12 Steps to Avoid Ponzi Schemes & Investment Frauds

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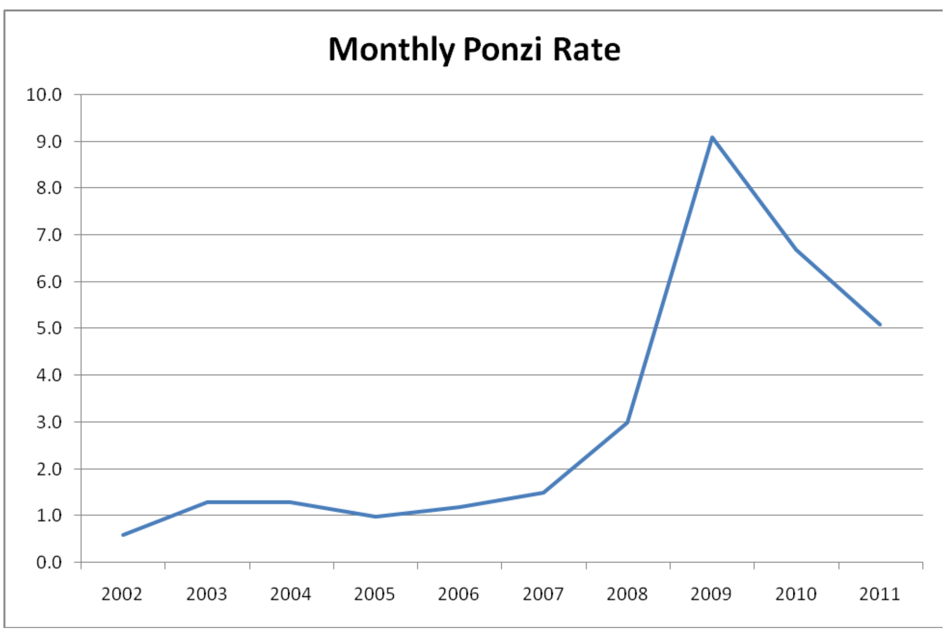
Economic downturns have a habit of revealing fraud – particularly investment fraud, such as Ponzi Schemes and similar shenanigans. In the wake of the Bernie Madoff multi-billion-dollar fraud case, I published a white paper analyzing major US investment fraud cases in the decade between 2002 and 2011, which is still relevant today. It illustrated, among many other key points, that these types of frauds tend to be revealed in times such as we find ourselves now, post Covid-19:[1]



[1] The Marquet Report on Ponzi Schemes, June 2011

With this in mind, I thought it prudent to remind the investment world about how best to avoid becoming a victim of these frauds in 12 steps:

1. **Do your due diligence** – thoroughly check out prospective investment advisors, money managers, hedge fund operators, private equity funds and any other individual or entity to be entrusted with your hard-earned investment funds. As my white paper, *The Marquet Report on Ponzi Schemes* illustrated, a significant percentage of Ponzi scheme operators (at least 1 in 8, according to our research) have a prior criminal action, fraud accusation or regulatory censure in their histories. Some are not even registered with the appropriate regulatory bodies and nearly 5% of the investment frauds we reviewed in this report involved the sale of completely phony securities. Make sure the outside auditors are reputable. In some cases, audit reports provided by Ponzi schemers proved to be completely phony from non-existent auditors.

    a) **Regulatory & professional checks** - The SEC requires investment adviser representatives and investment advisor firms to register by filing an "Independent Adviser Public Disclosure" called an "ADV Form". These can be searched directly on the SEC's web site. The SEC site can also be searched for regulatory actions, litigation notices, enforcement actions and other sanctions. The Financial Industry Regulatory Authority ("FINRA") maintains a searchable disclosure called "BrokerCheck" which includes files on registered brokers, including affiliations, qualifications and regulatory actions. Each state has a securities regulating body that can be contacted. A useful listing can be obtained at the North American Securities Administrators Association. Other professional associations can be checked as well, including The Financial Planning Association, The National Association of Personal Finance Advisors, and the Certified Financial Planner Board of Standards.

    b) **Background checks** – for deep digging, conduct a thorough background check on the individual(s) to be entrusted with any significant investment. This would include a thorough vetting of credentials, employment history, educational background, as well as independent civil and criminal checks, searches for liens, judgments and bankruptcies and the aforementioned regulatory bodies. Media coverage, business affiliations and online Internet profiles should all be checked. Identify "non references" – individuals who have had dealings with the subject in the past, but may not be listed as a client reference. Such individuals may be former business partners, former employees, current or former clients, industry analysts and others. Finally, a "lifestyle check" can also be conducted. As we have seen, most Ponzi schemers live an opulent and lavish lifestyle at investor expense. While not a conclusive indicator of fraud, it is certainly a common theme. Independent investigatory firms like Veritas Assurance Partners and other reputable outfits provide this kind of service.

c) **Talk to people** – it is not good enough to just "ask around" or talk to references provided. No one gives out bad references. Some fraudsters manufacture fraudulent references. Speak to actual longtime clients. Speak to "non" references. This latter category can be identified by asking any actual references for others to speak to as well as identified through the background investigation outlined above.

2. **If it sounds too good to be true, it probably is** – Ponzi schemers induce prospective investors with the promise of higher-than-market returns – often sky high or extraordinary returns. The Marquet Report on Ponzi Schemes analysis shows that the higher the promised returns the shorter the lifespan of the Ponzi scheme. Still, that is cold comfort for those who get burned. Any investment program that purports to deliver significantly higher-than-market rates of return should be an immediate yellow, orange or even red flag, depending upon how incredible they are. That, in fact, is the proper word for it – incredible – meaning "so extraordinary as to seem impossible," "not credible," "hard to believe," "unbelievable," "farfetched," "astonishing," and "preposterous," according to dictionary definitions.

3. **Be skeptical of exotic financial products** – if you cannot understand what the investment is and how it works, you probably should not be investing in it. Ponzi scheme perpetrators do not like to have to explain their programs with too much specificity and therefore often make the scheme appear highly complex or simply describe their trading program as "proprietary" or an "exclusive" program.

4. **Be skeptical of "once in a lifetime" claims** – as in the case of typical pyramid schemes, prospective investors are given a "once in a lifetime" opportunity to "get in on the ground floor" of an investment. While tempting, this is generally not a good sign.

5. **Be skeptical of "guaranteed" returns or "risk-free" investments** – as previously noted, no legitimate investment advisor can or will guarantee returns and no investments are risk-free. Since all investment involves risk, higher returns necessarily means higher risk. Therefore it is not credible that a high-return investment be risk-free. Also avoid investments described as "sure things" or require "special" or "exclusive" access.

6. **Be skeptical of investment programs targeted at specific "affinity" groups** – as *The Marquet Report on Ponzi Schemes* determined, elderly or retired individuals are the most common affinity group targeted by Ponzi schemers. The other two most common affinity groups include Religious sects and Ethic groups. Gaining the trust of the target affinity group is a key success factor for these Ponzi schemes. Ponzi scheme perpetrators sometimes attempt to create an exclusivity mystique about their investment "opportunity." Be concerned if your investment advisor claims you are now a member of an "exclusive" club.

7. **Be skeptical of flimsy disclosures and statements** – Many Ponzi schemers provide little disclosure information (naturally) upfront and provide fraudulent or completely fabricated statements to investors. Examine the statements, be sure they are detailed and regular, ie. monthly. Statements should come from the custodian of funds, not the investment advisor. As noted in the due diligence section above, be sure the auditors are real and legitimate.

8. **Be wary of too regular returns, especially in a volatile market** – it is impossible for actual securities investments to make overly consistent and exact returns, month after month, year after year. This was Bernie Madoff's hook (and tell), by providing stability of returns. Likewise, if promised returns or dividend payments are not forthcoming, investigate. Be sure your liquidation options are open.

9. **Be skeptical of new or unknown investment firms/advisors** – It is much less risky to work with a well-established reputable outfit than someone new or unknown. Again, see due diligence section, above.

10. **Be skeptical if your investment advisor is also the custodian of your investment** – the adjunct is also valid: be wary if the custodian is an affiliate of the investment

advisor. The custodian has direct access to your investment funds and may be able to move them as they please.

11. **Avoid high pressure sales tactics and Blind Internet solicitations** – you can be sure than many of these are not legitimate as reputable firms would not have to resort to such tactics.

12. **Diversify your investments** – Many investors lost their life's savings in the spate of Ponzi schemes revealed post 2008 economic melt-down. That is because they placed all of their eggs in one basket. If one basket rots through, a diversified investor will at least have other baskets protecting their remaining eggs.

Ponzi Scheme Resources:

US SEC: https://www.investor.gov/protect-your-investments/fraud/types-fraud/ponzi-scheme

US DOJ/FBI: https://www.fbi.gov/investigate/white-collar-crime

FINRA: https://brokercheck.finra.org/

Ponzitracker: https://www.ponzitracker.com/ponzi-database

Marquet Report on Ponzi Schemes: contact Chris Marquet at cmarquet@veritasap.com.