Key Topics:

- Financial Scams
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Avoiding Investment Scams

FINRA is issuing this Alert to warn investors about classic types of investment fraud and to help investors spot and avoid the types of persuasion tactics fraudsters use. We also describe key red flags and provide tools to help you avoid fraud. Our Scam Meter (*www.finra.org/meters/scam*) can help you assess whether an opportunity is too good to be true, and our Risk Meter (*www.finra.org/meters/risk*) reveals whether you share characteristics and behavior traits that have been shown to make some investors vulnerable to investment fraud.

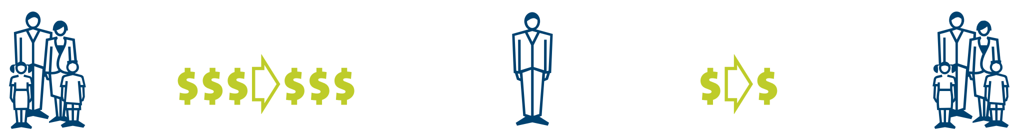
Types of Investment Scams

Investment scams can take many forms—and fraudsters can turn on a dime when it comes to developing new pitches or come-ons for the latest fraud. But while the wrapper or hook might change, the most common securities frauds tend to fall into the following general schemes:

- **Pyramid Schemes**—where fraudsters claim that they can turn a small investment into large profits within a short period of time—but in reality, participants make money solely by recruiting new participants into the program. The fraudsters behind these schemes typically go to great lengths to make their programs appear to be legitimate multi-level marketing schemes. Pyramid schemes eventually fall apart when it becomes impossible to recruit new participants, which can happen quickly.

Stage	Participants	Notes
Level 1	8	Each participant recruits 8 new investors
Level 2	64	Level 2 pays off Level 1—and so on
Level 3	512	
Level 4	4,096	
Level 5	32,768	
Level 6	262,144	
Level 7	2,097,152	
Level 8	16,777,216	
Level 9	134,217,728	
Level 10	1,073,741,824	More than triple the U.S. population
Level 11	8,589,934,592	More than the world's population

- **Ponzi Schemes**—in which a central fraudster or "hub" collects money from new investors and uses it to pay purported returns to earlier-stage investors—rather than investing or managing the money as promised. The scam is named after Charles Ponzi, a 1920s-era con criminal who persuaded thousands to invest in a complex price arbitrage scheme involving postage stamps. Like pyramid schemes, Ponzi schemes require a steady stream of incoming cash to stay afloat. But unlike pyramid schemes, investors in a Ponzi scheme typically do not have to recruit new investors to earn a share of "profits." Ponzi schemes tend to collapse when the fraudster at the hub can no longer attract new investors or when too many investors attempt to get their money out—for example, during turbulent economic times.



NEW INVESTORS | **PONZI HUB OPERATOR** | **EARLIER INVESTORS**

1. The hub promises high financial returns to new investors that aren't available through traditional investments.
2. Then, the hub collects money from additional new investors.
3. Instead of investing the money, the hub pays so-called "returns" to earlier investors from the new investors' money.
4. The fraud perpetuates itself as long as the hub finds new investors.

- **Pump-and-Dump**—in which a fraudster deliberately buys shares of a very low-priced stock of a small, thinly traded company and then spreads false information to drum up interest in the stock and increase its stock price. Believing they're getting a good deal on a promising stock, investors create buying demand at increasingly higher prices. The fraudster then dumps his shares at the high price and vanishes, leaving many people caught with worthless or near worthless shares of stock. Pump-and-dumps traditionally were carried out by cold callers operating out of boiler rooms, or through fax or online newsletters. Now, the most common vehicles are spam emails or text messages.
- **Advance Fee Fraud**—which plays on an investor's hope that he or she will be able to reverse a previous investment mistake involving the purchase of a low-priced stock. The scam generally begins with an offer to pay you an enticingly high price for worthless stock in your portfolio. To take the deal, you must send a fee in advance to pay for the service. But if you do so, you never see that money—or any of the money from the deal—again.
- **Offshore Scams**—which come from another country and target U.S. investors. Offshore scams can take a variety of forms, including those listed above. Many involve "Regulation S," a rule that exempts U.S. companies from registering securities with the Securities and Exchange Commission (SEC) that are sold exclusively outside the U.S. to foreign or "offshore" investors. Fraudsters can manipulate these types of offerings by reselling Reg S stock to U.S. investors in violation of the rule. Whatever form an offshore scam takes, it can be difficult for U.S. law enforcement agencies to investigate fraud or rectify harm to investors when the fraudsters act from outside the U.S.

Psychology of a Scam

The common thread that binds these different types of fraud is the psychology behind the pitch. We've all heard the timeless admonition "If it sounds too good to be true, it probably is"—which is great advice, but the trick is figuring out when "good" becomes "too good." There's no bright line. Investment fraudsters make their living by making sure the deals they tout appear both good and true.

In a 2006 study funded by the FINRA Investor Education Foundation, the Consumer Fraud Research Group examined hundreds of undercover audiotapes of fraudsters pitching investments scam. The tapes revealed that fraudsters are masters of persuasion, tailoring their pitches to match the psychological profiles of their targets. They look for an Achilles' heel by asking seemingly benign questions—about your health, family, political views, hobbies or prior employers. Once they know which buttons to push, they'll bombard you with a flurry of influence tactics, which can leave even the savviest person in a haze. Some of the most common tactics include:

- **The "Phantom Riches" Tactic**—dangling the prospect of wealth, enticing you with something you want but can't have. "These gas wells are guaranteed to produce $6,800 a month in income."
- **The "Source Credibility" Tactic**—trying to build credibility by claiming to be a reputable authority or expert. "Believe me, as a senior vice president of XYZ Firm, I would never sell an investment that doesn't produce."
- **The "Social Consensus" Tactic**—leading you to believe that other savvy investors have already invested.
  "This is how___ got his start. I know it's a lot of money, but I'm in—and so is my mom and half her church—and it's worth every dime."
- **The "Reciprocity" Tactic**—offering to do a small favor for you in return for a big favor. "I'll give you a break on my commission if you buy now—half off."
- **The "Scarcity" Tactic**—creating a false sense of urgency by claiming limited supply. "There are only two units left, so I'd sign today if I were you."

If these tactics look familiar, it's because legitimate marketers use them, too. However, when we are not prepared to resist them, these tactics can work subliminally. Little wonder that victims often say to regulators after they have been scammed, "I don't know what I was thinking," or "it really caught me off guard." That's why an important part of resisting these common persuasion tactics is to understand them before encountering them.

Red Flags of Fraud

To stay on guard and avoid becoming drawn into a scam, look for the warning signs of investment fraud:

- **Guarantees:** Be suspect of anyone who guarantees that an investment will perform a certain way. All investments carry some degree of risk.
- **Unregistered products:** Many investment scams involve unlicensed individuals selling unregistered securities—ranging from stocks, bonds, notes, hedge funds, oil or gas deals or fictitious instruments, such as prime bank investments.
- **Overly consistent returns:** Any investment that consistently goes up month after month—or that provides remarkably steady returns regardless of market conditions—should raise suspicions, especially during turbulent times. Even the most stable investments can experience hiccups once in a while.
- **Complex strategies:** Avoid anyone who credits a highly complex investing technique for unusual success. Legitimate professionals should be able to explain clearly what they are doing. It is critical that you fully understand any investment you're seriously considering—including what it is, what the risks are and how the investment makes money.

- **Missing documentation:** If someone tries to sell you a security with no documentation—that is, no prospectus in the case of a stock or mutual fund, and no offering circular in the case of a bond—he or she may be selling unregistered securities. The same is true of stocks without stock symbols.
- **Account discrepancies:** Unauthorized trades, missing funds or other problems with your account statements could be the result of a genuine error—or they could indicate churning or fraud. Keep an eye on your account statements to make sure account activity is consistent with your instructions, and be sure you know who holds your assets. For instance, is the investment adviser also the custodian of your assets? Or is there an independent third-party custodian? It can be easier for fraud to occur if an adviser is also the custodian of the assets and keeper of the accounts.
- **A pushy salesperson:** No reputable investment professional should push you to make an immediate decision about an investment, or tell you that you've got to "act now." If someone pressures you to decide on a stock sale or purchase, steer clear. Even if no fraud is taking place, this type of pressuring is inappropriate.

You can also use our Scam Meter to help spot red flags of investment fraud.

Who Gets Victimized?

Almost anyone who invests is a potential fraud target, though you can reduce your vulnerability if you know what to guard against. A 2007 survey by the FINRA Foundation examined how known investment fraud victims differed from non-victims. Among its key findings, the survey identified several investment fraud risk factors, including:

1. **Owning high-risk investments**, including penny stocks, promissory notes, futures, options or private investments in foreign currency;
2. **Relying on friends, family, co-workers for advice** (for example, one-third of the national sample—but 70 percent of victims—made an investment based primarily on advice from relative or friend);
3. **Being open to new investment information** (for example, three times as many victims went to a free investment seminar than the national sample);
4. **Failing to check the background of an investment or broker** (for example, 1 in 8 victims failed to check whether an investment professional had a criminal background, and 1 in 7 did not check their licensing or registration); and
5. **Being unable to spot persuasion tactics used by fraudsters.**

You can use our Risk Meter to assess whether you share any characteristics and behavior traits that have been shown to make some investors vulnerable to investment fraud.

How Can I Protect Myself?

In addition to paying attention to the red flags of fraud and learning to spot and avoid the persuasion tactics fraudsters use, it is critical that you ask questions about investments and the people who pitch them—and then verify the answers.

Here's how:

- **Check Out Investment Professionals**— Always ask whether the promoter of an investment opportunity is licensed to sell you the investment—and confirm which regulator issued that license, and if and when the license has ever been revoked or suspended. A legitimate securities salesperson must be properly licensed, and his or her firm must be registered with FINRA, the SEC or a state securities regulator— depending on the type of business the firm conducts. An insurance agent must be licensed by the state insurance commissioner where he or she does business.

Be sure to independently verify the salesperson's or promoter's answers as follows:

  - For a broker or brokerage firm, use FINRA BrokerCheck at *www.finra.org/brokercheck* or call toll-free: (800) 289-9999. BrokerCheck allows you to confirm not only licensing and registration, but also whether an individual or firm has a history of complaints or regulatory problems.
  - For an investment adviser, use the SEC's Investment Adviser Public Disclosure website at *www.adviserinfo.sec.gov* or call toll-free: (800) SEC-0330.
  - For an insurance agent, check with your state insurance department. You will find contact information through the National Association of Insurance Commissioners (NAIC) at *www.naic.org* or call toll-free: (866) 470-NAIC.
  - For all sellers, be sure to call your state securities regulator. You can find that number in the government section of your local phone book or by contacting the North American Securities Administrators Association at *www.nasaa.org* or (202) 737-0900 for the state's number.

- **Check Out Investments**—Ask whether the investment is registered and, if so, with which regulator. Most investors will want to buy securities products that are registered with the SEC or with state regulators. With very few exceptions, companies must register their securities before they can sell shares to the public.

  You can find out whether a product is registered with the SEC by using the EDGAR database (*www.sec.gov/edgar.shtml)*. You can also use our Scam Meter to help you determine whether an investment you are thinking about might be a scam.

A Word About Registration:

Smart Thinking: Investors should always ask whether a security is registered with the SEC—and if not, why not. Not all securities offerings must be registered with the SEC—such as those issued by municipal, state and federal governments.

The SEC also provides exemptions for certain intrastate offerings and small public and private offerings under a rule known as Regulation D. *www.sec.gov/answers/regd.htm*

Keep in mind that registration with the SEC does not guarantee that an investment will be a good one or immune to fraud. Likewise, lack of registration does not mean the investment lacks legitimacy. The critical difference is the extreme level of risk you assume when you invest in a company about which little or no information is publicly available. SEC registration carries a number of advantages for investors, including disclosure of financial and other information that can help investors assess whether to invest in a company's securities.

If a Problem Occurs

If you believe you have been defrauded or treated unfairly by a securities professional or firm, please send us a written complaint. If you suspect that someone you know has been taken in by a scam, be sure to give us that tip.

Here's how:

Online:

File a Complaint (for you)
www.finra.org/complaint

Send a Tip (for others)
www.finra.org/fileatip

Mail or Fax:

FINRA Complaints and Tips
9509 Key West Avenue
Rockville, MD 20850
Fax: (866) 397-3290

Additional Resources

Risk Meter: *www.finra.org/meters/risk*

Scam Meter: *www.finra.org/meters/scam*

Avoid Identity Theft and Fraud: *www.finra.org/Investors/ProtectYourself/AvoidInvestmentFraud*

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Investor Resources

FINRA Investor Information—Investor Alerts, tools and much more to help you invest smarter and safer.

- Investor Alerts
- Saving for College
- Fund Analyzer
- Bond Investing
- 401(k) Investing
- Financial Calculators

Website: *www.finra.org/investor*
Phone: (202) 728-6964

FINRA Market Data—Data on equities, options, mutual funds and a wide range of bonds, including real-time corporate bond prices and FINRA-Bloomberg Bond Indices.

Website: *www.finra.org/marketdata*

FINRA BrokerCheck—Check the background of a broker or brokerage firm.

Website: *www.finra.org/brokercheck*
Toll-free: (800) 289-9999

FINRA Investor Complaint Center—If you feel you've been treated unfairly.

FINRA Investor Complaint Center
9509 Key West Avenue
Rockville, MD 20850-3329

Website: *www.finra.org/complaint*
Fax: (866) 397-3290

FINRA Dispute Resolution—If you seek to recover damages.

FINRA Dispute Resolution
One Liberty Plaza
165 Broadway, 27th Floor
New York, NY 10006

Website: *www.finra.org/ArbitrationMediation*
Phone: (212) 858-4400
Fax: (212) 858-4429

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FINRA, the Financial Industry Regulatory Authority, is an independent regulatory organization empowered by the federal government to ensure that America's 90 million investors are protected. Our independent regulation plays a critical role in America's financial system—at no cost to taxpayers. We register brokers and brokerage firms, write and enforce rules governing their activities, examine firms for compliance, and foster market transparency and educate investors. For more information, visit *www.finra.org*.