



Naïve or Desperate? Investors continue to be swindled by investment schemes. Jonathan Hafen

Though the economy appears to be rebounding, many investors are still feeling the sting of having lost hefty percentages of their savings. Lower interest rates and returns on traditionally low risk investments put investors in a vulnerable position where they may feel the need to "catch up" to where they were a few years ago.

Investors, particularly if they are elderly, trying to find better than prevailing returns may let their guard down to seemingly legitimate swindlers offering high return, "low-risk" investments. Fraudulent investment schemes come in all shapes and sizes, but generally have two common elements—they seem too good to be true and they are too good to be true.

Eighty years ago, Charles Ponzi created his namesake scheme and investors are still falling for virtually identical scams today. Ponzi schemes promise either fixed rates of return above the prevailing market or exorbitant returns ranging from 45% to 100% and more. Early investors receive monthly, quarterly or annual interest from the cash generated from a widening pool of investors. Of course, they are receiving nothing more than a small portion of their own money back. The illusion of profit keeps the duped investors satisfied and delays the realization they have been tricked. Early investors usually play a part in keeping the scheme alive by telling friends or family of their good fortune. They essentially become references for new investors, which makes them unwitting accomplices. These scams always collapse under their own weight because new investments eventually slow and cannot sustain the rate of return promised as the number of investors grows. Eventually, the money runs out and everyone loses.

While we would all like to think we are smart enough to avoid such tricks, they continue to entice thousands of people annually. Seattle Postal Inspectors recently caught the mastermind of a Ponzi scheme responsible for bilking over 3,200 victims of approximately \$70 million. In April 2003, one issue of a metropolitan newspaper contained two articles related to Ponzi schemes. In one case, involving a phony insurance company, investors were swindled out of \$50 million with promises of a 100% annual return on investments for 99 years. In the other case, investors were reportedly told they could expect a 200% return at the one-year anniversary of the investment with a guarantee against loss for 108% of the original investment. These are all recent cases involving thousands of people and tens of millions of dollars. It happens to people every day and, in particular, it happens to the elderly.

Ponzi scam artists are also cunning and know how to strike at potential investors' weak spots. Such schemes will often be perpetrated against members of tight-knit groups or in organizations where lower ranking members are encouraged to trust in and follow those in authority and the pitches are customized to feed on a prevailing need. For instance, a scam artist may join a church or community group to gain access to and trust from other members. Fellow members may become susceptible to falling for a religious or philanthropic-based investment pitch because they inherently trust another member who appears to have the same values, interests and good intentions as the rest of the group.

In order for a phony investment scam to work, savvy schemers know they need to make the investment appear legitimate. Sales pitches are professional and may even include advertising campaigns in reputable magazines, brochures and a prospectus. Bogus investments are getting more difficult to recognize as the technology to create legitimate looking promissory notes, bonds, stocks and other phony investment instruments becomes more

sophisticated. Use of the Internet now allows con artists to reach a wider base of potential investors in a short period of time.

The best defense against falling for Ponzi or other investment schemes is education. An educated investor is a perpetrator's worst enemy. Financial advisors are in an ideal position to educate clients about common red flags and offer warnings to help prevent them from making costly and even criminal mistakes. Educate your clients on the major red flags and ask them to call you or a lawyer before they are pressured into making investments they will later regret. Red flags include:

Guaranteed returns in excess of 10%. Some returns are guaranteed on a monthly basis.

Claims the investment is covered by the Private Offering Exemption.

Requests that the program remain secret.

Investments that do not seem logical and, of course, seem too good to be true.

Investments involving foreign currency, metals, exotic minerals, oil and gas partnerships, rare gemstones, and other "can't miss" opportunities.

Clients should also know the key questions to ask before making an investment. They should:

Ask whether the seller is a registered securities broker.

Ask whether the security is registered in the state in which it is being sold. Clients should not take the seller's word for it. Registration of a security should be checked out firsthand.

Ask for references. The references should not be early investors and should include people actually involved in the business. Clients should be warned that references could be shills—people compensated to bring in new investors.

Ask for a written business plan.

Ask for a prospectus. If there isn't one, it is a major red flag.

The other critical aspect of client education includes warnings about possible inadvertent securities violations. Violation of The Securities Act of 1933 is a strict liability offense, meaning intent, reliance or negligence need not be proven for prosecution. Anyone selling an unregistered security is liable regardless of the care exercised. Selling an unregistered security simply means someone sold or offered to sell a security. The term "sell" includes solicitation of the sale if the motivation for the sale is financial. In other words, clients who are rewarded for bringing in new investors to purchase unregistered securities can be prosecuted under the securities act.

In addition, investors who get excited about an investment plan and invite others to join may become naïve accomplices to mail and wire fraud, civil conspiracy, unjust enrichment, tax evasion, fraud and misrepresentation. Criminal penalties include up to a \$10,000 fine and five years in prison. Civil liability may include monetary damages, litigation costs and attorneys' fees. Not only can investors lose their entire investment, they may be liable for substantial fees, restitution to other victims and even jail time.

The only obstacle standing in the way of a client making a tragic financial mistake may be you. If you suspect a client is being pursued to participate in a Ponzi scheme or similar scam, try to persuade them to reconsider or, at least, research the investment and the promoters before money exchanges hands. But, don't stop there. Report the promotion to the SEC as well as state and local authorities. In doing so, you may minimize the losses a client sustains if the scheme is allowed to continue.

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