



**SOUND *INCOME* STRATEGIES, LLC**

*The secret to a great retirement is our middle name*

# History of Financial Scams and Ponzi Schemes

*And What You Can Do  
to Avoid Becoming A Victim*

## ***Inside:***

- Why you need to watch out for financial firms that “Self-Clear”
- What’s the significance of the end of the Fiduciary Rule?
- What you should do if you become the victim of a scam

# What Causes Smart People, Who Usually Make Good Decisions, to Become Victims of Fraud?

Millions of Americans fall victim to some kind of fraud each year. According to the U.S. Department of Justice, fraud occurs when a person or business intentionally deceives another with promises of goods, services, or financial benefits that do not exist, were never intended to be provided, or were misrepresented. Typically, victims give money but never receive what they paid for.

Victims are often left feeling betrayed with their trust in their own judgment and their trust in others shattered. Fraud crimes can destroy the financial security of families, and for those who are retired or close to retirement age, the results can be devastating.

One of the first recorded incidents of fraud occurred back in 300 B.C. when a Greek merchant named Hegestratos took out a large insurance policy known as bottomry. Basically, bottomry is when a merchant borrows money and agrees to pay it back with interest when the cargo is delivered. If the loan is not paid back, the lender can acquire the boat and its cargo.

Hegestratos planned to sink his empty boat, keep the loan, and sell the corn, but it didn't work out. He drowned trying to escape his crew and passengers when they caught him in the act.<sup>1</sup>

These days, we've come to refer to financial scams as Ponzi schemes, which are named after Boston businessman Charles Ponzi who ripped off fellow Italian immigrants in Boston back in the 1920s. Ponzi promised 50% returns on investments in only 45 days.

A Ponzi scheme is defined as a fraudulent investment operation where the operator provides fabricated reports and generates returns for those who invest early on through revenue paid in by those who invest later on in the process. Operators of Ponzi Schemes focus on attracting new clients to make investments, so they can use that money to provide returns to those who invested early on.

Common signs of Ponzi schemes are that they offer unusually high short-term returns or unusually consistent returns—like 18 straight months without a loss.

## **Bernie Madoff Investment Scandal**

More recently, we saw the Bernie Madoff investment scandal wipe out the fortunes of many well-to-do investors. This scandal was a major case of stock and securities fraud that was discovered in late 2008. Bernard Madoff, former NASDAQ Chairman and founder of the Wall Street firm Bernard L. Madoff Investment Securities LLC, ended up admitting that the wealth management arm of his business was indeed an elaborate Ponzi scheme. Just like Charles Ponzi, Madoff lured investors in by guaranteeing unusually high returns over a short period of time.

## **Scott Rothstein Ponzi Scheme**

In 2010, Scott Rothstein, a former attorney with Rothstein Rosenfeldt Adler in Fort Lauderdale received a

50-year prison sentence for using his Fort Lauderdale law firm to run a \$1.2 billion Ponzi scheme. Rothstein pleaded guilty to two counts of wire fraud and three charges of conspiracy.<sup>2</sup>

Mr. Rothstein was accused of selling discounted stakes in fake settlements of sexual-harassment and whistleblower lawsuits that ranged from hundreds of thousands to millions of dollars. Mr. Rothstein told investors they would collect the full proceeds when the cases settled, while taking money from new investors to pay back those who had invested earlier.

Rothstein and his co-conspirators created fake settlement papers, bank statements, and personal guarantees to convince investors that the scheme was real. He also created a false court order and forged a judge's signature.

Rothstein used the money he generated from his scam to purchase real estate in Florida, Rhode Island, and New York. He also splurged on a Lamborghini, a Ferrari Spider, more than 300 pieces of jewelry, and a collection of sports memorabilia.

So, what causes smart people who usually make good decisions to become victims of fraud and scams? Two common reasons: Greed and Fear of Missing Out.

## **Beware: Scammers and Fraudsters often Target Friends, Family, and Associates**

Unfortunately, commonly targeted victims of financial scams often include old friends, family members, or business associates. Our founder, David J. Scranton, learned the hard way about how old friends or business associates can be the originators of these types of schemes.

Early in his career, he made the mistake of going into business with a high school friend who he thought he could trust. This person drove around in a Ferrari and gave off the appearance of being a successful builder. Even though going into business with this friend didn't pass David's "sniff test," he admits that he fell into the trap because he let greed take over.

To make a long story short, it wasn't long before things took a turn for the worst. "Mr. Ferrari" had one excuse after another to explain why he couldn't pay David back. After further investigation, David was able to determine that his "friend" never had any intention of paying him back. David had been taken for about \$100,000.

## **What You Can Do to Avoid Becoming a Victim of a Scam**

### **1. Watch out for financial firms that "Self-Clear"**

When it comes to hiring a Registered Investment Advisory firm to manage your capital, there should be a well-known and reliable "custodian bank" that handles your money. The account should always be listed in the client's name. Something like, "for the benefit of Mr. and Mrs. Smith."

Beware of financial firms that try to "Self-Clear" like Bernie Madoff did back in the day. This means that there is no third party to double check things like trades, reports, or the flow of money in and out of your accounts.

Shady folks like Madoff and Rothstein “self-cleared” with small private LLCs. They might have had the names of large banks or brokerage firms on their paperwork, but their first move was to send their clients’ capital to a small private account in the name of a small private LLC. Once they did this, this is where the shady dealings occurred.

**2. Watch out for anyone asking for personal information:**

Most legitimate institutions (Banks, IRS, Medicare) will not call and ask for your personal information like an account number, social security number, Medicare number, or address. If the person on the phone does indeed work for your bank or for the IRS, they will already have all your personal information. A good rule of thumb is to never give out any sort of personal or financial information over the phone unless you are the one that initiated the call.

**3. Tell the person on the phone or at the door to send you something in writing**

It’s a good practice to never buy anything from anyone who calls or knocks on your door unannounced. Remember that it’s okay to ask them to send you some sort of written information on any offer or request for a donation. Also, do not donate if the person requires you to provide your credit card number or bank account number.

**4. When in doubt, call the Institution back**

If something seems suspicious, you can let the person on the phone know that you would feel more comfortable calling them back. Next, grab your paperwork from that institution and find the customer service number listed on your documents. Keep in mind that if the person on the phone is legitimate they will have no problem understanding your concerns.

## **What You Should Do If You Become the Victim of a Scam**

It’s natural to feel afraid or embarrassed if you happen to fall victim to a scam. You are not alone. Doing nothing will most likely make things worse. Instead, give your local police department a call and notify your bank if you feel that your account information has been compromised. You should cancel any debit or credit cards that might have been compromised, and you should also reset the PIN for the cards that were compromised.

## **What’s the Significance of the End of the Fiduciary Rule?**

A fiduciary is a person who holds a legal or ethical relationship of trust with one or more other parties. Typically, a fiduciary prudently takes care of money or other assets for another person.

In February 2017, President Trump signed an executive order directing the Department of Labor to review and potentially rescind the fiduciary rule that requires financial advisors to act in the best interests of their clients. This rule basically required financial advisors, and more specifically, brokers, to put the interest of their clients above their own when working with retirement accounts—much like lawyers and doctors do.

On June 14, 2018, Barrons.com announced that the Department of Labor’s Fiduciary Rule was “Officially Dead,” marking the end of the rule, which was crafted by the Obama administration.<sup>3</sup>

The Securities and Exchange Commission has proposed its “Best Interest Rule” that could end up replacing the Department of Labor’s Fiduciary Rule for brokers and financial advisors.

*The Wall Street Journal* reported:

The SEC’s plan to require brokers to act in the best interest of clients is less restrictive than the Labor Department’s “fiduciary rule” affecting retirement accounts... The SEC’s rule wouldn’t ban any single conflict of interest, such as sales contests that brokers conduct to juice sales of particular products, but would generally require brokers to disclose conflicts of interest and try to blunt their impact. <sup>4</sup>

So, what this means, as of now, is that if you are working with a financial advisor who is a registered broker, he or she is only obligated to recommend investments that are “suitable” for you. This means that if your advisor has a choice between two similar mutual funds, but one pays a higher commission, the advisor could recommend the one that pays them a higher commission—even if the other fund has lower fees and might be better for your portfolio in the long run.

The Trump administration says the reason it wants to keep this system in place is that it believes that the Fiduciary Rule limited the investment choices for clients and burdened the financial industry with “unnecessary” regulations.

### **About Sound Income Strategies:**

Sound Income Strategies is a Registered Investment Advisory firm specializing in the active management of individual fixed-income securities. With our unique expertise and experience, our firm focuses on maximizing the value of our clients’ fixed-income portfolios and then building retirement plans that deliver consistent income, growth potential, and—most importantly—defense against damaging losses.

As a Registered Investment Advisory firm, Sound Income Strategies continues to diligently honor our fiduciary responsibility as spelled out in the Investment Advisers Act of 1940. Our goal is to always act and serve in the best interests of our clients.

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