

**Personal Financial Literacy Brown Bag Luncheon:  
Investment Fraud – Am I Getting Ripped Off?  
December 10, 2008**

John

I am pleased to be here and appreciate you taking some time during your lunch to come listen to me. I hope this going to be informative for you. I agree with Esther that this is a very timely subject for all of you. We see, often times, in down economic times the scam artist coming out because people are looking to recoup some their losses, and do so quickly. When someone comes along with a great sounding idea on how to do that we are often more susceptible to becoming victimized. So, what we want to do today is to help you check before you write one!

Now, as Esther mentioned, the State is very much involved in the concept of Personal Financial Literacy. As you know, the goal of financial literacy is to help people learn how to create a plan. It's also a way to learn how to budget and to invest. It's also learning about good and bad credit, debt, insurance, and how to get a job. Now, I stole a quote from your PFL Summit that you had earlier in the year, and I thought the quote was really great. It says, "Resolve not to be poor. What ever you have spend less. Poverty is a great enemy to human happiness. It certainly destroys liberty, and makes some virtues impracticable and others extremely difficult." That a quote from Samuel Johnson. So, Personal Financial Literacy then provides practical education on how to live a practical life. Ok, so what's missing from all of this?

Well, I've come up with a couple of my own quotes. One of them is an old English proverb that says, "A fool and his money are soon parted." And then, of course, the famous one from P.T. Barnum that says, "A sucker is born every minute." So, what's missing from all of this is investor education. Personal Financial Literacy and investor education are two sides of the same coin. The idea is that with Personal Financial Literacy you get people understanding about how to invest and how to budget wisely. It leaves off at the point of how to be a good investor, and that's where investor education...the role that our Department fulfills. How do you become an informed investor so that you don't get taken by the first sweet sounding opportunity that comes along? What good is it knowing how to budget and plan wisely if you then just fall prey to fraud. That's where we come in.

Now, I'm going to give you a little quiz here. I want to see if you can identify this fellow here for me. This fellow immigrated to the United States

in 1903 at the age of 20. In 1920, he devised a scheme that still bears his name today. He opened a company in Boston telling investors he could provide a 100% return in just 90 days of their investment. At one point he was deluged with \$1 million in one three hour period. He was just taking in the money because of this scheme. And he went from penniless to exceedingly rich, to penniless, and imprisoned in less than a year. There's his mug shot. What's his name? By the time he was exposed he'd taken in over \$10 million, and only having invested \$50 of his own money. His name is Charles Ponzi, and he invented the Ponzi Scheme. Now, what a Ponzi scheme is basically a fraudulent operation in which a person is promised astronomical returns, atypical returns; more than you would get from more conventional types of investments. The profits are paid from the monies that are coming in from new investors. So, it's essentially a rob Peter to pay Paul situation. As I am getting new investors I am paying out old investors or offering to pay. So, often times the promise of a return is made in such a way that you are encouraged to keep your money rolling forward. Don't take the money just roll it over and let this great scheme continue, and you'll be paid more based on higher principal. But, at root, there is no investment in a Ponzi scheme. There's money coming in and out, and often time just remaining in the back pocket of the person who's promoting the scheme.

In North Carolina who protects investors? Is it the Governor? I understand we're going to have new one in January. Is it the Attorney General? Is it the Insurance Commissioner? Or, is it someone else? All of you are smart enough to know it is somebody else. In North Carolina, the person who administers and oversees state security laws is the Secretary of State Elaine Marshall. It is her statutory responsibility to oversee the securities laws the State has enacted. These are laws that are essentially consumer protection laws for investors. They require certain amounts of disclosures on the part of the professional who are offering the investments, as well as those offer investment advice for a fee, and on the actual investment product itself. The different kind of functions that the Secretary of State provides is to administer and enforce. We respond to investor complaints about securities and the people who sell them. We are a law enforcement agency. We have sworn law officers who carry guns and badges, and we can investigate alleged violations. We work very closely with US attorneys, as well as the local district attorneys when we have a case that we feel warrants criminal prosecution.

Another important role of the Securities Division is our role in capital formation here in North Carolina. I think we all will agree that we have a wonderful system in the United States that we call Capitalism, and it operates

under the theory that each one of us has the ability to better our lives financially through public ownership through different types of securities investment. Now, the system can only work when each one of us has confidence in the market place as a place where we can do business. And that's where the regulators come in. We enforce the rules, we make sure that everyone plays by the rules so that each one of will collectively have confidence that the market is some place where each of us have a chance to better our lives financially. That's an important role.

Now, I talk about a security. What is a security? The full legal definition can be found in our general statues. If anyone of you suffers from insomnia I encourage you to pull your general statutes and read what has come to be defined as securities. It's less of a black and white definition as it is a laundry list of financial products that have come to be defined as securities of a kind, either by statute or court decision. So, let me just sort of explain in general terms what a security is. A security is any investment in which you the investor have reasonable expectations of making a profit based on the managerial or entrepreneurial skills of some third party. Notice that there's a passive relationship that you are not being asked to take any active role in the management of the financial venture. You are simply being asked for capital. So, we tend to think of securities as being stocks and bonds. Those are certainly the most common form of securities that we are familiar with. But, we humans are incredibly inventive when it comes to devising financial products, especially those involved with getting other people's money. So, securities can be many different types of financial products that you might not otherwise think would be classified as a security.

For instance, I dare say we could go to any local convenience store here in town and there will be an ATM machine there. Now, how did that ATM machine get there? It's not a bank; it's a convenience store, so how did the machine get there? Well, somebody realized that there was a high traffic area, and that as a convenience to costumers, would put an ATM machine there for convenience. Somebody took that entrepreneurial risk to purchase that machine, to hook it up to the financial services network, to stock it with crisp twenty dollar bills, and make sure the electricity was on and that sort of thing. It's a legitimate business opportunity. They generate income from service charges; \$2.50, \$3.50, what ever they charge. That's where the profits for that machine come from. So, an enterprising person might decide they want to open this opportunity up to other people. And they might pitch you that opportunity. Wouldn't you like to own a piece of this machine? It's generating a lot of profit because it's a very high traffic area. That arrangement could be considered a security under North Carolina law.

Again, they are not asking you to take ownership of that machine, or responsibility for its maintenance or upkeep. They are just looking for an investment in that, and under North Carolina law anyone who sells securities or provides investment advice for a fee must be registered with the Secretary of State's office.

The exceptions involve those big Wall Street firms that are subject to federal registration requirements. But, I don't want you to get bogged down with who is and who isn't subject to registration requirements because the central bottom line message is that you know that you have a State agency you can contact to find out if the person offering this sweet deal is properly registered and licensed to offer such investment opportunities in North Carolina. It doesn't matter if the person lives in Utah. If they are selling in NC they have to be registered. If they are selling securities they have to be registered, if not by the state, then by the Federal Government. So, again, you can contact our office and ask us to verify the licensing credentials of the individual who is offering this security. Again, not only can you check the individual, but you can also check the investment product itself. So, you can check people and product through the Secretary of States office. This is how you contact us; this toll free number (800) 688-4507, and we're real simple to find on the web at sosnc.com. You'll see these yellow rectangular boxes on our web page, and the top one says, "Investment securities", you click on that and it'll take you to our side of the web site where we have our brochures, which are all in PDF format. You can order them and we'll be happy to send them to you. I really encourage you to take a look at our web site, and I believe Esther was telling me that the PFL web site has our link listed. So, you go through your internal mechanism or go to sosnc.com.

Now, in Personal Financial Literacy classes I'm sure they talk about the different types of investment professionals that are out there. There're stock brokers, investment advisors, and financial planners. But, I'm not sure what depth there responsibilities are discussed, and I want to give you an overview of what each one of these do and what their responsibilities are.

A stockbroker is a person who buys and sells securities on behalf of themselves, their clients, and broker firms. They have to be registered with the Federal Securities and Exchange Commission (SEC), and with the state securities regulator (us). They have what is known as the "know the customer" requirement. When a person goes in to establish a new brokerage account the broker is obligated to try to get to know the potential investor. They have to fill out a new account statement. On that statement is information to characterize the investment philosophy of the potential client.

How risk tolerant is the client? Are they very conservative with their money and want conservative types of investments where principal is protected? Or, are they more willing to take some risks? How risky are they willing to be? They have to know who you are to act in the client's best interest. They are not required to be a fiduciary to the client. In other words, they do not have to stand in legal trust for the client. So, they are free to their own interest ahead of the clients. You have to understand that a stockbroker is nothing more than a salesperson. That's all they are. There's no special degree in stock brokerage or anything like that. They are hired primarily for their ability to sell product. So, when you go in to meet with one of these individuals you have to remember what their motivation is. Their motivation is to get you to buy something because that's a commission for them. You have to sometimes question whether or not a recommendation....although it might be a recommendation for a security that fits your temperament or profile, you have to question the amount of commission they are getting. Is this a product in which if you sell X number of products you get a plasma TV? Or, is it an internal competition? Why are you recommending this product to me? You have the right to ask these questions, and you have the right to get an answer that you can understand. I encourage all of you to treat this as a business relationship. No matter how chummy they seem to be they are not your friend. They are trying to sell to you, get you to buy something. So, you have to ask the question, and if you have to ask it fifteen different ways until Sunday, then do so until you understand what the relationship is, what's going on, what the fees are, commission and so on. Take the time to understand what it is that you're buying.

What then is an investment advisor? An investment advisor is somebody who does just that. For a fee, they will advise clients how to invest their money and what their portfolios should look like. Depending on the amount of assets that you place under their control they are either subject to federal or state regulation. Again, don't worry about whether a person is state or federal regulated; you're going to use our office to verify the credential and the licensing of your investment advisor.

Now, unlike a stockbroker, who has no fiduciary responsibility, all investment advisors do have fiduciary responsibilities to their investment clients. There are different ways investment advisors are compensated. Some receive commissions from brokerage firms whose products they recommend to clients. There's nothing wrong with that; they just have to disclose this information to you up front so that you know if you do purchase this product your investment advisor will ultimately get a commission from that. But, as I said, since they do have a fiduciary responsibility to the client they have to

have a firm and reasonable basis upon which they are making this recommendation to you. They have to justify why they are making this recommendation knowing they will make a commission out of it.

Yes Sir.

Audience They will tend to sell you things they make a higher commission out of.

John Some do. And stock brokers certainly. If they have a different product where one gives them 5% commission and a 3% commission which one do you think the stock broker is more likely to offer – the 5% commission product. Not all do, but again, they don't have that fiduciary responsibility. There are those investment advisors who are compensated solely through you - the client. In other words, based on the amount of assets that you place under their management they will take their commission directly from you. You are paying them directly so that they don't even have the appearance of a conflict of interest by taking compensation or a commission from a company. So, there are two different types of investment advisors, but if they are a newly registered investment advisor all of them have a fiduciary responsibility to the client.

Ok, we've talked about stockbrokers and investment advisors, what then is a financial planner? Well, that's an excellent question because there is no legal definition for what constitutes a financial planner. I could go out this afternoon and hang up a shingle and call myself a financial planner. I have difficulty balancing my checkbook so chances are I need to take one of your PFL courses! That being said, anybody can be a "financial planner". Typically these are people who help clients with their estate and tax planning, things like that. But, they are not subject to regulation by any state entity. Where they do become a regulated individual is when they cross the line of being a financial planner into telling you where you should invest your money; how your portfolio should be invested.

That's when they cross that line and become an investment advisor, and that's what triggers the regulation by requirement.

So what I want to impress upon all of you here is to be very very careful about professional titles and so-called certifications. As you can see here there are only six, and I've put six because I could only fit six on the screen different titles on the screen.

There's a financial analyst, financial advisor, financial consultant, financial planner, investment consultant, and wealth manager. All these sound impressive and important, but they are simply generic terms or job titles, and they can be used by investment professionals that may not hold any certifications. Some often add things like "certified professional" or "registered" to the name. These are simply marketing tools in a number of cases. There are only five credentials that our state statutes exempt from having to take the licensing exam here in the state. I'm not going to tell you what those are because, again, I don't want you to fall into a false sense of security by relying on a particular title as being a good profession or designation as opposed to one that may just be a marketing tool.

President Reagan had a wonderful quote some years ago. He was talking about the Russians. He said, "Trust, but verify." And that's what I want all of you to get in the habit of doing. If you are like me you don't have a head for finances. I mean, I have a theoretical understanding for some of this stuff, and would like to think that I am better informed than I am, but at some point if you don't have that knowledge and you want to be engaged in the investment process you're going to have to trust somebody. You'll have to rely on the expertise of somebody. But, we want you to verify the information and the credentials that these people profess to have before you sign a check. Check before you write one; before you transfer assets to any person, because once you do it's very difficult to get that money back if they turn out to be a con.

There's an organization, the self regulating industry, FINRA - Financial Industry Regulatory Authority. [Finra.org](http://Finra.org), has a lot of information and a lot of investor education resources. They have information about professional designations. And it would be really interesting for you if you are interested in doing so. Go to that site and type in professional designations and you'll see a list of maybe 100 or so different titles, like the six that I picked up there. It will go through and tell you who issues that title, whether there are any continuing educational requirements, if there's a grievance process for people that have problems with individuals that hold these degrees or certifications. You'll be surprised to find that most of these titles are simply marketing tools. People get these certifications by attending a weekend seminar or taking online courses.

Audience     So my certified financial planner may not be?

John No, a certified financial planner should be one where the educational requirements are sufficient to make them exempt from having to take the licensing exam. They are one of the five that I mentioned. But, I want you to call our office and verify the information about your financial planner. No information goes back to these individuals from us. So, unless you tell them that you've called us to check their licensing they're never going to know. What we can tell you is whether or not the person has ever had any complaints filed against him or her, whether any action has been taken against them, either administrative from a regulatory standpoint or their internal controls. It's like checking your credit every year. It's a good business practice to make sure that the person you are dealing with is not doing something that you don't know about.

Audience So, you said that the financial planner should be registered but, they don't have to be?

John No no. If they are calling themselves a certified financial planner, and using that.....because that is a proprietary title, that's a trademark title – CFP, and it's one that our statutes exempt from having to take the licensing exam. But, they have to still be registered. So, what I'm saying is that he should be registered. If he's calling himself a CFP, he should be in the database that we have access to, and we should be able to verify that he or she is a financial planner.

What are some warning signs of fraud? Well, the first red flag should be anytime someone promises you or guarantees any specific rate of return, especially one that seems out of the ordinary. We have seen con artist who make promises of 13%, 14%, 20%, 25%.....going back to Ponzi - 100% rate of return in 90 days. That is just outside the norm. So, if anyone is pitching that kind of rate of return that should be your red flag. I'm going to do some further investigating on this. Like a used car salesman, anyone who pressures you to make an immediate decision, "You've got to act now. This thing has a rocket on it. There going to be an announcement this week that this company is going to announce a product line or service so get in now, and next week it's going to shoot up." Anything that's a good investment today will be a good investment next week. So take some time and remove the emotion out of your decisions. That's a very important point to remember. Remove the emotion. It's a business transaction, treat it as such.

Be careful about appeals to your psychological needs or fears. Con artists are great psychologist. They understand human emotion. They work at you until they figure out where that hole in your protective armor is. It might be

concern over a spouse, concern about leaving something for your children or grandchildren. Fear of your own outliving your money. They'll figure out what motivates you, and once they do they'll zero in on it. If you are able to rebuff all those attempts that's when the true con artists will come after you with abuse and call you "stupid", and say things like "I got my own mother in this thing." We've heard it. I've heard transcripts of boiler rooms where they use abusive language. They get into the expletives and they try to bully the individual. When all else fails they try bullying tactics. The best advice is to hang up. You don't have to listen to it.

Be careful of offers that claim to help you get back lost money. Con artist trade or sell their mailing lists to other people. And they know if you have been victimized once you're more likely to be a victim a second time. So be careful of that. If you have been or know someone who has been a victim, you could be on somebody else's list. Sometimes the person may pretend to be someone from law enforcement or a consumer protection agency that is there to help people get money back, and for a small fee will help you to get your money back. No law enforcement agency will charge you money to help you get money back. So, remember not to chase good money after bad. One area that we're concerned about in the Securities Division is the fraud that's aimed at senior citizens. They tend to be the most vulnerable of our people. AARP did a study back in 2001 that found that 57% of all fraud victims were over the age of 57. Our own Division estimates that anywhere between 20 – 25% of the enforcement actions that we take involve some type of fraud aimed at seniors. This is because seniors are wonderful savors. They have the cash; that's what a con artist is looking for. My generation is a buy now pay later generation. We have no more money, right Esther? You are dealing with this every day. We have no more money for con artist; you can't get blood from a turnip. So, they look for ready sources of cash. Seniors tend to be very polite, courteous, trusting, wonderful social traits, but very bad for business. So, all of us that have ageing parents need to be vigilant, watch out for them, and help them understand that this nice young man from Alberta, Canada who keeps calling is not really her best friend. She needs to be careful about what she sends to this fellow.

One area that seniors are targeted through is free lunch centers. I'm sure you've all seen them. This is a typical one. They're all happy. Any why are they happy? Apparently, they've protected their nest egg from retirement vultures. There's nothing wrong or illegal with offering a free meal as an enticement for the person to come listen about something. All we want to do is to let people realize that these things are really nothing more than sales jobs. I pulled these headlines from a web site designed to sell marketing

techniques to the people who offer free lunch seminars. And you can see what the monetary incentives are: “Learn the Secrets to Legally Unlocking Your Clients 401K funds and easily earn \$500,000 working part-time; Eliminate Plate Lickers Once and For All.” Who are plate lickers? Plate lickers are the industry term for the people who come to the free lunch for the free lunch. They don’t like plate lickers. Plate licker cost them money. They want people to come and buy. This is the term that is used. And I think that’s a very derogatory term to refer to potential clients as.

“Take away accounts from brokers at will.” Well, we learned that stockbrokers have no fiduciary responsibilities to clients, but at least they have to know who the costumer is. These people we don’t know. We don’t know anything about them. So, we just urge people....I don’t have time to go into all the intricacies of what is going on in these letters, but just be careful about it. Are you going to go to a seminar where you don’t know the person from Adams housecat to learn about how to save money, taxes or where you should invest or things like that? No, you’re going to find someone in your local community that you know. Who here knows that man; the traveling salesman who comes through town to sell band instruments, right? Well, oftentimes, that’s what these folks are. They are just coming through the area and offering these wonderful opportunities, and then they leave and you have no way of following up with them knowing who is ultimately responsible.

So we have teamed up with AARP on a free lunch monitoring seminar, and we have passed out information here that describes the AARP Program. What it is is that if you are interested in going to these seminars, we have prepared a checklist of what to look out for. You don’t call attention to yourself. Just listen and take notes. Then you fill out this form and you can send this form to the AARP in Washington, DC, and they, in turn, will collect this information and will forward it to the appropriate state agency for review. Now, not all these seminars are unethical or bad, but it’s just a way for us to understand what’s going on out there. If there are problems we want to know about them, and perhaps take some action to the extent that we have the ability to do so. I put the web site for the AARP directly, you can find it if you just go to [www.aarp.org](http://www.aarp.org). If you have friends or family that would be interested please share that with them as well.

Another area that is of concern to us is what we call affinity fraud. Affinity fraud is aimed at people who share common characteristics. Think of yourselves and the circles that you walk in. You have friends, family, and professional circles. Or, you have social, religious, or ethnic circles. We all

walk in different circles. As humans, we are more likely to trust someone who is in our circle than someone who is outside, and that's where a good con artist can find a lot of easy prey, because we are more trusting of those in our circle and more suspicious of those outside. We have seen several cases where an individual has gotten into a group, and pitched a specific type of investment scheme to a couple of people who are the influential members within that group. Then they step back and let the word of mouth work its way through that community until everybody in it is throwing money at this individual, and then they disappear, or the scheme collapses and everyone loses their money.

Think about how you would feel if your best friend got you into this deal and you lost hundreds of thousands of dollars. What does that do to your relationship with your friend or family member, or if you were the one who brought them into the scheme. How would that make you feel as far as that relationship with that friend? It puts a very big strain on that friendship. Not only can you lose money, but you can lose social contacts. Where we see affinity oftentimes is in our churches. We've had cases in which a fellow makes a pitch and gets the entire congregation in on it. We're talking significant amounts of money, and then the scheme collapses. You have an entire church...just imagine the turmoil and emotions that something like that will churn up. It doesn't matter what group. It could be the Kiwanis club or any social group that you belong to. It could happen. So, if something sounds too good to be true, it is.

That's my concluding remark. Please don't invest until you take the 5 minutes, and it only takes 5 minutes, to check the registration status of the individual. We have very friendly state employees willing to talk to you and provide you with this information.