Investment Contracts, Ponzi and Pyramid Schemes

We all make investments in our daily lives and each investment is made with an expectation to derive some benefit. We invest in ourselves through education and learning with the hope that our job prospects and consequent earning potential would improve. We invest in a car, land and a house to satisfy our basic need for shelter and safety, and with it a sense of comfort and independence. We invest in our children to ensure they have a solid future.

It is clear that investments take many forms, thus the reason why securities related investor protection is one of the main responsibilities of the Trinidad and Tobago Securities and Exchange Commission (TTSEC). The Securities Act 2012 (SA2012) is an Act to provide protection to investors from unfair, improper or fraudulent practices; foster fair and efficient securities markets and confidence in the securities industry in Trinidad and Tobago, and to reduce systemic risk. One of the ways in which the TTSEC protects investors is through investor education where investors, as well as, potential investors can increase their knowledge and understanding of financial investment products and service providers. Therefore, in this week's article, we will be looking at what is an investment contract and assess two types of popular scams known as Ponzi Schemes and Pyramid Schemes.

What is an Investment Contract?

A monetary investment is normally an asset or item acquired with the goal of generating profit/income or future appreciation in value. Investors utilise their money to purchase these assets with the hope that some benefit can be derived in the future. The transaction between the buyer and seller of the investment will take the form of an investment contract. According to the SA2012, an Investment Contract includes any contract, transaction, plan, scheme, instrument or writing, whereby a person invests money or other property in a common enterprise with the expectation of profit or gain based on the expertise, management or effort of others, and such money or other property is subject to the risks of the common enterprise. The SA2012 also states that an investment contract is a security and all securities must be registered with the TTSEC.

What is a Ponzi Scheme?

Ponzi schemes are named after Charles Ponzi, who deceived thousands of New England residents into investing in a postage stamp speculation scheme back in the 1920s. At a time when the annual interest rate for bank accounts was five percent, Ponzi promised investors that he could provide a 50% return in just 90 days. Ponzi initially bought a small number of

international mail coupons in support of his scheme, but quickly switched to using incoming funds from new investors to pay purported returns to earlier investors.

According to the United States Securities and Exchange Commission (USSEC), a Ponzi scheme is an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors. Ponzi scheme organizers often solicit new investors by promising to invest funds in opportunities which are purported to generate high returns with little or no risk.

In many Ponzi schemes, the fraudsters focus on attracting new money to make promised payments to earlier-stage investors to create the false appearance that investors are profiting from a legitimate business. With little or no legitimate earnings, Ponzi schemes require a consistent flow of money from new investors to continue. *This is a scam and it is not sustainable as money is collected from one person to pay another person. There is no underlying investment product.* Ponzi schemes collapse when it becomes difficult to recruit new investors or when a large number of investors ask to cash out.

Some features of Ponzi schemes include:

- High investment returns with little or no risk;
- Overly consistent returns;
- Unregistered investments;
- Unlicensed sellers;
- Secretive and/or complex strategies;
- Lack of or issues with paperwork; and
- Difficulty receiving payments.

What is a Pyramid Scheme?

The USSEC defines a pyramid scheme, as an investment fraud in which new participants' fees are typically used to pay money to existing participants for recruiting new members. All pyramid schemes eventually collapse, and most investors lose their money. Some characteristics of a pyramid scheme include:

- The requirement to enlist a stated number of persons in order to receive a payment;
- No genuine product or service is sold;
- Promise of high returns in a short period of time;
- Promoted as easy money or passive income;
- No demonstrated revenue from retail sales;
- Buy-in required;
- Complex commission structure; and
- Emphasis on recruiting.

Why are Ponzi and Pyramid Schemes Deemed Illegal?

Ponzi and pyramid schemes are closely related because they both involve paying longer-standing members with money from new participants, instead of actual profits from investing or selling products to the public. These schemes are considered to be an illegal business practice in which new participants' money is used to make payments to earlier members. A typical investment scam raises money and disappears. However, the Ponzi or Pyramid scheme stays in business by circulating investor funds over and over. This may give it the appearance of being a legitimate investment, however, there is no meaningful investments taking place. Most of the funds obtained by sellers/distributors of these schemes are used to maintain their own expensive lifestyles and transferred into property or offshore accounts. It never ends well and people always lose their hard-earned money.

Take the time to understand what you are investing in before you part with your money. Know the "ABCs" of investing. **Ask Questions**, **Beware of Investment Fraud** and **Check with the TTSEC** to ensure the investment, the investment representative or adviser is registered.

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