegal because they involve deceiving people in order to get money from them: that is the legal meaning of fraud.

In actual fact, however, no pyramid scheme will ever work this way because the scheme will never get the number of recruits we've been speculating about. All pyramid schemes will begin to die when the later recruits don't sign on in numbers large enough to pay off the earlier recruits. There will always be enough people who will smell the scheme out. There will always be too many people who will say "if it sounds too good to be true that's probably because it is." There may even be a good number of people who will

sci.logic: Ponzi or Pyramid Schemes

realize that though one person recruiting ten doesn't sound like much, it quickly adds up to unrealistic and improbable numbers. Also, all it takes is one person to stop the whole thing, either by adamantly persuading recruiters of their indecency, or by reporting them to the police.

greed and wishful thinking

Pyramid schemes are popular because people are greedy and greed can do wonders to a person's thinking. For a person desiring to make a lot of money from a small investment in a short amount of time, wishful thinking often takes over where critical thinking should step in. Wishes become facts. Skeptics become idiots for not getting on board. Desires become reality. Asking questions seems rude and unfriendly. Scam artists know how greed works and all it takes is one con man to get the thing started.

With the odds so stacked against a person, why would one gamble on a pyramid scheme? Greed is only part of the answer. Most pyramid people don't envision themselves anywhere near the bottom layer of the pyramid. Even the most greedy person on the planet would probably see that if one is near the bottom layer of recruits it will be very hard to get new recruits. They have to see themselves near the top in order to envision the immense wealth from minimal effort that is going to come their way.

Furthermore, if I hope to get people involved in a pyramid scheme, the first thing I must do is convince them they are not getting involved in a pyramid scheme. They may know they are illegal. Or they may realize that pyramid schemes are a losing proposition for at least 90 percent of those who get involved. So, I tell them they are joining a club. I give the club a nice name such as The Friendly Investors Club (FIC). I reassure them that the FIC is approved by the IRS and run by a CPA with a Ph.D. who is not an ASS. If I'm really good, my recruits will believe me and the police officers, secretaries, teachers, ministers, etc. whom I recruit. These well-respected, intelligent, honest people will pass on this line to others. If I am really, really good, I will have convinced my recruits not only that they are getting into a legitimate and lucrative Club, but that any earnings are tax-free. I would indicate to recruits that as long as their take in the scheme is less than \$10,000, it wouldn't be taxable because gifts aren't taxable until they exceed \$10,000. I would convince the recruits that, for legal purposes, they would be giving money away and others would be giving money to them.

even the police like pyramid schemes

In 1995–96, at least 67 employees of the Sacramento Police Department, including 45 officers, were investigated for their alleged involvement in a pyramid scheme (Sacramento Bee 10/28/95, 11/1/95 and 11/15 & 16/96). The scheme was similar to five others that had been operating in southern California, also involving police officers and support staff. The main suspect in the Sacramento scheme was a police captain's wife. The chief of police said that he would try to fire at least seven officers and discipline 60 other police department employees. Nine officers were placed on

sci.logic: Ponzi or Pyramid Schemes

administrative leave and relieved of their guns and badges. According to a prosecutor, the scheme involved more than 200 people. However, only three of the accused faced criminal misdemeanor charges. Reportedly, some in the scheme made tens of thousands of dollars. The minimum amount lost by those who were on the bottom of the pyramid was \$500.

The police pyramid schemes are called "investment clubs" and have attractive names such as "The Friendship Investment Club" and "A Gift Network." They're sold to investors with the assurance that they are perfectly legal, approved by the IRS or a CPA, and that they definitely are not a pyramid scheme.

The Sacramento scheme was called The Freedom Club or something like that. And it was hyped by a police officer as being legal because it required people to sign a waiver claiming that they were making an unconditional gift to the Freedom Club. A local news reporter, Mike Boyd, asked an IRS agent if this waiver meant the Freedom Club wasn't a pyramid scheme. The IRS agent said that since the people who were signing the waiver expected to get back money for the money they were allegedly making a gift of, the money wasn't really a gift. An attorney, also interviewed by Boyd, agreed that just signing a paper saying you're making an unconditional gift didn't make it so if your intention was not to make an unconditional gift. (Receiving gifts, of course, is legal, and tax free.) The cops and their recruits for the Freedom Club put in at least \$500 each and expected something like \$4,000 in return for their phony gifts, according to Boyd. The Bee reported that sources told them that some Police Department personnel got more than \$10,000 out of the scheme. The WINNERS in the scheme got their money from "gifts" to the Freedom Club from those who later joined the Club. Such schemes continue, if the participants are not caught, until there are not enough new recruits to pay off the old ones. That is, they would continue until there were a good number of people who had "given" away \$500 and got nothing in return because the scheme folded. The scheme would have to fold eventually, because there can't be an endless stream of recruits.

The Sacramento Police Pyramid scheme involved what we might call "pyramid pods". An organizer (Numero Uno) would start the pod by getting six others to join as organizers. Presumably, the six would be ranked depending on when they were recruited. The organizers pay nothing to join the pod but together they must recruit enough people into the pod to buy eight spots at the bottom of their pyramid. Each spot costs \$500. Numero Uno pockets the \$4,000. The pod splits into two pods of seven people (or spots) each, with a new Numero Uno in each pod (and a new number 2, 3, 4, 5, 6 and 7). Each pyramid pod recruits more people at \$500 for each of eight spots in the pyramid. The two new Numero Unos take their \$4,000 each and the two pods split into 4 pods and those 4 into 16, ad infinitum. To make even more money, some joined more than one pod.

How many in this scheme told the new recruits that 6.7% of those who join will get a 700% return on their investment (\$3,500 on a \$500 investment) as long as 93.3% get nothing? How many advised their recruits to "get in early"?

sci.logic: Ponzi or Pyramid Schemes

To have police involved adds a special dimension to this pyramid scheme because (a) officers have ranks and can use their rank for recruiting leverage over those beneath them; (b) officers and ex-officers have positions of authority and trust which will influence potential recruits, especially young people; and (c) police personnel are supposed to enforce the law; when the law enforcers become lawbreakers and encourage others to break the law for monetary gain, respect for law and law officers diminishes.

chain letters

In the money chain letter, the recruiter sends the new recruits a letter with a list of names on it, including the recruiter's name at the bottom of the list. The recruits are asked to send money to the person whose name is at the top of the list and to add his or her name to the bottom. Money is made solely by getting new recruits to join the chain, adding their names to the list and recruiting others to do the same. In theory, eventually each recruit's name will be at the top of millions of lists and receive millions of dollars. In practice, most people will receive nothing. Anyone can break the chain, thus depriving all those on the list of any possible "earnings." But, even if no one broke the chain, 95% of those who sent money out will get nothing in return.

If pyramid schemes are a bad investment, how about chain letters? The principle is basically the same, except that with chain letters, you don't have to deceive yourself as much as with pyramid schemes. You probably know up front that the scheme depends on duping friends into giving money to strangers in exchange for the promise of riches coming to you later on from other strangers. You get a letter with a list of names on it. You are told to send money to the name at the top, delete that name and add your name to the bottom, and recruit 5 or 10 people to do the same by sending them the letter with your name at the bottom.

Ponzi schemes

A Ponzi scheme, named after Charles Ponzi who defrauded people in the 1920s using the method, involves getting people to invest in something for a guaranteed rate of return and using the money of later investors to pay off the earlier ones. Who will make money from such a scheme? Those who start it and those who get in early. Does anyone really make money from these schemes. They must, or they would have died off long ago. How? If I start the scheme, I just skim off the top and pay off enough people to make it look like it's working, even if that means buying in again at the bottom. I might even be stupid enough to think that I can keep the scheme going when the recruiting has dried up. I can try to get money quickly by some other scheme. For example, I can take a big chunk of money and go to Las Vegas and hope to hit it big. This happened to a fellow I played Little League Baseball with long before we both grew up. He took his investors' money to the craps table where he "invested" their funds. Unfortunately, his "investments" didn't pay off and he went to prison.

sci.logic: Ponzi or Pyramid Schemes

I don't know how many people lost money "investing" in my Little League buddy's scheme, but it could not have been as bad as what happened in Romania in 1993 or what happened in Albania in 1997.* In both cases, thousands of people with little opportunity for investment of capital were swindled by pyramid scheme operators. Romania's newspapers claimed that millions of Romanians lost their life savings in a scheme called Caritas. Reports from Albania claim that hundreds of thousands of Albanians "have invested their life savings or money they earned working abroad" in one of several outlawed pyramid schemes. "The schemes offered very high interest rates, with the first investors paid from later investors' deposits. They eventually failed when no new investors came in" ("Investment–scam protest turns violent in Albania," by Merita Dhimgjoka, Sacramento Bee, Feb. 6, 1977). Any such scheme is doomed to fail because there cannot be an endless line of "investors." Only greed and self–deception are endless.

<http://skepdic.com/pyramid.html>

<http://members.impulse.net/~thebob/Pyramid.html>

<http://www.mlmstartup.com/articles/ponzi.htm>

<http://crime.about.com/od/scams/qt/pyramid.htm>

<http://www.ftc.gov/speeches/other/dvimf16.htm>

<http://www.investopedia.com/university/scams/scams1.asp>

<http://www.investopedia.com/university/scams/scams2.asp>

<http://www.socialsecurity.org/daily/05-11-99.html>