

Investment Pitfalls

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**I MET YOU AT CHURCH AND I HAVE A DEAL FOR
YOU!**

Ann Gibson, PhD, CPA
Andrews University

What is Safe When Investing Funds?

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“Investment fraud is a global—not just an American—epidemic.”

investorswatchdog.com

Examples of Investment Fraud

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From the UK: John Neil Hurst

From Austria: Investors in Styria, Austria

From Canada: Quintin Sponagle

Examples of Investment Fraud

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- The most famous Ponzi scheme: Bernie Madoff
- Current losses identified: US\$64.8 billion

Examples of Investment Fraud

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Bernie Madoff today:

In a medium-security prison in North Carolina

Convicted of securities fraud, investment advisor fraud, mail fraud, wire fraud, money laundering, false statements, perjury, false filings with the SEC, theft from an employee benefit plan.

Ponzi Scheme

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Definition: A fraudulent investment operation that pays returns to separate investors, not from any actual profit earned by the organization, but from their own money or money paid by subsequent investors.

Named after Charles Ponzi (1920)

Ponzi Scheme

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A Ponzi Scheme will always collapse.

Collapse may be due to:

a liquidity crisis within the scheme, or

external market forces, such as economic decline

The Extent of Madoff's Reach

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International Reach:

Through Fairfield Greenwich Group (Tucker & Noel)

Connected with the Caribbean, Singapore, Qatar, Dubai, Korea, and Japan.

The Extent of Madoff's Reach

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International Reach Broadened:

Through Bank Medici (Sonja Kohn)

Connected with Vienna, Geneva, Italy, Holland, Cayman Islands, Central Africa, Central and South America.

The Extent of Madoff's Reach

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Through the Jewish Community (Ezra Merkin)

Connected with endowments, educational institutions, foundations, and investments committees, including through Merkin, those with Yeshiva University, Bard College, Tufts University, New York University, New York Law School.

The Extent of Madoff's Reach

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Madoff's Magic Formula:

- Magnetic
- Exclusivity
- Confident
- Masterful Knowledge

SDA's Ponzi Scheme

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Donald J. Davenport

Seventh-day Adventist doctor

Well-known

Wealthy

Charismatic

Offered investments to church leaders through friends

SDA's Ponzi Scheme

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How did the Davenport scheme happen?

Through the charisma factor.

Through affinity fraud.

Through conflicts of interest on boards.

The Charisma Factor

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Charisma:

A personal quality attributed to leaders who arouse fervent popular devotion and enthusiasm. It usually results in making the individual capable of influencing or inspiring large number of people.

As a result, these individuals are very likely to persuade others to do their bidding.

The Charisma Factor

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The case of John Bennett and New Era Philanthropy.

The Charisma Factor

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“Bennett’s charisma, charm, and religious dedication captured the trust and attention of those around him, and he was perceived as a saint with a mission to rescue charities in need of funds. It was this unchallenged public trust that allowed Bennett to perpetuate his massive Ponzi operation.”

Allen and Romney (1998)

The Charisma Factor

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To avoid falling prey to a charismatic investment promoter:

1. Maintain an attitude of professional skepticism.
2. Investigate what does not make sense.
3. Beware of trust over reason.
4. Avoid placing faith in other people's faith; don't jump on the bandwagon.
5. Be wary of limited time offers or exclusive status.

Affinity Fraud

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Affinity fraud occurs when the con artist uses the trust already established by group connections to exploit individuals.

Group connections most used include: trusted friends, family members, groups connected by ethnicity, culture or religion.

Affinity Fraud

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To avoid affinity fraud:

1. Use the principles outlined to avoid the charisma factor.
2. Insist that investment details be in writing, not oral.
3. Beware of investment opportunities promoted over the Internet.

Affinity Fraud

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Examples:

Canada: Nicholas Smirnow
Pathways-2-Prosperity

Canada: Gary Sorenson and Milowe Brost
Syndicated Gold Depository (SGD)

Ethical Responsibilities of Boards

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“To be effective, a nonprofit needs a strong board, but a board that does the board’s work. The board not only helps think through the institution’s mission, it is the guardian of that mission and makes sure the organization lives up to its basic mission.”

Peter Drucker
Managing the Non-Profit Organization

Ethical Responsibilities of Boards

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“Over the door to the nonprofit’s boardroom there should be an inscription in big letters that says:

**MEMBERSHIP ON THIS BOARD IS NOT POWER;
IT IS RESPONSIBILITY.”**

Peter Drucker
Managing the Non-Profit Organization

Ethical Responsibilities of Boards

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A board's core activities include:

“How the board spends its time, what data it reviews, what questions it asks, if or how it holds management accountable for reaching organizational goals, time spent on strategic discussions, if it can conduct meetings effectively—essentially, adherence to the core fiduciary duties and responsibilities of oversight.”

Piesert & Locke (2009)

Ethical Responsibilities of Boards

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Board responsibilities include:

1. Determine the organization's mission and purpose.
2. Support and evaluate the chief executive.
3. Ensure effective strategic planning, and then assist in implementing and monitoring the plan's goals.

Ethical Responsibilities of Boards

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4. Ensure adequate financial resources so the organization can fulfill its mission.
5. Protect the organization's assets through the development of internal controls and provide proper financial oversight.
6. Build a competent board which includes orientation for new members and evaluation of the board's performance.

Ethical Responsibilities of Boards

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To strengthen boards:

1. Hold private sessions of the board (without management).
2. Establish “whistleblower” protocols for handling complaints or concerns.
3. Prohibit loans to directors.
4. Establish an audit committee whose membership includes a financial expert.

Ethical Responsibilities of Boards

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Conflict of interest:

A conflict of interest arises whenever the personal or professional interest of a board member are potentially at odds with the best interests of the organization.

Ethical Responsibilities of Boards

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To avoid the appearance of impropriety:

1. Adopt a conflict of interest policy.
2. Disclose conflicts when they occur.
3. Require board members to withdraw from decisions that present a potential conflict of interest.

Ethical Responsibilities of Boards

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4. Establish procedures such as competitive bids, that ensure that the organization is receiving fair value in the transaction.

What If?

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What if the board of Yeshiva University had insisted on obtaining information on how Bernie Madoff invested their money, instead of trusting these funds with a friend who shared their religious beliefs?

What If?

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What if the boards of the SDA conferences and unions involved in Davenport had refused to violate church policy with respect to investing church funds—even when the promoter was a Seventh-day Adventist church member?

What If?

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What if the members of the SDA conferences and unions' boards, when they signed the annually-requested conflict of interest statements, had disclosed their own investments with Dr. Davenport and thus identified that they had a conflict of interest?

What If?

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What if potential investors always remembered that risk is higher when returns are higher and that, if an investment opportunity seems too good to be true, it probably isn't true?

Principles of Investing

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Read the fine print.

High returns are always tied to high risks.

One should never put all one's eggs in one basket.

Never invest in something you cannot understand.

Principles of Investing

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Never hand over all your money to anyone simply because you trust him/her.

Or because someone you admire recommends and trusts him/her.

Questions?

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