Investor Beware: How to Protect Your Money from Scams and Fraud

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Keith: Welcome to the Empowered Investor. My name is Keith Matthews and I'm joined by my cohost Marcelo Taboada. Marcelo, how are you today?

Marcelo: Keith, I'm really good. Happy that we're doing this episode. I'm always excited about the subjects, that's why we do the podcast, but I can't believe we're at episode 72. It's been a great journey, a great learning experience.

Keith: We're coming up on our three-year anniversary, and a special thank you to all our listeners, our clients, our friends, and contacts for giving feedback on what subjects they want to see and hear about. So why are we going to be talking about financial fraud today? Marcelo, what triggered this episode?

Marcelo: Listen, it's an exciting subject, but I think we both watched the same documentary. So there's a new documentary out on Netflix. Everybody should see it. It's called Madoff: The Monster of Wall Street. And it's four episodes, they're about an hour long, and it goes through the whole saga of the Ponzi scheme perpetrated by Bernie Madoff that lasted a long time and involved a lot of money. So we'll go through the details, but I don't know about you, Keith, but I was sitting through that documentary just like my jaw was on the floor. I couldn't believe how many missteps happened. And that Ponzi scheme was insane.

Keith: So we both watched it. It is a 2023 release, and it did, in fact, trigger us to say let's put together a show on financial fraud. We're really going to focus in on Ponzi schemes today. We'll look at what a Ponzi scheme is. We'll discuss and review some of the biggest Ponzi schemes that we've seen both in Canada and the United States. We'll really hone in on why individuals fall prey, like what is going on in the background. And then we have a whole series of recommendations provided by the Ontario Securities Commission, the AMF in Quebec, and the Canadian security administrators about how to watch out and what to do to protect yourself. Because in the end, Marcelo, as all of these shows on TV are now depicting behind these frauds, a lot of lives are ruined. A lot of misery comes through from this. So we're going to review this carefully. There's lots of different concepts going on here, but before we jump into Ponzi schemes, let's discuss some of the different types of fraud that investors unfortunately can get caught up in.

Marcelo: There are many types of financial frauds. I think we know that. And again, the Ponzi scheme is just a form of them, right? We have so many different types like corporate fraud, like people remember Enron back in the 2000s. That was huge. Theranos recently with Elizabeth Holmes. That one was incredible because you look at the people who invested, it wasn't only regular people like us, it was big names like Jim Mattis, George Schultz, Henry Kissinger, Rupert Murdoch. These are big caliber people that invested in this corporate fraud. There is a great book called *Bad Blood*. If anybody can read it, that's a great read on how that happened. And the whole sequence of that fraud was incredible as well. Then we have FTX just recently in the news. Now we still don't know what's happening with this. There's a lot of stuff going on with crypto right now. There was QuadrigaCX in Canada. There's still a lot of fuzzy details about that. Then you have pump and dump boiler room type of scams, which is like people doing cold calls and trying to pump certain fly-by-night penny stocks, pump them to a level of price, and then start selling. And then they just cash in and everybody loses a lot of money.

Keith: Those are the ones that were around in the nineties before the internet and before emails, and it was old school, get a lot of people in a room, make a lot of phone calls, try to create excitement, and try to trap investors.

Marcelo: Then we have all the internet email texting scams that we have and that have been going up during the pandemic. They're death by a thousand cuts. They're like super small frauds that happen on a day-to-day basis, but if you look at them on a yearly basis, they amount to a lot of money. And these are like the scams. I know somebody who fell for a scam. It was something like, "Hey, pay your bill here," and it brought you to the website of the bank. The website looked exactly like the website of the bank, and the only thing that worked was the link where you go to pay. So this person, who's a bit older, clicked on that, and they got scammed out of $200. And you have a lot of them like that. And the thing is, Keith, we have a lot more awareness now. Because people have access to the internet, we have documentaries, books, and good journalists who cover all this stuff. But the reality is that all these scammers, the more people are aware, the more sophisticated they become and the harder they work at tricking people. And we're going to see more and more of it, I have no doubt about that.

Keith: You're absolutely right. We do hear from our clients on that about either they're a little concerned about all this information that's coming at them. What's correct? What's true? What should I click on? And then we're hearing from some of our younger clients who are concerned for their parents. Again, a lot of that internet is really geared around trying to take some form of funds from individuals. A lot of them are seniors. We're actually going to put together a show just on that. We're going to get some computer experts to come in and talk about what can be done to protect yourself. Okay. So today's focus is going to be on Ponzi schemes and all of the things around that. So what exactly is a Ponzi scheme?

Marcelo: Yeah. So when we think about Ponzi schemes, there is an anatomy to them. There is a process that follows. They won't all look the same, but usually they follow the same trajectory. So step number one is to invent a business or a type of investment that offers some kind of wild returns and wild profits. Induce a few people to invest or get those early investors by promising huge and steady returns in a safe environment, right? So imagine that would be Bernie Madoff telling people, "Look, we're going to offer X amount of return with very little risk. It's a safe, guaranteed investment." And it takes off from there. That's step one, right? Convincing those few early investors to trust you and give you their money. Number two is you take those early investors and you pay them huge returns, just as promised. They become excited. They invest more. They tell their friends and associates. They spread the word, and it just catches fire in that sense.

Keith: And I'm going to just say it doesn't have to necessarily be huge returns. They're promising something. It could just be steady returns. Don't invest in the traditional way because there's volatility. Invest in this way because it's steady and guaranteed.

Marcelo: Step number three is you try to repeat step number two as much as possible. So you want to get more money in as that money keeps coming in. You can keep paying those investors as they're coming in. The thing is, here, you have to convince also the investors. Step three is also to convince investors to leave the money in it because the problem is when you start, because you're taking money in from new investors to pay old investors, that flow of money and steady cash has to keep coming in, but also the money has to stay in. If all of a sudden, we're jumping steps here, but most of them get uncovered when people start withdrawing money. That's why in a financial recession or there is a bear market and people start withdrawing money, the Ponzi schemes tend to collapse. So it's very important that people leave their money there. Now step number four is since there is no profitable company or investment, now the underlying promises start slowing down. And when the Ponzi scheme hits a point where it cannot sustain itself, this is where you start having problems. So when people start realizing this is a bit unrealistic or they're not getting the returns that they got, or they start getting weird excuses, this is when the house of cards starts to collapse.

Keith: The house of cards collapses when there's no new money coming in. You need money coming in. And along the way, one of the things that I think needs to be mentioned is the Ponzi organizer is taking money out. So money isn't just being paid to the first investors. The Ponzi organizer is actually taking money. What are the next steps?

Marcelo: The last step is either the fake business fails and they just declare bankruptcy and they just take the money and leave or the Ponzi scheme collapses just like it happened with Bernie Madoff in 2008. People start panicking. They want their money out. They want to hold on to their cash, and it gets uncovered. And then the last step is that person either goes to jail or runs away, and that's it. It ends. And then people end up ruined, right?

Keith: Yeah. So interestingly enough, some of the biggest Ponzi schemes have been uncovered in market corrections. So 2003 in particular, 2008, 9, 10, that whole turbulence uncovered some massive Ponzi schemes. When you have market turbulence and equities are down and there's uncertainty, this is exactly when individuals say, "You know what? Maybe I'm going to keep my money close to me. I'm actually not going to put it in this concept." And that's where things fall apart.

Marcelo: Or you maybe lose your job and you start saying, "You know what? I need this money to live on now." You start withdrawing that money. It's not necessarily just keep the cash because maybe a good opportunity, right? Some people actually need the money to live on, right?

Keith: Yeah, absolutely. So thanks for that, Marcelo. Let's now go over some of the biggest Ponzi schemes in the US as well as some in Canada and then move to the next section after.

Marcelo: So I think we can't talk about Ponzi schemes without the original Ponzi himself. So Charles Ponzi in the 1920s stole about $15 million in just eight months. So he created this fake investment in international postal coupons. Now, because it was one of the first ones and the biggest ones at the time, the fraud now bears his name. So again, same concept. He takes the money from early investors, pays the new ones coming in, and he keeps perpetuating that until it collapses. So he spent around 13 years in prison and there's still around, I think, $7 million that were still owed to the investors at the end. And there is not much information on how much was recovered. So some of it was recovered, but still there was some money owed from the money that he stole.

Keith: So Charles Ponzi, 100 years ago, created this scheme.

Marcelo: It's not the first one, but it was one of the big ones at the time. So now the fraud bears his name, right? Like people call it a Ponzi scheme now because of him.

Keith: Fair enough. And of course, the biggest one would be Bernie Madoff. Why don't you give us a couple of comments on that one? And this is the show on Netflix, which reviews the entire process, how it started, and how he basically kept it going for almost 20 years.

Marcelo: I think that on paper, it's the biggest one because there's a very clear distinction we need to make. So there's the actual money that went in and there's the actual market value of how much was on paper put into the Ponzi scheme, right? So the total value of the Ponzi scheme at the end when he was uncovered was $65 billion. Then the actual cash that went into the Ponzi scheme was about $19 billion. And about $14 billion was recovered at the end. So he was sentenced to 150 years in prison, but he ended up dying in 2021 of kidney disease. Very tragic story. His two kids died. One of them committed suicide because of this. It's a total catastrophe.

Keith: And then not to mention, of course, the thousands of investors whose lives were completely ruined because of losing the funds, losing the money.

Marcelo: Yeah, it's losing the money, it's reputation, the stress it causes. You name it, everything that could go wrong went wrong in that. But when it was happening, I think a lot of the things that he did because he had the legitimacy, like he'd started a legitimate business as a market maker. He was the head of the NASDAQ exchange at some point. So he had that legitimacy around him and then he exploited that to commit this fraud. Keith, when you think about it, people say that for a plane to crash, there's a series of mistakes that need to happen at the same time. I think this is similar. Like you had a failure of regulators, lack of due diligence from investors, and then the fact that he exploited all these weaknesses in the system. So everything that could go wrong went wrong for investors in this type of scheme. Its crazy how many things lined up for him.

Keith: What is amazing is that he had that entire side and it was unregulated. So we'll talk about regulation a little bit later, but that is a critical component for investors to understand, which is make sure you work with regulated individuals. That was an unregulated business that he was running.

Marcelo: And the crazy thing is that on paper, he never invested a single dollar. They were all fake trades, but the actual strategy that he was selling was an actual strategy that people were implementing. But the first person who caught it on was, I think, Harry Markopolos is the name, he's featured in the documentary. He was this mathematician working for another firm. And he said mathematically he was well aware of the strategy and mathematically he knew that the returns that he had based on the strategy were impossible. And he alerted the SEC in 2000. The beginning of 2000, that was the first letter he sent to the SEC, the regulators, and he just kept getting ignored, which is crazy.

Keith: Yeah, absolutely. So that was the big one. That's the high-profile Ponzi scheme. And again, to the listeners, if you're interested, it is a great documentary on Netflix, four-part series. Let's switch gears and talk a little bit about Canada.

Marcelo: So we have one here for the listeners in the rest of Canada, Earl Jones was an "investment advisor" in the West Island here in Montreal. And he stole from 1982 to 1999. He stole $51 million. He served only four years in prison out of his 11-year sentence. And what he did, Keith, pretty much was he was a notary, unregistered as a financial advisor. He would settle estates for...

Keith: Hang on, hang on. He was not a financial advisor.

Marcelo: No, not a financial advisor. Pretended to be one.

Keith: He pretended to be a person who could give returns. Correct. His background was in notary and generating wills and estate planning. What did he do exactly, Marcelo?

Marcelo: He stole from the elderly. So what happened is he would settle the estates and then he would take the money from that and then he would promise them returns, which essentially, at the end of the day, he didn't invest in anything. It was a Ponzi scheme. And this was an unregulated individual. There was no custodian involved. So people were writing checks to him personally. So at the end of the day, it was uncovered. And there was a settlement by the bank involved in these transactions because there was a lack of oversight. There was a settlement of about $17 million paid to the victims without an admission of guilt from the bank involved. Because at the end of the day, any transaction above $10,000 needs to be flagged and investigated. Also, there was a lack of oversight there.

Keith: I remember that one specifically because it happened, as you said, in our backyard. I recall calling the regulators and actually saying, "How did this happen?" And their response was, it was interesting. They're like, "Keith, we didn't even know he existed." And I go, "How does that happen?" And they said, "We don't know. This is an individual that's portraying this, doing an active business." Again, he was unregulated, which means there's no inspections. He's not a registered investment advisor. This is an individual who basically put together a make-believe business. And that make-believe business had an offering, and as long as he could pull it off, he got away with it. It's a common theme amongst a lot of these. You have individuals that are very charismatic, that can really draw in and somehow earn trust, but they're actually not regulated. So what else, Marcelo? What are some of the other ones in Canada that have unfortunately happened?

Marcelo: Yeah, there was a big one in Calgary, Gary Sorenson and Milowe Brost. I'm not sure I'm butchering that name, but that's, I think, how it's pronounced. From 1998 to 2008, they stole $300 million. So none of this money was recovered, and it's doubtful that it'll ever be recovered according to what we read. So again, Ponzi scheme, take early investors, pay it out to the, take more money from investors coming in and pay it out to the early ones and keep that going until it was discovered. So at the end of the day, these guys moved out of the country. There was no sentence issued. There was a sentence issued. They both served only two years in prison out of the 12-year sentence, which is crazy. How can you just do two years after stealing $300 million? It's crazy. Anyway...

Keith: One of the things that we highlighted before was this idea of what happens when individuals get caught, and there's a big difference between Canadian law and US law. In the United States, when you get caught for these types of actions, you get sentenced for 50 years. Bernie Madoff got 150 years. In Canada, you get sentenced for 5 to 10, maybe a bit more, but you're typically released within 2 to 3. Unfortunately, white-collar crime isn't penalized anywhere near as much as it needs to be in Canada.

Marcelo: Yeah, these guys, we have some information here, more detail on what they were promising. So this guy Sorenson and Brost were promising 34% annual returns if you invested $99,000, which they said would grow to $1 million after just eight years and it was supposed to be low risk. So again, you get those early guys, they brag about it, and then it's word of mouth, right? It just spreads.

Keith: We'll talk about that in the recommendations because from all the regulators, one of the number one things that they mentioned is be wary of anybody promoting high returns. So that's one of the warning signals. The last one that we wanted to touch base on in Canada was the Norbourg story, Vincent Lacroix, which happened here in Montreal. And while that's not a Ponzi scheme, it was nonetheless a very important moment for, there's actually a great movie that I watched on the plane about a month ago called Norbourg, and it speaks to the story of what actually happened. So this is more business fraud. You have an individual who creates a business and unfortunately takes money from the business which has end investors. So for those that are interested, that is also another very good movie about this type of subject called Norbourg.

Marcelo: Yeah, people can watch it on Crave. And what was interesting about that one is it wasn't a Ponzi scheme like you said, but the company was actually investing. So people could buy their mutual funds and there were actual investments happening, but he stole about $70 million from misappropriating funds. Essentially, he was using the money from the investors for personal use. And at the end, he stole about $70 million, $55 million was paid out to victims, but he only served two years out of a 12-year sentence. And there was another individual also that helped him perpetrate the fraud, which is an ex-employee of the AMF, the regulators that were supposed to be overseeing what this company was doing. So yeah, great movie. Again, I was just, my jaw was on the floor. The same thing with the Madoff one. It's like, how could this happen? It's crazy. And the amount of people that got scammed and suffered for this is crazy.

Keith: So Marcelo, why does this happen? Why do people fall for these schemes? What triggers an individual to start moving towards investing in these concepts?

Marcelo: It's common themes. People say history does repeat itself. At the end of the day, the context changes, but we've had the same brain for millions of years. So I think it's greed, FOMO, fear of missing out, it's human nature, it's lack of knowledge. What can I say? Those are the big four that I can identify, but I think greed is the one that is the most important one when it comes to this type of thing because it's just the idea that you can get more with no risk. And yeah, I think people get mentally blocked and they say, you know what, maybe it is true. And they just don't want to believe after they've been convinced that this can be done.

Keith: Yeah. And I would also add lack of knowledge. It's a really big one. I'll give you an example. I remember 20 years ago, somebody coming up and saying there was another, Norshield was another one that happened in Canada. I remember somebody coming and saying, "Oh, I can get a 9% guaranteed return." And I said, "That's not how it works." A guaranteed return, tell me what a seven-year Government of Canada bond is yielding. Or maybe a 10-year. And that is a guaranteed return. The Government of Canada, you have faith that money will come back to you in the form of an interest rate. So let's say the Government of Canada 10-year was yielding 4%. Anything over 4% has risk.

Marcelo: That's what we call the risk-free rate, right?

Keith: So you sit back and say, if they're going to offer you 7%, there is risk in that. If they're offering you 12%, there's risk in that. So that's the problem. And I think a lot of individuals don't necessarily understand the mechanics of risk and return and what is reasonable and what is not. I think the industry has gotten so much better at protecting individuals and so much better in terms of transparency compared to even just 10-15 years ago.

Marcelo: And that FOMO is a big one too. We've talked about this many times. It's social media and the fear of missing out leads people to do this. You look at some of the studies. If you want to predict where somebody is going to live or what car they're going to drive, just look at what their neighbors drive. So there is this human psychology of if you see someone getting something that you don't have, you'll want it more. So I think this is a big psychological aspect of a Ponzi scheme too, where you're hearing somebody getting amazing returns. Then you want in, you feel left out.

Keith: No, you're right. You're right. And I would add to that this idea that somehow they can get an investment return higher than a government bond without any volatility. So the only way you can get extra returns is by taking on extra risk. And it does come with uncertainty. It does come with volatility, and that's part of a diversified portfolio. So if you don't want to live through the bumps, you can't have the extra returns. Let's start wrapping this show up here. Key recommendations, and we have a bunch of them. We're pointing to really three key organizations. The AMF, which is the regulator in Quebec, has some very strong documentation. We're talking also about the Ontario Securities Commission, which has some very strong documentation. And then finally, Canadian Security Administrators, which also have great recommendations. So let's start with some of the warning signals. What do these organizations speak to to prepare investors? What should they be looking out for?

Marcelo: Yeah, so the red flags are the promised high returns with little to no risk and the feeling of pressure to buy now. I think that's a big one. So those are the two red flags that we identified. They're very basic ones, but those are the ones we need to be really careful of.

Keith: So hang on. So what are you saying? If somebody is offered a high return for no risk, that's amazing. That shows up in every single warning from all of these regulators.

Marcelo: Correct. In other words, if it sounds too good to be true, it probably is. There's an old saying about that. And the feeling of pressure to buy now, I think that's a big one because if you're getting into something like that, I've experienced being sold pyramid schemes and that type of thing. And you do feel that environment where the salesperson knows that if they let you walk away, you won't sign. So you feel that pressure of signing today. So I think that is a huge red flag because they know that if you go home and start talking to friends and people who have more knowledge, you're probably going to uncover it and start asking tougher questions. So I think that environment of the pressure of buying now, like right now, is a huge red flag.

Keith: I like the way you've said that, and the AMF has actually stated it as a now or never offer. So be wary of the "you've got to get in now, or it's not going to be available for you." There's high returns at little risk, there's pressure, stay watchful of pressure. They've also spoken about things like be wary when individuals say, "We have inside information," or "It's a hot tip," or "I've got this information that you can't get somewhere else and so therefore you must act."

Marcelo: Okay. So that's a big one.

Keith: What about registration? What are all these organizations saying about registration?

Marcelo: Let's go through the five steps of the AMF to avoid fraud. I think that's a good list. The first one is to check that the organization is legitimate. So for example, us, if you go and check out the name of the firm or my name, your name, you're going to see us registered in the securities regulators' website, right? Everybody needs to be registered. So that's the first step. Then, before investing, insist on getting documents explaining the investment. You need to get documentation. The regulators have standard documentation that needs to be presented in a certain way to investors. So if you get something that looks maybe poor, maybe it looks professional, try to consult a professional, several professionals if you have to, and compare it, or even call the regulators and ask them how this document is supposed to look, right? Make sure you take those steps. Make sure the offer is not too good to be true. We talked about that one. Number four is beware of offers like guaranteed offers with no risk, do-or-die type of investments. If you don't do it now, it's going to disappear. So those types of things, beware of, and do not make any deals with people who try to guilt you into investing if you say no. If they say things like, "Oh, I can't disclose the firm or can't name the name of the investor I have the money with because XYZ," beware of those things. Beware of people who get defensive when you ask questions. That's a big one.

Keith: That's a very good one.

Marcelo: I think in this industry you have to be an open book. You have to be an open book, and sometimes people confuse being friendly for being a friend. At the end of the day, the relationship we have with our clients, Keith, is a professional relationship. We're not friends with these people. If we have a friendly relationship, that is okay. And I could be friends with some of my clients, that's not a problem. But I think when you're shopping for an advisor, just because somebody is friendly doesn't mean they're trustworthy. You have to dig deep and ask the tough questions.

Keith: Yeah, a hundred percent. So that's a great list from the AMF, Marcelo. And the Ontario Securities Commission offers similar pieces of recommendation, as does the Canadian Securities Administrators. So what's nice is that for all listeners, if you were to go to any one of these websites, the AMF, Ontario Securities Commission, Canadian Securities Administrators, you'd get these documents that you'd be able to download and just go through. And a lot of it appears common sense, but they're still nonetheless very powerful.

Marcelo: We're going to put all those links in the show notes. And before we go, there's a checklist that I want to just share with you because that's a good one. So the OSC put this checklist. It's five questions. It's a yes or no, and that'll tell you if it is a scam or not.

Keith: So share the five questions.

Marcelo: Let's say you come to me, Keith, and you say, "Marcelo, I have this great investment." So I'm going to go through this checklist, and I'm going to say, okay, number one, were you promised a high return on a low-risk investment? Yes or no, right? Number two, did you have enough time to make a decision? Yes or no? Were you given confidential or inside information? That's number three. Number four, can you verify the investment with a credible source? Number five, is the person who contacted you registered? So five questions, yes and no, that should give you a good indication of whether you're dealing with a scam or not. So again, we'll put the resources for people to check. Also, I will put a list of the books where people can read more about frauds. There's the Enron one, *The Smartest Guys in the Room*. There is the Madoff one called *The Wizard of Lies*. There's the one on Theranos. And also, if people want to read more, we'll put a link to all those books that people can go read if they're interested.

Keith: Excellent. Listen, Marcelo, I want to thank you for your research in today's episode and today's show. Also, Chloe, who's one of our new associates, who jumped in and helped us put together the research behind today's very important topic. So thank you so much for contributing and sharing and providing great recommendations as to what investors should be looking out for.

Marcelo: Thank you for listening.

Keith: All right, guys, thank you so much and have a great week. We'll see you next time.

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