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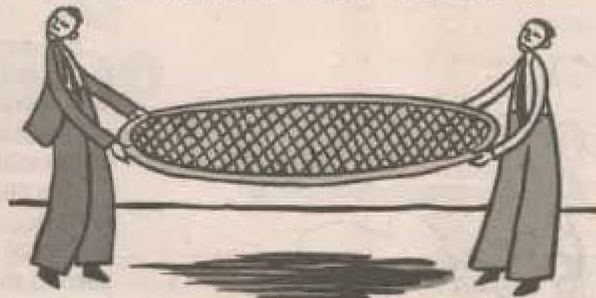
SPECIAL REPORT: SECURITIES LAW

Investors, take steps to minimize fraud, maximize trust



Commentary by **Wayne Klein**

Trust is absolutely essential to the efficient functioning of our economy. Depositors trust banks will keep their money safe. Policyholders trust insurance companies will pay claims when disasters occur. Online purchasers trust goods will be delivered. Even vending machine users trust products will be dispensed upon payment.

Trust is even more crucial for investors who face the risk of losing money because of economic downturns and business failures.

To encourage trust, the government created safety nets that encourage investors to provide this indispensable capital: imposing fiduciary duties on executives, requiring independent audits, providing Securities Investor Protection Corp. insurance, mandating money managers conduct due diligence and creating regulatory agencies such as the Securities and Exchange Commission to oversee the investment markets.

Klein

But now there is a general feeling that everyone has failed and no one left can be trusted.

The economic meltdown was triggered and is being prolonged by the credit freeze: the unwillingness of investors to put their money at risk. Almost every safety net has been exposed as either illusory or full of holes. Failure and fraud seem to abound. Bernie Madoff is notable for the size of his fraud but not its originality. His $50 billion scheme follows on the heels of Tom Petters' $3.5 billion scheme last October and Bayou Group's fraud back in 2006 when we thought $450 million was a big scam.

No matter how tempting it may be to bury what is left of your money in the backyard, that approach is counterproductive.

It is possible to protect yourself through self-defense. What President Reagan said about the Soviets is apropos: "Trust but verify."

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Here are seven steps to verify the legitimacy of investments to prevent fraud.

- Change your attitude. It is human nature that when you want to believe something is true, you ignore contrary evidence. Look for warning signs rather than ignoring them. Ask yourself whether the investment sounds "too good to be true," follow your instincts, not your greed.
- Change your investment expectations. If you want guaranteed returns, keep your money in the bank. If you want higher returns, accept there will be risk. Anyone who tells you there is a no-risk way to earn high returns is a liar. If you believe it, revisit step No. 1.
- Affinity facilitates fraud. Most fraudsters play up religious and social connections, counting on victims being too embarrassed to ask questions. This is the herd mentality, where investors send money because neighbors or prominent people do. Instead, subject every business decision to the scrutiny you would impose on a stranger.
- Educate yourself about investing and the financial markets. If you don't understand an investment strategy, don't participate. If you feel investing is the inherent domain of people who know more than you, you are setting yourself up to be taken.
- Consider worst-case scenarios and diversify your investments. The adage "Don't put all your eggs in one basket" is good investment advice. Banks and public institutions are limited to investing only 5 percent in any one investment. Follow this example. Never put more than 25 percent of your money in any one investment and keep bank deposits under Federal Deposit Insurance Corp. insurance caps.
- Ask questions. Secrecy, a mysterious allure and a sense of exclusivity are sign of fraud. If others cannot duplicate the success the promoter claims, fraud is more likely. Asking questions identifies warning signs, signals that you are paying attention and helps you understand the investment strategy. Madoff expelled investors who asked too many questions Who feels foolish now?
- Even though safety nets can fail, insist on them. Ensure the financial manager is licensed. Get audited financial statement from reputable firms and read them. Read the prospectus. Conduct Internet checks on the financial adviser. Require funds be held by an independent custodian. The absence of any of these invites fraud. Investing involves a risk-reward ratio. The greater the potential reward, the higher the risk. Investors can reduce risk if they do their homework and carefully manage their investments. The tortoise beat the hare because it was slow but sure.

These seven steps, whether used by investors or by businesses concerned abou employees, can detect signs of fraud.

Failing to take these steps is the financial equivalent of ignoring "The Seven Deadly Signs of Fraud." Fraudsters take your money with computers, smiles and promises — not guns. You can still control whether that happens. ■

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