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Financial AdviceFont Size: **To Avoid Ponzi Schemes, Look Out for 'Red Flags'**

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Capital Gains

Charles Ponzi is synonymous with the "rob Peter to pay Paul" swindle, infamously known as a "Ponzi scheme." As further detailed in "The Money Lords" by Matthew Josephson and "The Great Bull Market" by Robert Sobel, the swindle started in 1920, when Ponzi placed a newspaper ad promising a 50 percent return in 45 days and a 100 percent return in 90 days from playing currency spreads by trading International Postage Union reply coupons.

As the millions flowed in, Ponzi used new investor money to pay older investors. This scheme continued to work until an investigative report by *The Boston Post* revealed that only \$75,000 in International Postage Union reply coupons were printed in a given year. Thus, Ponzi could not have invested the millions he had received from his trusting investors. As further revealed by the *Boston Post*, Ponzi had received about \$10 million, issued notes for \$14 million, but his accounts held less than \$200,000. At the time of Ponzi's death in 1949, he had \$75 to his name.

Like any pyramid scheme, Ponzi did not spend all \$10 million. It appears that most went to pay his earliest investors. This pyramid scheme is the very basis of what is now famously called a Ponzi scheme.

Bernie Madoff pleaded guilty to running a \$65 billion Ponzi scheme and prosecutors allege a Forbes 400 member, R Allen Stanford, has stolen billions. Although recent pyramid schemes are sensational in size and have scammed wealthy investors, the less wealthy or smaller investor should not feel safe from these con artists. Such pyramid schemes have proliferated on smaller scales in communities and towns everywhere.

Here in the Delaware Valley, for example, Joseph Forte of Broomall has pleaded guilty to wire fraud, mail fraud, bank fraud and money laundering charges in a Ponzi scheme involving more than \$50 million, according to court papers. These sensational stories and egregious patterns of conduct leave investors searching for an answer to the following question: How can I protect myself from being the next Ponzi scheme victim?

Although the fraudsters can be creative, their approaches to the investing community bear many similarities. This is good news to investors, large or small, frequent or infrequent. Here are 10 red flags to avoid so that you are not the next Ponzi scheme victim:

- Funds are deposited directly with the investment adviser and not in a separate custodian account.

If the investment adviser also has custody of your investments, the adviser is now in a position to take your funds at any time. This is akin to the proverbial, "fox watching the hen house." Do not ever provide your adviser with this primary element of every fraud — that is, the "opportunity" to perpetrate the fraud. Therefore, you should require that your assets are deposited directly in a third-party, well-known custodial institution with 24/7 online access; and held in a separate account in either your name, a joint account name with your spouse or in a trust name for your benefit.

- Funds are deposited in a broker-dealer that is an affiliate of the adviser.

Although your assets are deposited in a broker-dealer who has custody of your assets separate and apart from your investment adviser, you may still be a victim of a pyramid scheme if your adviser is affiliated with the broker-dealer. An affiliated relationship exists when a business enterprise is controlled or can be significantly influenced by another enterprise.

Therefore, as noted above, you have provided your adviser the opportunity to take your funds at any time. Thus, if your adviser recommends a broker-dealer that is not a large custodial institution with whom you are familiar, then you should require your investment adviser to provide the details of the recommended broker-dealer ownership, along with the details of any affiliated relationship. Funds should not be deposited with any broker-dealer, custodian, etc. in which any or all of its ownership can be controlled by the investment adviser through an affiliate relationship.

- Monthly brokerage statements are sent by the adviser and not the custodian.

As noted before, it is essential that the functions of the investment adviser and custodian remain separate. Accordingly, you should require monthly brokerage statements direct from the custodian and compare the information on this statement to the information statements received from your investment adviser. Any differences should be immediately investigated.

- Your adviser's investment returns are consistently good, even in a volatile economy.

There is an old cliché from Mark Twain's, "Huckleberry Finn," which states, "If it is too good to be true, it is too good to be true." In typical Ponzi scheme fashion, fraudsters will make claims of great, non-volatile, consistently positive returns. Thus, victims will not complain about investment returns that are consistently outpacing the market even in a volatile or recessionary economy. Unfortunately, volatile and recessionary economies have been the norm and not the exception.

Therefore, in order to identify the true investment adviser from the investment scammer, you should: Determine if the adviser manages to a stated benchmark; examine the adviser's record of past performance, require the adviser to explain deviations from the benchmark, particularly, those deviations that are higher; and require the adviser to explain investment performance that consistently far outperforms typical market indicators, such as the Standard & Poor's 500, The Russell Index, etc.

- Your adviser's returns are consistently the same, year after year.

A study of stock market performance over the last 65 years reveals an average performance of about 10 percent. However, during this period, the Standard & Poor's 500 has experienced positive annual returns exceeding 40 percent but has also experienced negative annual returns of 30 to 40 percent. Therefore, promises of consistent, positive returns from an investment adviser are another red flag you must avoid.

- Your adviser's investment strategy is complex and not clearly explained.

Madoff confessed to an investment strategy of split-strike conversions. Other con artists have employed investment strategies using futures, forwards, swaps, derivatives, options, and others. All of these strategies sound complex, and are complex to the novice investor. Such complex strategies are another red flag to avoid if the investment adviser is not explaining it in clear, simple terms. If the adviser cannot, or will not, explain the strategy clearly in a manner you understand, then walk away.

- Your adviser's investment strategy is not compatible with either your short-term or long-term goals.

Although certain investors may not be able to articulate a specific investment strategy, the goals of most, if not all investors, are growth (the funding of future needs), or income (the funding of current needs), or both. Therefore, it is essential that your investment goals are compatible with the risks and investment strategies employed by your adviser. If they do not mesh, and your adviser is not willing to meet your expectations, then walk away from this red flag of incompatibility.

- Your adviser claims you are now part of an exclusive club.

There are many individuals who join private, social clubs to gain the aura of comfort associated with exclusivity. To join such exclusive clubs, individuals often have to work at being accepted. It is this sense of exclusivity that provides another red flag for con artists. Madoff was the leader in investor exclusivity. Madoff did not market his services. He required that new investors be introduced by a trusted source, and even required a vow of secrecy to perpetuate the exclusivity of the club.

When selecting an investment adviser, the roles should be reversed. The investment adviser should be the one working at being accepted. Exclusivity is not a benefit when trusting someone to manage your money. It is just another red flag.

- Your adviser shares your views regarding politics, religion, sports, etc.

The comfort zone resulting from being a member of an exclusive club also extends to being among those who share your same views regarding politics, religion, sports, etc. Investment scammers know this and, thus, prey upon these individuals' comfort zones. For example, Madoff scammed his fellow club members at the Palm Beach Country Club. Do not allow these individuals to provide you with a false sense of security. Be particularly wary of their ulterior motives that benefit them and not you.

- Your adviser was recommended by a member of your church, country club or affinity club who, like yourself, has not performed the proper due diligence.

The one fact consistent with nearly all victims of a Ponzi scheme is that they failed to perform the proper due diligence, and, in some cases, did not perform any due diligence. Many were led by a trusted intermediary from their church, country club, affinity club, etc., who was also led to the belief of consistently high annual returns without doing their own due diligence.

Do not be fooled by this comfort zone. Due diligence is your job, whether you do it yourself, or hire someone else to do it for you. The Securities and Exchange Commission has set rigorous standards of reporting for investment advisers. Even at that, investment scammers may misrepresent the truth in such filings. This is all the more reason why you must be rigorous in your efforts. Otherwise, you too may be the next Ponzi scheme victim.

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