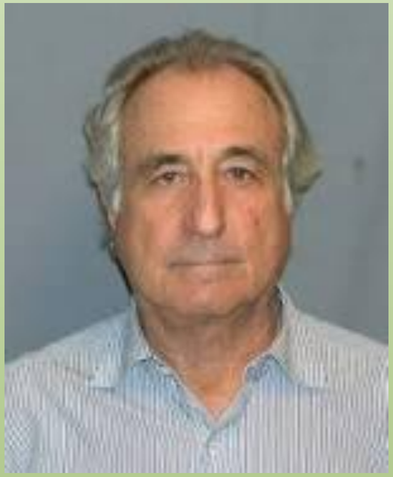
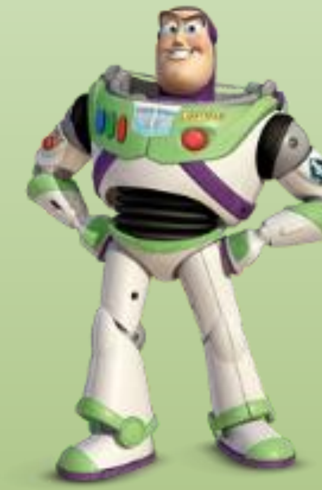
Fraud in Wealth Management from Ponzi to Madoff and Beyond





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- Leading white collar criminologist
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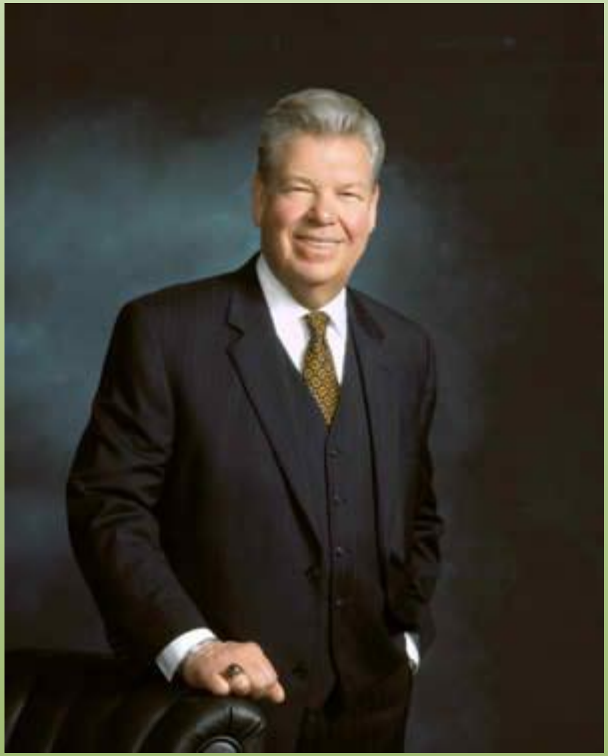

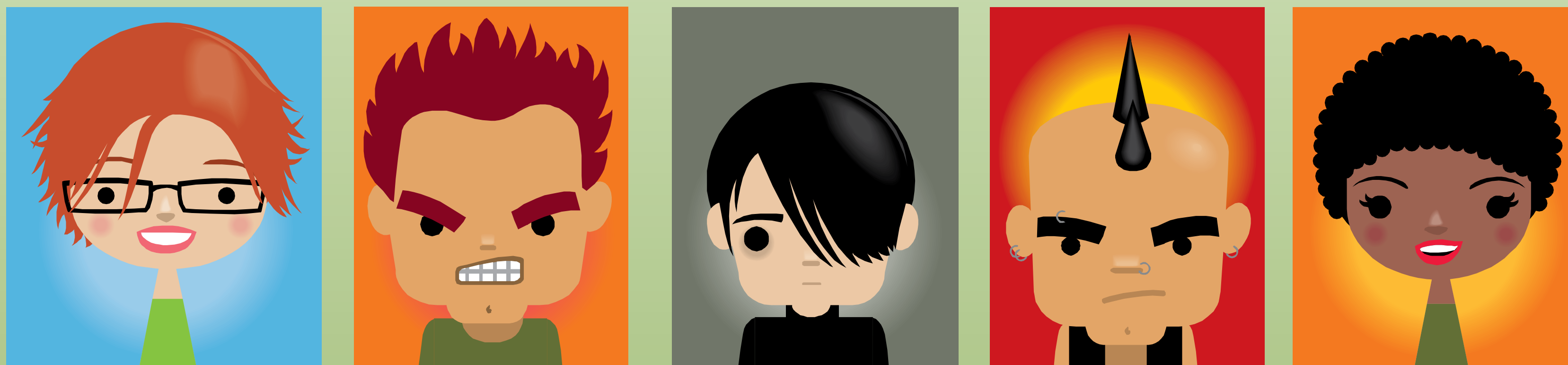

WHO ARE THE VICTIMS AND PERPETRATORS IN FIDUCIARY FRAUD?

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Who are the Victims?

- Investment fraud requires trust in a fiduciary which leads fraudsters to market to people who are part of their community (church, religion, socio-economic status, etc.)
- Typically individuals with money such as elders, those making more than $50,000, or somebody who has been widowed (thus receiving a large life insurance payment)

Elder Abuse

National Committee for the Prevention of Elder Abuse (NCPEA)

- **Fastest growing population** – by 2050 the senior population will triple to 19 million
- **Wealth** – people over the age of 50 control over 70% of the nations wealth
- **Decline in Decision Making** – more than 50% of seniors have some cognitive impairment yet their perception does not change
- **Increase in Senior Divorce** – the rate for people over the age of 50 has doubled since 1990

Who are the Perpetrators?

- Family members:
  - Can include substance abuse or gambling
  - Fear of losing out on inheritance
  - Sense of entitlement
  - Negative feelings towards other family members

Who are the Perpetrators?

- Predatory individuals:
  - May profess their love via the internet
  - Seeks employment to gain access to individual
  - Identify older people through obituaries to find widows
- Unscrupulous professionals or business persons (bankers, trustees, etc.):
  - Overcharge for unnecessary services
  - Use their position as fiduciary to gain trust and compliance
  - Brokers may be gaining excessive commissions or trying to meet other objectives

FIDUCIARY DUTY

What is a Fiduciary Duty?

- People in a position of trust or fiduciary relationship who owe certain duties such as loyalty and care to their principals or employers.
- A breach of fiduciary duty must show that the defendant:
  - Occupied a position of trust or fiduciary responsibility with respect to the plaintiff;
  - Breached that duty to advance a personal interest.

Who Owes a Fiduciary Duty?

- Corporate officers, directors, and high level employees
- Trustees of an estate
- Bank Officers
- Portfolio/Investment Managers
- Wealth Management Companies

Duty of Loyalty

- Requires the fiduciary to act in the best interest of the principal free of any self-dealing, conflicts of interest, or other abuse
- Fiduciaries can also breach their loyalty duty by committing embezzlement, theft, acceptance of kickbacks, and conflicts of interest

Duty of Care

- Requires the fiduciary to act with such care as an ordinarily prudent person would employ in a similar position.
- Reckless fiduciaries are responsible for resulting losses which can be recovered in civil action for negligence, mismanagement, or waste of corporate assets

SECURITIES FRAUD SCHEMES

Fraud Schemes Committed by a Fiduciary

- Securities Frauds
  - Churning (Excessive Trading)
  - Unsuitable Recommendations
  - Selling Away
  - Operating without a License or Registration
  - Unauthorized Trading

Churning Definition

- Fiduciary/Advisor will make excessive trades on a customer account in order to generate large commissions disregarding the client's interest
- The fiduciary will ignore any investment goals of the client and focus on the commissions being generated

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Proving Churning

- To prove churning three elements must be proven:
  - Trading in the account is excessive in light of the investor's objectives;
  - The broker exercised control over trading in the account;
  - The broker acted with intent to defraud or willful disregard for the investor's interest

Churning Detection – Turnover Ratio

- Turnover Ratio – measures how often, on average, the securities in an account are traded in a year
- The turnover ratio is calculated by taking the lesser of purchases or sales and dividing by average net assets
- A high turnover ratio represents an actively traded account while a low turnover ratio represents a buy and hold strategy

Churning Detection

- Cost-to-Equity Ratio – measures the annual cost of the trading as a percentage of the client's investments
- These ratios are calculated by dividing the fees and commissions by the average account value
- Typically commissions exceeding 1%-3% should be investigated

Churning Detection

- Pertinent inquiries for detecting churning:
  - Did the broker have discretion over the account?
  - Are commission increasing while market volatility is decreasing?
  - Are commissions for the period in question substantially higher than the average commission?
  - Were numerous trades entered and exited over short time periods for small gains or losses?

Unsuitable Recommendations

- Recommending high risk options to senior citizens with limited assets
- Persuading a client to purchase an unnecessary product
- Utilized high pressure sales tactics to sell a strategy or investment that does not fit the client age, status, objectives, financial needs, time horizon, etc.

Selling Away

- Investment professional trades or solicits the trade of securities not held or offered by the brokerage firm with whom he is affiliated
- Often times the trade is in the form of private investment opportunities

Operating without a License

- Verify licenses and registration with regulatory authorities such as FINRA, SEC, or the FCA
- Red flags may include:
  - Agents with a criminal record
  - Unexplained gaps in work history
  - Prior customer complaints
  - Historic regulatory issues
  - Poor credentials
  - Website comes across as generic

Unauthorized Trading

- A broker trading without customer authorization
- Potentially to meet capital requirements, generating excessive commissions, or meeting performance targets
- Any losses from unauthorized trades are the brokers responsibly while gains still belong to the customer

Red Flags for Security Fraud

- High Commissions – typical commission rates are between 1%-3%
- Excessive portfolio turnover
- Lack of questions posed to the client about risk and strategy
- Failure to communicate investment goals regardless of complexity
- Clients with products that don’t match their lifestyle and spending habits

OTHER FIDUCIARY FRAUD SCHEMES

Fraud Schemes Committed by a Fiduciary

- Embezzlement of Client Funds
- Gross Negligence
- Elderly Frauds
- Loan Schemes

Embezzlement

- Embezzlement is the wrongful appropriation of money or property by a person to whom is has been lawfully entrusted
- Requires a breach of trust but not necessarily a breach of fiduciary duty

Gross Negligence

- A fiduciary who intentionally fails to perform a duty in reckless disregard of the consequences to the victim
- Examples of negligence by a trustee/fiduciary could include:
  - Failure to file the appropriate tax returns
  - Failure to inform and account beneficiaries

Elderly Fraud

- The elderly are a prime victim for all frauds in this presentation
- Telemarketing Fraud
- “Sweetheart Scams” – alleged suitors appealing to older victims and widowers lonely nature gaining access to their personal property and accounts
- Overcharging for Essential Items (hearing aides and safety devices)
- Offering False Prizes

Red Flags for Elder Fraud

- Unpaid bills, eviction notices, and unpaid utilities
- Unexplained withdrawals and transfers
- Financial documents no longer being addressed to the elder's home
- New "best friends"
- Unexplained legal documents such as a Power of Attorney
- Missing property or belongings
- Unknown signatures on checks
- Absence of documentation for financial arrangements

CASE STUDIES

"Shanghai police arrest 21 suspected of wealth management fraud"

- Zhongjin Capital Management committed illegal fundraising
- Illegal fundraising is a form of shadow banking where an institution raises funds and invests the funds into long term assets just as a bank would but without the backing of any regulations or federal funding

"She Wished She Knew: Alanis Morissette's Ex-Manager Admits to Having Hand In Her Pocket"

- Jonathan Todd Schwartz, Business manager (fiduciary) of Morissette stole $4.8M through embezzlement
- Filed false returns, committed wire fraud, and forged Morissette's signature
- Attempted a cover up claiming the money was for an investment in an illegal marijuana growing business

Questions or Comments?

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