GREAT AMERICAN and LOWERS & ASSOCIATES

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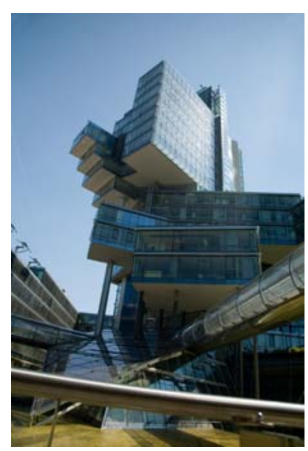
"But Harry is a Great Guy; I've Known Him For Years…"

Harry's employer and good friend owned a large development company based in the mid-Atlantic area. The company specialized in small, high-end housing developments in carefully selected locations. Even in today's troubled economy, their houses sold well and the company remained profitable.

Harry was a senior vice president at the company, in charge of acquisition and development. He had worked for the company for over twenty years. Assisted by a small staff, his job was to find and select promising areas for the company's projects. Once the location was approved, he would then work with an architect to design the development. When the design was completed, he would then oversee the construction. His work was supposed to be reviewed by the executive vice president of operations.

Harry found two promising locations in coastal South Carolina. After the site acquisition was complete, Harry suggested to his boss, an executive vice president, that they put the jobs out to bid with two west coast companies that he had been checking out. He told his boss he expected construction savings of up to twenty per cent. When the two bids were received, one was significantly higher than the other. Harry told his boss that he and his staff had reviewed both bids in detail and had discussed them with the contractors. He also explained that the low bidder had several imaginative ideas that might reduce the cost of the projects even further.

The low bidder won both jobs and to the delight of upper management, each project came in well under the estimate. Little attention was paid to verifying day-to-day construction. As the projects were nearing completion, the general counsel for the company got a call from a sub-contractor. According to the sub-contractor, one of the insured's employees and the prime contractor were stealing from the company. The owner and the general counsel visited the jobs on a weekend. They discovered the high end materials they had specified were only being used in the model houses and that many corners were being cut on the construction. They hired an engineering firm to help audit actual costs. The engineering firm and a forensic accountant quickly discovered they had been overbilled by $4,000,000, including $1,000,000 for work never done. Even though all the evidence pointed to Harry's involvement, the owner refused to believe it.



They reported the situation to the U. S. Attorney. The Federal Bureau of Investigation reviewed the banking records

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Investment Fraud:
Myth and Reality—Part 2

Know the warning signs of investment fraud

Major Types of Investment Fraud

To summarize, in Investment Fraud—Part 1, in the January 2010 Fidelity & Crime Observer, investment con artists or swindlers know what it takes to get a consumer's money. It is therefore important to be familiar with the common types of investment fraud and the key warning signs for each type. There are seven main types of investment scams consumers are likely to encounter:

- ⇒ Pyramid Schemes
- ⇒ Ponzi Schemes
- ⇒ Precious Metals Fraud
- ⇒ Stock Swindles
- ⇒ Phony International Investments
- ⇒ Affinity Fraud
- ⇒ Bogus Franchise and Business Opportunities

And now we will continue with the last three types of investment fraud:

Con artists may offer scams with an international flair

Phony International Investments is a fast growing area of interest for US investors. With the rapid pace of political and economic changes overseas and the strong performance of some foreign stock markets, many American consumers are investing funds abroad. Con artists have responded by offering scams with an international flair. In one case, a Washington State con artist fleeced 400 investors out of $7 million by promising 30 to 40 percent returns on certificates of deposit and other investments through a bank in the Marshall Islands. After the swindler fled the United States, investigators found that the bank existed only on paper and that its sole officer was a Marshall Islands gas station attendant who was instructed to go to the post office, pick up investors' checks, and then mail them back to the con artist.

Even when US investors deal with legitimate investment opportunities overseas, they remain vulnerable to such factors as loose or nonexistent investor protection regulation, currency fluctuations, limited opportunities to pursue grievances, and political instability in some nations.

Affinity Fraud exploits the tight-knit structure of identifiable groups

Affinity Fraud describes investment schemes that prey upon members of identifiable groups. Con artists promote affinity scams that exploit the sense of trust and friendship that exist in groups of people who have something in common. For example, one thousand immigrants from El Salvador recently lost $6 million of their savings in a phony investment bank that promoted itself exclusively to Latinos in the Washington, DC area.

Con artists recognize that the tight-knit structure of many groups makes it less likely that a scam will be detected by regulators and law enforcement officials and that those who become victims will be more likely to forgive one of their own. Affinity fraud is also dangerous because the usual warnings about investment schemes

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Investment Fraud: Myth and Reality—Part 2

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promoted by strangers don't apply. In these cases, a friend, colleague, or someone else who inspires trust may introduce the investor to the scheme.

Affinity fraud swindlers will enlist respected leaders within a community or group to spread the word about an investment deal. The key to avoiding affinity fraud is to check out everything, no matter how trustworthy the person may be who presents the investment opportunity.

Bogus Franchise and Business Opportunities appeal to the dream of being your own boss. In fact, legitimate franchise operations may soon account for a majority of all retail sales made in the United States. Unfortunately, con artists realize that the desire of many Americans to own their own business may make them less cautious when it comes to evaluating franchises and business opportunity deals. Such investments may be promoted on the basis of the fear of losing a job or general uneasiness about the economic situation.

Ads for fraudulent business opportunity schemes may appear in otherwise reputable television programs, newspapers, and magazines. Investors incorrectly assume that because the media outlet is reputable, the advertisers are as well, not realizing that the media outlet may not screen its advertisers. Ads for frauds often offer high income to the person who will invest enough to cover individual start-up costs, ranging from $50 to several thousand dollars. The only people who make money are the swindlers who receive the start-up investment money. Fraudulent business opportunity ads frequently appeal to people who have few job skills and are desperate for money. Examples include work-at-home and animal-raising schemes.

Bogus business opportunities appeal to the dream of being your own boss

Hallmarks of Phone Based Investment Scams:

- ⇒ Sales pitches with slick talk about little or no risk, secret tips, and an unrealistic high rate of return
- ⇒ Demand for immediate action
- ⇒ No disclosure of the street address of the boiler room operation
- ⇒ No use of the US mail
- ⇒ Stalling suspicious investors who suspect that they have been defrauded
- ⇒ Pulling a vanishing act

Self Defense Tips:

- ⇒ Stop and think before acting
- ⇒ Study the deal—and get input
- ⇒ Stick to what is clearly understood
- ⇒ Apply critical thinking skills
- ⇒ Report the scam to the proper authorities (*See page 4 for details*)

"But Harry is a Great Guy..."

Continued from page 1

of the contractor. They discovered that checks totaling $1,100,000 had been sent to a small furniture business owned by Harry's wife. They also discovered the high bidding company was a shell formed by Harry and the contractor. The contractor, six of his employees, and Harry were all arrested and charged with multiple counts of grand theft. The owner of the company was totally shocked. When denial finally gave way to anger, he filed suit against Harry, the contractor, the contractor's employees, and the contractor's company and put liens on all assets. The criminal case is pending due to ongoing plea negotiations.

Beyond the $4,000,000 lost in the scam, the company has paid $500,000 to date in legal and accounting fees, as well as $150,000 for a new accounting system. They will also absorb a $150,000 deductible on their crime policy. The owner fired Harry's entire staff as well as Harry's boss.

The lesson to be learned here is that no matter how senior or how trusted an employee may be, their activities must be supervised and reviewed. Often the most honest, trusted employees are the ones who have the least oversight and are able to do the most damage through dishonest activity.

The above narrative is fictional; however it is based on situations that have been reported.

Written by William F. Marston, Vice President, Claims—Fidelity & Crime Division, Great American Insurance Group.

How Regulators Help To Protect Investors

State and federal agencies and self-regulatory organizations devote millions of dollars and many hours each year to stopping investment fraud. However, one of the biggest obstacles to stopping investment fraud are the embarrassed individuals who would rather suffer their losses in silence than admit that they have been cheated.

Consumers who are approached by a con artist, or have been victimized by such a person, should report it to the proper authorities. The longer a con artist goes unreported, the more money victims will lose. Enforcement authorities, such as the state securities regulator, the Financial Industry Regulatory Authority, and the US Securities and Exchange Commission will prosecute scam artists, but they cannot carry out their responsibility without the public's help. Information about how to report investment fraud schemes may be found on the following web sites:

North American Securities Administrators Association
http://www.nasaa.org

US Securities and Exchange Commission
http://www.sec.gov

Financial Industry Regulatory Authority (FINRA)