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Market Bulls Fertilize Soil for Ponzi Schemes: Corporate Finance Attorney Laura Anthony Explains

There's an old adage in the financial industry: "In an up market, everyone is a genius." The saying is dated and a bit cynical, but everyone still understands the message. The problem is that it simply isn't true. It should more accurately be phrased: "In an up market, everyone thinks they can't be taken."

There's one particular hazard that rears its head in a bull market: financial scalawags take advantage of the over-eager investment public and pitch an array of bogus financial instruments. Ultimately, whether it's life insurance policies that have been bundled or foreign government backed bonds, it all comes down to the Ponzi.

A Little Man from Lugo, Italy

In 1919 Carlo Pietro Giovanni Guglielmo Tebaldo Ponzi, known more commonly as Charles Ponzi, recognized a disparity in the way that international postal reply coupons (IRCs) were bought, sold and redeemed. He was small in stature but big in terms of ingenuity.

The concept was simple. Someone in one country could write a letter to someone in another country and include an IRC in the envelope. The recipient could then use the IRC to pay for the postage needed in order to write a letter back to their overseas pen pal.

IRCs were priced at the cost of postage in the country of purchase, but could be exchanged for stamps to cover the cost of postage in the country where redeemed; if these values were different, there was a potential profit. Inflation after World War I had greatly decreased the cost of postage in Italy expressed in U.S. dollars, so that an IRC could be bought cheaply in Italy and exchanged for U.S. stamps of higher value, which could then be sold.

The pricing disparity in postage was a crude form of an arbitrage, something that is and was completely legal. Ponzi decided to capitalize on this pricing disparity by creating a financial instrument that could easily be sold to investors – something that everyone could understand that generated a return that no one could ignore. He approached several of his friends in Boston and promised that he would double their investment in 90 days. He later shortened this to 45 days at 50% interest, thus doubling investments in three months. This original investment group was paid as promised. There would be little actual selling on the horizon for Ponzi; this type of thing sells itself.

Almost exactly to the day that the Roaring Twenties kicked off, Ponzi founded his own financial firm, the Securities Exchange Company. Investors flocked to his door, millions of dollars poured in and Ponzi quickly became the talk of the town.

The problem was that there were not nearly enough IRCs in circulation to account for all of the money that Ponzi took in from investors. To cover this deficiency, Ponzi simply paid profits to existing investors from the proceeds raised from new investors.

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Bull Markets Fuel Ponzi Schemes

Charles Ponzi's scheme lasted for more than a year before it collapsed; investors lost approximately $20 million, or about $250 million in today's dollars. His scheme was so innovative and malignantly lucrative that the name Ponzi would be immortalized.

About the same time that Ponzi was making money (for himself) by the wheelbarrow, the Dow Jones Industrial Average was a bottle rocket, soaring 329% until the great crash, Black Tuesday, in October of 1929.

The disparity in IRC pricing only provided Ponzi an angle; it was the environment that made his plan work. Investor confidence was so high that investors shed any healthy degree of skepticism and charged headlong into many unscrupulous investment opportunities as long as the story was simple and the person telling it had confidence – hence the term "con." Like most great con games, Ponzi's IRC pitch instilled urgency in potential investors: get in now while there is still enough to go around.

When an investor comes to believe that they have the chance to get over on someone else and the entire thing is perfectly legal, they are the ones about to be taken for a hard ride.

Investor confidence is currently through the roof, or more accurately, through the stratosphere. The indexes are repeatedly setting record highs and so are Ponzi schemes. Authorities uncovered 60 alleged Ponzi schemes last year with a total $3.25 billion in investor funds in play. This is the greatest amount of money invested into Ponzi schemes since the Great Recession of 2008.

The Bernie Madoff story has been told far too many times so it is unnecessary to rehash the minutiae. However, the environment that Madoff exploited is the very same one that currently exists.

Whether the public markets are soaring or languishing, there is never an appropriate time for the investment public to drop their guard. A little cynicism keeps everyone on their toes, and it is imperative that retail and institutional investors alike look up from their screen from time to time to survey the lay of the land. When the forest can no longer be seen through the trees, odds are danger is lurking. If they fail to mind their footing because screen blindness has set in, then they are bound to stumble.

Ponzi's contemporaries are more sophisticated and better equipped to appropriate an abundance of precious capital. They are more strategically astute, strike hard and fast, and can disappear overnight. In the event that the perpetrator is apprehended, the majority, if not all, of their ill-gotten gains are almost always gone.

This type of wisdom is not easily imparted on investors until after they suffer a catastrophic loss, but it's still worth a try. For lack of a better analogy, if ten people walk into a casino and saw that every last slot machine was paying, nine of them would start pouring money into the machines. Maybe one of them would remember that they were still in a casino and that the house always wins.

This is not to say that we are headed toward some sort of investment Armageddon and that investors should become paralyzed with paranoia, but the fundamental due diligence should never be ignored when assessing the credibility of financial instruments and the people who operate them.

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Securities attorney Laura Anthony is the founding partner of Anthony L.G., PLLC, a corporate and securities law firm based in West Palm Beach, Florida. Her firm represents private and publicly traded companies, and coordinates a wide variety of corporate transactions, due diligence matters and going public transactions.

On a personal level, Ms. Anthony resides in Palm Beach, a town hit particularly hard by the Bernie Madoff scandal. Madoff maintained a residence in Palm Beach, was a member of the Palm Beach Country Club, and many elite locals invested heavily in Madoff's wealth management program.

"People were simply incredulous upon learning that the money they had invested with Madoff was gone," Ms. Anthony said. "Initially there was disbelief and outright denial. People believed that one way or another, the whole thing would get sorted out and they would retrieve their money. Unfortunately, this never happened. Madoff's local investors were very astute and financially sophisticated people. Some families lost the majority of their net worth. Local art stores were flooded with multimillion-dollar paintings and jewelry stores suddenly became top-heavy with inventory. People liquidated a staggering amount of luxuries just so they could pay for necessities. It was nothing short of a nightmare."

A prolonged bull market incentivizes and emboldens new Ponzi pirates, but even when the market cools these charlatans will persist. Federal regulators will continue to use every asset at their disposal to identify and sideline Ponzi perps but investors must assume the responsibility of being smarter than the bad guys. Astute investors may not be able to stop the next Charles Ponzi or Bernie Madoff, but they can certainly make their duplicitous endeavors far more difficult to execute.

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Palm Beach securities attorney Laura Anthony and her experienced legal team provide ongoing corporate counsel to small and mid-size private companies, OTC and exchange traded public companies as well as private companies going public on the Nasdaq, NYSE American or over-the-counter market, such as the OTCQB and OTCQX. For more than two decades Anthony L.G., PLLC has served clients providing fast, personalized, cutting-edge legal service. The firm's focus includes, but is not limited to Regulation D and Regulation S and PIPE Transactions, securities token offerings and initial coin offerings, Regulation A/A+ offerings, as well as registration statements on Forms S-1, S-3, S-8 and merger registrations on Form S-4; compliance with the Securities Exchange Act of 1934, including registration on Form 10, reporting on Forms 10-Q, 10-K and 8-K, and 14C Information and 14A Proxy Statements; all forms of going public transactions; mergers and acquisitions including both reverse mergers and forward mergers; applications to and compliance with the corporate governance requirements of securities exchanges including Nasdaq and NYSE American. Palm Beach attorney Laura Anthony is also the author of SecuritiesLawBlog.com, the producer and host of LawCast.com, Corporate Finance in Focus, and a contributor to The Huffington Post and Law360.

Ms. Anthony is involved throughout the community of Palm Beach. She is on the board of directors for the American Red Cross for Palm Beach and Martin Counties, and provides financial support to the Susan Komen Foundation, Opportunity, Inc., New Hope Charities, the Society of the Four Arts, the Norton Museum of Art, Palm Beach County Zoo Society, the Kravis Center for the Performing Arts and several other organizations. She is also a financial and hands-on supporter of Palm Beach Day Academy, one of Palm Beach's oldest and most respected educational institutions. She currently resides in Palm Beach with her husband and daughter.

Ms. Anthony is an honors graduate from Florida State University College of Law and has been practicing law since 1993.

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