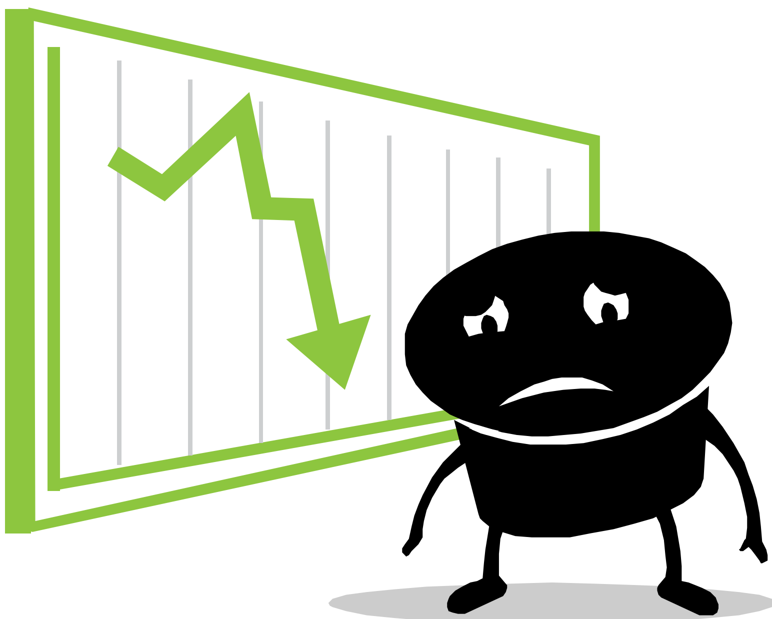
DON'T GET MADOFFED

A Consumer's Guide to Avoiding Investment Scams



By James A. Daniel, CFP®

Disclosures: all quotes, stories and examples contained in this e-book are derived from public media sources and in no way presume the guilt or innocence of the individuals or companies involved.

Please feel free to post this e-book on your blog or email it to whomever you think would benefit from reading it.

THANK YOU.

DON'T GET MADOFFED

A Consumer's Guide to avoiding Investment Scams

Introduction

Consumers lose an estimated **$10 billion dollars** annually to investment scams. In this e-book we will address common scams and look for ways to prevent it from happening to you.

The purpose of this guide is not to frighten you or have you become paranoid about investing. In fact the purpose is quite the opposite. Investing is a necessary tool for long term financial security, but it is up to you to control emotions and have realistic expectations of risk vs. return.

My hope is that sharing these examples will allow you to separate the good investment opportunity from the one that can wipe out your life savings.

- James A. Daniel CFP®

$10 Billion

Bernard Madoff perpetrated the largest investment fraud in history, wiping out billions of dollars of investor assets. Ordinary individual's lives were turned upside down overnight as their life savings vanished.

Unfortunately, this won't be the last fraud reported in the news.

The Lure of Easy Money

As human beings it seems we are all predisposed to be lured by the prospect of easy money. Maybe it's the way we are wired genetically, but take normally rational, intelligent people and tempt them with the possibility of multiplying their money quickly and all logical thinking goes out the window.

Although I am a financial planner, it doesn't mean that I'm immune to it. Like many folks, I have been guilty of playing the lottery, putting some dollars in a slot machine and even buying penny stocks on occasion, with the dream of multiplying my money quickly.

This e-book is not about games of chance or speculating on penny stocks, but rather about a more serious issue. It's one that plays upon our sense of greed and desire for easy money. I am talking, of course, about investment scams.

The problem with investment scams is that a person doesn't just risk a little, but rather a good chunk of their life savings. Like you, I have seen story after story of the scams being exposed. And it happens much more often when the stock markets are heading down and the economy is in a recession. At the end of 2008 the granddaddy of all Ponzi schemes was revealed, the Madoff scandal. Since then a new scam is revealed almost once a week! I have been captivated by this and have more than a passing curiosity to understand what causes people to fall victim. You see, as an independent financial planner, each time I hear about a new scam I cringe at the thought of what happens to the reputation of our industry, of which the vast majority of folks are very ethical and play by the rules.

The problem as I see it is that there will always be bad eggs in the financial services industry as there are in all occupations. In fact I don't believe one can name any occupation that has ever had a pristine record of ethical behavior: Medical? Accounting? Law? Corporate Execs? Certainly not. You see, the answer is not to denigrate other professions or be an apologist for the financial services industry, but to help you understand that in any occupation you will inevitably encounter a small number who act either unethically or down right criminally. To combat this you must arm yourself with enough information to know when something just doesn't feel right……………….

No matter how many regulators, governing bodies, or professional organizations exist, they won't be able to prevent all the scam artists from trying to steal your money. It is physically impossible for any regulatory agency to police the activity of each individual investment guru 24/7. Eventually the scam artist will get caught by the authorities. Unfortunately, by the time a scam is exposed, many people have already become victims of the scheme.

So, what can be done about this? Precisely the reason I have put pen to paper. The consumer needs to be armed with tools to spot potential scams before investing.

In this e-book, I will review how some of the more common scams operate. Next I'll touch on some of the warning signs to watch for. Finally, I'll list questions to ask before investing.

"Bernard Madoff was scentenced to 150 years in federal prison for masterminding the largest Ponzi scheme in history.......

.... The epic swindle may have reached $65 billion in both real and phantom investments."

David Glovin, Patricia Hurtado and Thom Wiedlich for Bloomberg.com 6/29/2009

"one primary mistake is uniquely intertwined with Madoff's alleged scheme...the allure of consistent small gains. A chart of Madoff's purported returns shows a line going steadily up, month after month, 1 or 2 percent"

Michael S. Rosenwald for The Washington Post 1/04/2009

COMMON SCAMS:

<u>The Ponzi Scheme</u>: Named for Charles Ponzi, this is by far one of the oldest and most widespread type of investment scams. The basic pitch is an investment that has a track record of market beating returns with very low risk. More than likely, you learned about so called ABC Investment Co. through someone you associate with who takes every opportunity to brag about how much money he is making. Immediately your greed sensor kicks in and you can't resist the urge to get in on this marvelous opportunity. In all honesty who would want to be left out? In a brief state of reason, you wonder, "could this be safe?" but dismiss the thought because you trust your friend. So you invest your hard earned life savings and bam! the first statement arrives showing nice returns. Then the next month the statement arrives and despite the fact that the stock market is down, your account is up. Hallelujah! You're a genius and it's just a matter of time before you're on easy street. To celebrate your newfound investing prowess you begin bragging to your friends and family about your returns with ABC Investment Co. then they, too, are compelled to invest.

"How could so many smart people do something that, in hindsight, seems so dim-witted? The answer is simple. No matter how accomplished, experienced or savvy, people succumb to age-old human behaviors – and failings – when making investment decisions"

Michael S. Rosenwald for The Washington Post 1/04/2009

The cycle repeats…until it doesn't. Eventually, all Ponzi schemes fail when the money from new investors is no longer sufficient to pay redemptions or distributions to the previous investors. The returns were fictitious. Each new client account recruited was used to pay "earnings" to the previous clients. The Ponzi scheme is a classic because the victims, themselves, are an irresistible word-of-mouth sales force.

SO, HOW DID MADOFF DO IT?

How did Bernie Madoff get away with it for so long and with so much money? Madoff was able to fool not only the average investor, but some very savvy hedge fund and institutional investors as well.

While Madoff's scam was classic Ponzi, there were some noticeable characteristics that allowed him to carry it out for so many years:

- $ Exclusivity: From many reports Madoff kept a low key approach. Even as he solicited new investors he made them believe that investing with him was an exclusive privilege. Had you heard of Madoff Securities prior to the scandal breaking?
- $ Celebrities: Madoff's client roster included a who's who of the rich and famous. Business moguls, Hollywood stars and large foundations all invested with Madoff Securities. People were falling all over themselves to become a client of his.
- $ Image: Madoff Securities was located in a prominent New York office building. A very impressive office location and a large staff of employees tends to show well. It presented the image of a top notch investment firm.
- $ Philanthropy: Madoff gave away huge sums of money to charities and was widely viewed as generous person. This instilled confidence in his investors that he was legitimate.
- $ Board Membership: by sitting on the board of the NASD, it was natural to assume he was ethical and that his operations were above reproach. (it would take guts to sit on a securities regulation board while committing fraud, right?)

The tipping point for Madoff came when he received redemption notices for $7 billion in the fall of 2008. The money wasn't there to fulfill the request and he finally had to admit that his investment plan was a house of cards. Had it not been for the market meltdown at the time and the need for some large investors to request redemptions, he would probably still be in operation today.

Fortune Magazine has a good history of Madoff if you are interested in learning more:
http://money.cnn.com/2009/04/24/news/newsmakers/madoff.fortune/index.htm

Alleged Ponzi Schemes in the News

Here's sampling of recent news stories to give you an idea of how these operate:

FINRA Bars Broker for Fleecing Widows and Alzheimer Patients
"Between 1988 and October 2008, Sullivan allegedly stole clients' money by making them believe they were investing in promissory notes and other products. He gave his clients a one-page "note" stating the amount of principal and a guaranteed annual interest rate ranging from 6% to 12%. The clients paid for the notes with personal checks made out to a fictitious corporation." Helen Kearney for Financial Planning magazine 8/31/2009

SEC Uncovers Another Ponzi Scheme
"Pacheco, who according to the complaint is well known throughout the Chula Vista, Calif., Community where he operated the alleged Ponzi scheme, raised nearly $15 million from more than 200 investors through an 'unregistered offering of securities in the form of investment contracts' during the 2005 through 2008 period. He boasted of profits of between 30% and 48% annually, all the while using new investor principle to finance those returns, the complaint alleges." Gerelyn Terzo, Iddmagazine.com 6/29/2009

And it affects charitable giving to:

SEC Charges Seattle-Area Firm in Multi-Million Dollar Scam Targeting Religious Community and Charitable Investors
"The Securities and Exchange Commission today charged John H. Min of Tacoma, Wash., and his company Dime Financial Group LLC for raising more than $6 million in a fraudulent investment scheme that targeted churches, church members and senior citizens. The SEC alleges that Min misled some investors into believing their money would support Third World charitable causes while in fact spending the funds on his own lavish lifestyle and on failed high-risk investments." SEC Press Release 3/31/2009

Disclaimer: *these reports are from public sources and do not presume the guilt or innocence of the person(s) involved.*

Common Scams

<u>Private Investments / Pooled Investments / Entity's and Partnerships</u>: While this type of scam is a type of Ponzi scheme, generally the criminal doesn't ever pay you "earnings" but instead uses all the money raised as his personal piggy bank. These scams are all about ***pooling*** investor money into a private entity that promises big returns with little to no risk. The criminal makes his pitch primarily to retirees and plays upon their fears of losing money in the stock market. His pitch is to invest in his group that will then use the combined money to purchase __________ (fill in the blank: real estate, mortgages, commodities, oil & gas, futures, etc). They have a "proprietary method" with an expert on staff that will generate risk free returns of 10% to 20%. It's a great sales pitch and when the average consumer hears they can achieve big returns risk free, they're sold. The only problem is that it isn't true. You find this out when you either: a) try to get your money out or b) when the FBI busts them. It's then that you learn your investment has gone only to support the lavish lifestyle of the scam artist.

"The deposition dispute is the latest twist in a case first brought by the SEC in 2006 claiming that Jack Utsick fleeced some 3000 investors out of nearly $300 million between 1998 and 2005. Utsick allegedly created a Ponzi scheme in which he paid older investors out of money from new investors, while his company actually lost gobs of money."

Curt Anderson – Associated Press

"On April 17, 2006 the SEC obtained permanent injunctions against Worldwide Entertainment, Inc., Jack Utsick, Entertainment Funds, Inc. The SEC complaint alleged that the defendents raised more than $300 million in connection with their fraudulent sale of unregistered securities used to fund entertainment ventures produced or promoted by Utsick."

www.sec.gov

Alleged Scams involving Futures & Commodities

The US Commodity Futures Trading Commission is the regulator which oversees futures and options markets. This regulator functions much like the Securities and Exchange Commission (SEC) which regulates the stock and bond markets.

There is a multitude of funds that invest in "alternatives" to the traditional stock market. This can be in the form of currencies (forex market), commodity futures and/or options. This asset class can be a beneficial part of one's portfolio in limited numbers and there are many reputable funds that operate in these markets. The problem is that these areas are also ripe for scams as investors are lured into claims of easy money.

Here are just a few of the recent headlines from the CFTC website:

September 9, 2009
CFTC Charges North Carolina Foreign Currency Firm CapitalStreet Financial LLC and its Principal Sean F. Mescall with Operating a $1.3 Million Forex Ponzi Scam, 5714-09

September 4, 2009
Federal Court Freezes the Assets of Florida Resident Beau Diamond and Diamond Ventures LLC, Charged by the CFTC with Operating a $37 Million Dollar Forex Fraud, 5711-09

September 4, 2009
CFTC Charges Illinois Resident and One of His Companies with Fraud in $6 Million Commodity Pool, 5712-09

August 26, 2009
Georgia Court Imposes Fines and Other Sanctions Against Atlanta-Based Saxon Financial Services Inc., Charged by the CFTC with Commodity Option Fraud, 5705-09

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Common Scams

Offshore Investments Scams: So far we have focused on greed as the one factor that causes human beings to lose all form of rational behavior, but there is another: taxes. It is quite amazing what people will do to avoid paying Uncle Sam. In fact, some folks are more concerned with tax implications than investment returns. But combined it makes for quite a sales pitch for an investment scam. The pitch usually sounds something like this: Scammer Investment Co. has put together an offshore entity (domiciled in another country, usually someplace tropical) and has a great investment opportunity that is completely free of U.S. taxes. The only problem is that these rarely work. You either lose your money when the scam is revealed, or worse, because you've made some "tax-free" profit, the Feds send you a nice little letter about tax evasion and potential jail time. Loss of money vs. jail time for tax evasion. I don't think the risk / reward works in your favor.

"The indictment alleges that from January 1994 through at least August 2000, Clyde Hood and his co-conspirators devised a scheme to enrich themselves at the expense of others by soliciting and selling what they represented as a "unit" or part in an offshore trading program…They then converted at least $12,500,000 in funds from unsuspecting participants"

US Attorney's office press release 8/28/2000

"The indictment alleges Clyde Hood and his co-conspirators represented Omega as a high yield investment program that would generate extraordinary profits from trading "debentures" or "prime bank notes" in foreign banks. Investors were promised a return of 50 times their investment within 275 days"

US Attorney's office press release 8/28/2000

Offshore Scams

The largest problem with offshore scams is that often the U.S. has no jurisdiction in the country in which the fraud takes place. This means that you are at the mercy of foreign security laws which may be less stringent than the U.S. laws.

As noted in the previous press releases many offshore investment scams involve prime bank notes or high yield bank debentures. While these may be legitimate, the overriding lesson is "buyer beware." A great website for learning more about Offshore Scams: http://www.quatloos.com/offshore_planning.php

The Stanford Financial Scandal

> "R. Allen Stanford, the Texas billionaire charged Tuesday with perpetrating an $8 billion investment fraud, cast himself as offshore investment guru to the transatlantic jet set…"
>
> "Stanford and his close circle of family and friends with whom he runs his businesses perpetrated a massive fraud based on false promises and fabricated historical return data to prey on investors," said Linda Chatman Thomsen, director of the SEC's enforcement division."
>
> "The SEC called Stanford's promises of high interest returns on his bank's certificates "improbable and unsubstantiated" The 25-page complaint filed in federal court in Dallas cast doubt on Stanford's claims of a unique investment strategy that allowed the bank to achieve double-digit returns on its investments over the last 15 years."
>
> -Carol J. Williams for The LA Times 2/18/2009

The Stanford scandal is especially painful for investors as their deposits were covered by neither SPIC nor FDIC insurance because the entity was headquartered outside the U.S. To learn more about this scandal and how they pulled it off: http://feedroom.businessweek.com/?fr_story=09922362afd1e498263a16e6a93efa9ecf05512e&rf=sitemap

Disclaimer: *these reports are from public sources and do not presume the guilt or innocence of the person(s) involved.*

Warning Signs:

So now that you have a taste of a few of the more popular scams, let's take a look at some clues that may tip you off that something is not quite right with your investment…..

1) **Custody:** One generally common trait among investment scams is that there are no separations in the investment trail (no checks and balances, per se). What this means is that the entity or financial company where you place your money (or open an account) is directly controlled by the individual with (the can't fail) investment strategy. This opens up a lot of opportunity for fudging of numbers.

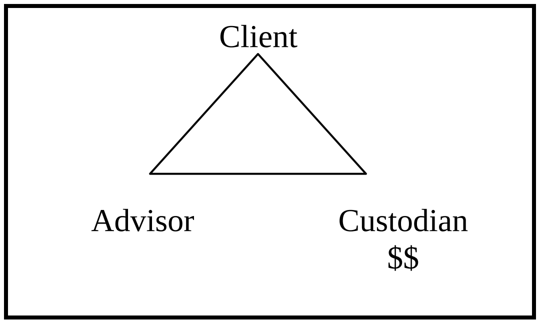
   Think it through with me. If the individual controlling the investment strategy, pooled investment or entity also owns the entity where your account is housed, then what's to prevent him or her from manufacturing statements with whatever info they want to put on there? Please note, I am not speaking of opening an account at Brokerage company A and working with one of their employee brokers. There is nothing wrong with that scenario. What I am referencing is the Madoff case, in which he controlled the "investment strategy", and he personally owned and controlled Madoff Securities in which individuals established their accounts. Or in another scenario, one is lured into a "private Investment" and the money is routed to an entity controlled by the investment guru. He has "the can't fail" investment strategy and has sole control over the entity and all of its accounting. Do you see where the potential is for fraud? Where are the checks and balances?

   A preferable method would be a complete separation of the investment manager from the entity that houses your account. This is the way Registered Investment Advisors generally work. They manage their client accounts with an independent 3rd party custodian. By doing this and not having direct custody of a client's assets it adds a much higher level of security for a customer (notice I said higher level – not complete safety)

See Diagrams on the next Page………

Who Holds Your Money?

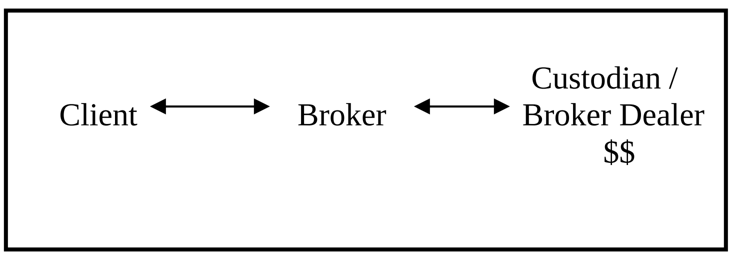
This visual diagram will help you better understand the Investment Advisor relationship:



The "typical" Registered Investment Advisor, Client and Custodian relationship. Note that the Custodian holds the client's account – NOT THE ADVISOR

The Custodian does not employ the Advisor and is a completely separate entity.

Reputable Broker Dealers offer similar levels of security via the compliance department which acts as an oversight between the broker and the client's account.



In a brokerage relationship the broker is generally employed by the brokerage company that custodies or holds your accounts.

Full Disclosure: As an Investment Advisor, I have a natural bias toward that type of client relationship. However, the majority of major brokerage firms/brokers are fine institutions and very safe for clients to work with. As mentioned before, you should probably pay a bit more attention only when your Investment guru actually owns or has controlling interest in the Broker / Dealer holding your money.

Warning Signs….continued:

2) **Statements:** Where does your investment account statement come from? It should always come directly from the custodian. You should also be given online access to review your account via the internet. Pay special attention to the account statements you are given. If it looks like someone produced it using a home computer it is time to be concerned.

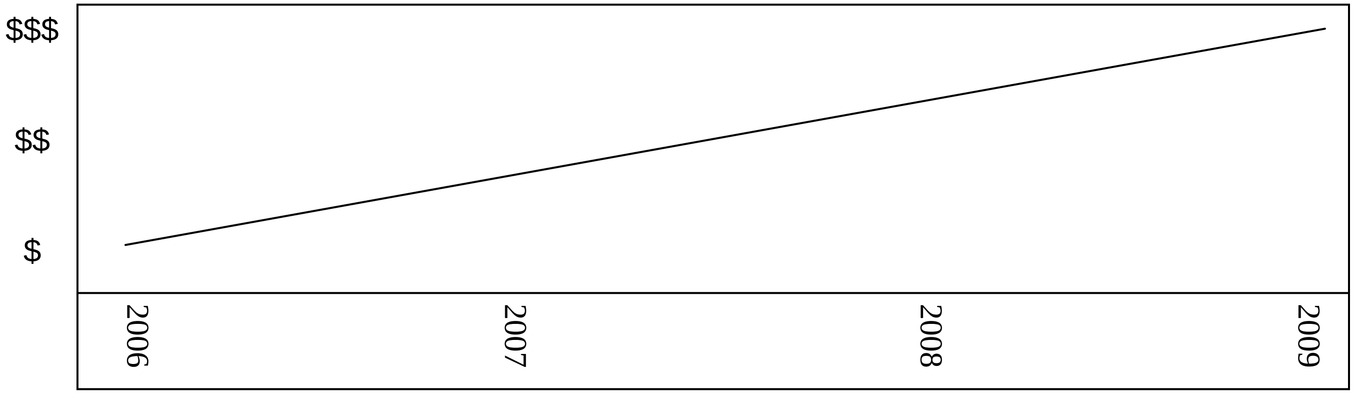
3) **Investment Strategy:** The investment strategy should be understandable. If the Investment guru glosses over strategy, tries to talk over your head or says it is proprietary, alarm bells should go off. If someone pitches you on an investment model that they have created, there is no reason for it to be inexplicable. They don't have to divulge their processes, but you do have every right to know how they are going to produce returns with your money.

4) **Accessibility:** Are you having trouble reaching a representative on the phone when you call? Does the operation seem too casual for an investment business? Have your calls gone unanswered or have you been given excuses when trying to take a distribution from your account? Any of these issues could be a sign of a problem. Wherever you invest your money, the advisor / investment manager / salesperson should be accessible to answer questions.

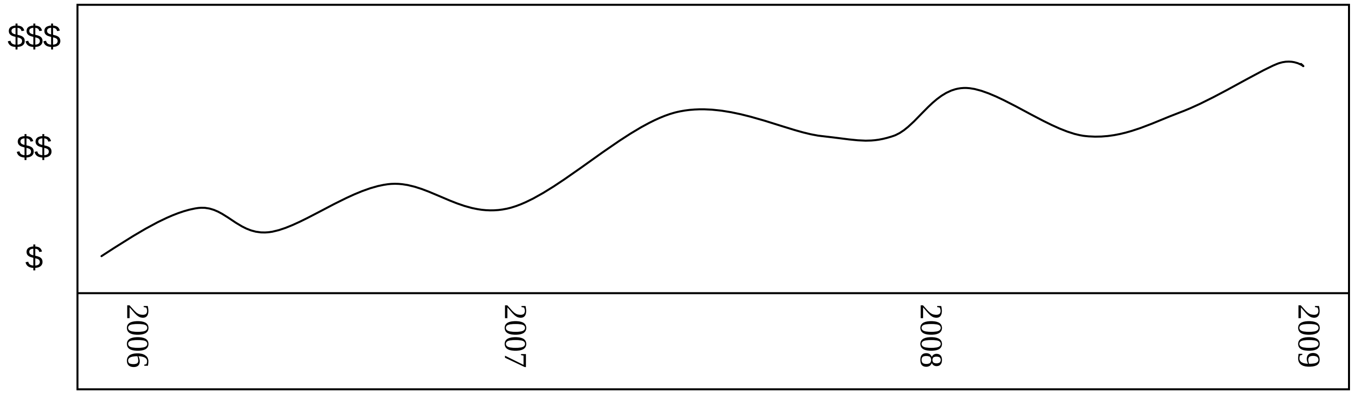
Be Alert!

5) **Returns:** Markets oscillate from month to month, as should your account values. If you consistently see positive returns in a difficult market you may want to take a closer look. If your account returns look like the first diagram below and you aren't in U.S. Treasuries, it may behoove you to investigate the investments a bit more closely. Even the very best Wall Street Traders have down months…so should you.

Unrealistic:



More Realistic:



The difference between an Investment Scam and a Bad Investment

The e-book was primarily written to cover investment scams, the ones that can wipe out your entire investment because someone was acting not only unethically but criminally. (Their intent was to steal your money from day one)

There is a large difference between an investment scam and a bad investment. Bad investments happen, just ask anyone holding an internet stock in 2000 that went from $100 to $1 in the blink of an eye. You may have actually encountered this at some point in your lifetime. The big difference is that this was just a bad recommendation. It may have even been a highly touted stock at the time but ended up crashing with the market. It would only be unethical if the Broker / Advisor had recommended that you put 100% of your portfolio into this one stock. (fraudulent if done without your knowledge)

In the case of unethical or fraudulent behavior by a financial advisor you do have some recourse against the brokerage company or the investment advisor's firm through the court system or arbitration. On the next page I have listed some links to the FINRA and SEC websites. If you feel that you have a grievance you may contact either of those regulatory bodies and/or consult a securities attorney.

A Note about FDIC vs. SIPC Coverage:
There always seems to be confusion regarding FDIC and SIPC protection of your money, so here is a brief explanation:

- **FDIC**: This is federal insurance coverage for cash deposits at banks only (when a bank fails). It does not cover your investment accounts, IRAs or Annuities held at a bank (unless they hold CDs). (coverage is generally $100k total per person but temporarily increased to $250k). To learn more visit the FDIC website: **http://www.fdic.gov**
- **SIPC**: This is what you need to look for with your investment custodian. SIPC coverage is insurance that protects your account when a brokerage firm / custodian **fails**. SIPC **does not** cover bad investments or protect your account from investment losses! (coverage is generally $500k per person with $100k coverage for cash) Many custodians carry additional insurance for clients above this amount, but they aren't required to do so. To learn more visit the SIPC website: **http://www.sipc.org**

Prior to Investing

The last item on the agenda is to give you information to review *PRIOR* to making an investment. This list is a good starting point for reviewing an investment solicitation. It's not foolproof but will arm you with enough information that you can spot a potential scam before putting your hard earned money at risk.

BE SKEPTICAL:

- It is not rude to question someone's claims when asking you to invest a large amount of money.
- If told that it is a limited time offer or limited to a certain number of people and you must act quickly, walk away. A legitimate investment opportunity will always allow time for due diligence.
- Does it claim to provide risk free or low risk returns well in excess of a bank CD or U.S. Treasuries? Well, there is no such thing. If there were, everyone would already be invested.
- Is the person pitching this investment registered or licensed to sell it? Make sure to check out the person and/or investment entity via the SEC website, FINRA website or through the State Securities website NASAA.
  - **http://www.sec.gov** to search for investment advisors or enforcement actions
  - **http://www.finra.org/brokercheck** for checking brokers and firms
  - **http://www.nasaa.org/quicklinks/contactyourregulator.cfm**
- Is there a prospectus or offering circular for the investment? This is the document that a company files with federal or state regulators prior to publicly offering an investment. It should be provided to all potential investors up front. If not, decline the investment.
- Is this a pooled investment in which they take money from many investors and pool it into a single account? Who will audit this? Is there an outside accounting firm that will be providing oversight?
- If you have a friend or associate who is pitching you on this deal, is he getting paid a referral fee? A legitimate investment would never have to pay existing clients a bonus for referring new investors.
- Is the investment publicly traded? If not, what is the holding period and how liquid is it?
- Are you being asked to write a check for this investment? To whom is it payable?

Print out the handy checklist on Page 22 when reviewing an investment!

The Summary

As Gordon Gekko said in the movie, Wallstreet, "*Greed is Good*". There is nothing wrong with a little greed. It is why capitalism works, investments increase in value and our standard of living improves. However, left unchecked, greed can also lead to the loss of your life savings (you know how the movie ends, correct?). As I mentioned before, human beings are conditioned to lose all sense of reasoning when presented with the opportunity to make big money quickly. It's why investment scams have been around for 100 years and will continue to be around for another 100 years.

The takeaway from this e-book should simply be that guarantees only exist with Bank CDs or U.S. Treasuries. The next time you are presented with a "can't fail - big return investment opportunity", be skeptical. While it may not be a scam it most certainly carries risk.

Where to get help:

If you are considering an investment and would like to get a 3rd party opinion, consider spending a few minutes with a financial planner:

- **National Association of Personal Financial Advisors: http://www.napfa.org**
- **Financial Planning Association: http://www.fpanet.org**
- **Certified Financial Planner website: http://www.cfp.net**

If you think that an investment you are in is a potential scam:

- **Contact your state regulator: http://www.nasaa.org**
- **Contact the SEC: http://www.sec.gov**
- **Contact the CFTC: http://www.cftc.gov**
- **Contact your State Bar for a listing of securities attorneys**

About The Author:

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The business: http://www.theadvisoryfirm.net

For Financial Education: http://www.myVizer.com

The Blog: http://www.marriedtoamiser.com

Investment Scam Checklist:

- Does the opportunity pitch big returns at low risk or risk free?
- Do you feel pressured or rushed into making a decision by the representative?
- Is the representative registered to sell the investment?
- Is the investment company registered with regulators?
- Have they offered you a prospectus or offering circular for review?
- In a pooled investment opportunity do they have outside auditors?
- Are you getting pitched on this opportunity from a friend or associate?
- Is that friend or associate getting compensated through referral fees?
- Is this a publicly traded investment? How liquid is it? (can you get your money out at any time?)
- Is there an account application? To whom are you making your check payable?
- Have you done a search on the internet for this company or investment?

AND REMEMBER …….A LITTLE SKEPTICISM IS HEALTHY WHEN YOUR MONEY IS ON THE LINE!