

THE RISE OF FINANCIAL FRAUD

BY KIMBERLY BLANTON*

Introduction

Individuals save for decades to ensure that they will have financial security in retirement. That security can be threatened or eliminated virtually overnight if an individual who is in or near retirement becomes the victim of a financial fraud, such as a Ponzi scheme or sham investment in high-yield securities.

Fueled by the Internet, the incidence of financial fraud is on the rise. Law enforcement officials and fraud experts expect the trend to continue or accelerate as aging baby boomers increasingly become targets. According to the Federal Trade Commission (FTC), Americans in 2011 submitted more than 1.5 million complaints about financial and other fraud – up 62 percent in just three years.¹ But these data do not fully represent fraud’s pervasiveness, because researchers say that it often goes unreported to the authorities.

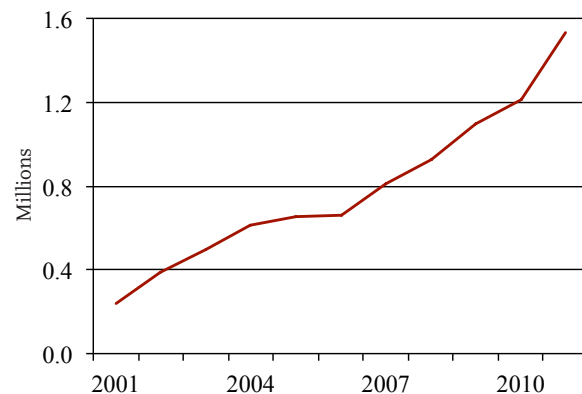
Identifying the patterns of fraud can be helpful because scams and the con men who perpetrate them, once identified, are more easily recognized by a potential victim. This *brief* discusses fraud trends and describes some of the patterns.

The first section documents the surge in fraud. The second section identifies what is driving this increase. The third section explains why seniors are often targets of fraud. The fourth section defines four major categories of financial-product fraud. The fifth section reports three of the many disguises used by scammers to persuade their targets to purchase investments or financial products. The conclusion is that all Americans, especially older Americans, should learn how to recognize the signs of fraud.

Financial Complaints Increase

The FTC tracks all types of consumer fraud, including financial fraud, by compiling complaints reported by a range of consumer groups and law enforcement.² As shown in Figure 1, fraud complaints have increased sharply over the past decade.³ Financial losses per capita have also increased: the median loss per victim rose from \$218 in 2002 to \$537 in 2011.

FIGURE 1. FRAUD COMPLAINTS FILED BY CONSUMERS, 2001-2010, IN MILLIONS⁴



Source: Federal Trade Commission (2012).

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An FTC survey found that 13.5 percent of Americans – more than 30 million adults – admitted to being taken by fraud in 2004.⁵ This finding is consistent with numerous surveys asking individuals whether they have been targeted by fraud solicitations, both financial and non-financial.⁶

But the public is not fully aware of the pervasiveness of fraud, because news media focus primarily on major scams, such as Bernard Madoff's Ponzi scheme.⁷ They frequently do not report the hundreds of small and medium-sized cases filed each year by state securities commissions. Commissioners, whose investigators are pursuing fraud cases inside state lines, say it is increasing. Alabama, for example, had an unprecedented 31-case backlog of criminal trials involving financial fraud in September 2011.⁸ This backlog is inordinately large for a state that closes 20 to 25 convictions every year. In addition, the Securities and Exchange Commission (SEC) filed a record 146 enforcement actions against investment advisers and companies in 2011.⁹

Many more scammers are never caught by a state and federal regulatory system rife with staff shortages and inadequate resources. In addition to state backlogs, the SEC admitted in April 2010 that it had never examined some 3,000 registered U.S. investment advisers.¹⁰

What Fuels Financial Fraud?

Current economic conditions may be fueling fraud. People face serious financial problems ranging from stagnant incomes after the 2008 stock market crash to skyrocketing medical costs and house values that are less than the mortgage amount. Any one of these can make an individual more vulnerable to get-rich-quick schemes.

But public and law enforcement officials primarily blame the Internet, which enables scammers to contact thousands, or even millions, of people with a single keystroke.¹¹ "Phishing" is a common cyber-avenue for fraud in which a scammer sends a mass email proposing a sham investment. If even a small percentage of recipients bite, the sender can bring in big dollars. Scammers have begun using Facebook and LinkedIn to target potential victims.

Complaints about scams perpetrated over the Internet have increased sharply. High-dollar investment schemes via the Internet or email from safe havens overseas allow perpetrators to remain anonymous, making them more dangerous. Using a cutting-edge tactic, a resident of India involved in a group operating out of Thailand and India received a two-year sentence in 2008 for hacking into 95 Americans' investment accounts at their brokerage firms to buy a stock the hacker owned. Once these "purchases" inflated the stock price, the scammer sold his shares for a profit, but investors sustained losses.¹²

Who Are Fraud's Targets?

Some fraud watchdog groups and public officials are especially wary of fraud against seniors. Concerned about scammers tailoring investment pitches to seniors, the North American Securities Administrators

Association, the trade organization for state securities regulators, in 2007 alerted seniors to check the credentials of people they do

business with.¹³ California regulators felt that fraud against seniors in that state warranted creation of its Seniors Against Investment Fraud program.

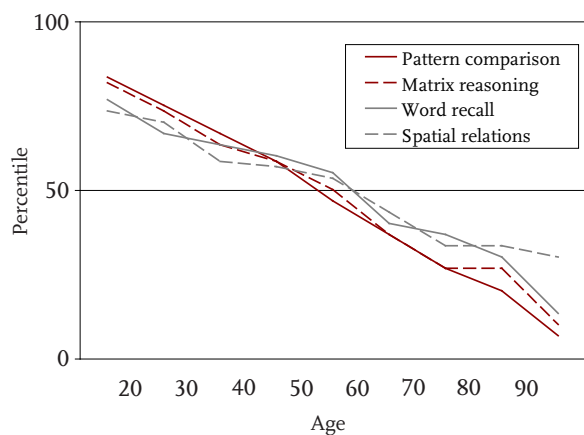
As baby boomers age, the problem is expected to grow in the future. This generation is potentially a lucrative target due to three characteristics: it is enormous, with some 75 million people; increasingly well off; and facing cognitive decline.

Baby boomers are accumulating inheritances from their parents, adding to substantial home equity and a lifetime of saving for retirement as the first generation to experience the transition from traditional pensions to 401(k) accounts. When money is combined with cognitive decline among aging baby boomers, it can be a recipe for fraud.

Research has determined that the ability to make effective financial decisions declines with age as dementia and other types of cognitive impairment increase.¹⁴ Between ages 71 and 79, one-fifth of individuals are impaired but that rises to half of those between ages 80 and 89. Figure 2 on the next page shows that "fluid intelligence," which is critical to performing novel tasks such as comparing patterns, reasoning, and word recall, also declines sharply with age.¹⁵

As baby boomers age, the nation's fraud problem is expected to grow in the future.

FIGURE 2. TRENDS IN COGNITIVE ABILITY, MEASURED BY FLUID INTELLIGENCE, BY AGE



Source: Salthouse (2005 and 2010).

Failed memory is another problem. Older people often do not remember that information they have previously received was negative. Seniors can more easily be charmed by a charlatan, because they tend to process the positive information about him, such as how nice, warm or attractive he is – that’s what they remember. Young adults are more likely to be suspicious and to look for and remember inconsistencies in someone’s story.¹⁶

Nothing New Under the Sun

To help individuals recognize fraud, this section describes four enduring financial frauds: investment fraud, advance-fee fraud, insurance fraud, and tax fraud. The box that appears on this page also lists 10 common red flags associated with fraudulent deals, which may be helpful in alerting consumers to when they are being targeted.¹⁷

Investment Fraud

A wide variety of investment frauds all have one thing in common: they sell something – a company, product, or security – that either does not exist or will not live up to the financial return being promised.

Madoff’s \$50 billion scheme was fundamentally no different than Charles Ponzi’s promises in the 1920s. Both deceived people into believing that some-

thing new was being offered. But investors failed to realize that their money was used illegally to support the scammer’s personal lifestyle and pay high “returns” to earlier investors to perpetrate the scam. The Ponzi schemes collapsed, as they always do, when new investors stopped supplying money.

“Pump-and-dump” scams occur when con men send out inflated and inaccurate information about a company’s stock they already own. Sham reports hyping the company’s profits or business prospects encourage naive investors to rush in and buy stock. When they do, the fraudster sells his shares for a large gain, depressing the price and leaving those who were defrauded with losses on their shares.

Fake or dubious investment companies sell securities purportedly backed by a hot new consumer product, technology, or business opportunity. Scammers often capitalize on news events such as a natural disaster or stock market decline, going to great lengths to create an appearance the company they are touting is real.

High-yield investment fraud is especially popular when stock- and bond-market returns and yields on certificates of deposit are low. Con men claim the securities they sell possess the impossible combination of low risk *and* very high returns.

Fraud’s Red Flags

Investments may be fraudulent if they:

- Look too good to be true.
- Offer a very high or “guaranteed” return at “no risk” to the investor.
- Require an urgent response or cash payment.
- Charge a steep upfront fee in return for making more money on an unspecified date.
- Suggest recipients do not tell family members or friends about the offer.
- Lure prospective investors with a “free lunch.”
- Come unsolicited over the Internet, are of unknown origin, or come from overseas.
- Instill fear that a failure to act would be very costly.
- Cannot be questioned, inspected, or checked out further.
- Are so complex that they are difficult or impossible to understand.

Advance-fee Fraud

The outcome never varies for the myriad advance-fee scams: money is paid but the service or product is not delivered.

Debt-settlement scams that purport to help struggling consumers pay off debt become more pervasive during periods of recessions or slow growth. Recent high rates of foreclosure spurred advance-fee mortgage scams. Fraudsters pose as mortgage experts or attorneys and offer, for a fee, to negotiate with the lender for an affordable payment schedule or a reduction in the debt balance that never materializes.

Others involve credit cards. Scammers charge a fee to negotiate with credit card companies to reduce debts or repair credit ratings but never complete the work. This type of fraud is specious, because credit card companies are often willing to negotiate directly with financially strapped consumers.

Insurance Fraud

Insurance fraud against individuals occurs when unscrupulous insurance agents or brokers sell health, auto, home or life insurance and divert premium payments to their personal bank accounts. Fabricated policy documents give victims the impression that the coverage is in effect, so they continue paying their premiums.

As insurance products become more complex, they also spawn fraud. Legitimate insurance products such as annuities and so-called viatical settlements, for example, can be useful tools for people near or in retirement. But con men use the complexity to target victims. The U.S. Department of Justice has charged that some 30,000 people lost \$1 billion when scammers in Florida sold fraudulent viatical settlements, under which terminally ill patients or elderly persons assigned the death benefits on their life insurance policies to investors in return for lump sums to pay living or medical expenses.¹⁸ One state regulator views this area as rife with more potential for fraud.¹⁹

Tax Fraud

Some scams exploit low-income tax filers' chronic need for cash.

Tax preparers deceive working people into thinking they can obtain larger tax refunds than they are eligible for by filing false deductions or, for example,

manipulating clients' income on their tax forms to qualify for the Earned Income Tax Credit. The preparer then extracts a fee from the inflated tax refund. If the IRS discovers the fraud, it may require the tax filer to repay the fraudulent refund, plus any interest and fees.²⁰

Refund Anticipation Loans (RALs), which provide tax filers with a loan to be paid when their IRS tax refund comes in, were offered in Arkansas, New York, and North Carolina. Some RALs charge fees or interest rates in violation of state laws, though they are becoming less common due to tougher regulation.²¹

Fraud's Many Disguises

Scammers disguise themselves by adopting different personalities to appeal to different types of people or groups. These transformations are inseparable from their basic strategy of winning a potential target's trust. Three common disguises that scammers use are the senior specialist, the problem solver, and the magician.²²

The Senior Specialist

Senior specialists claim to possess special training to help clients deal with problems unique to the elderly, another sign that this population may be a focus of fraud. Nearly half of respondents to one survey stated that if an investment professional held a special accreditation to advise seniors they would be more likely to listen to the advice.²³

Knowing that seniors are more risk-averse, con men often ease seniors' fears by peddling financial products they say are "low-risk" or "no-risk." Whether they are selling stocks, bonds, debt, or high-yield investments, the schemers tap into a senior's source of anxiety: earning enough money on their investments to support themselves comfortably in retirement while keeping their money safe.

Case: Jeffrey Gordon Butler's clients in southern California trusted him, because he had helped them prepare their wills and trusts. So they believed him when he said an investment would pay them 12 percent. It was a Ponzi scheme. At first, retirees said, they received money from their investment, prompting them to turn over more money. Some 100 people lost \$10 million in Butler's scam, including a retired school teacher who had given him \$300,000.²⁴

The Problem Solver

Problem solvers are empathetic and target emotionally vulnerable people in financial distress who feel they have nowhere to turn for help. Problem solvers offer to help people having difficulty paying credit cards, mortgages, or pay-day loans. This type of fraud spiked during the recession, law enforcement said. Senator Charles Schumer felt the problem was so pervasive that he sent out a public alert about “robocalls,” or automated calls, by scammers charging up-front fees to negotiate debt reductions.²⁵

These scams offer deceptively simple solutions to what their targets probably should already know are complex financial problems. Many have already tried, and failed, to remedy them on their own.

Case: An Alabama judge in February 2010 permanently shut down what the state Attorney General called “one of the largest debt settlement schemes in the nation” against 15,000 Americans mired in credit card and personal debts.²⁶ The Alabama Securities Commission, which had requested the action, said the company promised “superior results” and convinced people to pay millions in upfront fees and then to stop paying their debts, which would force the credit card or other lenders to settle. The plan failed, and the victims’ credit ratings were ruined.

The Magician

Although an investment with a high return, at no risk to an investor, is impossible, the magician promises just that. The magician often tantalizes customers with a free lunch, steak dinner, or educational seminar – in fact, senior fraud victims were three times more likely to attend an investment seminar offering a free lunch.²⁷

To sell his fraud, the con man lures his prey with such carefully chosen jargon as “minimum guaranteed return,” “triple your investment,” “profits guaranteed,” or “can’t lose any money.” These returns can be conjured up for any type of investments.

Case: Law enforcement said “outlandish” rates of return were promised to some 40,000 people in more than 120 countries who believed Nicolas Smirnow’s sales pitch on his website, Path to Prosperity, or “P 2 P.” They invested and lost more than \$70 million in the global fraud, which promised 546 percent returns in seven days, law enforcement said.²⁸

Conclusion

Fraud has surged as scammers have used the Internet to solicit large numbers of potential victims with greater ease. Fraud is expected to continue rising in the future, as the growing population of elderly baby boomers, who have substantial assets, increasingly experience cognitive decline.

The pervasiveness of fraud makes it incumbent on individuals to be wary of scams. Individuals who are knowledgeable about the standard fraud strategies and are able to recognize some of the disguises used by scammers can better protect themselves.

Endnotes

- 1 Federal Trade Commission (2012).
- 2 The FTC compiles consumer complaints it receives, along with those filed by other organizations, including the FBI's Crime Complaint Center; the Better Business Bureau; the U.S. Postal Service; the non-profit Identity Theft Assistance Center, which is supported by the financial industry; and the National Fraud Information Center, which is operated by the non-profit advocacy group National Consumers League.
- 3 One reason for the increase is that more organizations over time have submitted their fraud complaint data to the FTC. Complaints flattened out in 2010. In slow economic times, two counteracting tendencies can influence fraud trends. Individuals are less willing or able to part with their money if they're in financial distress. However, a subset of the population – those with large debts they are no longer able to repay – become more vulnerable to debt consolidation frauds or schemes that claim to solve their financial problems.
- 4 The FTC tracks three categories of consumer fraud complaints: Fraud, Identity Theft, and Other. To more closely estimate financial fraud only, data in Figure 1 exclude Identity Theft complaints. The Fraud category includes debt-collection scams, business opportunities, fraudulent lenders, and advance-fee fraud, as well as non-financial fraud; Other includes misleading real estate practices, false debt collection protection, and deceptive lending.
- 5 Federal Trade Commission (2007).
- 6 Surveys compiled by the Financial Fraud Research Center at Stanford University (2011) found that 10-15 percent of the U.S. population has reported that they have been victims of fraud.
- 7 Power (2010).
- 8 Borg (2010 and 2011).
- 9 Securities and Exchange Commission (2011).
- 10 Horowitz (2010).
- 11 Dozens of interviews with law enforcement and government officials were conducted for the report on which this *brief* is based. This *brief* cites only interviews that provided specific facts used here. More complete information about interviews, as well as legal documents and news articles supporting this *brief*, are available in the full report (Blanton 2012).
- 12 U.S. Department of Justice (2010a).
- 13 North American Securities Administrators Association (2006).
- 14 Agarwal et al. (2010).
- 15 Salthouse (2005 and 2010).
- 16 Park (2005).
- 17 This list was compiled from tips posted on the websites of securities regulators, attorneys general and law enforcement officials around the country.
- 18 *South Florida Business Journal* (2009).
- 19 Galvin (2010).
- 20 Internal Revenue Service (2009).
- 21 Wu (2011).
- 22 These disguises are based on interviews with law enforcement and fraud experts and reviews of dozens of federal and state fraud cases and news articles.
- 23 FINRA Investor Education Foundation (2007).
- 24 Welborn and Salazar (2006).
- 25 Schumer (2009).
- 26 *Birmingham Business Journal* (2010).
- 27 FINRA Investor Education Foundation (2007).
- 28 U.S. Department of Justice (2010b). A resident of the Philippines, Smirnow, whom authorities said operated out of Canada and the Philippines and whose website was based in the Netherlands, could not be located to comment on the allegations.

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