

# PONZI SCHEMES: CHARACTERISTICS AND RECOMMENDATIONS TO PROTECT INVESTING UGANDANS

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## 1.0 Background

A government has a mandate to protect her citizenry from crime including all forms of economic crime. Economic crime, also known as financial crime, refers to illegal acts committed by an individual or a group of individuals to obtain a financial or professional advantage.<sup>1</sup> In the Annual Crime Report 2020, the Uganda Police Force reported that a total of 10,057 cases were reported in reference to Economic Crimes (representing 5.1% of all the crimes reported) compared to 13,264 cases in 2019.<sup>2</sup> Obtaining gain by false pretenses, which is often termed as fraud, accounted for 8,096 cases, which is equivalent to 80% of the reported economic crimes.

The principal motive of economic crimes is economic gain. It can metamorphose into various forms that include, but are not limited to, the following: investment fraud, mass-marketing (telephone calls, social media, and internet), insurance fraud, procurement rigging. With respect to investment fraud, the most common fraud schemes in Uganda include ponzi schemes and the pyramid schemes (that are similar but structurally different from the Ponzi schemes). In May 2021, the Criminal Investigations Directorate (CID) at the Uganda Police commissioned an investigation into an alleged fraud where Ugandans purportedly lost more than 34bn in fake savings and investments.<sup>3</sup>

In a bid to protect her citizenry from fraudulent securities offerings and unregulated investment schemes, governments develop regulatory frameworks to provide basic guidance to business owners and issuers of securities, intermediaries and investors on each of their roles. When left unchecked, fraud schemes such as ponzi schemes can cause economic and institutional damage, undermining the confidence in financial institutions. In Albania, upon the collapse of several Ponzi schemes in 1996, the people took to the

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<sup>1</sup> <https://www.europol.europa.eu/crime-areas-and-statistics/crime-areas/economic-crime>

<sup>2</sup> <https://www.upf.go.ug/wp-content/uploads/2021/04/ANNUAL-CRIME-REPORT-2020-1.pdf?x74136>

<sup>3</sup> <https://www.newvision.co.ug/articledetails/101767>

streets, riots grew uncontrollably, the government collapsed and the country went into anarchy.<sup>4</sup>

The purpose of this note is to understand Ponzi schemes, determine their characteristics, make a jurisdictional comparison of regulators dealing with ponzi schemes to inform the case of Uganda.

## 2.1 Definition of Ponzi Schemes

Ponzi schemes are named after Boston con man Charles Ponzi, who perpetrated a fraudulent investment scheme that collapsed in 1920. Ponzi schemes can be defined as investment fraud in which returns are paid to investors out of the money paid in by subsequent investors rather than from genuine returns generated by an investment or business activity. On the other hand, Pyramid schemes are an investment fraud in which participants profit almost exclusively through recruiting other people to participate in the program.

## 2.2 Characteristics of Ponzi Schemes

Most of the Ponzi schemes globally share common characteristics. These include, but are not limited by, the following;

- a) Ponzi schemes generally lure investors by offering higher returns, with limited or no risk, than any legitimate business activity could plausibly sustain.
- b) Ponzi schemes usually attract new investments at an exponentially high growing rate through immense and extensive advertising to sustain payments to existing investors. Ponzi schemes inevitably collapse when the new investment needed to pay existing investors in the scheme exceeds payments by new investors into the scheme. At that point, most investors lose most or all of their investment, while early investors including the scheme's founders may have obtained high returns.

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<sup>4</sup> Ponzi Schemes in the Caribbean, IMF Working Paper

- c) Unregistered investments-ponzi schemes typically involve investments that are not registered with any regulator. Registration is important because it provides investors with access to information about the company's management, products, services, and finances.<sup>5</sup>
- d) Unlicensed sellers-regulators, globally, require investment professionals and firms to be licensed or registered. Ponzi schemes usually employ unlicensed individuals or unregistered firms.<sup>6</sup>
- e) Ponzi schemes are insolvent from the moment that they take in money from investors. Their liabilities to investors exceed their assets as the value of liabilities increases at the inflated rate of return, while assets may be depleted by the running costs of the scheme or possibly suffer from other deprecations.<sup>7</sup>

The experiences of different countries show that the exponential growth rate needed to sustain schemes can lead to large-scale economic and institutional damage. The negative consequences include:

- a) Undermining **confidence** in **financial markets**-the financial markets ecosystem is heavily hinged on trust for settlement and investment. Financial crime not only erodes savings but also, weakens regulation meant to protect investors within the financial markets.
- b) Diverting **savings** from **productive** to **unproductive** uses and, in some cases, from the domestic economy to foreign destinations, with a balance of payments impact. In 2021, a retired commissioner is said to have lost over Ugx 700 million in a Ponzi scheme. He invested his gratuity that amounted to Ugx 300m. He later sold his house at 1.7 billion and invested an extra 400m with Global Digital Currency.<sup>8</sup>

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<sup>5</sup> <https://www.investor.gov/protect-your-investments/fraud/types-fraud/ponzi-scheme>

<sup>6</sup> <https://www.investor.gov/protect-your-investments/fraud/types-fraud/ponzi-scheme>

<sup>7</sup> IMF Working Papers on Ponzi Schemes in the Caribbean, 2009

<sup>8</sup> <https://www.newvision.co.ug/articledetails/101767>

- c) Diverting **deposits** from **banks** and increasing **non-performing loans** if loan proceeds were diverted into schemes; In May 2021, a scheme that was established in Kenya fleeced thousands of their savings including an individual who reported that he had borrowed money to invest in the scam before he was defrauded.<sup>9</sup>
- d) Undermining the **reputation** of **political authorities, regulators, and law enforcers** for failing to: prevent open fraud; address money laundering; curb illegal enterprises by schemes' operators.

In analyzing the Ponzi Schemes in the Caribbean, the IMF notes that:

Controlling and closing down ponzi schemes is often difficult for a variety of reasons. In many cases, neither the perpetrators nor the schemes themselves are licensed or regulated, thus making it more difficult for them to appear on the radar of regulators. In addition, in many countries, regulators have not been able to detect and shut down unregulated investment schemes (UIS) at an early stage.<sup>10</sup>

The IMF further notes that:

Once ponzi schemes become large, the authorities may become increasingly reluctant to trigger their collapse. If government authorities close or suspend a scheme—curtailing its ability to meet cash flow obligations—subscribers could blame the government's intervention rather than the scheme's inherent flaws. However, even when the schemes collapse by themselves, the experience shows that governments may also face criticism for failing to act more promptly. Interestingly, many scheme operators have managed to extend their operations by ostentatious charitable contributions, significant political contributions, and pretentious demonstrations of their own or their scheme's wealth. Prior to collapse, operators may be regarded as pillars of their communities.<sup>11</sup>

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<sup>9</sup> <https://allafrica.com/stories/202105170964.html>

<sup>10</sup> IMF Working Papers on Ponzi Schemes in the Caribbean, 2009

<sup>11</sup> IMF Working Papers on Ponzi Schemes in the Caribbean, 2009

### 3.0 Jurisdictional Comparisons on Responsible Regulators for Ponzi Schemes

Various countries make an effort to put in place regulations, rules and guidelines to help protect her citizenry from the enticement of fraudsters and operators of Ponzi schemes.

Table 1 below details the country, the Regulatory Agency responsible for enforcing and protecting investors, and the regulation supporting the enforcement.

**Table 1: Summary jurisdictional Comparison on Responsible Regulators for Ponzi Schemes**

COUNTRY	RESPONSIBLE REGULATORY AGENCY
Kenya	<ol style="list-style-type: none"> <li>1. Capital Market Fraud Investigations Unit (CMFIU) collaboration by the Kenya Police and Capital Markets Authority (CMA)</li> <li>2. Banking Fraud Investigation Unit (Central Bank of Kenya)</li> </ol>
United States of America	<ol style="list-style-type: none"> <li>1. Securities Investor Protection Corporation</li> <li>2. United States Securities and Exchange Commission</li> </ol>
South Africa	Financial Sector Conduct Authority
Nigeria	Securities Exchange Commission
Namibia	<ol style="list-style-type: none"> <li>1. Namibia Financial Institutions Supervisory Authority (NAMFISA)</li> <li>2. Bank of Namibia</li> <li>3. Financial Intelligence Centre.</li> </ol>
Botswana	<ol style="list-style-type: none"> <li>1. Competition and Consumer Authority</li> <li>2. Bank of Botswana</li> <li>3. Non-Bank Financial Institutions Regulatory Authority</li> </ol>
Zambia	<ol style="list-style-type: none"> <li>1. Bank of Zambia</li> <li>2. Securities Exchange Commission</li> <li>3. Competition and Consumer Protection Commission</li> </ol>
Zimbabwe	<ol style="list-style-type: none"> <li>1. Reserve Bank of Zimbabwe</li> <li>2. Securities and Exchange Commission of Zimbabwe (SecZim)</li> </ol>

*Source: CMA RMD Department*

A review of regulatory agencies charged with combating ponzi schemes indicates that in most jurisdictions, activities aimed at preventing Ponzi related fraud cuts across different regulators. This is due to the recognition of the fact that Ponzi schemes are multi-faceted in nature, coming in different forms, shapes and approaches. Some Ponzi schemes products are sold as foreign exchange products (which is within the central bank realm), securities investments (securities regulators), part of the payment system (such as crypto-currencies), insurance products or savings cooperative products.

In jurisdictions such as Zambia and Botswana, consumer protection regulators have been roped, in as protection of the public from fraud is part of the mandate of such regulators. Anti-money laundering agencies are also co-opted in countries such as Namibia, indicative of the money laundering aspects of Ponzi schemes.

Central Banks and securities regulators in countries such as Kenya, Zambia, Namibia and Zimbabwe have a role to play in dealing with Ponzi schemes. Majority of Ponzi schemes are sold as investment products with characteristics of the banking sector or securities industry.

#### **4.0 Conclusion and recommendations for the Capital Markets Authority Uganda**

The key recommendations for Uganda include the following:

1. Amend the laws of regulators in the financial sector that include the Bank of Uganda, Capital Markets Authority, Insurance Regulatory Authority and Uganda Retirement Benefits Regulatory Authority to enable the regulators deal with Ponzi Schemes under their respective sub-sector. The laws should allow for criminalization and prosecution of any form of fraud within the mandates of the respective regulator.
2. Empower and train the staff of the respective regulators to look out for any forms of fraudulent Ponzi schemes within the mandates of their regulatory jurisdiction.