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WEALTH ADVISORY SERVICES

Fraud avoidance steps

April 2009 – The fraud perpetrated by Bernard Madoff remains in the headlines months after it first came to light. At least some of the recent news gives some hope of relief for as many as 13,000 investors who may have lost as much as $65 billion. The IRS has announced that it will allow investors who fall victim to investment fraud and schemes to claim an income tax deduction under the casualty and theft loss section of the tax code. Details are forthcoming, but claiming the deduction is sure to be a complex and time-consuming process.

Many people following the Madoff saga still wonder how highly intelligent and even sophisticated investors found themselves caught in his net. The Financial Industry Regulatory Authority (FINRA), the regulator of securities firms doing business in the U.S., has been searching for answers. It's especially important now, because fraud will be on the rise as scam artists look for any hook that they can find to exploit investors, who may be especially vulnerable as they look for ways to recover from their recent losses.

The psychology behind the pitch

The old saying goes: "If it sounds too good to be true, it probably is." Solid advice, but probably too simplistic today, FINRA suggests. The problem is deciding when "good" becomes "too good." There's no bright line. Investment scammers make their living by making sure that the deals they tout ***appear*** both to be good and true.

FINRA's Consumer Fraud Research Group has examined hundreds of undercover audio tapes of those they call the "masters of persuasion" at work. The tapes reveal that pitches are tailored to match the psychological profiles of their targets. Groping for an Achilles heel, they ask seemingly benign questions about health, family, political views, hobbies or prior employers. "Once they know which buttons to push, they'll bombard you with a flurry of influence tactics, which can leave even the savviest person in a haze," warns FINRA.

The five tactics that ensnare investors

The tactics that scam artists use may seem familiar to their targets because legitimate marketers use them, too. That familiarity may lend credibility to the pitch and throw an investor off guard. An important part of resisting persuasion tactics, FINRA suggests, is to know them before encountering them.

- The ***phantom riches tactic*** dangles the prospect of wealth, luring an investor with something similar to Madoff's double-digit returns or R. Allen Stanford's high-interest rate CDs.
- The ***source credibility tactic*** cloaks the scam artist in legitimacy with claims that he or she is with a reputable firm or has special credentials or experience. "Believe me, as a senior vice president of XYZ Firm, I would never sell an investment that doesn't produce."
- The ***social consensus tactic*** leads investors to believe that other savvy investors are already on board. It often goes something like this: "This is how Jones got his start. I know it's a lot of money, but I'm in – and so is my mom and half her church – and it's worth every dime."
- The ***reciprocity tactic*** works by having the scam artist offer to do a small favor for an investor in exchange for a big favor. One common example is a promise to give the investor a reduction in a commission that would be charged.
- The ***scarcity tactic*** traps an investor by creating a false sense of urgency, encouraging the investor to act immediately. Often, there's a claim of limited supply, such as: "There are only two units left, so I'd sign today if I were you."

continued

High on the list of targets

By comparing victims of fraud against nonvictims, FINRA research has identified several factors that make it more likely that an investor will succumb to the attentions of a scam artist.

Key among them is reliance on friends, family and coworkers for advice. For example, in a study of groups of investors, 70% of victims of fraud chose investments based primarily on advice from a relative or friend. Yet the percentage was only one-third for the national sample of investors examined. Other factors included: owning high-risk investments; being open to new investment information; and failing to check the background of the individual making the investment offer.

The seven red flags of fraud

FINRA offers the following warning signs that should put anyone on notice that an investment offer may not be what it seems.

1. *Guarantees:* An investor should suspect anyone who guarantees that an investment will perform in a certain way. Nothing is absolute in the world of investing.

2. *Unregistered products and unlicensed "professionals":* Many investment scams involve unlicensed individuals selling unregistered securities. Madoff wasn't even a registered investment adviser until 2006. His SEC filings show some technical violations, which might have been enough to scare away some investors, if they had done their research.

3. *Overly consistent returns:* Any investment touted as consistently going up month after month – or that provides remarkably steady returns regardless of market conditions – should be regarded with suspicion.

4. *Complex strategies:* Anyone who credits a highly complex investing technique for unusual success probably should be avoided. Legitimate professionals should be able to explain clearly what they are doing.

5. *Missing documentation:* If someone tries to sell a security without all the paperwork (a prospectus for a stock or mutual fund; an offering circular in the case of a bond), he or she may be selling unregistered securities.

6. *Account discrepancies:* Unauthorized trades, missing funds or other problems with account statements could be the result of a genuine error, or might indicate churning or fraud.

7. *An overeager salesperson:* No reputable investment professional should push anyone to make an immediate decision about an investment, or tell the person that he or she has to "act now."

The best protection

Finally, the chance of being a victim of a Madoff or Stanford type of scheme may rest on the questions that an investor asks and the answers that he or she receives. Is the individual licensed to sell the investment? Which regulator issued the license? Has that license ever been revoked or suspended? Is the investment registered? If so, with which regulator? Find out about support organizations, too. According to some reports, Madoff, who was managing billions of dollars, used a three-person accounting firm, one of whom was a secretary and another a retired partner. This should have raised some eyebrows.

Persistence is the hallmark of a successful schemer. Investors who are persistent themselves – doing the necessary research and insisting upon all the answers to their questions – should be successful, too, outwitting any schemer's plans to part them from their money.

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