How to Avoid Financial Fraud

By
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A

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## CONTENTS

 Preface ......................................................... i  
 Introduction ................................................. 1  
 
 I. Victims and Perpetrators ................................. 4  
 Victims ....................................................... 4  
 Perpetrators ............................................... 6  
 
 II. Establishing Contact and Common Sales Tactics ......... 8  
 Establishing Contact—Hello, Mr. Jones, It’s Your Lucky Day! 8  
 Common Sales Tactics—Getting You to Say Yes! ............ 11  
 Identity Theft .............................................. 14  
 
 III. Investor or Speculator? ................................. 19  
 Saving and Investing ...................................... 20  
 An Overview of Various Assets ......................... 22  
 Your Dollar Holdings .................................. 22  
 Bonds ....................................................... 22  
 Collectibles .............................................. 23  
 Gold ......................................................... 24  
 Precious Metal Mining Shares ......................... 24  
 Real Estate .............................................. 25  
 Common Stocks ........................................ 25  
 Mutual Funds ........................................... 27  
 Summary .................................................. 29  
 
 IV. The ABCs of Financial Planners ....................... 30  
 Compensation ............................................. 31  
 Checking Credentials .................................. 31  
 Selecting a Financial Planner ......................... 33  
 A Final Warning… ...................................... 36  
 
 V. Selecting a Broker .................................... 38  
 Full-Service Brokerages ................................. 39  
 Discount Brokerages ................................... 40  
 Online Brokerages ..................................... 42  
 SIPC ....................................................... 43  
 Background Check ..................................... 44  
 Your Account ........................................... 45
NOT too many decades ago, when schoolchildren routinely were required to conjugate verbs and parse Latin sentences, the maxim caveat emptor was part of the vernacular. Its common use then reflected learning that differed greatly from that promoted by most of today’s educators and civic leaders. Given the prevailing notions that over the past several decades have replaced traditional benchmarks of performance in human transaction with an “I’m O.K., you’re O.K.” standard, it comes as a surprise when school children today are cautioned to beware of anything. In this sense, today’s young are being conditioned as the easiest of marks.

Much the same might be said about the oldsters. Over the past half century government has intruded into every facet of daily life, and many decisions that formerly were the individual’s responsibility now reside elsewhere. To a much larger extent than ever before, group interest politics has replaced individual endeavor. No one knows whether this tendency may have reached the point where most people no longer can make effective decisions about their own well-being. But that is plainly the view of many politicians and pundits who say that people must not be allowed to assume control over their personal finances, and that mandatory government administered welfare, retirement, healthcare programs and the like be maintained or expanded.

Whether or not we all are as naïve or incompetent as today’s policy planners seem to believe, such developments have fostered profound corruption of the social order and the further division of society, in the words of the late Arthur Okun, into “sharpies” and “suckers.” In such an environment, it may sometimes be difficult even for informed individuals to distinguish the legitimate from the fraudulent.

Of course, there are some financial frauds, such as Social Security, which no one can escape — at least for the foreseeable future. But many others can be avoided. It is our hope that the pages that follow will help you to do so.
INTRODUCTION

_It was beautiful and simple, as all truly great swindles are._
from _The Gentle Grafter_, O. Henry

ALTHOUGH tourists visiting a Grand Rapid’s museum gift shop were disinterested in shelling out $22.95 for century-plus old bonds issued by the defunct Chicago, Saginaw & Canada Railroad Co. to keep as a curio, investors snapped up roughly $24 million of the bonds. Why? They were told that each $1,000 face value bond had been accruing interest for the past 125 years at an annual rate of 7% and could be worth anywhere from $80 to $110 million. The scam hooked hundreds of people—including college students, retirees, a golf pro, and an attorney, among others. Said one victim who lost $10,000: “It was presented as a real safe investment,” and then solemnly added, “I am really a fool.” Authorities aren’t sure who came up with the idea of promoting the bonds, but they would have to agree that it was beautiful and simple, as all truly great swindles are.

Commonly defined, fraud is an act in which attempts are made to deceive with promises of goods, services, or financial benefits that do not exist, were never intended to be provided, or were misrepresented. Fraud is not, in general, dependent upon the application or threat of physical force or violence. Before the fact, the victim is a willful, albeit unwary participant. It is after the fact, when less is delivered than promised, that a person realizes that he or she has been victimized.

Fraud differs from such crimes as robbery and larceny or theft. Robbery is taking or attempting to take anything of value from the care, custody, or control of a person or persons by force or threat of force or violence and/or putting the victim in fear. Robbery is both a property crime and a violent crime. Larceny-theft is the unlawful taking, carrying, leading, or riding away of property from the possession of another. This crime includes such actions as shoplifting, pocket picking, purse snatching, and the like. It too is a property crime, but the use of force or fraud is absent.

Furthermore, merely losing money on an investment does not necessarily imply that a fraudulent act took place. A poor investment is one whose subsequent value is less than the value of the resources that were originally expended on it. Losing money on a poor investment is frequently the result of investor ignorance and excessive optimism—the same reasons people are often swindled. And, losing money on a legitimate investment is likely to evoke the same sort of emotions that might occur after being swindled. The difference, however, hinges on whether an intentional misrepresentation, concealment, or omission of the truth for the purpose of deception or
manipulation detrimental to the investor occurred.

The line between legitimate and illegitimate business dealings is often hard to draw because most fraud schemes are designed to closely resemble lawful business operations in order to thwart prosecution. Quite often, swindlers will give you something for your money even if what you receive is much less than what you bargained for. Rarely is a victim swindled out-and-out; that is, sold something that does not exist. But it does happen.

Just how large a problem is fraud? Several studies suggest that it is both widespread and very costly. One study that examined telemarketing abuses found that one in three Americans had been cheated out of money. A different study revealed that three quarters of those surveyed were deceived or defrauded by some type of direct marketing scheme—with one in seven reporting that they had suffered a major fraud. According to the U.S. Office of Consumer Affairs, those involved in fraud take in about $100 billion annually. Stated another way, yearly losses from fraud average roughly $370 per American. Of course, in any given year, not all Americans are victimized. For the ones that are, losses range from less than one hundred to over thousands of dollars. These statistics are sketchy at best because most fraud goes unreported. Victims rarely step forward to file complaints with legal authorities, lest they appear stupid or be branded greedy.

There are many types of fraud, but they generally fall into one of two categories: consumer fraud or financial fraud. This booklet will focus on financial fraud—from an investor’s perspective. Financial fraud encompasses bogus investment or business schemes, scams involving credit assistance or loan consolidation, unauthorized use of credit card or bank account numbers, insurance rip-offs, and more.

Investment scams are fairly simple: the typical fraud involves the target exchanging money today for a phony promise of much greater riches tomorrow. Most of the ploys are not new. What makes them work time and again is the swindler’s marketing ingenuity. He is renowned for his ability to repackage the most timeworn scheme to make it appear as a fresh and exciting opportunity. No less astonishing is his skill in convincing investors to trade their hard-earned cash for an assortment of flimsy promises that the opportunity at hand is both lucrative and risk-free.

Research has found that people are more likely to fall for a scheme that they’ve never heard about. In addition, targets were more likely to be victimized if they did not check out the promoter or proposition before investing. These findings suggest that sheer ignorance and naïveté are two of the swindler’s greatest allies. The less you know, the better his chances
of success.

A book on financial fraud and abuse should include more than just examples of scam artists blatantly violating people’s trust. Such examples may make for interesting copy, but they fail to inform the reader about why it happens and how to avoid the same fate. This booklet is intended to provide the reader with useful information about financial fraud. You will learn about the people that perpetrate swindles, the way they attract their victims, and the methods they employ. Reading this book is not a guarantee against being defrauded. But if it makes you think twice about an opportunity and spurs you to investigate the claims being made and the people behind them, it is our hope that you will greatly reduce your chances of being ensnared.
I. VICTIMS AND PERPETRATORS

Fraud is an act of deceit or trickery by one party—the perpetrator—intended to induce another—the victim—to part with some thing of value. What sorts of characters orchestrate fraud? Who are their victims? There are no hard and fast answers to either of these questions. This should not be surprising. Victims and fraudulent promoters are as diverse an assortment as the variety of swindles plied. The discussion below looks at some of the common stereotypes associated with swindlers and their prey. As you will see, these stereotypes are not always accurate. The chapter concludes with an examination of the characteristics surrounding fraud incidents.

Victims

The only common demographic characteristic shared by all victims is that they ended up with less than they bargained for. The National Institute of Justice (NIJ) found that variables such as education, income, age, race, gender, or location were of no help in accurately predicting whether an attempted fraud would be successful. The key factor in victimization by personal fraud, according to the NIJ, appears to be whether one is exposed to an attempt. The NIJ also looked at how various circumstances surrounding an attempt to defraud affected its outcome.

It is commonly believed that the elderly are especially vulnerable to fraud. This notion may stem from the belief that the elderly tend to: (1) have money, property, savings, and investments; (2) have unsuspicious natures; or (3) listen to fraudulent sales pitches out of loneliness or respect for others. Alternatively, the perception may be based on the tendency of elderly persons to report fraud to the authorities more often than other groups. Regardless of the reason, the fact of the matter is that older people are less likely to be victimized than younger people. Seniors apparently are not the trusting and compliant victims law enforcement authorities and the media portray them to be.

Conventional wisdom also holds that better educated people are less susceptible to being defrauded. The NIJ found this belief to be only partially founded. The people least likely to succumb to fraud included those without a high school diploma and those with graduate degrees. The group most likely to fall prey had some college or an undergraduate degree. There is no simple explanation for these findings other than the conclusion that a formal education does not necessarily make one “streetwise.”

That fraud visits younger educated types most often may be due to their
lack of maturity and experience in financial matters, desire to attain financial riches quickly, belief that success comes from “working smart, not hard,” or some combination thereof. This group may also feel a sense of immunity derived from the conventional wisdom that swindlers primarily target the unsophisticated and senior citizens. This misperception gives the swindler a big advantage. Fraud generally happens to people who think it couldn’t happen to them.

People with deep pockets are no more or less likely to be defrauded than people with limited means. The rich and poor, however, may be more prone to different types of scams. For instance, swindlers often assure small investors that the get-rich-quick opportunity being presented is one of the investment strategies and techniques used by the wealthy. This pitch is not likely to lure people who are already wealthy. People who attain their riches quickly—lottery winners, athletes, rock stars, etc.—are especially vulnerable to fraud and financial misdealing because they often hire others to manage their money. It is not unusual to stumble across rags-to-riches-to-rags stories about people who neglected to monitor their money managers.

Studies have also found that minorities, females, and those who live in rural areas are no more likely to become victims of fraud than their counterparts. As gender and racial barriers break down and these groups are mainstreamed into society and the economy, they become equal opportunity targets. Swindlers certainly can’t be accused of discrimination—they’ll take anybody’s money. In the end, it all spends the same. In addition, the methods used by swindlers to attract their victims—such as the mail, telephone, media, and internet—have eliminated the need for face-to-face interaction. Fraud is no longer limited by traditional geographic boundaries.

Victims may not share the same demographic factors, but they do seem to let greed and self-esteem cloud their judgment. A swindler is quick to exploit these emotions. He may make a glib assurance that an investor “owes it to himself” to make a quick and easy “killing.” He may quell any uneasiness from not understanding, or an inability to verify what exactly it is that is being offered, by questioning an investor’s intelligence or ability to trust others. He knows that no one likes to be considered stupid. Additionally, he knows that rebuking an investor who dares to doubt his integrity “without good cause” will foster guilt.

Remember the following advice: (1) no one is completely immune from being swindled; (2) don’t be blinded by greed—if it sounds too good to be true, it probably is; (3) don’t be afraid of looking stupid by asking for more details—never invest in any opportunities that you don’t fully understand;
and (4) don’t hesitate to doubt a stranger’s integrity—far from being rude, it’s a necessity in today’s world.

**Perpetrators**

Fraudsters vary as much as the victims they target. They come from every educational, geographical, racial, religious, gender, and socioeconomic background. They may be a stranger or a friend. Some may be quite visible in the community while others remain hidden in the shadows. They may operate out of a plush office, a “boiler room,” or suitcase. So beware—con men come in all shapes, sizes, and colors. Don’t rely on a single stereotype to send up a red flag. The only thing many—but not all—swindlers have in common is a well documented past. Checking into it may save you both money and grief.

The type of swindler profiled below is the career swindler, not a person that took your money under legitimate circumstances and then made off with it. A career swindler intends from the outset to walk away from any and all promises that are made. In the second case, the promoter starts out with a legitimate proposition, but due to mismanagement or other mishap, winds up cheating you. The latter situation will be dealt with separately.

Many people believe that career swindlers take advantage of others for the money. While there is certainly some merit in that belief, it may not be completely accurate. You may remember the infamous bank robber, Willie Sutton. When asked why he robbed banks he allegedly replied, “Because that’s where the money is.” Only he didn’t say it. According to Willie, “The credit belongs to some enterprising reporter who apparently felt a need to fill out his copy.” What was Sutton’s reason for robbing banks? In his own words he explains, “Because I enjoyed it. I loved it. But to me the money was the chips, that’s all.” Interviews with career swindlers have revealed similar insights. They do it because they enjoy it. To them, it’s a job.

You might wonder how somebody could enjoy fleecing others. That can be explained by delving into the swindler’s background and psyche. The typical swindler has a sordid background. Many have little experience doing anything else. They could be successful in legitimate occupations or ventures; they just don’t see much difference between what they’re doing and what society considers suitable. Simply put, they know they’re cheating, but they don’t view their behavior as abnormal.

In his mind, the swindler is no different than anyone else. He thinks all politicians, lawyers, brokers, businessmen, and their ilk are cheats. Don’t politicians build their campaign platforms on a bunch of empty promises? What makes a successful businessman? Using deceptive advertising and
sales tactics to charge as high a price as the market will bear. Lawyers? Lawyers are just as crooked as the clients that hire them to make sure that their business dealings meet the letter of the law, and little else. Brokers make money whether the stock they touted rises or falls. People cheat their employers and cheat on their taxes, and even cheat on their spouses.

If everybody else is a cheat, it’s easy for the swindler to rationalize that he too better cheat. The swindler feels he is merely taking money from somebody that cheated it out of another (who cheats too). Moreover, at least he admits he is a crook. The others are hypocrites—why do they bother to hide behind a veil of integrity and self-righteousness?

The discussion thus far neglects to explain why a con man would target naïve or charitable persons that are neither greedy nor avaricious. Swindlers may be fond of claiming that “you can’t cheat an honest man” but they also adhere to the old adage that “a fool and his money are soon parted.” Why shouldn’t the swindler grab what he can from the stupid and gullible now before they spend it or somebody else comes along and takes it? Moreover, swindlers feel entitled to a victim’s money. They have more important and worthy uses for the money than the victim does.

A con artist may be morally deficient but he doesn’t suffer from a lack of personal skills. Not unlike any good salesman, a swindler is likeable and easy to get along with. He seems to care about you and the things you care about. Commonly noted for being a smooth talker, he takes just as much pride in his ability to listen. Listening aids the swindler in a number of important ways. First, people like to talk about themselves and tend to like others who willingly lend an ear. Secondly, listening allows the swindler to size up his target’s interests and pet peeves and readily adopt the same positions. Finally, the more forthcoming and self-absorbed a potential victim is, the less a swindler has to reveal about himself—a definite plus.

A swindler’s reputation as a “smooth talker” is notorious and well deserved. His ability to avoid saying anything personally disagreeable or offensive comes from being a good listener. But when the initial chit chatting is over and the conversation turns to the opportunity at hand, his act is well rehearsed. The next chapter discusses some of the well-polished techniques a cheat uses.
II.

ESTABLISHING CONTACT AND
COMMON SALES TACTICS

SELLING a product or service—legitimate or not—involves reaching out to attract customers. Swindlers may reach you by mail, e-mail, or telephone. You may have run across one of their newspaper or magazine ads, visited their internet websites, or seen a TV infomercial they produced. They also associate with affinity groups and use referrals. It is no accident that swindlers copy the methods used by law-abiding firms to develop business. First, they work. Second, mimicking familiar marketing techniques makes it more difficult for consumers to distinguish legitimate products and services from scams. Most people are wary of transacting business in a fashion counter to common practices—that is, they know legitimate business is rarely conducted in cash on a street corner.

Once contact is made, swindlers use a number of techniques to close the deal. Although most salesmen practice many of these same techniques, a swindler is free to make whatever claims and promises that are necessary to convince you to take the bait, all the while knowing that he doesn’t have to make good on any of them. An honest salesman won’t make a promise he can’t keep, whereas a crook won’t make a promise he cannot break. Remember that a promise is only as good as the person behind it.

Establishing Contact—Hello, Mr. Jones, It’s Your Lucky Day!

According to a study funded by the National Institute of Justice, victimization is related to the method of contact. In particular, the attempt to defraud is more successful if a person knows, or knows of, the offender. People are less likely to be swindled by a complete stranger. How initial contact is made also seems to matter. The likelihood of being swindled increases if initial contact is made in person, through a third person, through television or the print media, or initiated by the victim. Initial contact by telephone or mail is the least successful. Finally, where initial contact is made makes a difference. The chances of being defrauded increase when initial contact occurs at the swindler’s home or place of business, at a victim’s workplace, or in the victim’s neighborhood. A swindle is least apt to succeed if initial contact occurs at a target’s residence.

Telephone. Legitimate telemarketing is big business. Last year, 265,000 U.S. companies used telemarketing to sell over $500 billion in goods and services to nearly 50 million households. And, telemarketing’s popularity is rising. Advanced communications, including speed dialing, automatic dialing, and fax machines have improved upon the techniques used back in
the early 1930s during the industry’s infancy. Fraudulent telemarketing is big business too. The FBI estimates there are 14,000 illegal telephone sales operations bilking consumers out of as much as $40 billion each year.

The best way to avoid getting telemarketing calls that you don’t want, is to contact the Federal Trade Commission (FTC) and have your phone number placed on the National Do Not Call Registry. You can register online at www.donotcall.gov or call toll-free, 1-888-382-1222 (TTY 1-866-290-4236). If you register by phone, you must call from the number you want to register. If you register online, you must provide an email address for confirmation.

Mail. Mail is another widely used and acceptable direct marketing tool. Everybody at one time or another has received a junk mail promotion. In all likelihood, the promoter purchased or “rented” your name and address from a firm or organization that you had prior dealings with. Although swindlers may work from bona fide mailing lists, more often they purchase “mooch” or “ sucker” lists from other crooks containing the names of known victims. Names on these lists can cost as much as $10 to $100 each, depending on how gullible a mooch has been in the past. Telemarketers use the same or similar calling lists.

Mailings are generally used to prompt prospective victims to write or call for more information. A salesman then contacts the people that inquire about the promotion to close the deal. This technique is more effective than a “cold call” because the mark has demonstrated an interest by responding. In some cases, a salesman may call to notify a person that they almost passed by a great opportunity by not responding to the mailing.

Advertising. Newspaper, magazine, TV, and radio advertising is another way swindlers lure in suckers. Although some crooks prefer to advertise in narrowly circulated publications to remain inconspicuous, others seek out the authority and respectability that advertising in a publication like the Wall Street Journal or other major periodical can provide. TV infomercials depict formerly unhappy and cash-strapped investors enjoying the material and spiritual benefits made possible by the books, tapes, videos, or seminars being promoted. What many viewers fail to realize is that the burblers are paid shills and the limos, jets, and mansions are often rented props. The promoter’s true source of wealth didn’t come from the “ system” he’s selling, but rather from selling the system.

Internet. The internet is an ideal tool for fraudsters. Simply by building an impressive and credible looking website, posting a message on a bulletin board, joining a chat room discussion, or sending so-called spam (junk
e-mail), an unscrupulous operator can reach a wide audience without spending a lot of time, effort, or money. And because of the relative anonymity of the internet, crooks can remain essentially nameless and faceless—appearing and disappearing at will. Moreover, the internet’s rapid expansion provides a huge base of unsophisticated new users or “newbies” to exploit.

People often let down their guard when they are online. Persons who may be properly wary of receiving unsolicited mailings or cold calls from unfamiliar salespersons may be less skeptical of a website they come across while “surfing.” Unfortunately, many readily accept what they see and read on the web at face value. Most of the fraud and abuse problems floating around in cyberspace are the same scams perpetrated over the phone and through the mail.

*Affinity Groups.* Another way swindlers try to attract prospective victims is by using the leverage afforded by being affiliated with an affinity group. An affinity group is an organization or association with shared interests, backgrounds, or beliefs. Examples include family, religious, ethnic, community, and professional groups. People are generally more trusting of others if a common bond between them exists. If a swindler is not directly connected to an affinity group, he may approach one or more prominent members in the group to gain their trust. He then uses the trust placed in the prominent members by the group to gain the trust of others in the group. Utilizing referrals eliminates the need for the swindler to find new victims; they will find him.

*Reputable Business Fronts.* Finally, crooks may operate out of seemingly legitimate business offices. The operation will have all the activity, personnel, and trappings of a reputable investment firm, with one exception—a rogue broker or other dubious financial type. For instance, a rogue broker or financial planner may steer you toward unsuitable investments, misrepresent or omit material facts, churn your account, or steal your funds. Brokers have certain legal and ethical responsibilities to their customers. Sometimes brokers neglect to uphold these standards. What to look for while shopping for a financial planner is discussed in Chapter IV; selecting a reputable broker is covered in Chapter V.

It may also be that a business starts out on the up-and-up, but turns crooked because of poor management or financial difficulties. In cases like these, the swindler’s goal is to keep any troubles under wrap for as long as possible and act as though nothing is wrong. This type of swindle may go undetected for years, even if you closely monitor your funds. It’s usually when you try to retrieve your funds and the promoter becomes elusive,
evasive, or tries desperately to persuade you to leave your funds with him that the swindle surfaces.

**Common Sales Tactics—Getting You to Say Yes!**

After making contact, the swindler turns to his primary objective: closing the deal. One crook explained his closing technique this way: “One hand goes up to the wall and starts painting pictures, while the other hand reaches for their checkbook.” Chapter I noted that a con artist was not only a skillful listener, but a smooth talker too. In this section we’ll look at techniques swindlers use to paint pictures and convince you to let them empty out your bank accounts.

Swindlers appear to be superb salespersons. They really aren’t. But they are congenital liars. A cheat can make any type or amount of claims and promises he needs to. He is not constrained by the ethical and legal boundaries an honest businessman observes. For example, a scam artist can tout a highly lucrative yet speculative investment as low risk—guaranteed! The honest salesman must make sure an aggressive investment is appropriate and point any inherent risks involved. Cheats purposely avoid such considerations. Why should they jeopardize a deal by revealing its negative aspects? A scam artist wants to eliminate the barriers to closing a deal, not emphasize them.

**Wealth.** A fish eats the worm because it is hungry. A “sucker” takes a plunge looking for happiness. The swindler’s primary bait is wealth, but wealth is merely the means to an end—which is happiness. Think about it. Happiness means different things to different people. For some, happiness is financial security. For others, it’s material things such as homes, cars, or the like. Maybe it’s providing for their kids’ education. Or in rare cases, the means and the end are the same. Although people have different visions of what happiness is, all share one belief—it takes money to get there. So, like a fisherman that puts a worm on his hook to catch a hungry fish, a con man uses wealth to lure in victims searching for happiness. How he presents the bait is a lesson in applied psychology.

A swindler will generally confine any discussion of profits to numbers that are high enough to draw your interest, but not spark your skepticism. Earning thousands of dollars is believable, but not millions. For many, happiness is just out of reach, not miles away. To wit, super-jackpot lottery winners often say they will do some or all of the following: pay off their bills, buy a new car, buy a new house, take a trip, or quit their job. They have thought of doing such things before. However, few have thought about being “filthy rich.” That takes real imagination. People view themselves as needy and deserving, not avaricious. Having too much money is
as likely to bring unhappiness as not having enough.

Second, a swindler will present a range of possible profits. For example, he’ll say: “It’s possible to make anywhere from $5,000 to $100,000 yearly following my simple advice and secret method. Keep in mind that the average is about $50,000, but half make much much more. The total cost of the books and tapes is just $199.” These numbers have been chosen very carefully.

The cost of the program can’t be too high or too low. Hey, nobody gives away a secret formula for success. Everybody knows good information doesn’t come too cheap. He figures people can probably scrape up $199 for the cost of the program. For those that balk, he might add: “Don’t you agree that most people will find the money to buy the things they really want?” He wants you to think that the $199 is buying a cash flow that can be swapped for what you really want. Sacrificing a couple of hundred bucks for some books and tapes is a rip-off. Spending the same amount to get a Corvette (or whatever) is a bargain.

Stating a range of possible profits, including the average, is quite clever. The low end of the range must be high enough to keep an investor’s attention. After all, they are spending money. Keeping the average around what most people earn a year working implies a good chance that they could quit their job. There is also a reason for the upper figure. That is, research has shown that people tend to view others as average, but themselves as above average. The cheat knows this. The higher figure sticks in the suckers’ minds.

**Low Risk.** All investments involve some degree of risk—even obligations of the U.S. Treasury. Some risks are fairly obvious, and some not so. The clearest risk is credit risk. A U.S. Treasury Bill has no credit risk because there is no risk of default—if the Government finds itself unable to roll over its obligations, it has the power to tax and print money. (It may be worth noting that the power to print money only guarantees that you will be repaid, not that the money you receive will have value.) Less apparent types of risk include interest rate risk, liquidity risk, operational risk, legal risk, exchange rate risk, political risk, and more. The more exotic the investment, the greater the risk. Furthermore, in some cases, it’s possible that your risk of loss is not limited to the initial investment. That’s why you need to fully understand whatever financial instrument or proposition you are considering. Failure to do so may expose you to unfamiliar risks that you may not wish to take or be prepared to deal with.

If pushed, most scam artists will not deny outright the possibility of some risk in the proposition at hand. The amount of risk admitted to will be
heavily discounted or explained away. Another trick is to redirect a mooch’s attention back to the potential returns. A con man may challenge a person’s commitment to achieving success. For example, he may accuse you of being the type of person who lacks the courage and foresight required to make money. Furthermore, he may claim that you are wasting his time. After all, how is it possible for a person like him to help out somebody who isn’t willing to do what is in his or her own best self interest?

*Magic of the Hour.* Invariably, a cheat will insist that you invest in whatever he is offering right now. He may inform you that the investment is being offered for a limited time only or being offered to a limited number of people. Or, he may claim that he’s giving you a chance to get in on the “ground floor” before every Tom-Dick-and-Harry jumps on the bandwagon.

There are important reasons why the swindler wants you to act today. The simplest, of course, is that he doesn’t want to expend any more time or energy than needed to get your money. But there are other, just as compelling reasons. He doesn’t want to give you a chance to talk to others or investigate him or research the investment. If you mention that you would like to consult with your attorney or accountant about the matter, he may quip, “There isn’t time for that,” or “Can’t you make your own investment decisions?” or “What would your accountant or lawyer know about this business? This is my livelihood, if you have questions, ASK ME!” If you mention that you need to discuss the proposition with your spouse a cheat will have an equally quick retort. To a man: “Who wears the pants in your family?” and to a woman: “Do you let your husband run your life?”

A swindler certainly doesn’t want you to check him or his deal out. He will try to convince you that there is no need to check him out—“Don’t you trust somebody that’s trying to help you out?” Better yet, a scammer will establish credibility in some fashion that can later be used as leverage to gain a mark’s trust. Specific examples of how this is done will be pointed out in detailing particular scams. With respect to the deal itself, the swindler will persuade you that you already know as much about the investment as you need to know—it’s profitable and it’s low risk. Time is money! Any further hesitation or delay could only jeopardize your chances of making a killing.

There are, of course, other sales techniques used by cheats. The salesman may evoke a higher authority, claim that some of the profits will go to worthy causes, and so on. But the three techniques described above are familiar to all swindles. Realize that it is not easy to fob off one of these salesmen. For every objection you raise, they have a ready reply. It takes a very secure person to say “no” to the pressure and manipulation.
Don’t think how swell it would be to make a killing; rather, dwell on how devastating it would be to lose everything. If you buy into a bogus investment opportunity, you have no chance of profiting and every chance of never seeing your money again. Furthermore, to replace any after-tax money you lose, you will have to earn it back in pre-tax dollars. That is, if you lose an after-tax dollar and your marginal tax rate is 28 percent, you must earn $1.39 before-tax \[\frac{1}{1-.28}\] to replace the dollar that vanished.

**Identity Theft**

Identity theft is one of the fastest growing crimes in the United States. Identity theft occurs when an individual’s personal information is stolen by another person and used to commit fraud or engage in other unlawful activities. According to a June 2002 report by the U.S. General Accounting Office (GAO), this type of fraud is generally not a stand-alone crime, but rather a component of one or more other financial crimes. In other words, a major risk associated with being a victim of one fraud is the possibility that the perpetrator will steal your identity and commit a rapid succession of other frauds. Once a fraudster gets a hold of personal information such as your name, date of birth, Social Security number, and credit information, it can cause great harm to your finances, reputation, and credit rating.

Congress addressed this issue with the passage of the Identity Theft and Assumption Deterrence Act of 1998 (the Identity Theft Act), which made identity theft a separate federal crime against the person whose identity was stolen and provided punishment of a fine or imprisonment for up to 15 years or both. Many states also have enacted laws to criminalize identity theft. Nevertheless, it is estimated that less than five percent of all reported cases result in an arrest.

**Top Complaint Categories for Fraud and Identity Theft**

<table>
<thead>
<tr>
<th>Category</th>
<th>Percent Of Total Complaints</th>
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<tbody>
<tr>
<td>Identity Theft</td>
<td>42%</td>
</tr>
<tr>
<td>Internet Auctions</td>
<td>15%</td>
</tr>
<tr>
<td>Shop-at-Home and Catalog Sales</td>
<td>9%</td>
</tr>
<tr>
<td>Others</td>
<td>8%</td>
</tr>
<tr>
<td>Internet Services and Computer Complaints</td>
<td>6%</td>
</tr>
<tr>
<td>Prizes/Sweepstakes and Lotteries</td>
<td>5%</td>
</tr>
<tr>
<td>Foreign Money Offers</td>
<td>4%</td>
</tr>
<tr>
<td>Advanced-Fee Loans and Credit Protection</td>
<td>4%</td>
</tr>
<tr>
<td>Telephone Services</td>
<td>3%</td>
</tr>
<tr>
<td>Business Opps and Work-at-Home Plans</td>
<td>2%</td>
</tr>
<tr>
<td>Magazines and Buyers Clubs</td>
<td>1%</td>
</tr>
<tr>
<td>Office Supplies and Services</td>
<td>1%</td>
</tr>
</tbody>
</table>

Based on 516,740 complaints received in 2003 by Consumer Sentinel, a national law enforcement program.
The Federal Trade Commission (FTC) established a central database in 1999 (the Identity Theft Data Clearinghouse) to collect information reported by identity theft victims. Identity theft has become the number one complaint received by the FTC and, as the table above indicates, it now accounts for more than 40 percent of all complaints.

You are well advised to be vigilant and alert in taking steps to protect yourself from identity theft, because even when a thief is arrested and convicted, the victim may still spend hours, days, and sometimes months and years addressing the damage that has been done to his finances and credit rating.

It is important to monitor your mail to make certain that you receive your routine monthly statements, and to check these statements for unusual or unauthorized activity. Pay close attention to your billing cycles; if you do not receive a scheduled bill, it could mean an identity thief has taken over your account and changed your billing address to cover his tracks. Although there is no way to guarantee that you can avoid being a victim of identity theft, you can reduce your risk by taking the following steps:

- Shred junk mail such as pre-approved credit card mailings and pre-approved blank checks, as well as tax information and financial records, before you put them in the trash. This can stop thieves who steal identities by sorting through garbage and dumpsters, a practice known as “dumpster diving.”

- You can limit the number of pre-approved offers of credit that you receive by calling 1-888-5OPTOUT (1-888-567-8688) and having your name removed from the marketing lists of the three credit reporting bureaus – Equifax, Experian and Trans Union.

- When placing passwords on credit cards, bank and other accounts, avoid using easily available information like your date of birth or mother’s maiden name.

- Do not give out personal information on the phone, internet, by mail or in person, unless you initiated the contact and you know whom you are dealing with.

- If you are planning to be away from home, arrange to have your mail picked up or call the U.S. Postal Service at 1-800-275-8777 and ask for a vacation hold.

- Keep your Social Security card in a safe place and give your Social Security number only when absolutely necessary. Ask to use other identifiers whenever possible.
• Limit the identification information and the number of debit and credit cards that you carry to only what you need.

• Be wary of promotional scams. Identity thieves may use phony offers to get you to give them your personal information.

• Always keep your purse and wallet in a safe place.

• For additional information on protecting your identity visit the FTC website at www.ftc.gov. Another helpful website that provides information on identity theft is www.privacyrights.org.

Keep in mind that no matter how well you protect the information available about you in the mail or over the telephone or the internet, you are still at risk for identity theft. For example, consider the arrest of a software employee who stole the credit histories of 30,000 people and sold them to a ring of thieves. It could take days, months, or years before some of these victims become aware that their identities have been stolen.

If your identity is stolen, the FTC recommends taking the following steps as soon as possible:

• File a police report. Get a copy of the report to submit to your creditors and others that may require proof of the crime.

• Close the accounts that you know or believe have been tampered with or opened fraudulently.

• File a complaint with FTC by contacting the FTC’s Identity Theft Credit Bureaus

<table>
<thead>
<tr>
<th>Credit Bureaus</th>
<th>Website</th>
<th>Order Report Call</th>
<th>Order Report Address</th>
<th>Report Fraud Call</th>
<th>Report Fraud Address</th>
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<tr>
<td>Equifax — <a href="http://www.equifax.com">www.equifax.com</a></td>
<td>To order your report, call: 1-800-685-1111 or write: P.O. Box 740241, Atlanta, GA 30374-0241. To report fraud, call: 1-800-525-6285 and write: P.O. Box 740241, Atlanta, GA 30374-0241.</td>
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<td>Experian — <a href="http://www.experian.com">www.experian.com</a></td>
<td>To order your report, call: 1-888-EXPERIAN (397-3742) or write: P.O. Box 2104, Allen TX 75013. To report fraud, call: 1-888-EXPERIAN (397-3742) and write: P.O. Box 9532, Allen TX 75013.</td>
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<td>TransUnion — <a href="http://www.transunion.com">www.transunion.com</a></td>
<td>To order your report, call: 800-888-4213 or write: P.O. Box 1000, Chester, PA 19022. To report fraud, call: 1-800-680-7289 and write: Fraud Victim Assistance Division, P.O. Box 6790, Fullerton, CA 92634.</td>
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Hotline toll-free at: 1-877-IDTHEFT (1-877-438-4338) or www.ftc.gov. The FTC maintains a database of identity theft cases used by law enforcement agencies for investigations.

- Contact the fraud departments of any one of the three major credit bureaus listed in the box above to place a “fraud alert” on your credit file. This informs creditors that fraud has been associated with your credit report. The alert requests creditors to contact you before they open any new accounts or make any changes to your existing accounts, to make sure that an imposter is not attempting to get credit in your name. As soon as one credit bureau confirms your fraud alert, the other two major credit bureaus will be automatically notified to place similar alerts, and all three will send credit reports to you free of charge.

The table below (from the FTC website) describes how credit alerts are handled by the three major credit bureaus. (Note: TransUnion and Equifax use a combined fraud alert and victim statement.) Be sure to confirm these policies when you contact the credit bureaus as they may change.

There are an increasing number of services that, for a fee, will monitor your credit reports for activity and alert you to changes. The prices and services vary widely and some of the services may monitor only one of the three major credit bureaus. In addition, some insurance companies offer protection against the costs associated with resolving identity theft. There are two types of “identity theft insurance.” The first type is a stand alone product; the other is a rider to another policy, such as a homeowner or renter insurance policy. As with any product or service, make sure you understand what you are getting before you buy. Also, check out any

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<th>Credit Alerts</th>
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<td><strong>Initial Alert</strong></td>
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<td>Credit Bureau</td>
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<td>TransUnion</td>
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<td>Equifax</td>
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<td>Experian</td>
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<th><strong>Renewals</strong></th>
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<tr>
<td>Credit Bureau</td>
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<td>TransUnion</td>
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<td>Equifax</td>
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company you are not familiar with before doing business with it.

The FTC cautions individuals to be aware that claims by companies that they can clear up your credit record are often misleading or false. Identity theft victims, in particular, need to clear up debts with the original creditor. Most companies will not deal with a third party. For more information the FTC provides a helpful publication, *Credit Repair: Self-Help May Be Best*, available at its website www.ftc.gov.
III.

INVESTOR OR SPECULATOR?

*I'm not so much concerned about the return on my principal as I am about the return of my principal.*

Will Rogers

One common attribute of financial scams seems to be that they are sold to, rather than purchased by, the investor. That is, contact is initiated by a salesman hoping to sell a financial service or product to a naïve speculator and not by an informed investor looking to buy something. This chapter is about investing—that is, the patient and prudent accumulation and management of assets for the long term. It is not a treatise or all-encompassing account of the subject. Most notably, it is not about how to get-rich-quick.

In the *Wealth of Nations*, Adam Smith writes:

The principle which prompts us to save is the desire of bettering our condition, a desire which, though generally calm and dispassionate, comes with us from the womb, and never leaves us till we go to the grave. In the whole interval which separates these two moments, there is scarce perhaps a single instant in which any man is so perfectly and completely satisfied with his situation, as to be without any wish of alteration or improvement of any kind. An augmentation of fortune is the means by which the greater part of men propose and wish to better their condition.

In this passage regarding man’s propensity to pursue a brighter future by investing today, Smith notes that the desire to better one’s condition is “generally calm and dispassionate.” While this tendency may apply to most men at most times, there are instances in which people allow their aspirations to overwhelm their caution. Unfortunately, a certain element of society is familiar with, and even cultivates, this proclivity. They know that they can get-rich-quick by using fraudulent means to fool others into believing that they too can get-rich-quick.

Richard Russell, publisher of the biweekly *Dow Theory Letters*, explains the difference between “buying” and “being sold,” and the importance of remaining calm and dispassionate:

…the wealthy investor never feels pressured to “make money” in the market.

The wealthy investor tends to be an expert on values… And if there are no outstanding values, the wealthy investor waits. He can
afford to wait. He has money coming in daily, weekly, monthly. In other words, he doesn’t NEED the market. He knows what he’s looking for, and he doesn’t mind waiting weeks, months, or years (they call that patience).

What about the little guy? This fellow always feels pressured to “make money,” to “force the market to do something for him.” … The little guy doesn’t understand…compounding, and he doesn’t understand money.

…He’s impatient, and he constantly feels pressured. He tells himself he has to make money fast. And he dreams of “big bucks.” In the end, the little guy wastes his money in the market, he loses his money on gambling, he dribbles it away on senseless schemes. In brief, this “money nerd” spends his life running up the down-escalator.

Now here’s the ironic part of it. If, from the beginning, the little guy had adopted a strict policy of never spending more than his income, if he had taken that extra income and compounded it in safe income-producing securities—in due time he’d have money coming in daily, weekly, and monthly just like the rich guy. And in due time he’d start acting and thinking like the rich guy. In short, the little guy would become a financial winner instead of a loser.

**Saving and Investing**

Investing cannot be discussed sensibly without first discussing saving. This is because spending less for consumption than is possible with the resources at one’s disposal is the only source of investable funds.

For most people, saving is difficult. Just meeting very basic living expenses, such as housing, transportation, insurance, and so forth, may at times claim all the resources at hand. If you find yourself continually “treading water,” or even worse, repeatedly “falling short,” you may be living beyond your means. More likely though, you simply need to limit any unnecessary spending. To fix this, write down how much money you spend and for what. You may be surprised to find that spending on many small miscellaneous items tends to add up to much more than you thought. Quite often people have little idea “where it all goes” until they complete this exercise.¹ Many financial scams are sold as ways to alleviate the discomfort of controlling spending or bypass the need to save. Don’t fall prey to such hype.

¹ Thousand of readers have found AIER’s “Rubber Budget Account Book” an invaluable tool for family budgeting (price $5 postpaid).
In addition to providing for day-to-day living expenses, you must set aside a cash reserve fund for emergencies. This reserve should typically amount to 6 to 12 months living expenses. Individual circumstances vary greatly and such holdings might be larger or smaller than this “rule of thumb” would indicate. Reserves for emergencies should be held in liquid short-term fixed-dollar claims such as insured “passbook” savings accounts, Certificates of Deposit (CDs), or money market mutual funds or accounts.

Although it may not be obvious, repayment of debt—that is, paying off your credit cards, car loan, or home mortgage—is equivalent to saving because reducing the amounts you owe increases your net worth just as adding funds to a savings account increases your net worth. In the event that paying bills becomes a problem, beware of businesses that promise to repair your credit. This topic will be discussed later in the booklet.

Debts that do not have a fixed payment schedule, like credit cards and charge accounts, typically bear high interest rates and should be repaid before any funds are set aside as savings. Amortized loans in which a fixed monthly payment includes both an interest and principle component can usually be repaid ahead of schedule. Whether it is desirable to do so depends on the interest rate and whether the interest payments are deductible from taxable income. If the after-tax interest cost is greater than the after-tax returns you expect to earn on your savings, then you should consider prepaying such loans.

When beginning a savings program, you should accumulate the funds in conservative fixed-dollar holdings. The same applies to funds accumulated toward large outlays that you can anticipate during, say, the next 5 years or so (such as buying a home or paying tuition). This is because, during the first few years, the annual contributions—rather than investment performance—will account for most of the growth of the funds. The expenses associated with more complex or diversified investments cannot be justified when holdings are relatively small or when they might need to be liquidated quickly. In addition, the risks involved in “reaching” for higher returns on more volatile types of assets are not warranted.

When the time comes that you find yourself with liquid assets in excess of what you need for anticipated outlays and/or emergencies, you are ready to become an investor. At this point, many people seriously consider hiring the services of a financial planner. Not everyone however, needs the advice of a financial planner. For instance, a planner cannot force you to control your spending and borrowing. Likewise, you don’t need high-priced advice to know that participating in your employer’s tax-deferred retirement savings plan is a good idea. Chapter IV outlines what a planner can do for you, as well as what to look for in a planner.
An Overview of Various Assets

Choosing the right type of investment is more important than choosing the very best product of that type. Understanding the basics about some various classes of assets is essential to a sound investment plan. Discussion of every type of asset available in the markets today is well beyond the scope of this book. Moreover, our advice is that you should steer well clear of most of them. Knowing which assets serve what purposes will help you pass over assets that don’t make sense for you as an investor—whether they happen to be legitimate offerings or fraudulent.

Your Dollar Holdings

As mentioned earlier, fixed-dollar claims are appropriate vehicles for your working balances, emergency cash reserves, and accumulations for foreseeable outlays. When you first embark on an investment program, such holdings will inevitably account for a significant portion of your estate.

Insured bank deposits are usually the most convenient for working balances. No more than the maximum insured amount of $100,000 should be deposited in any one bank. For questions regarding deposit insurance, call the FDIC at (800) 934-3342, write FDIC Consumer Affairs, 550 17th St. NW, Washington, DC 20429, or visit the FDIC’s website at www2.fdic.gov.

Note that if funds are placed in bank CDs, you should have several rather than one large one. By having a range of maturities and interest rates, you will be less subject to interest rate fluctuations, and, more significantly, if you need cash prior to maturity, you will only have to pay the penalty for early withdrawal on the portion you actually need to liquidate.

Money market mutual funds (MMMFs) often offer the convenience of checking privileges. They are not insured and carry some degree of risk. MMMFs that hold only U.S. Treasury obligations pay somewhat lower rates, but are generally to be preferred.

Bonds

U.S. Treasury bonds, which are backed by the “full faith and credit” of the Government, have traditionally been viewed as a safe haven for those who view their saving as deferred consumption. However, chronic inflating causes sizeable and unpredictable price changes in such fixed-dollar long-term assets, and forces investors to become speculators. Simply put, price inflation is one of an investor’s worse enemies. As for the nominal principal due investors, AIER estimates that inflation has cost savers in the United States over $11 trillion (in terms of today’s dollars) since 1939, or over half of the real wealth they have set aside in fixed-dollar claims since then.
Bonds may be appropriate for financial institutions that have long-term fixed-dollar liabilities, such as deposits, conventional life insurance, or other nominal dollar claims. By matching the maturity of the instruments, they simply use the funds from the bonds to make good on their claims. This works because there is no need to preserve the purchasing power of payments. Long-term bonds are not an appropriate vehicle for individual investors, however, because inflating causes uncertainty regarding the value of a dollar at a bond’s maturity. The same principle holds true for all fixed-dollar claims, such as mortgages.

A separate but related problem arises if people treat interest receipts as spendable income, but fail to realize that interest rates on dollar-denominated financial instruments include an implicit inflation premium. When inflation falls, this premium shrinks, and the investor’s nominal income drops. Consequently, these people incorrectly view the fall in nominal income as a decline in purchasing power (which hasn’t changed). In order to restore their spendable balances, they may seek higher yields by switching to riskier investments—such as junk bonds. The point is that a lower nominal rate accompanied by lower price inflation is not a rational reason to accept more risk.

Investors are ill-advised to hold long-term bonds in an environment subject to inflationary pressure. Over and above the balances mentioned earlier that should be kept in fixed-dollar assets, your investments should include only so-called inflation hedges—that is, items that are not linked to the value of the dollar. These are treated below.

Collectibles

A basic problem with tangible items or “collectibles” such as antiques, art, and the like, is that they can require considerable care and maintenance. Unless you are prepared to become a dealer and to become highly knowledgeable about such items and the market conditions for them, you can expect to pay roughly twice as much to buy as you can expect to receive from the sale of the same item. Such large spreads between bid and asked prices are typical even for things, such as gems or numismatic coins, that do not require much in the way of storage, care, and maintenance. Enthusiasts should not be dissuaded from purchasing collectibles for hobby purposes, but such items are inappropriate for individuals motivated solely by investment interests.

Swindlers like selling art, coins, gems, etc. because it is easy to deliver low-grade items at high prices to investors who naively believe they are getting a deal and making a sound investment. The law offers very little recourse for investors in this area, and cheats take full advantage.
Gold

The reason to hold gold directly is not to take advantage of price fluctuations, but to obtain a protection for a portion of one’s wealth against the possibility of serious economic, monetary, and political disruptions that lead to a breakdown of payment and credit mechanisms based on fiat currency. Gold cannot default or otherwise have its value destroyed by the stroke of a pen. Because there is a limited amount of gold in the world and paper money can be created without limit, gold is the ultimate protection.

Gold coins should thus be the cornerstone of any sound investment portfolio. The reason to hold gold is not so much as to make money as it is to have money in all circumstances. Investors without this security would be well advised to begin a systematic program of accumulation of bullion coins, which are gold coins whose market value is directly related to their gold content and the price of bullion. Such issues include the American Eagle, Canadian Maple Leaf, British Sovereign, Mexican 50-peso, Austrian 100-Corona, and South African Krugerrand. The bid and asked spreads on such coins are very low, and, in contrast to holdings of bullion or gold bars, they can be purchased and sold in small amounts and without assay (*i.e.*, checking the weight and quality). Two caveats apply, however: 1) do not leave the coins in the custody of a coin dealer; and 2) do not buy fractional coins (on which the dealer takes a higher mark-up).

Coins priced on their gold content alone are not as easily misrepresented as the numismatic variety whose value is based on rarity, physical condition, age, and historical value. Because of the difficulty in valuing the latter type of coins, scammers find them easier to sell to unwary investors.

Precious Metal Mining Shares

Another way to benefit from gold ownership is to indirectly own it by holding precious metal mining shares. Shares in gold mining companies provide ownership of gold “in the ground” via their ore reserves. From the investor’s point of view, this ownership is leveraged by the cost of extracting the gold from the ground. Because levers work in both directions, only high-grade, low-cost, long-life mining companies that are currently paying dividends to share holders should be held. Such mines can be expected to survive adverse conditions and to prosper when the price of gold goes up more rapidly than their costs.

Of the many gold mining companies, only a few meet the criteria that we believe make them suitable for investors as opposed to speculators. The first, and most important criterion is that a company actually be producing. Secondly, the company must have adequate reserves to support production for a prolonged period. Thirdly, the company must not be overly lever-
aged, either financially by debt service requirements on its balance sheet or operationally through high production costs. Fourthly, a company must be large enough so that its shares are highly liquid and its operation adequately diversified to protect investors from political and other risks to company assets. Lastly, the company should pay a dividend so that investors can gain some current income from this portion of their portfolios.

Offering the opportunity for investors to take a flyer in precious metal mining shares has long been a favorite ploy of scam artists. By heeding the advice above, you have a greater chance of avoiding the problems inherent in buying these types of shares.

Real Estate

Real estate is widely regarded as an attractive investment and as an inflation hedge. With commissions and closing costs typically under 10 percent, the effective bid and asked spread on real estate purchases and sales is reasonable. Because they are heavily favored by the tax code, personal residences are most families’ largest single investment and home ownership is nearly universal among those with higher incomes and assets.

However, real estate as a portfolio investment (not a place to live) can be burdensome. Property taxes on undeveloped land can make it costly to hold. Developed “income” properties—residential or commercial—generate income, but they require active management. Perhaps the greatest drawback from holding land is that existing laws or regulations (or a change in them) could result in confiscation or limitations put on the use of the property. In short, each parcel of real estate is unique and the expertise needed to buy, sell, and manage it is usually beyond the ability or desire of the average investor.

Enterprising promoters push four types of real estate: raw land, recreation sites, second homes, and retirement residences. These types of properties are ripe for abuse, because buyers can be fooled about the nature of the property, rights and titles, waivers, restrictions, and so forth. For example, unwitting people have been sold land shares rather than individual plots, real estate on the basis of “contract for deed,” as well as house lots in never-to-be-developed “vacation paradises.”

Common Stocks

Common stock in a corporation represents a residual claim against the assets of that corporation—i.e., the stockholders are entitled to whatever is left after all the other claims by vendors, creditors, tax collectors, et. al., have been paid. Because corporations hold tangible assets that can be expected to appreciate with general price inflation, and because the prior
claims are fixed, their shares have long been regarded as an inflation hedge. Additionally, stocks represent an investment in whatever business a corporation is engaged in. Common stocks are easily held in liquid and diversified form and would appear to be as useful or better as an inflation hedge than any of the other assets commonly believed to be such (e.g., gold coins).

However, the value of a corporation’s physical assets cannot be established with certainty without selling them off and the value of the assets to the corporation as a going concern may differ from their value to potential purchasers. Thus the value of a given share of stock at any given time is vastly more difficult to ascertain than, say, the value of a one ounce Krugerrand. Accordingly, common stock valuations are subject to large fluctuations in both the long and short term.

Enormous effort and resources are devoted to security analysis by brokerage firms, fund managers, investment advisors, and institutional and individual investors. Many academic economists espouse what has come to be called the random walk hypothesis. This hypothesis states that since market prices reflect the knowledge and expectations of all investors, the best predictor of tomorrow’s price is today’s price. Price changes in response to new or additional information are unpredictable—that is, random. This hypothesis implies that an investor who throws darts at a newspaper’s daily stock listings would have as good a chance at outperforming the market as any investment professional. Needless to say, professionals vociferously dispute this hypothesis. They claim that some companies perform better than others, and that they possess the ability to identify which ones.

An investor can choose among literally thousands of stocks that are traded on various exchanges. How is an investor to choose which stocks to buy? We believe there is a simple selection strategy. It emphasizes looking for value rather than growth. A brief explanation follows.

Value Stocks. The strategy based on value investing is to invest in large, solid businesses that are undervalued in the marketplace for one reason or another. This is accomplished by looking for firms whose stocks have relatively low ratios of price to book value or earnings.

Earnings and book value are subject to arbitrary accounting judgments and appraisals.

Dividends, on the other hand, are unambiguous and reflect management’s

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2 Certain corporations today, e.g., internet stocks, have very little in the way of tangible assets.
view of their long-term outlook for the company. Directors and managers of large publicly held U.S. corporations generally follow a policy of paying regular quarterly dividends. Payouts are only increased when the firm’s insiders believe they can be sustained for the long run, and cut only in dire circumstances. Thus, dividends represent the long-term prospects of a company. Given a consistent and reliable dividend stream, changes in the dividend yield then reflect price movements induced by unwarranted fluctuations in investor sentiment.

This method assumes that companies with high dividend yields will one day return to favor with investors. (When this occurs, the stock is sold and the process is repeated.) Moreover, this strategy provides a larger stream of income at the outset than a portfolio of so-called growth stocks that are characterized by relatively low dividend yields. Our studies indicate that compounding this higher income stream produces better results than all but the most outstanding portfolio of rapidly growing companies. One reason is that dividends are far more assured than continued growth.

**Growth Stocks.** Much of the enormous expenditures of the securities industry on analysis and research is devoted to identifying so-called growth stocks. Growth investors, who look for companies whose sales and earnings are increasing rapidly, are less concerned with getting a bargain; growth and future potential are emphasized over current price.

One characteristic of growth stocks is that they offer relatively low dividend yields, either because they retain most of their earnings to finance expansion, because they sell at a high multiple of earnings, or both. Investing in such stocks requires a great deal of homework before and after purchasing them—timing and judgment are essential. As alluded to above, continued growth is far from assured.

Moreover, brokers know growth stocks are especially tempting bait for investors trying to “outsmart” the market. These investors chase after new issues and obscure companies with a “story” in “hopes of getting in on the ground floor.” Every issue is touted as the next IBM, Microsoft, etc. The allure is often too strong to resist. Swindlers too exploit investor fascination involving stocks with a potential for growth. Usually the offering itself is bogus, and sold as a sure thing as well. Such a ploy is not possible with the large, well-established firms mentioned above.

**Mutual Funds**

Assets of mutual funds of all types—stock, bond, and money market funds—have grown from $135 billion in 1980 to more than $4.4 trillion currently, surpassing the $2.7 trillion on deposit in U.S. commercial banks. Mutual funds are corporations whose assets are mainly comprised of secu-
rities rather than physical objects such as buildings, equipment, inventories, etc. The major purpose of a mutual fund is to facilitate a degree of investment diversification that would not be possible for its investors to achieve individually. Such diversification may include holdings that cannot be purchased in small amounts (such as commercial paper) or that may be traded more efficiently in large amounts. Each fund is characterized by an investment and objective policy with respect to income, growth of principal, and stability of principal. The two main types of mutual funds are stock funds and bond funds.

Stock Funds. Owning shares in a stock fund is similar to owning shares of any corporation, except that stock funds tend to produce different patterns of returns than individual stocks. Since a stock fund is a diversified portfolio of stocks, price changes in individual securities are somewhat offset, thus reducing overall portfolio volatility.

Most stock funds have a money manager who actually runs the portfolio and makes the buy and sell decisions. He or she is supported by a group of security analysts who analyze securities and search for viable investment candidates, and traders, who try to buy and sell big blocks of securities at the best possible price. Contrasted with this arrangement is the stock index fund. These funds have a different investment strategy: they seek to mirror the performance of a published security price index—e.g., the S&P 500—by holding all of the securities or a representative sampling of the securities in its chosen index. Their returns do not depend on their portfolio managers’ skill and luck, or lack thereof. In addition, index funds have minimal expenses, because they need not spend money on research or excessive trading. Index funds necessarily underperform their chosen indexes by the amount of their expenses and trading commissions.

Bond Funds. “Bond fund” is a misnomer. Conventionally, a bond represents an equal share in the cash flow from a loan to a single borrower. That cash flow consists of a lump-sum repayment of principal on a specified maturity date and semiannual interest payments at a fixed-rate between the date of the bond issue and the maturity date. Bond funds sell shares of stock to purchase these bonds.

A bond fund’s shares lack some of the key features of the securities the fund holds. A bond fund share is a share of stock, so it has no maturity date. Additionally, bond fund shares are not callable. But, bond fund shares have one important feature that individual bonds lack: diversification.

Diversification alters the pattern of returns from individual bonds. However, the effect of diversification is less important for bond funds than for stock funds because bond prices are much more closely correlated than
stock prices. That is, prices of bonds with comparable maturities and coupons move almost in lockstep. Since interest rates exert an overriding influence on bond prices, any change in interest rates affects comparable bonds’ prices similarly. Diversification, even across a wide variety of maturities, coupons, and credit qualities, is only moderately effective as a hedge against interest rate related variability.

**Blind Pools.** One type of investment instrument that should be avoided at all costs is the “blind pool” offering. Blind pools are investment vehicles that raise capital by selling securities to the public, but investors are not told what the specific use of the proceeds will be. In general, the promoter knows exactly what he intends to do with the money. Do not “write a blank check” and commit your funds to totally unspecified purposes lacking firm assurances or commitments.

**Summary**

This chapter briefly examined a variety of asset classes and the purpose they serve. The limited scope of this book prevents a more in depth discussion of these assets. On the other hand, many types of investments, such as futures, options, viatical settlements, leases, penny stocks, licenses, and more, were excluded altogether from discussion—purposely. As a rule, investing in such vehicles is inappropriate. However, these off-beat investments are precisely the ones that are pushed by scam artists. Since an investor would not ordinarily be interested in buying them, these highly speculative plays are marketed as sound investments to anyone naïve or ignorant enough to believe that they provide a risk-less opportunity to get-rich-quick.
IV.

THE ABCS OF FINANCIAL PLANNERS

A man accustomed to think in millions—other people’s millions.
Arnold Bennett

A FINANCIAL planner can analyze your personal financial circumstances and recommend strategies consistent with your financial needs and goals and then assist you with implementing the plan. Not everyone needs the advice of a planner, but should you seek one’s advice you should carefully check their credentials and understand how they are paid.

Not all people need the services of a financial planner. Those that have not provided for such basic living items such as housing, transportation, insurance, and an emergency cash reserve should seek information or help in mastering basic money management. Financial planning requires that a person have income above and beyond what is needed to finance these basic needs. People with discretionary income and a knowledge of estate planning, retirement planning, taxes, insurance, family budgeting, debt management, and investing may prefer to develop their own financial plan.1

A good financial planner will help you complete a comprehensive and confidential financial analysis of your present circumstances. He will identify areas of weakness in your finances and help you develop a coordinated plan based on your current finances, future goals, and attitudes toward risk. A planner will then assist you in implementing the plan, either by selling you financial products himself or referring you to specialists as needed. Financial planning is an ongoing process. Your planner should be willing to periodically review your plan and suggest changes if warranted.

Assuming that you have decided to hire a financial planner, you have some homework to do before meeting with one. First, you have to decide your long-term financial goals. A financial plan constructed lacking concrete goals is likely to be arbitrary. Moreover, the chances of adhering to such a plan are slim to none. Second, you must collect and organize your important papers. Third, you should figure out how much you own (your assets) and owe (your liabilities) in order to establish your current financial position. Next, you must determine where your money goes. Keeping account of your income and expenditures—that is, your cash flow—is necessary if a financial plan is to be designed that is consistent with your

1. AIER offers separate publications containing useful information on many of these topics. See the inside of the back cover of this booklet for more details regarding AIER’s publications.
current circumstances and future objectives.

**Compensation**

Realize that financial planners are paid in a variety of ways. *Fee-only* planners charge on the basis of service (e.g., a flat fee or a percentage of assets) or time (hourly)—they have nothing to sell. *Commission-only* planners account for the vast majority of planners and make their money by selling you financial products. In fact, some merely use the term “financial planner” as a tool for selling life insurance, mutual funds, annuities, and so on. One potential drawback of this fee arrangement is that planners may purposely steer their clients toward high commission-generating products. *Fee-plus-commission* planners charge an up-front fee for consultation and a written plan, plus earn commissions on any financial products you buy from them or their associates. *Fee-offset* planners charge up-front fees for consultation and a plan, but apply credits against these fees if they sell you commission-earning products. Finally, some planners are paid a salary by an institution such as a bank, credit union, or other organization that offers financial products. Make sure you understand how and how much the planner is paid.

**Checking Credentials**

The next step when shopping for a planner is to check credentials. Between 250,000 and 400,000 people—including accountants, bankers, lawyers, insurance agents, real estate and securities brokers, and independent practitioners—call themselves financial planners. That works out to be one financial advisor for every $25,000 of U.S. disposable income. While many of these individuals may be licensed on the state and federal levels within subsets of financial planning—such as insurance agents and stockbrokers—there is no state or federal regulation of individuals who hold themselves out as financial planners. Instead, the financial planning field is largely policed by an alphabet soup of various member associations.

The prerequisites, testing, and continuing education requirements for membership vary substantially across these organizations. Furthermore, certification does not guarantee the quality of advice you might receive. Rather, it simply means that the planner has met the standards of the designating group. The major groups that represent financial planners are briefly described below. Contact information is also provided.

*Registered Investment Advisor (RIA).* The U.S. Government has a two-tier system for the registration of investment advisors. Generally speaking, an investment advisor with more than $25 million or more in assets under management must register with the Securities and Exchange Commission
(SEC); those with less than $25 million must register with the appropriate state securities regulator. An investment advisor with its principal office and place of business in a state that does not have an investment advisor statute (Colorado, Iowa, Ohio, and Wyoming) must register with the SEC regardless of the level of assets under management. Information for contacting the SEC and your state’s securities regulatory agency is listed on p. 45. If a planner is not registered, you are probably dealing with a salesperson who does planning as a sideline to his or her insurance, brokerage, or other business.

In most cases, registering as an investment advisor is as simple as completing the necessary paperwork and paying a fee. Registrants are asked to disclose their educational backgrounds, employment history, potential conflicts of interest, and disciplinary record. An applicant’s disciplinary record includes any civil or criminal actions against the applicant and disciplinary actions by federal and state regulatory agencies and self-regulatory organizations (e.g., National Association of Securities Dealers). Registration does not imply any particular level of competence in the financial planning field; that is, there are no educational or special training, proficiency testing, or continuing education requirements. And, registration does not guarantee a planner’s integrity. The SEC and state authorities do little to check the accuracy of the information provided in the registration form.

*Chartered Financial Analyst (CFA).* Chartered Financial Analyst is a designation awarded by the Association for Investment Management and Research (formerly the Institute of Chartered Financial Analysts) to those who meet AIMR’s membership requirements. CFAs are employed as securities analysts, portfolio managers, strategists, consultants, educators, and other investment specialists. More than 24,000 hold the CFA designation.

The CFA designation represents the most rigorous and practice-oriented professional standard in the investment industry. Members must have a bachelor’s degree or equivalent education or work experience; have three years of acceptable professional work experience in the investment decision-making process; and pass a series of three, six-hour exams covering economics, portfolio management, securities analysis, and ethics. Members must also agree to adhere to ethical standards set forth by AIMR and meet continuing education requirements. You can reach AIMR at (800) 247-8132 or visit their website at www.aimr.org.

*Certified Financial Planner (CFP).* Certified Financial Planners are licensed by the Certified Financial Planner Board of Standards. To be certified, a person must meet certain education, ethics, examination, and experience standards set by the CFP Board. A CFP can be viewed as a coordinator, organizing the expertise of other advisors—such as, attor-
neys, accountants, and investment or insurance specialists—for the benefit of the client. Roughly 33,000 planners have this designation.

Before sitting for a two-day, 10-hour examination covering the broad areas of insurance, investment, income tax, retirement, estate, and fundamentals of financial planning, individuals must acquire three to five years of professional planning-related experience, depending on the amount of relevant coursework completed in a college setting. Once licensed, a CFP must obtain 30 hours of continuing education every two years to remain up-to-date on new developments in the financial planning areas. For more information, you can call the CFP Board at (303) 830-7543 or visit their website at www.icfp.org.

National Association of Personal Financial Advisors (NAPFA). NAPFA is a professional association of comprehensive, fee-only financial advisors. “Fee-only” planners believe a significant conflict of interest exists if an advisor stands to gain financially from the purchase of any product he or she recommends to the client. NAPFA has received endorsement from such groups as AARP, Consumer Federation of America, National Institute for Consumer Education, and state financial regulators for its fee-only approach. NAPFA membership totals 600 plus financial planners.

NAPFA members are held to strict professional qualifications. Although there is no test requirement, members must submit a written comprehensive financial plan addressing at least seven areas of planning; have at least 36 months of experience within the last 60 months, including the most recent 12 months; and hold a bachelors degree with extensive coursework in the various areas of planning or have a degree in financial planning. NAPFA can be reached by dialing (888) 333-6659 or found on the internet at www.napfa.org.

Other certifications or group memberships you may encounter in the planning field include:

<table>
<thead>
<tr>
<th>Certification</th>
<th>Telephone</th>
<th>http://</th>
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<tbody>
<tr>
<td>Chartered Financial Consultant (ChFC)</td>
<td>(800) 263-7265</td>
<td><a href="http://www.amercoll.edu">www.amercoll.edu</a></td>
</tr>
<tr>
<td>Certified Funds Specialist (CFS)</td>
<td>(800) 848-2029</td>
<td><a href="http://www.icfs.com">www.icfs.com</a></td>
</tr>
<tr>
<td>Chartered Life Underwriter (CLU)</td>
<td>(800) 263-7265</td>
<td><a href="http://www.amercoll.edu">www.amercoll.edu</a></td>
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<tr>
<td>Certified Public Accountant (CPA)</td>
<td>(800) 862-4272</td>
<td><a href="http://www.aicpa.org">www.aicpa.org</a></td>
</tr>
<tr>
<td>M. S. of Financial Services (MSFS)</td>
<td>(800) 263-7265</td>
<td><a href="http://www.amercoll.edu">www.amercoll.edu</a></td>
</tr>
<tr>
<td>Certified Fraud Examiner (CFE)</td>
<td>(800) 245-3321</td>
<td><a href="http://www.cfenet.com">www.cfenet.com</a></td>
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Selecting a Financial Planner

There are a number of ways to find a financial planner. One way is to ask a friend or business colleague who their planner is. Make sure that they
have enjoyed a satisfactory relationship with this person over several years, but beware that a planner that meets their needs may not be suitable for you. In addition, seek out the advice of a financial professional that you know and trust, such as a banker, broker, or accountant. They may give you a name or list of names from which to start your search. Finally, the trade associations discussed above would be glad to supply you with the names of their members in your area.

You may see an advertisement or be invited to attend a low-cost or free financial seminar offered by an individual or company. Be advised that the underlying intent of these seminars is to promote something, be it legitimate financial products or a get-rich-quick scheme. The best advice, should you decide to attend such a seminar, is to be skeptical and don’t buy anything on impulse. If you see others lining up in a frenzy to buy products or materials, realize that it’s possible that the promoter may have “seeded” the audience with paid “shills.” In other words, these enthusiastic people are paid employees, not paying customers.

After you have a list of several financial planners, you can begin the selection process. Before signing on with a broker, you need to explicitly address a number of issues with any planner you are considering. They are as follows: competency, experience, working style, compatibility, compensation, and references.

First, you need to ascertain what educational credentials, financial experience and professional affiliations the planner holds. A college degree, even if it is from a business program, is not all that relevant. Financial planning is a specialized field and requires specialized training. It is also wise to only consider advisors who are properly licensed or accredited. Again, remember that accreditation is no guarantee of honesty or competence. With respect to experience, consider advisors with at least 5 years working in the areas consistent with your financial needs—and make sure that the experience is current.

Second, clarify what the planning process will encompass. Your planner should be willing to analyze your current financial situation, discuss your goals, understand your tolerance for risk, and then create a detailed written plan. He or she should also be willing to assist you in implementing his recommendations and review your progress periodically. Some planners merely enter certain information into a computer software package that generates a standard financial plan—a sort of one-size-fits-all approach. While this method is simple, quick and inexpensive, it is not appropriate for people with complex financial situations. And, be wary of planners who promote various financial products or strategies without discussing your current circumstances, goals, or risk preferences. These
individuals are probably not planners at all, but rather salesmen hawking particular products. Or worse, they could potentially be cheats.

Next, you need to understand how your planner is compensated. If the planner is fee-only, he or she should be able to give you a written estimate

**Fee-Only?**

A recent survey done by the National Association of Personal Financial Advisors (NAPFA) and the Consumer Federation of America (CFA) found that three out of five financial planners claiming to offer “fee-only” services actually earned commissions or other financial rewards for implementing their recommendations for clients. A fee-only planner, by definition, is one that charges a fee for analyzing your financial situation, recommending a plan of action, and helping you implement it. They do not earn commissions or receive other rewards from selling or suggesting financial products to you.

The study of planners in the greater Washington, D.C. area turned up the following examples of abuse involving fee-only claims:

- A firm consisting almost entirely of securities and insurance salespeople disclosed on its ADV form that the principal of the firm, despite claiming to be a fee-only planner, earns approximately 70 percent of his income from commissions on securities transactions. He claims that clients “are under no obligation to use the services” of the firm in question.

- A different financial planner claims in his promotional material that “...we are compensated only by fees and do not receive commissions.” According to his ADV form, however, he earns commissions when he sells his clients insurance, depending on their “selection and needs.”

- Another planning firm’s brochure proclaims: “Real advisors are not salespeople.” In spite of this view, the firm is affiliated with a broker/dealer and an insurance agency, both of which are used to handle “all” transactions for financial planning clients, according to the firm’s ADV form.

There is a “built in” conflict of interest when planners earn commissions selling financial products to their clients. This problem is minimized if a customer receives full disclosure—that is, knows exactly what conflicts of interest exist. However, this problem is exacerbated when a planner touts himself as fee-only but also earns income from the recommendations he makes to his clients.
of the cost. Remember, you must pay for the plan regardless of whether it is ever implemented. If your planner works on a commission, fee-plus-commission (sometimes called fee-based), or fee-offset basis, you need to get full disclose regarding any conflicts of interest. Ask your planner to review Part II of the ADV form they file with the SEC or state securities regulator.

Part II addresses disclosure of such information as “Other Business Activities,” “Other Financial Industry Activities or Affiliations,” “Participation or Interest in Client Transactions,” and “Additional Compensation.” Someone who represents a single firm is probably a broker or salesperson. Inevitably, any plan they draw up will most likely be tailored to the products offered by the companies they represent—and the highest commission generating ones at that! If the individual claims that he or she is a fee-only planner, check to see if others at the firm earn commissions as insurance agents or securities brokers. If so, he person is probably earning a fee plus a share of the business he steers toward his colleagues. You may ask for a written agreement to disclose yearly total commissions earned by the planner and the planner’s broker/dealer on recommendations made to you.

Finally, ask the planner for at least three references with similar circumstances as yourself that have been associated with the advisor for a number of years. Ask them about their general level of satisfaction with the planner and whether they had any complaints regarding the plan, fees, referrals, etc. Also ask if they plan to continue their relationship with the planner. Pay attention to any positive or negative remarks about the planner that pop up consistently.

A special warning to those considering granting a planner discretionary power over your account to buy and sell securities: Most complaints to regulatory authorities concerning planners involve the abuse of discretionary power. To protect yourself against fraud, never give discretionary authority to a planner that is not bonded. Be sure that you and your planner agree about the process for handling your account. It is not unusual to find instances in which planners bought and sold securities without their client’s knowledge or approval.

*A Final Warning…*

The SEC reports that more than 22,000 investment advisor firms—entrusted with $10 trillion in customer funds—are registered in the U.S. Most of these firms legitimately serve their clients. However, individuals need to take responsibility for their selection of an advisor. To unquestioningly hand over all of one’s assets to someone to manage is asking for
Swindlers make themselves “difficult to investigate,” preferring to operate in regulatory cracks to remain off the radar screen. They will try to convince you that there is no need to investigate them.

This chapter closes with a few recent examples of the type of fraud and abuse that happens to people who blindly trust so-called financial advisors:

- A Maryland-based investment advisor and host of a popular Saturday-morning radio show persuaded clients to pour over $4 million into a bogus mutual fund called the GTC Fund that promised “maximum capital growth consistent with the preservation of capital.” The fund was a typical Ponzi scheme, paying earlier investors off using later victims’ money. Investors would later discover that the crook, although lacking integrity, did possess a sense of humor—in the parlance of stockbrokers, GTC means “Good Til Canceled.”

- A father and son from Illinois convinced 12 of their accounting firm clients to pool their funds in order to purchase securities. The pool of $1.7 million was diverted into the promoters’ pockets, who then drained the fund for personal benefit.

- A former pro football player and self-proclaimed investment guru fleeced residents in New England and Florida out of as much as $30 million running a Ponzi scheme. Although various securities regulators had disciplined him repeatedly, investors fumbled the ball when it came to checking him out before handing him their money.
V. SELECTING A BROKER

Everyone lives by selling something.
from Across the Plains, Robert Louis Stevenson

Most investors, whether they are individuals with a few hundred dollars to invest, or large institutions with millions, use securities sales representatives to purchase and sell securities for them. Securities sales reps are also commonly referred to as registered representatives, account executives, or stockbrokers. The term stockbroker is a bit of a misnomer though, as such individuals may assist you in trading stocks, bonds, shares in mutual funds, options, futures, and other types of securities.

When an investor wishes to buy or sell securities, brokers relay the order through their firms’ offices to the floor of a securities exchange, such as the New York Stock Exchange. There, the brokers’ floor representatives buy and sell securities. If a security is not traded on an exchange, the broker sends the order to the firm’s trading department, where it is traded directly with a dealer in an over-the-counter market, such as the National Association of Securities Dealers Automated Quotations (NASDAQ) computerized trading system. Confirmation that the transaction has been executed is then routed back to the customer. Brokers may also provide other related services, depending on whether they are “full-service” brokers or “discount” brokers. This will be discussed shortly.

This field has grown dramatically over the past 25 years, as depicted in Chart 1. According to the Bureau of Labor Statistics, the number of security and commodity brokers during this period has nearly tripled. Several reasons may be driving this trend. First, individuals seem to be shifting from saving to investing. The percentage of American families having

Chart 1
Security and Commodity Brokers
(Thousands)
direct or indirect stock ownership has increased substantially during the 1990s, from around 30 percent at the beginning of the decade to a current figure nearing 50 percent. Deregulation has also played a part. Brokerage firms can now sell CDs, offer checking and deposit services through cash management accounts, and sell insurance products, such as annuities and life insurance.

Two points seem relevant. The burgeoning number of new investors may increasingly rely on brokers and financial planners to assist them in selecting the proper options among the maze of financial alternatives. In addition, the rapid increase in the number of securities sales reps is likely to have included some less competent individuals as well as outright crooks looking to make a quick and easy buck off unsuspecting investors. Therefore, selecting the right broker is important.

The first major decision you need to make when investing is what kind of brokerage you want to use. Stockbrokers fall into two basic categories: “full service” and “discount.” A recent development has been the growth and popularity of discount “online” brokerages. These will be discussed below.

**Full-Service Brokerages**

In addition to merely carrying out purchase and sale transactions, full-service brokers offer their clients a host of other services. They offer financial planning advice, investment strategies, as well as information about retirement and estate planning. In addition, they recommend specific stocks, bonds, and mutual funds. These brokerage firms also provide a wide array of free information, ranging from stock quotes to research reports. Most major brokerages also offer cash management accounts.

The key to a full-service brokerage is that an individual broker is there to hold your hand every step of the way. In theory, this personalized attention seems advantageous, especially for novices facing the multitude of complex investment alternatives available in today’s ever-changing marketplace. However, just as strong a case can be made for the opposite conclusion.

Perhaps it is worth stating from the outset that it is wise to maintain a strict business relationship with your broker. You want a broker that understands your investment objectives and can effectively assist you in pursuing them. Sounds straightforward enough. But, state securities authorities report receiving more complaints about abusive sales practices—such as sales of unsuitable securities to investors—than telemarketing fraud. In addition, maintaining a strict business relationship eliminates the possibility of social concerns interfering with your financial affairs. Finally,
mixing business with other facets of your life may expose you to affinity group fraud. Recall that attempts to defraud are more successful if a person knows or knows of the offender. Dealing with someone solely because they are a fellow high school or college alum or attend the same church is asking for trouble.

Using a full-service broker to trade is at least twice as expensive as the most costly discount brokerage. Furthermore, full-service firms often charge annual maintenance fees based on the percentage of your account balance. While it is true that these costs include access to advice and information, much of the information is readily available today on the internet and any advice you receive should be taken with a grain of salt.

Most brokers have limited education and training in investments. Their greatest skill rests in salesmanship. Brokers are focused on attracting new customers and generating commissions from the sale of their brokerages’ house picks or fund picks. Advice of this kind should be treated for what it is—sales hype.

Brokers make their money based on how often you trade, not how well you do. Each fresh investment idea is a chance for more commissions. The brokerage industry has identified what it calls “best practices” regarding broker compensation. Some “best practices” include paying the same commission for in-house products as for others; paying a portion of compensation based on client assets (called wrap accounts), so that brokers receive some remuneration even if they advise a client to “do nothing;” prohibiting sales contests tied to specific products; and eliminating the bounty or “up-front money” a broker receives when he switches firms and brings along his customers. These approaches to compensation are designed to ensure that a broker holds the client’s interests above all others. Ask your broker if her firm has adopted any of these practices.

If you plan to rely heavily on your broker’s advice to develop your investment plan and suggest specific investment products, do not take the next step and give him or her discretionary trading authority. You should always require your broker to present his recommendations, discuss them in the context of your overall investment goals, provide you with any relevant written information, and obtain your approval before buying or selling any information on your behalf. The North American Securities Administrators Association (NASAA) has developed an easy to use information form that investors should fill out when their broker calls. The form appears in the box on p. 36.

*Discount Brokerages*

At the other end of the spectrum is the discount brokerage. Discount
Broker Call Sheet

Name of Broker: ________________________________

Company: ________________________________

Company Location: ________________________________

Date: ___________ Time: ___________

Phone call Meeting Location: ________________________________

Recommended that I buy: _____ sell _____

Name of security: ________________________________

How does this recommendation meet my investment objectives? What are the specific reasons why I should invest in this? (or sell this?)

________________________________________________________________________

________________________________________________________________________

What are the specific risks if I buy this investment?

________________________________________________________________________

________________________________________________________________________

I asked to receive written information about this investment before making a decision:

_____ yes _____ no

I asked for:

____ a prospectus
____ most recent annual report (10K)
____ most recent quarterly report (10Q)
____ any other recent report (8K)
____ any other available written material
____ other __________________________

After looking at the written material, I decided to:

____ do nothing
____ buy
____ sell

____ how much? _____________
____ at what price? ____________

The total cost of this transaction will be: ______________

Other Notes:

Date: ________________________________
brokerages make security trading cheap and efficient. You save on commissions because these brokerages do not spend money on in-house research or maintain a cadre of brokers in expensive branch offices to pitch investment ideas. Many discounters offer a wealth of investment tools, databases, and research materials, most of which is easily accessed via their website.

Although reduced commissions are a definite plus, discount brokerages offer an even greater benefit to investors—a reduced opportunity for broker abuse or fraud. Making your own decisions will lessen the chance that you will be sold on an unsuitable investment. Brokers must follow what is called the “know your customer rule.” This rule requires them to only suggest investments that are “suitable” in terms of your depth of investment experience, net worth, annual income, investment objectives, and tolerance for risk, and other factors. Fortunately, the vast majority of brokers adhere to this rule. Some brokers, however, recommend securities to a customer without having reasonable grounds for believing the securities were suitable for the customer.

On the other hand, calling your own shots also entails undertaking certain personal responsibilities. The terms of an account with a discount brokerage clearly state that the investor is left to determine the nature, potential value and suitability of any particular security, transaction or investment. A discount broker does not give any legal or tax advice regarding particular stocks, including advice involving suitability of and investment strategies for particular stocks. In other words, you may end up making uninformed decisions that result in unsuitable investments, or unnecessarily churning your account through excessive trading.

**Online Brokerages**

Trading stocks online now accounts for about 30 percent of the transactions by individuals. That works out to be roughly 340,000 online trades per day. The same advantages and caveats that apply to discount brokers apply to online brokerages, plus a few that are unique to this type of trading because of its special nature. Online trading offers investors lower costs and faster accessibility to the markets. But, investors need to remember investment basics, and not allow the ease and speed with which they can trade to lull them into a false sense of security or encourage them to trade too quickly or too often. As usual, do your homework. The SEC reports that the number of complaints regarding online investing increased 330 percent during 1998.

Online trading firms, like most businesses, target particular types of customers. Some try to appeal to investors looking for low commissions,
fast trade executions, and real-time stock quotes and little else. Others provide research materials, news, and screening tools, plus the ability to trade offline as well as on. There are brokers that require you to keep more money in your account than you have—or plan to invest. The higher the minimum requirement, the more qualified and experienced the customer the brokerage is trying to attract.

Investors should understand the issues and limitations of online brokerages. One problem is that you may experience delays on the system. Some examples of the types of delays you may encounter are getting online and less than instantaneous execution and reporting of trades. You should learn about and understand the options and alternatives available to executing and confirming your orders should you encounter online problems. Selecting a broker that has been online for a while, and has a sound track record in the online business, is preferable. Many business periodicals have up-to-date information on which brokerages do what best. Also, you might find this situation is one (of the few) in which reading messages posted to investment bulletin boards is useful.

Although online brokerages advertise low trading commissions, make sure you compare commissions based on your typical trades. There may be additional charges for calling a representative, transferring funds electronically, accessing research tools, and receiving real-time quotes. Compare the total costs across online brokers given your particular needs.

**SIPC**

Regardless of whether you are considering a full-service, discount, or online broker, make sure that the broker/dealer is a member of the Securities Investor Protection Corporation (SIPC). The SIPC is a nonprofit corporation authorized by the Securities Investor Protection Act of 1970 designed to protect customer accounts against the financial failure of a brokerage firm. Although subject to SEC and congressional oversight, the SIPC is not an agency of the U.S. Government.

The SIPC protects customers’ cash and securities. Most types of securities, such as notes, stocks, bonds, and CDs, are covered. No protection, however, is provided for investment contracts that are not registered as securities with the SEC under the Securities Act of 1933. This coverage is not to be confused with the various types of deposit insurance offered by banks and other depository institutions which insures the principal amount. SIPC coverage applies only in the event of a broker’s insolvency and does not insure the value of specific holdings in the account.

SIPC funds are available to satisfy each customer up to a maximum of $500,000. Cash protection is limited to $100,000, the same maximum that
applies to a FDIC-insured bank deposit. A customer may have protected accounts with more than one SIPC member, and have more than one protected account with the same SIPC member. Customer accounts with different SIPC members are protected without regard to accounts with other SIPC members, but customers that wish to have more than one protected account with the same SIPC member must meet the requirements of SIPC’s “separate customer” rule. For instance, a customer may have a protected account in his own name and maintain a protected joint account with his spouse. A person who in a single capacity has several different accounts with the same firm would be considered a single customer for purposes of applying the protection limits.

If a broker-dealer’s registration with the SEC is terminated, so is its SIPC membership. The SIPC loses its power to protect customers of former SIPC members 180 days after the broker-dealer ceases to be a member of SIPC. Normally, the SEC does not terminate the registration of a brokerage firm that owes securities or cash to customers. However, the SEC has done so in cases where it was unaware that the firm owed securities and cash to its customers. The point is that you should be diligent in monitoring the status of your broker. Failure to receive your periodic account statements in a timely fashion may indicate that the broker-dealer has gone out of business.

It is important to remember that the SIPC does not insure investors against market risks. SIPC insurance applies only if a brokerage firm goes out of business. If the firm fails, you are protected against the loss of securities or cash held by the broker. This has nothing to do whatsoever with getting bad advice from a broker.

To find out if a brokerage is a member of SIPC, write SIPC, 805 15th St. NW Suite 800, Washington, DC 200005-2215; telephone (202) 371-8300; fax (202) 371-6728; or visit their website at www.sipc.org.

**Background Check**

The same principle of thoroughly checking out a financial planner applies to investigating a stockbroker’s background. You should know whom you are dealing with and make inquiries prior to putting your financial affairs in their hands.

There is a great deal of free information available to the public about your prospective broker’s background available through your state’s securities regulation division and the National Association of Securities Dealers Regulatory (NASDR). The NASDR is intended to help investors obtain information about NASD member firms and their associated persons. The information provided is contained in the Central Registration Depository
(CRD) system, a registration and licensing database used by regulators throughout the securities industry to collect data about securities firms and their brokers. The NASDR has approximately 5,300 broker-dealer members employing roughly 460,000 sales persons and principals. You can reach the NASDR using their toll-free disclosure hotline at (800) 289-9999 or use their website to perform an online search at www.nasdr.com.

Your state securities agency can help you determine if your broker and broker-dealer are licensed to sell securities in the state. Furthermore, they can tell you if the individual or firm has a history of regulatory violations, disciplinary actions, or investor complaints. The contact number for your state’s securities regulatory authority is listed in the appendix.

From the public records, you can learn how long the broker has been a registered stockbroker, how long and for what brokerage firms he has worked, his employment and educational background, and the number and nature of complaints filed against him. In addition, this information contains the outcome of the complaints or legal actions and any regulatory or disciplinary actions on his record.

With this information in hand, your next step is to visit the broker. If he has changed firms, ask why. If he has been named in customer complaints, arbitrations or regulatory investigations or disciplinary actions, ask for details regarding these matters. You should not be surprised to find that brokers who have been in the business long enough are bound to have changed firms or possess a blemish on their record. However, an unstable employment history or multiple complaints are cause for alarm—dealing with such a person may lead to a problem situation.

**Your Account**

When you begin a relationship with a broker, you will be asked a series of questions about your income and assets, investment objectives, level of understanding and risk tolerance. Do not take offense at the broker’s intrusion into your financial profile, brokers are required to know their customers. This information is supposedly necessary for your own protection. You should, however, be troubled if the broker does not ask these questions even if you’d rather they didn’t. The reason is that they are supposed to ask. Make sure your answers to the questions posed are accurately reflected on your new account form and keep a copy for your records. Never sign a document when opening an account that you do not fully understand.

You must review all account statements, trade confirmations, and correspondence received from the broker or brokerage firm. This information is important. Trade confirmations typically note that any objections to the
trade must be made within a certain number of days from receipt of the confirmation. Any confusion arising about a trade confirmation should be cleared up immediately. Do not hesitate to call your broker. If there are problems with the trade, you should respond in writing without delay and keep a copy of your letter. You cannot object to a trade long after receiving a confirmation. Any inaction on your part to correct disparities promptly will be considered tacit approval of the transaction and held against you should you file a complaint.

Make sure you also review your monthly statements. These statements should be easy to understand, but if not, ask questions. The trading activity reported on your statements should match what you have authorized. Any discrepancies must be dealt with quickly. If the broker does not correct the problem, request a meeting with the broker’s supervisor or branch manager. Failure to take these steps will again imply that you were satisfied with the status of your account.

At times, brokerage firms send letters requesting the letter be signed and returned in order to confirm that the trading in the account has been satisfactory, is in accordance with your investment objectives, and that the broker has thoroughly explained the inherent risks of his proposals. These letters, called “comfort letters,” appear to be a pleasant formality. However, they are sent when brokerages detect unusual activity in an account. If you have had problems, indicate it on the letter, mail it back and keep a copy for your files. If you have not experienced trouble, write the firm and ask them to indicate exactly why they wrote to you. Do not ignore a comfort letter.

**Resolving Problems**

Bring any problem to the attention of your broker. Spell out what resolution you expect and some adequate time frame for resolving the problem. Follow up any discussion with the broker in person or via telephone in writing. Keep a copy of the written correspondence for your records.

If the situation remains unresolved after the specified time frame, do not let the broker persuade you to grant him an extension. Contact the broker’s supervisor or branch office manager. Again, put your complaint in writing and keep a copy. It is important to create a paper trail documenting your complaint and efforts to rectify it.

Should the matter continue unsettled, your next step is to contact the compliance division of the brokerage firm. A compliance department is an arm of a securities firm who seeks to uncover fraud or unauthorized or unethical behavior in the buying and selling of securities. At this point, contact your state securities agency. As always, time is of the essence.
Delaying immediate action is always interpreted later as approval on your part should you seek redress later.

**Arbitration**

Virtually all brokerage firms require their customers to agree to settle any unresolved disputes with them using arbitration instead of going to court. You probably agreed to the following conditions regarding arbitration when you opened your account: (1) arbitration is final and binding on all parties; (2) the parties are waiving their right to seek remedies in court, including the right to a jury trial; (3) prearbitration discovery is generally more limited than and different from court proceedings; (4) the arbitrators’ award is not required to include factual findings or legal reasoning, and any party’s right to appeal is strictly limited; and (5) the panel of arbitrators will typically include a minority who were or are affiliated with the securities industry.

Arbitration is intended to be a fair and efficient method of resolving disputes by impartial persons who are knowledgeable in the subject in controversy and is a quicker and less expensive alternative to the courts. The pre-hearing discovery (procedure for obtaining documents and information from the opposition) and procedural matters regarding rebuttal exhibits and witnesses are more lax than formal litigation, although this is less true today than it once was.

Each year, roughly 6,000 arbitration cases are filed. The vast majority of cases are resolved between parties without arbitration. The NASD reports that between 1989 and 1995, customers won 54 percent of the disputes that went to arbitration, and were awarded 39 percent of the total compensatory damages claimed.

To begin the process, contact the appropriate arbitration forum (consult your customer account form) and request a “demand for arbitration” packet. The packet will explain how to file an arbitration claim. You will have to complete a “statement of claim” form, outlining the nature of the dispute and the damages that you are seeking. There is a filing fee. It is important that your statement be accurate, documented, and that the damages you are seeking be in line with the losses attributable to the broker misconduct. This is where it becomes important that you put all correspondence with your broker and brokerage firm in writing and kept a copy for your records.

There is no requirement for a customer to be represented by an attorney during the arbitration process. However, be assured that the broker and brokerage firm will mount a vigorous defense. Keep in mind that arbitration is final and binding. If you fail to effectively represent your case by neglecting to raise important or relevant points during arbitration, seeking
a lawyer afterwards will be too late. Should you opt for representation, choose a lawyer that is familiar with securities law and the arbitration process. Assistance in finding a qualified lawyer is available through the Public Investors Arbitration Bar Association by calling (888) 621-7484 or visiting their website at www.piaba.org.

You will be notified of the date, place, and time of the hearing. Generally, there are three arbitrators on the panel: a chairperson, one person from outside the securities industry, and one from within the industry. The hearing will proceed with opening statements, followed by presentation of evidence and testimony, rebuttal, and closing arguments. At the end of the hearing, all parties will be excused. A straightforward arbitration hearing usually takes up two to three full days. More complex matters take longer. You will be notified by mail of the decision of the arbitration panel, usually within 30 days. The decision will not give a reason; it will simply state whether damages are to be awarded, how much if any, and the terms of the payment.

Mediation

Mediation is a new alternative to arbitration. It is an informal, voluntary, nonbinding process in which an impartial, neutral person facilitates negotiations between the disputing parties in an effort to reach a mutually acceptable resolution.

The primary difference between mediation and arbitration (or litigation) is that the mediator does not impose a binding resolution, but rather helps make it possible for the parties to reach agreement. Any party can withdraw from mediation at any time, and parties retain their right to proceed to have their dispute arbitrated. Also, in mediation, the proceedings and final agreements are private and confidential. While arbitration proceedings are private, the final awards are publicly available.

During 1996, mediation’s first full year of operation, the NASD reports that 82 percent of all claims submitted to mediation were settled. The claims ranged from $10,000 to $5 million.

Summary

The NASD has nearly 6,000 member firms that operate 60,000 branch offices and employ over a half a million registered representatives. The NASD takes roughly 1,000 formal disciplinary actions each year. This includes suspending or barring individuals from the industry. Honest brokers are many and unethical brokers are few—but you should know how to avoid them. Below is a sample of disciplinary actions taken by the NASD during the month of February 1999.
• A registered representative from Ohio was fined $925,000 and barred from the industry for depositing $179,624 of customer funds into accounts under his control to use for his own benefit without their knowledge, authorization or consent.

• A registered representative from New York was fined $700,000 and barred from the industry for making baseless price predictions or guarantees, failure to execute customer orders, and requiring customers to purchase aftermarket shares as a condition of receiving initial public offering units.

• A different New York registered representative was fined $275,000 and barred from the industry for borrowing $50,000 against the life insurance policies of customers without their prior authorization or consent. He had the loans mailed to a post office box under his control, endorsed the checks, and used the proceeds for his own benefit.

The best advice is to avoid getting into or exacerbating a problem situation by (1) choosing a broker carefully; (2) understanding all documents related to your new account; (3) reviewing all account statements and correspondence from your broker or broker-dealer; (4) putting all correspondence in writing and keeping a record; and (5) acting promptly should discrepancies arise.
APPENDIX

DIRECTORY OF STATE SECURITIES REGULATORS


Along with the Securities and Exchange Commission, each state has its own securities regulatory agency. These agencies, listed below alphabetically, may also be able to assist investors with problems and questions.

ALABAMA SECURITIES COMMISSION
770 Washington Ave., Ste. 570
Montgomery AL 36130-4700
334/242-2984 or 800-222-1253

ALASKA DEPT. OF COMMERCE & ECONOMIC DEVELOPMENT
Division of Banking, Securities & Corporations
Post Office Box 110807
Juneau Alaska 99811
907/465-2521

ARIZONA CORPORATION COMMISSION
Securities Division
1300 West Washington, 3rd Floor
Phoenix AZ 85007
602/542-4242

ARKANSAS SECURITIES DEPARTMENT
Heritage West Building
201 East Markham, 3rd floor
Little Rock, Arkansas 72201
501/324-9260

CALIFORNIA DEPT. OF CORPORATIONS
320 West 4th St., Ste. 750
Los Angeles CA 90013-1105
213/576-7643

COLORADO DIVISION OF SECURITIES
1580 Lincoln
Suite 420
Denver CO 80203
303/894-2320

CONNECTICUT DEPT. OF BANKING
260 Constitution Plaza
Hartford CT 06103-1800
860/240-8230
DELAWARE DIVISION OF SECURITIES
Dept. of Justice
820 N. French St., 5th Fl.
Carvel State Office Bldg.
Wilmington DE 19801
302/577-8424

DISTRICT OF COLUMBIA
Dept. of Insurance & Securities Regulation
810 First St. NE Ste., 701
Washington DC 20002
202/727-8000

FLORIDA OFFICE OF COMPTROLLER
Dept. of Banking
101 E. Gaines St.
Plaza Level, The Capitol
Tallahassee FL 32399-0350
850/410-9805

GEORGIA OFFICE OF THE SECRETARY OF STATE
Securities Division
2 Martin Luther King, Jr. Drive
#802 West Tower
Atlanta GA 30334
Information: 404/656-2895
Complaints: 404/656-3920

HAWAII
Dept. of Commerce & Consumer Affairs
1010 Richards St.
Honolulu HI 96813
808/586-2744

IDAHO DEPT. OF FINANCE
Securities Bureau
700 W. State St., 2nd Fl.
Boise ID 83720
208/332-8004

ILLINOIS OFFICE OF SECRETARY OF STATE
Securities Dept.
17 N. State St., Ste. 1100
Chicago IL 60601
312/793-3384

IOWA INSURANCE DIVISION
Securities Bureau
340 E. Maple
Des Moines IA 50319-0066
515/281-4441
INDIANA OFFICE OF THE SECRETARY OF STATE  
Securities Division  
302 West Washington, #E-111  
Indianapolis IN 46204  
317/232-6681  
800/223-8791 (toll-free)  

IOWA DEPARTMENT OF COMMERCE  
INSURANCE DIVISION  
Securities Bureau  
Lucas State Office Building  
Des Moines IA 50319  
515/281-4441  

KANSAS OFFICE OF SECURITIES COMMISSIONER  
618 S. Kansas Ave., 2nd Fl.  
Topeka KS 66603-3804  
785/296-3307 or 800/232-9580  

KENTUCKY Dept. OF FINANCIAL INSTITUTIONS  
1025 Capital Center Dr., Ste. 200  
Frankfort KY 40601  
502/573-3390 or 800/223-2579  

LOUISIANA SECURITIES COMMISSION  
3445 N. Causeway Blvd., Ste 509  
Metairie LA 70002  
504-846-6970  

MAINE  
Dept. of Professional & Financial Regulation  
Securities Division  
121 State House Station  
Augusta ME 04333-0121  
207/624-8551  

MARYLAND ATTORNEY GENERAL’S OFFICE  
Division of Securities  
200 St. Paul Place, 20th floor  
Baltimore MD 21202  
410/576-6360  

MASSACHUSETTS SECRETARY OF THE COMMONWEALTH  
Securities Division  
One Ashburton Place  
Room 1701  
Boston MA 02108  
617/727-3548
MICHIGAN
Office of Financial & Insurance Services
6546 Mercantile Way
Lansing MI 48909
517/241-6350

MINNESOTA DEPT. OF COMMERCE
133 E. Seventh St.
St. Paul MN 55101
651/296-4026

MISSISSIPPI SECRETARY OF STATE
Business Regulation & Enforcement Division
202 N. Congress St.
Jackson MS 39205-0136
601/359-6371

MISSOURI OFFICE OF SECRETARY OF STATE
600 W. Main St.
Jefferson City MO 65101
573/751-4136

MONTANA OFFICE OF THE STATE AUDITOR
Securities Department
P.O. Box 4009
Helena, MT 59604
406/444-2040
800/332-6148 (toll-free)

NEVADA OFFICE OF THE SECRETARY OF STATE
Securities Division
555 E. Washington Ave, 5th Fl.
Las Vegas NV 89101
702/486-2440
800/758-6440 (toll-free)

NEW HAMPSHIRE
Bureau of Securities Regulation
Dept. of State
State House Annex, 25 Capital St.
Concord NH 03301
603/271-1463
NEW JERSEY Dept. OF LAW & PUBLIC SAFETY
Bureau of Securities
153 Halsey St., 6th Fl.
Newark NJ 07102
973/504-3600

NEW MEXICO REGULATION & LICENSING DEPT.
Securities Division
725 St. Michael’s Dr.
Santa Fe NM 87505-7605
505/827-7140

NEW YORK DEPT. OF LAW
Bureau of Investor Protection and Securities
120 Broadway, 23rd floor
New York NY 10271
212/416-8200
(Requests for information must be in writing)

NORTH CAROLINA DEPT. OF SECRETARY OF STATE
Securities Division
300 N. Salisbury St., Ste. 100
Raleigh NC 27603-5909
919/733-3924

NORTH DAKOTA OFFICE OF THE SECURITIES COMMISSIONER
State Capitol, 5th Floor
600 East Boulevard
Bismarck, ND 58505
701/328-2910
800/297-5124 (toll-free)

OHIO DIVISION OF SECURITIES
77 South High Street, 22nd floor
Columbus OH 43215
614/644-7381

OKLAHOMA DEPT. OF SECURITIES
Suite 860, First National Center
120 N. Robinson
Oklahoma City OK 73102
405/280-7700
405/280-7742 (FAX)

OREGON DEPT. OF CONSUMER & BUSINESS SERVICES
Division of Finance & Corporate Securities
350 Winter St., NE Rm 410
Salem OR 97301-3881
503/378-4387
PENNSYLVANIA SECURITIES COMMISSION
Eastgate Office Building
1010 N. 7th Street, 2nd FL
Harrisburg PA 17102
717/787-8061
800/600-0007 (toll-free)

RHODE ISLAND DEPT. OF BUSINESS REGULATION
Securities Division
233 Richmond St., Ste. 232
Providence RI 02903-4232
401/222-3048

SOUTH CAROLINA OFFICE OF ATTORNEY GENERAL
Securities Division
1000 Assembly St.
Columbia SC 29201
803/734-4731

SOUTH DAKOTA DIVISION OF SECURITIES
118 West Capitol Avenue
Pierre SD 57501
605/773-4823

TENNESSEE DEPT. OF COMMERCE & INSURANCE
Securities Division
Davy Crockett Tower, Ste. 680
500 James Robertson Pkwy.
Nashville TN 37243-0575
615/741-2947

TEXAS STATE SECURITIES BOARD
P.O. Box 13167
Austin TX 78711
512/305-8332

UTAH DIVISION OF SECURITIES
Heber M. Wells Bldg.
160 E 300 South, 2nd Fl.
Salt Lake City UT 84111
801/530-6980

VERMONT DEPT. OF BANKING, INSURANCE & SECURITIES
Securities Division
89 Main Street, Drawer 20
Montpelier VT 05620
802/828-3420

VIRGINIA STATE CORP. COMMISSION
Division of Securities & Retail Franchising
1300 E. Main St., 9th Fl.
Richmond VA 23218
804/371-9051
GLOSSARY OF SELECTED FINANCIAL SCHEMES

This section details common investment scams and abuses. While we hope that you would not seriously consider squandering your hard-earned money on any of these dubious propositions, we know that people have done so in the past and will do so in the future. Research indicates that the more people know about scams, the less likely they will fall prey to one. This glossary attempts to fulfill this purpose. Of course, not every conceivable swindle is listed.

**Advanced Fee Schemes.** Advanced fee schemes involve a person paying money to someone in anticipation of receiving something of greater value, such as a loan, credit card, scholarship, lottery winnings, tax refunds, unclaimed prizes, and so forth, and then receiving little or nothing in return. Many variations of this scam exist. The tip-off is that you are asked to pay money up-front for a promoter’s promise or guarantee to do something in the future.

An example of this type of rip-off is an advanced fee loan scheme targeted at individuals or businesses having difficulty obtaining credit through normal channels. The swindler claims to be able to help obtain a loan for you—in fact, he’ll guarantee it—from a legitimate lending institution, such as a bank. The fee is normally some percentage of the gross loan amount, say 5 percent. For example, you would be required to pay $500 in order to receive a $10,000 loan.

If the play is an outright fraud, which is sometimes the case, the cheat simply steals your money and disappears. More often than not, this is not the case. Rather, you will be sent a contract to sign that stipulates that, in exchange for a fee, you are promised that you will be introduced to the financing source. Such agreements are legal.

Perhaps the most insidious of all advanced fee stings is the loss reclamation scam, which offers to recover money lost in a previous swindle, for an up-front fee. Cheats identify their targets by purchasing “sucker lists,” or in some cases they may even be the original perpetrators. Either way, they are guaranteed that everyone solicited will have been the victim of a prior scam.

Do not confuse this scam with fees you may be asked to pay by a bank to process a loan application. The difference between an advanced fee scheme and a loan application fee is that in the latter situation you are dealing directly with the funding source and there is no assurance made that you will receive the loan.

If money is not available through traditional lending channels, it is
unlikely to be available through questionable classified ads. Do not give your credit card, checking account, or Social Security numbers out over the phone to businesses you are not familiar with as part of a loan application process. This will only compound any financial difficulties you may already be experiencing with your credit.

**Blind Pool Investments.** Blind pools are investment vehicles that raise capital by selling securities to the public without telling investors what the specific use of the proceeds will be. While a blind pool may provide at least some indication of how the funds will be invested, a “blank check” offering does not identify any proposed investment intent whatsoever. You can find out if an offering is a blind pool by reading the prospectus and paying particular attention to the risk factors and operational details mentioned.

Blind pool offerings are typically characterized by undercapitalization—that is, virtually no assets exist other than the money obtained through the offering itself. Shares in blind pools are usually offered at low prices to lure investors into speculative ventures without their knowledge.

**Commodity Futures.** Futures are negotiable contracts to make or take delivery of a standardized amount of a commodity during a specific month, under terms and conditions established by the futures exchange market where trading takes place. The primary purpose of futures is to provide an effective and efficient mechanism for offsetting the risk of loss from price fluctuations in the market. Because a future’s contract price moves more or less in tandem with the commodity’s current market or “spot” price, it is possible to “hedge” or reduce price risk by taking an equal and opposite position in the spot and future markets. Speculators in the futures markets accept the price risks that hedgers wish to avoid. While speculators are needed to provide active, liquid, and competitive markets, speculation in futures contracts is clearly not appropriate for the average investor.

Investors should beware of sales pitches concerning investments in commodity futures appearing in investment newsletters and newsprint, seen in infomercials or on the internet, or heard on the radio. These ads—targeted at people with at least $50,000 in income and $25,000 in equity—typically promise large, quick profits with little risk by taking a position in futures in advance of seasonal changes in the demand for certain commodities. For example, sales pitches may urge investors to buy heating oil futures in the fall, pointing out that spot prices are “sure” to rise once winter and cold weather sets in. Such pitches may seem reasonable to a novice investor. However, market participants always factor seasonal demand changes for commodities into futures prices. If you take a speculative position by buying heating oil futures in the fall, your bet is not that it will be cold
(which everyone knows), but that it will be colder than usual (which nobody can predict).

Another major drawback is that futures trading is a highly leveraged form of speculation. In other words, only a relatively small amount of money is required to control assets having much greater value. Said another way, while buying (or selling) a futures contract provides exactly the same dollars and cents profit potential as owning (or selling short) the actual commodities covered by the contract, low margin requirements sharply increase the percentage profit or loss potential. Furthermore, it is possible to lose more trading futures than your initial investment. While a salesperson may outline a number of steps that can be taken in an effort to limit the size of possible losses (e.g., placing a stop order), there are no guarantees that these steps will prove effective.

**Franchise and Business Opportunities.** Franchises appeal to people that want to start a business but have limited resources or business experience. Such persons make ready victims. Before you buy a business you should study the disclosure document and proposed contract carefully. The disclosure statement lists the names, addresses, and telephone numbers of other purchasers; a fully audited financial statement of the seller; the background and experience of the business’s key executives; the cost of maintaining the business; and the responsibilities the buyer and the seller have to each other. All claims made by the seller should be put in writing. Make sure to visit and talk with other owners. Moreover, consider getting professional advice. Ask a lawyer, accountant or business advisor to read the disclosure document and proposed contract. The money and time you spend on professional assistance and research will probably be less than the amount you could lose from a bad investment decision.

**Infallible Forecaster Fraud.** This fraud can be promoted through the mail or by telephone. Unlike many scams, it is does not involve high-pressure sales tactics; rather, victims are deluded into thinking that they are investing in a sure-fire opportunity. Here’s how it works.

The promoter makes his initial contact. He doesn’t want to sell anything. Instead, he merely wishes to introduce his firm and demonstrate its superior forecasting ability. He then predicts that, say, that the price of soy bean futures will rise. He goes on to explain how a prospective victim could have invested and profited using his firm’s research. Later it just happens that soy bean futures do rise.

The promoter calls back again. Again, he doesn’t want to sell anything. He points out that the price of soy bean futures did rise, just as he predicted. But, he says that being correct once is not very convincing—his
accuracy could just as easily be based on luck as skill. He leaves the target with another price forecast. This time he is predicting that wheat futures will fall. Again, he gives a seemingly valid reason and explains how the person could profit from the trade. Later, just as he predicted, wheat futures fall.

When the phone rings a third time, the person is hooked. He lost out on two chances to make big money, and he’s not going to let it happen a third time. The caller obviously knows this business. In addition, the caller has said that he can’t keep wasting his time on somebody that doesn’t know a good thing when he sees it. When the caller predicts that orange juice futures will rise, the mooch wants in.

Making infallible forecasts has nothing to do with luck or skill. The swindler starts out with 1000 names and tells 500 that soy bean futures will rise. He also tells 500 people that soy bean futures will fall. If prices rise, he calls back the first group with his second prediction; if prices fall, he calls back the second group. After the second time around, he will have made two accurate price predictions to 250 people. It is possible to accurately predict a total of nine price movements (starting out with 1,000 names).

**Internet Fraud.** Many abuses found on the internet are time worn scams. The internet is more efficient than other means in terms of cost and ability to reach a vast audience. One example of fraud is the “pump and dump,” which involves talking up an obscure, thinly traded stock on a website or in a chat forum to draw others in, then getting out with a quick profit before the price collapses. A single person can create the illusion of widespread interest in a stock by posting a series of messages under various aliases. An organized group can do even more. Following up “hot tips” is often difficult because there is usually not much current information readily available about the company, except for press releases disseminated by the company or its paid promoters. Links provided to web pages that supposedly corroborate a hot tip may deliver you to a phony website. Increasingly, swindlers are copying authentic finance sites and luring investors to fake ones.

**IRA Approved Investments.** Investors should avoid responding to sales pitches received over the telephone or by mail, or seen on the internet touting Individual Retirement Account (IRA) approved investments. These ads are designed to swindle people that may understand what an IRA is, but not the role of the IRS when it comes to IRAs. As discussed below, the IRS allows certain investments to be held in a self-directed IRA account, but it does not approve any investments.
The IRS issues letters to IRA sponsors, trustees, and custodians certifying that they are complying with requirements concerning investor rights, account administration, and standards that allow contributions to be deductible. The IRS does not review or approve investments; advise people on how to invest their IRAs; endorse any investments; or issue statements that an investment in an IRA is protected because the IRS has approved a particular trustee or custodian.

Note that if you have a self-directed IRA, you may not invest in collectibles, such as art works, gems, stamps, antiques, rugs, metals, or guns. Coins are not allowed except for state-issued coins or certain U.S. minted gold or silver coins. Assets used to acquire a prohibited collectible are treated as distributions and are taxed.

**Living Trusts.** A living trust is a revocable trust; that is, you convey property to a trustee (yourself, another person, or an entity, such as a bank) for your benefit during your lifetime, and you retain the ability to cancel, or revoke the trust any time and get your property back. You can name a backup or successor trustee to manage the property should you become unable to do so or and to distribute the property according to your wishes after your death. Living trusts are a legitimate planning tool. (Living trusts are not to be confused with “living wills,” which instruct doctors, lawyers, clergy, and family to allow a patient that is unable to speak for himself die when there is no reasonable hope of survival.)

Bogus promoters are hawking living trusts as an estate planning cure-all, which they are not. Inaccurate or misleading claims are made, such as, “Living trusts will reduce your income and estate taxes; are cheaper than wills; substitute for a will and cannot be challenged like a will.” The promoter will then offer a package or kit—possibly “endorsed” by an organization such as AARP—to set up a living trust. The kits are often overpriced and normally do not comply with the appropriate state laws. If you are considering a living trust, you must understand how they should be properly formed, as well as their limitations. Whether setting up a living trust makes sense depends on your particular circumstances.

**Offshore and Secret Bank Accounts.** Scammers show you the laws of the offshore jurisdiction and assure you that the account will remain secret and out of reach of the IRS. But to “hide the money,” you have to give up your interest in the account. The offshore service provider declares the money is theirs and you deny the money is yours. The money then grows tax free, and your creditors can’t get at it because it “does not” exist. Many providers will tell you that although they own the account, you will get a debit card to use to access the funds. That’s the pitch.
Whoever you give your money to will likely disappear, or will not give it back. The debit card is meaningless—a debit card clearly constitutes authority over the account, which you gave up. You cannot complain to the U.S. Government authorities because you committed tax evasion—a serious crime. The Government of the country where you placed your funds will be of very little help either. Sometimes the cheat is not satisfied with simply stealing your money. He uses the fact that you committed tax evasion as leverage to extort additional money out of you. There are legitimate ways to organize your affairs to reduce your taxes that do not involve breaking the law and getting ripped off at the same time.

**Nigerian Letter or 419 Scheme.** Known as “419” fraud after the section of the Nigerian penal code which addresses fraud schemes, this advanced fee scheme involves an unsolicited letter mailed from Nigeria, authored by a “senior government official.” The letter informs the recipient that a large pool of funds exists as a result of the Nigerian government over-invoicing a procurement contract. The official wants to transfer these funds out of Nigeria, but needs a reputable foreign firm or individual into whose account he can deposit the funds. A commission of up to 30 percent is offered for assisting in the transfer.

The letter recipient is asked to forward blank letterheads and banking particulars, such as account numbers so the Nigerian “officials” can file a phony claim for disbursement of the funds. Shortly after responding to the initial letter, the prospective victim receives back seemingly official Nigerian documents bearing letterhead, seals, as well as false letters of credit, payment schedules, and bank drafts. Later, the victim will be asked to cover incidental expenses that arise, such as taxes, bribes, and legal fees. The target is assured that these expenses will be reimbursed once the money is spirited out of Nigeria.

Victims are invited—even requested—to travel to Nigeria to complete the transaction. Once in Nigeria—often illegally—the deal will continue to flounder due to unanticipated glitches. The victim will be asked to cover additional expenses for taxes, bribes, and legal fees. If an individual eventually balks, he may be turned over to Nigerian authorities or threatened with physical violence. In 1995, an American involved in a 419 scam was murdered in Lagos, and numerous other foreign nationals drawn in by this scheme have been reported missing. Failure to avoid this scheme may endanger your freedom or your life. Although most would find the letter and proposition ridiculous, this swindle has been unusually effective, presumably because it plays to the victim’s greed and the prospect of “easy money.”
**Penny Stocks.** So-called penny stocks get their name because they are traded at very low prices or for “pennies.” For reasons not entirely understood, investors are enticed by the opportunity to own a lot of shares for a small amount. Buying penny stocks generally provides the investor with a share of a company that is undercapitalized, has unproven or nonexistent products, and novice or corrupt management. There are, of course, legitimate companies whose securities are traded at low prices, but discriminating between a legitimate offer and a penny stock fraud is difficult.

In the classic penny stock fraud, promoters assign themselves millions of shares of stock at a fraction of a cent per share, or no cost to them at all. Next a prospectus is prepared disclosing that the product has little or no chance of success, the management is inexperienced, and that the company has virtually no assets. The stock is marketed through a “boiler room,” a room outfitted with desks and telephones manned by high-pressure brokers who make outrageous promises regarding the profitability and riskiness of the venture. The goal is to inflate the share price high enough and long enough for the promoters to sell their shares at a tidy profit.

Brokers that make cold calls must follow certain rules. They must: call only between 8 a.m. and 9 p.m.; promptly tell you their name, their firm’s name, address, and telephone number; explain that the purpose of the call is to sell you an investment; and put you on their “do not call” list if you ask. Although honest brokers use cold calls to attract clients, it is not a good idea to do business with a stranger over the phone.

**Ponzi Schemes.** Ponzi schemes are named after Charles Ponzi, an Italian immigrant who moved to Boston in 1919. One of the oldest and simplest forms of investment swindle, these schemes lure investors in with promises of large and quick returns. The victim’s money, however, is usually never invested in anything. Early investors are paid their profits out of money put up by later investors, and the process continues until the bubble finally bursts. A major factor in the eventual collapse of a Ponzi scheme is that there is no significant source of income other than from new investors. This scheme works well because early investors report the high returns to their friends, bringing them into the scam.

**Precious Metal Mines.** The allure of precious metals—especially gold—is one of the age-old allies of the swindler. Ignore claims of being able to turn common substances into precious metals through “chemical promises” and the existence of new and “secret” methods for reclaiming mineral reserves from untested or abandoned mines. Be wary of companies that have discovered new mines. Geological reports can be fabricated or the mine may be “salted” to exaggerate the quality and quantity of minerals present.
**Prime Bank Notes.** There is no such thing as a “prime bank note.” Investors are told that their money is being pooled together to buy AAA rated bonds at deep discounts issued by “prime” international banks to raise funds “for good causes” that will be sold at face value to pension funds. Extraordinary profits are possible with little risk to the investor, swindlers claim, because the notes sell at such deep discounts and then the profit is “rolled” into more notes and the process is repeated.

The purpose of these frauds is to get the victim to send money to a foreign bank, where it is then transferred to an off-shore account that is controlled by the cheat. From there, the victim’s money is used for the promoter’s personal purposes.

Big banks sometimes do issue “medium-term debentures” at discounts. However, the large discount is designed to compensate for higher risk. And there is such a term as the “prime rate.” This is the base interest rate that banks use in pricing short maturity commercial loans to their best, or most creditworthy, customers.

**Pyramid Schemes.** A pyramid scheme is a fraud wherein an investor is sold the right to become a sales representative or distributor, often at a substantial price, thereby gaining the right to sell the same privilege to others. The sale of a product or service may be included in the scheme, but is always secondary to the recruitment of new members. The fraud collapses due to the ever-decreasing number of potential investors in a given area. The scheme functions much like the old-fashioned chain letter, which has gone hi-tech and is now sent more cheaply and efficiently across the internet electronically by e-mail.

The number of investors needed to keep a pyramid scheme working quickly exceeds the **population** of the United States. If a promoter initially sells “distributorships to 5 persons in January, each of who brings in an additional 5 persons in February,” and so on, by the end of the year, each and every American would have to participate to support the scheme.

Pyramid schemes share two important aspects with Ponzi schemes. First, ever-increasing numbers of investors are required to keep the frauds from collapsing. Secondly, these frauds often afflict affinity groups, as family, friends, or other associates recruit each other to invest. Finally, there is generally an absence of a profitable product or efforts to make profits through productive work.

**Viatical Settlements.** A viatical settlement is the purchase of a terminally ill person’s life insurance policy for a certain percentage of the policy’s face value. The amount paid depends on the size of the policy and the length of time the policyholder is expected to live. Generally speaking,
there are three parties involved in a viatical settlement: patients who get money they may need to live their remaining years with dignity; dealers and brokers who make markets in viatical settlements; and investors who collect the policies’ face value upon death of the “viator” or insured.

These investments are touted as the “perfect no-risk investment.” Viatical firms and brokers advertise that viatical settlements are not subject to fluctuations or market risk and that there is safety of principal and high returns. Added benefits alluded to include short maturities, tax-free income, and that the viatical company ensures that premiums are paid. The problem is that these claims are highly misleading.

In a sense, there is safety of principal and return. The insurance company will pay the face amount of the policy upon death, assuming that the insurance company does not fail, policy premiums remain current, and the life insurance company does not refuse to pay a death claim. However, even if death occurs during the incontestability period (normally 2 years), insurers are free to dispute policies that were obtained by fraudulent means. (Incontestability prohibits an insurer from canceling a life insurance policy except for failure to pay premiums.) Some states recognize fraud as an exception to incontestability. Moreover, a named beneficiary can challenge the legality of the policy sale after the viator’s demise.

The guaranteed return is the difference between what the investor pays and what is received when the insured dies—i.e., the return is a fixed amount. However, the longer the insured lives, the lower the annual rate of return on your investment would be. Although the investment’s maturity is based on a doctor’s best guess of the patient’s life expectancy, some patients have survived much longer than originally predicted. Not only does extending the maturity reduce the investment’s appeal from an annual return perspective, it also jeopardizes the investment itself because the viatical firm may find it impossible to continue paying the policy premiums. You could end up paying the policy’s premium to keep it in force.

Finally, the investment is not tax-free. Life insurance companies are exempt from the 1099 form filing requirements normally associated with the payment of funds to beneficiaries. Death benefits paid to named beneficiaries with an insurable interest (the beneficiary suffers some loss if the insured dies) are tax-free. Once a policy is transferred (sold) for value, however the new owner must treat it as a taxable investment.
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