Crypto as a Ponzi Scheme: You Don't Know the Half of It

Greg Baer | July 5, 2022

They say that history doesn't repeat but it does rhyme. Reading a wonderful biography of Charles Ponzi and They say that history doesn't repeat but it does rhyme. Reading a wonderful biography of Charles Ponzi and comparing it to today's crypto headlines would make Stephen Sondheim blush. See below a comparison of Ponzi's adventures in the early 1920s and the work of today's crypto bros.

The Pitch. Ponzi offered investors a promissory note maturing in 45 days with a guaranteed return of 50 percent. He promised to generate those returns through arbitrage trading in something called an International Reply Coupon. Those Coupons were created as a global stamp to make it easier to send mail across borders. The Coupons traded at fixed exchange rates to the currency of each of the 62 participating countries.

Ponzi's idea was to look for countries whose currencies had depreciated relative to the dollar in the post-WWI period – for example, Spain. So, in that case, he would use dollars to buy pesetas; use the pesetas to buy Coupons at a fixed exchange rate that overstated the value of the peseta and produced a lot of Coupons; and then cash in those Coupons in the United States for stamps, which he could convert to dollars. In the process, he would effectively earn a spread equal to the difference between the actual and fixed exchange rate on the peseta.

In sum, he proposed to engage in an arbitrage trade among a variety of instruments, while creating no underlying value.

> ***Celsius Customers Are Losing Hope for Their Locked-Up Crypto***
> *By Vicky Ge Huang, Wall Street Journal – July 3, 2022*
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> *It has been three weeks since crypto lender Celsius Network LLC took the drastic step of halting customers' withdrawals. Many people are starting to wonder if they will ever see their money again.*
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> *****
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> *The crypto market is crashing, and the resulting credit crunch is pummeling small-time traders and big-name companies. At least four other crypto firms—Babel Finance, CoinFlex, Voyager Digital Ltd. and Finblox—have told customers that they can't withdraw their money or capped the amount they can take out.*
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> *Crypto companies like Celsius have sprung up in recent years to offer services that seem like traditional banking tasks, like paying interest on deposits and making loans. They often offer eye-popping interest rates on deposits, sometimes near 20%.*

The Backup Plan. In reality, Ponzi never actually bought any stamps, recognizing that he could never do so in sufficient volume to repay the tens of millions of dollars in investments he received, and also because there actually is no practical way to exchange U.S. stamps for U.S. dollars. (For that reason, a "Ponzi scheme" is not synonymous with clever stamp trading but rather using the money from new investors to repay maturing obligations from earlier investors.)

So, he looked for another way to generate returns, and conceal his losses. To this end, he bought a bank, Hanover Trust, and took actions to take control of others.

In the end, Hanover Trust failed. Its failure triggered a run on other Boston banks, and three more failed in short order.

> ***Bill to Grant Crypto Firms Access to Federal Reserve Alarms Experts***
> *By Tory Newmyer, Washington Post – July 3, 2022*
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> *A wave of notoriously risky cryptocurrency firms could one day be integrated into the traditional banking system under a little-noticed provision in a new bill that is raising alarms among financial experts about potentially destabilizing consequences.*
>
> *The provision … would force the Federal Reserve to grant so-called master accounts to certain crypto firms seeking them from the central bank.*

But… Banks Are Bad. Showing a capacity for hypocrisy, closet banker Ponzi delighted in comparing the 50 percent returns on his notes to the paltry 5 percent returns then being paid by banks.

Alas, Ponzi never thought to deride the holdings of banks as mere fiat currency.

AVOIDING THE LAW PART I

Ponzi benefited greatly from a jurisdictional dispute among the Massachusetts Attorney General, the U.S. Attorney, the Suffolk County District Attorney and the Massachusetts Banking Commissioner, which delayed any effective investigation while he continued to sell his notes.

Too easy….

(By the way, the name of Ponzi's company was the Securities Exchange Company, or SEC.)

AVOIDING THE LAW PART II

Ponzi also publicly invited investigation of his business, saying he had nothing to hide, and even agreed to host an independent investigator. He calculated that doing so would earn the trust of his investors and the broader public, and that any investigation would take a long time.

Hmmm….

Conspicuous Consumption as Marketing. To convey how successful he, and therefore his scheme, were, Ponzi purchased a Locomobile, the most luxurious and expensive car in the world, which cost $12,600 in 1920.

Of course.

CREDULITY IN THE FACE OF DOUBT

On July 26, 1920, the *Boston Post* published a devastating critique of Ponzi's scheme, written by journalist Clarence Walker Barron, the most respected financial journalist of the day. It explained how there were not enough stamps in the world to generate the returns he was claiming. The *Post* editors expected a run to commence on Ponzi the next day. Instead, "When Ponzi arrived at work [that] morning, School Street was teeming with people desperate to trust their money to the Securities Exchange Company. It was as if Barron had endorsed the idea as foolproof. The street was so jammed police closed it to traffic."

On April 25, 2022, Sam Bankman-Fried, owner of one of the world's largest cryptocurrency exchanges, spoke on the Bloomberg Odd Lots podcast:

> *In an attempt to explain how yield farming works, Bankman-Fried asks viewers to imagine a box. He says, "You start with a company that builds a box," and that the marketers of this box will attempt to sell it as some sort of world-changing protocol. He explains how you can put digital currencies like Ethereum into the box and get an IOU.*
>
> *The next step is for the developers to issue a token. Holders of said token will often have governance rights over what happens inside the box. For example, they might get to say what happens to the newly minted tokens that derive from the box. This token is then given away or purchased, giving it a larger market cap, causing other market participants to notice it and view it as valuable.*
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> *"I acknowledge that it's not totally clear that this thing should have a market cap, but empirically I claim it would have a market cap," Bankman-Fried pointed out.*
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> *The FTX boss then describes how the high returns derived from these boxes entice new speculators to put more money in. The fact that there's now a large amount of money in the box causes others to think it must be legitimate and to put more in. This can cause the token price to rise rapidly, and the whole process is amplified if the total number of tokens available is small.*
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> *Matt Levine intervenes at this point of the conversation, describing this as "cynical" and likening it to an outright Ponzi scheme. Bankman-Fried says that these boxes mostly value market participants' perception.*

And DeFi rolls on….

ENDORSEMENTS

Ponzi actively sought endorsements of his scheme by prominent Bostonians. On that Monday morning, the only cars allowed through the mob belonged to him and the Mayor of Boston.

Yes, Matt Damon, this means you.

Cooptation. To forestall unwelcome scrutiny, Ponzi made friends with the Boston Police Force, and nearly three quarters of the Force ended up investing with him.

Check.

Overseas. Ponzi was eventually deported to Italy in 1934, where he tried to swindle more people, to no avail.

Alas, the Cayman Islands did not obtain true independence until 1972.

HIS LEGACY

The SEC (the current one) provides the following definition on its Investor.gov website: "A Ponzi scheme is an investment fraud that pays existing investors with funds collected from new investors. Ponzi scheme organizers often promise to invest your money and generate high returns with little or no risk."

Wait, isn't that the Howey *test?*

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