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## FRAUDULENT SCHEMES IN THE FINANCIAL MARKET (FINANCIAL PYRAMIDS) – DETECTION AND PREVENTION<sup>1</sup>

### Abstract

This contribution deals with fraudulent schemes in the financial market. The main aim of the contribution is to provide main identifying features of fraudulent practices that prove to be a financial pyramid. The author summarizes in one place numerous features that indicate the financial pyramid (Ponzi scheme), especially operating on the financial or capital market. He concludes, the state of play of legislation regarding the features is insufficient. The hypothesis to confirm or disprove is there is no uniform legal provision covering all features of the pyramid scheme in Slovakia, the relevant legislation is limited to the prohibition of certain practices, which a priori may not constitute a pyramid scheme.

**Key words:** Ponzi scheme, financial pyramid, spontaneous Ponzi system, multilevel marketing pyramid schemes, features of the pyramid scheme, prevention tools ex ante/ex post.

**JEL Classification:** K34

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<sup>1</sup> The article is partly based on the content of the author's lecture entitled "Regulatory Aspects of Financial Pyramids - Supervisory Point of View", held at the invitation of the OSCE Program Office in Nur-Sultan, on 12 July 2019 in Almaty, Kazakhstan as part of the event "Identifying and countering the financial pyramids".

## 1. Introduction

Ponzi schemes ruin lives. Unfortunately, we must state that the relevant European legislation is still absent, as well as the harmonization of intervention powers for supervisory authorities (supervisory authorities) at national and European Union level (for example for the European supervisory agency EBA) [Štrkolec 2012: 521], which would create a legal and operational framework for effectively combating the financial pyramids. The responsibility for punishing such conduct is mainly in the hands of law enforcement authorities. It should be noted that there is no uniform definition of the pyramid scheme in the legal order of the Slovak Republic or in European law. Various designations are used in this area, such as "Ponzi scheme", "pyramid game", "pyramid club", "pyramid scheme" or "airplane game"<sup>2</sup> [Rosenberg 1992: 67, 71]. The aim of the article is to provide main identifying features of fraudulent practices that prove to be a financial pyramid. The hypothesis of the article is: there is no uniform legal provision covering all features of the pyramid scheme in Slovakia, the relevant legislation is limited to the prohibition of certain practices, which a priori may not constitute a pyramid scheme. The article is based on the author's practical experience of working in a financial market supervisory authority, besides that methods of analysis and synthesis from doctrinal research methods were used.

## 2. Detection and identification of the fraudulent scheme (financial pyramid)

National regulations differ considerably in the way in which a procedure fulfilling the features of a pyramid scheme is named or described, usually resigning to an exhaustive description and limited to a general ban on a particular conduct which conflicts with the licensed activity (eg regarding financial market) and which may result in misleading the investing public and consequently the loss of its investment. From the point of view of the supervisory authority in the European Union, it is not appropriate to provide a comprehensive definition, as fraudulent practices (not only in the financial market) are constantly improving, constantly taking various forms that may deviate from standard typification of individual models.

In this context, the following definitions of the various authorities need to be satisfied.

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<sup>2</sup> The terms Ponzi scheme and financial pyramid are considered by some national regulators to be synonymous (e.g. National Bank of Slovakia), although, for example, the U.S. Securities and Exchange Commission distinguishes between them. In my opinion, the Ponzi scheme can be considered as one of the types of pyramid schemes.

According to academics is Ponzi scheme an entity or group of entities that routinely finances its obligations to claimholders with the proceeds from newly issued liabilities but deceives its claimholders as to the source of the financing. The scheme leads to reduction of the balance of claim of any kind. Claim is the right to payment [Winters 2012: 122].

According to Black's Law Dictionary (9th ed. 2009) is Ponzi scheme a fraudulent investment scheme in which money contributed by later investors generates artificially high dividends or returns for the original investors, whose example attracts even larger investments. Money from the new investors is issued directly to repay or pay interest to earlier investors (usually) without any operation or revenue-producing activity other than the continual raising of new funds [according to Winters 2012: 122].

There is a generalized broader definition in the decision-making practice of the US courts. According to the U.S. District Court for the District of Connecticut in a Ponzi scheme an enterprise makes payments to investors with monies received from newly attracted investors, rather than from profits of a legitimate business venture [according to Winters 2012: 122]

The essential original feature of the pyramid investment scheme is the fact that the entity finances its liabilities with further new liabilities, while any creditor represents the nature of its activity differently. This feature has long been sufficient to qualify a subject as a pyramid scheme.

A special species is the naturally occurring **spontaneous Ponzi system**. In such a scheme, there is no manipulator and sophisticated fraudulent plan, i.e., individual-controlled experiment and direct manipulation. On the contrary, the principle of its operation is based on the "herd", respectively the "avalanche" behavior of the masses and the "self-fulfilling prophecy" [Shiller 2010: 105]. It is necessary to distinguish between this scheme and direct and organized market manipulation, from which a specific person benefits [Siems 2008: 39-49]. This may include, for example, the dissemination of misleading information, misleading price signals, unnatural instructions to buy/sell a financial instrument and other similar procedures and which may further constitute a financial pyramid in the capital market.

According to Art. 12 of the Market Abuse Regulation (Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014) market manipulation shall comprise mainly the following activities: a) entering into a transaction, placing an order to trade or any other behaviour which: 1. gives, or is likely to give, false or misleading signals as to the supply of, demand for, or price of, a financial instrument, a related spot

commodity contract or an auctioned product based on emission allowances; or 2. secures, or is likely to secure, the price of one or several financial instruments, a related spot commodity contract or an auctioned product based on emission allowances at an abnormal or artificial level; unless the person entering into a transaction, placing an order to trade or engaging in any other behaviour establishes that such transaction, order or behaviour have been carried out for legitimate reasons, and conform with an accepted market practice, b) entering into a transaction, placing an order to trade or any other activity or behaviour which affects or is likely to affect the price of one or several financial instruments, a related spot commodity contract or an auctioned product based on emission allowances, which employs a fictitious device or any other form of deception or contrivance; c) disseminating information through the media, including the internet, or by any other means, which gives, or is likely to give, false or misleading signals as to the supply of, demand for, or price of, a financial instrument, a related spot commodity contract or an auctioned product based on emission allowances or secures, or is likely to secure, the price of one or several financial instruments, a related spot commodity contract or an auctioned product based on emission allowances at an abnormal or artificial level, including the dissemination of rumours, where the person who made the dissemination knew, or ought to have known, that the information was false or misleading; d) transmitting false or misleading information or providing false or misleading inputs in relation to a benchmark where the person who made the transmission or provided the input knew or ought to have known that it was false or misleading, or any other behaviour which manipulates the calculation of a benchmark.

The identifying features of fraudulent practices that prove to be a financial pyramid can be summarized as follows:

- Fraudulent conduct that constitutes economic crime. This is a procedure that exploits legislative gaps and operational failure in the preventive activities of various public law bodies (including supervisory authorities). These schemes are not licensed by a supervisory authority (such as a central bank) in order to avoid related public prudential requirements, information obligations towards consumers, etc. If the operation of the financial pyramid activity falls within the scope of a regulated activity, which is associated with the obligation to obtain a public authorization product, failure to apply for such authorization by the person constituting the crime on violation) of the Banking Act, the Securities Act). It can also be activities with cryptomas, which are still out of the interest of the regulator [The 2020 State of Crypto Crime].

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- Financial pyramids do not usually fall under financial market regulations as publicly supervised entities. However, some of them try to operate as supervised entities with the appropriate authorization, thus gaining the necessary credibility with the public, such as banks, especially capital market entities. The performance of the activity is legal (the concluded contract is not contra legem), in addition to performing real business operations, they also deceive their (some) investors, sometimes without the promise of an artificially (unnaturally) high return on investment.
  - Financial pyramids can simultaneously perform other – legal – activities.
  - Presence of the intention to personally enrich the members of the statutory or supervisory body.
  - Abuse of investor confidence (the organizer provides a "credible story", which creates the conditions for an excited state of investors, is an example of a successful investor in the system and promotes the confidence of a potential client); usually only a small part of the money is invested in real assets.
  - Existence of a mechanism consisting in the transfer of created money funds from new investors (so-called recruits) to those who are higher in the organizational structure of the scheme (older recruits / earlier clients, members of the bodies of the pyramid entity). The basic idea of Ponzi's scheme is to "rob B to pay A".
  - Necessity of repayment of initial deposits by investors (in the case of a multi-level marketing pyramid, these are the initial purchases required to enter the scheme). The first investors are skeptical and initially invest small sums of money.
  - Declaration of misleading claims about the amount of return and return on investment (the presented income is above the realistically achievable limit).
  - Investors are promised (in a monthly, annual interval) a high return on investment in a short period, which is very contrary to the basic principles of standard investment (it is a denial of economic laws, eg the triangle of the financial market investor with peaks: risk – return – liquidity). In this context, however, it should be emphasized that the annual rate of return always depends on market circumstances (market risk), so that although promised rates were not low in some pyramid schemes, they did not necessarily conflict with fixed interest rates normally available on the market. Pyramids therefore sometimes become difficult to read even for the average investor. The

overpayment of investment returns is temporary in nature and is associated with the moral hazard of investors who expect continuity of equal payments.

- Temporary duration of excessive payouts and associated moral hazard of investors.
- A permanently unsustainable system leading to collapse. Fraud activity is not based on a realistic business plan. Pyramid schemes are not designed to create a viable entity and therefore all go bankrupt. The competence to perform a feasibility test of the business plan of the entrepreneur is from the perspective of national supervisory authority crucial.
- Lack of detailed information available to the investor on the basis of which it would be possible to verify the feasibility of the business plan in the scheme. This situation subsequently raises doubts about the claimed investment strategy.
- Misleading advertising and publicity. Regulatory provisions for financial market participants therefore include, as part of prevention, an obligation that any promotion of a regulated investment contains a strong warning that the value of the investment may also be reduced and the return on the amount originally invested is not guaranteed or that there is a risk associated with the investment (in Slovak Republic eg § 151 para 2 of Act no. 203/2011 Coll. on collective investment).
- Suspicious circumstances of the acquisition of clients for investment, for example through telephone calls, the Internet, etc.
- The probability of success for new participants in the pyramid scheme decreases in proportion to the size of the pyramid, regardless of the actions of the individual participants.

Similarly, the US Securities and Exchange Commission (SEC) names seven warning signs for investors (so-called red flags) [U.S. Securities and Exchange Commission: Ponzi Schemes]:

- high investment returns with little or no risk,
- overly consistent returns,
- unregistered investments,
- unlicensed sellers,
- secretive and/or complex strategies,
- issues with paperwork,
- difficulty receiving payments.

In particular, we could identify other features of the **financial pyramids in the stock market**. Schemes in securities markets have **some additional features**. We can summarize them as follows:

- trustworthy and attractive story (presenting an example of successful investor in the scheme) that supports self-confidence of potential investor,
- con man (operator of the pyramid) and cooperating persons,
- they often use connected legal persons (close links through the same members of statutory/supervisory bodies),
- targeting a specific group of clients (not addressed to the masses; eg wealthy investor),
- the system is designed to reward services provider more than consumers,
- commissions are paid in anticipation of future proceeds.

However, not all of main features of financial pyramids are still present, pyramids come in variations. Detection of pyramids can still be complicated because some features are not obvious at first glance.

### **3. Particularities of multilevel marketing pyramid schemes**

Multilevel marketing (MLM) is a way of distributing products or services in which the distributors earn income from their own retail sales and from retail sales made by their direct and indirect recruits. Definition of sell-pyramid scheme (according to U.S. Federal Trade Commission so called "Koscot test", FTC vs. Koscot 1975) [Vander Nat, Keep 2002: 141] is as follows: A pyramid scheme is an arrangement in which participants pay money in return for which they receive: 1. the right to sell a product 2. the right to receive in return for recruiting other participants into the program rewards that are unrelated to the sale of product to ultimate consumers.

Regarding the financial market, financial intermediation via network of financial agents has similarities to MLM:

- way of distributing financial products/financial services (current account agreement, insurance contract, credit agreement, contract for the purchase of securities, contract for portfolio administration, etc.),
- based on face-to-face communications between representative and potential client (personal appointments, catalogs, product parties),
- rely on the selling skills of the sales forces than on indirect communications,

- almost all salespeople operate as independent contractors rather than employees,
- the sales force is generally paid through a commission system which requires maximum selling motivation,
- schemes provide continually training and motivating their sales forces,
- the main financial intermediary shifts the burden of recruiting onto the cooperating net of agents,
- the hierarchical reward system encourages recruitment and sales,
- financial agents suggest market opportunity (that does not truly exist),
- opportunity offered by pyramid schemes passes in chainlike fashion from one participant to another,
- main benefit to participants: 1. the right to receive monetary compensation from recruiting others into the scheme 2. profit from acquiring new clients,
- some schemes do not even require the completion of a consumer sale before paying a reward for recruitment.

#### **4. Prevention against pyramid schemes (regulation of tools used ex ante and ex post)**

For the preventive legal protection of investors, the regulatory approach of the legislator is important, whether he decides to outlaw certain features of the conduct typical of financial pyramids. In our opinion, the legislation can distinguish whether it is a general prevention against financial pyramids that use legally recognized forms of companies (or cooperatives) or other forms of participation in business (silent partnership), or whether they are specific prohibitions that are they relate to the illegal activity of investment schemes which operate on the financial market and seek to gain credibility as licensed entities [e.g. Kohajda 2018: 229-231] under the public supervision of specific authorities.

General prevention in the Slovak Republic is represented by selected provisions of the Commercial Code (Act no. 513/1991 Coll.) governing the silent partnership agreement, the prohibition of returning the deposit to the partner (§ 67j), § 123 para. 3 in the regulation of a limited liability company, § 179 para. 2 in the regulation of a joint stock company) and the prohibition of interest payments for a share in the profit (§ 123 para. 2 in the regulation of a limited liability company [Mamojka 2016: 483], § 179 para. 5 in the regulation of a joint-stock company, § 223 para. 8 in the regulation of a cooperative). Since the adoption of the Commercial Code, there has also been a ban on the issuance of shares in the regulation of



a joint-stock company, which have been associated with the right to a certain interest rate growth from the company's economic results (§ 159 para. 2).

The content of the silent partnership agreement (§ 675) is the right to control the silent partnership. (the right to learn about the manner of managing his deposit and the corresponding information obligations of the entrepreneur towards the partner). This is a provision in the wording effective from 1 January 2002, in response to the collapse of the first "non-banknotes" in the Slovak Republic. According to the explanatory memorandum to the addition of this paragraph, the aim of the regulation is "to prevent the abuse of this institute by non-banking entities providing services equivalent to banking without the appropriate authorization" [Explanatory Memorandum, special part to Act no. 500/2001 Coll. of 3 October 2001 amending the Commercial Code, as amended].

Specific prevention is the legal regulation of the financial market, which is contained in individual laws regulating the activities of financial market entities [Kotáb 2009: 477]. The basic legal prevention against the pyramid scheme on the financial market is the provision of a legislative ban on providing loans (or credits) and accepting deposits without the relevant valid permit granted by the market regulator [Pihera, Smutný 2011: 35-39]. In the Slovak legal order, the mentioned ban is stipulated in § 3 para 1 and 2 of Act no. 483/2001 Coll. on banks. According to that, no person without a banking authorisation may accept deposits, unless other legislation provides otherwise. At the same time no person without a banking authorisation may pay interest on, or other compensation for, deposits, which constitutes a tax expense under other legislation. Finally, no person without a banking authorisation may provide credit and loans within the scope of its business or other activity using repayable funds obtained from other persons on the basis of a public offer.

Provisions on the protection of the designations of supervised entities and their foreign language translations (for example, the words "bank", "insurance company") against use in the trade names of unlicensed entities may also be included among the general prevention.

As part of the licensing process, the financial market supervisory authority has the opportunity to examine the reality (viability) of the submitted business plan, which forms an annex to the application for the relevant permit (e.g. § 7 para 2 letter g) of Act no. 483/2001 Coll. on banks).

In addition, precautionary provisions can be identified for a specific financial product, e.g. a ban on the issuer from using false or misleading information in promoting the issue of its securities or withholding facts important when deciding on the acquisition of securities (§ 112 para 1 of Act no. 566/2001 Coll. on securities and investment services).

Within the distribution of financial products, there are also certain precautionary prohibitions on the creation of mechanisms in the form of rewards, sales targets, or other instruments that may provide an incentive to recommend a particular financial product to a client when performing financial intermediation through a network of financial agents (see § 32 para 6 of Act no. 186/2009 Coll. on financial intermediation and financial advisory services). In this case, it is a ban on multi-level marketing in the sale of specific financial products.

At the same time, the supervisor has ex post tools at its disposal to deal with infringements that have already occurred in the financial market. These are repressive rights, which consist in the possibility of administrative sanctions of the above-mentioned prohibitions on the financial market [Daudrih 2017: 285-292]. The supervisory authority's activity of publishing "warnings" on suspects is only a complementary prevention tool.

A specific protective institute on the financial market in the Slovak Republic was the public offering of assets, which was to serve at the time of the adoption of the Securities Act as a preventive tool for partial regulation of various investment activities of infamous non-banking entities from the late 1990s. It was a legal regulation contained in § 126 to 130 of Act no. 566/2001 Coll. on securities and investment services, as amended by 21 July 2013. This regulation did not regulate a specific method of raising funds. However, an investment prospectus approved by the national supervisory authority (National Bank of Slovakia) was required for their collection. For the promotion of the investment, the rule was that a public offer should not be published in the means of disclosure which contained an obvious or hidden condition for the investor to acquire additional investors. At the same time, loans and borrowings could not be provided from the public funds thus obtained [Čunderlík 2019: 91-92].

Most financial pyramids in the financial market do not participate in the investment protection guarantee scheme. On the other hand, the investor himself must be vigilant and reflect the warning signs of the investment.

## **5. Typology of financial pyramids**

Financial pyramids can operate on the financial market and provide services otherwise subject to financial regulation or carry out their activities outside the regulatory framework of the financial market, thus pretending to carry out normal business activities (standard business). The new business models use "gray" legislative zones and operate on the edge of existing public law restrictions. Within the classification of financial pyramids on the

financial market, we consider the usual division into these types (models) according to the position of the investor to be significant [Winters 2012: 123-124, 137-138]:

- fixed income based on model (fixed-income scheme) as a savings program,
- a model based on owning and investing a financial asset (equity-type schemes) with investment risk.

A fixed-income scheme is a property distribution scheme in which is paid a fixed rate of return in the form of interest. The fixed-income contract as a standard debt contract involves a simple promise to repay principal and to make interest payments (fixed rate is promised). The value the debtholder (investor) gives in exchange for his payouts is a reduction in the entity's debt to him. Some of that type of scheme were banks (simple model of pyramid), or more sophisticated schemes which were not under the supervision of public authority.

An equity-type scheme is that, instead of issuing fixed-income securities, the entity contracts with the investor to take custody of the investor's funds and invest them on his/her behalf. The equity-type contract involves the investment operator (as the only pyramid organizer or as a part of a group of entities) and promise to repay only the earnings that accrue/or that fail to accrue therefrom. The contract does not embody a promise to pay interest or repay principal. The shareholder (investor) has in general the right to payments (dividends), but the invested sum is simply misappropriated by the organizer of such scheme. Rather than pursuing any legitimate investment strategy, con man uses investor's funds to pay earnings to other investors and to enrich himself. In an equity-type scheme there is no debt because the investor does not have a fixed right to repayment of principal and interest as well. The shareholder bears investment risk and the ownership of assets gives the investor the right to profits the company makes. Invested money might have fall in some cases under the guarantee schemes, eg if the assets of client are received by an investment firms or asset management companies providing an investment service. In this context arises the issues of the moral hazard and the reputation risk of the supervisory authority, if the pyramid company fails.

As we know also from the recent past in the Slovak Republic, both types of financial pyramids can occur in the financial market and beyond.

## 6. Recommendations and conclusion

Pyramid schemes work on the principle that the money you invest is used mainly to pay those who have made upfront payments before you and are waiting for the return on their 'investment'. A large share of the money is used to enrich the management at the top of the pyramid. The scheme continues until no more payouts can be made, i.e. when no new investors can be found, at which point the scheme collapses. The article provided a catalogue of the features of fraud, which can be considered as a pyramid scheme. However, this catalogue does not represent a *numerus clausus*. The hypothesis, stated in the introduction: there is no uniform legal provision covering all features of the pyramid scheme in Slovakia, the relevant legislation is limited to the prohibition of certain practices, which a priori may not constitute a pyramid scheme, was partially confirmed. The legislation is fragmented into several legal acts, including the Commercial Code and acts in the field of the financial market law. The provisions of these acts mentioned in the article prohibit only certain features of the financial pyramids, in particular excessive payments.

With regard to the legal situation in the Slovak Republic, the author recommends the adoption of legislation (for example, in the Act on securities and investment services), which would at least broadly define the term "financial pyramid". In this definition, the payment of early investors' deposits from later investors' deposits and the false promotion of the source of funding should be decisive. The other features mentioned by the author in the article would be complementary and would serve as an aid to assessing whether a particular investment scheme is a fraudulent pyramid scheme. However, it seems more appropriate to introduce such a definition in EU law.

What to watch out for? 1. Spectacularly high returns. The higher the return, the greater the risk. Be careful and consider whether the promised gains are realistic. Check the internet to see what returns are offered by rival companies and whether the return in this case is not improbable. Be particularly on guard against offers of guaranteed returns. 2. An interesting investment opportunity but one that you did not fully understand, further information available only if you pay a membership fee, make an upfront investment, or recruit others as new investors. Such an offer is very likely to be a pyramid scheme fraud. 3. One should find out about the company offering the investment in following steps: a) check internet for whether the company is supervised by national or any other foreign supervisory authority, and whether it has authorization to conduct such business, b) check warnings published by supervisory authorities for whether these has issued any warning about the company, c) check where the company has its registered office. Be suspicious if the

registered office of a company offering services exclusively online is in a tax haven, d) find out about the company on the internet, e) check online discussion forums to see whether consumers are complaining about the company or have lost money by investing with it. Hereinafter are some tips for the investors: a) Never conclude a contract for a financial product or service (such as, for example, a loan, insurance policy, investment, savings vehicle or pension scheme) other than with an entity authorized to conduct such business, b) before investing with an unknown company, consider whether you are prepared to risk losing all your investment, c) do not take decisions under pressure and take time to think over any investment offer. Respectable companies will never urge you to decide, d) such investments are not covered by the Guarantee Funds and if, for example, the company is dissolved, the investors will most probably never get their money back, e) be on particular guard against products/services not subject to supervision.

What to do if someone becomes a victim of a pyramid scheme? Immediately should be informed the police and supervisory authority. Such office cooperates with the law enforcement authorities. Although supervisory authority has obviously no power to recover money of investors, it may issue a public warning and thus help other consumers.

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