FINANCIAL SERIAL KILLERS

Inside the World of Wall Street Money Hustlers, Swindlers, and Con Men

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A Herman Graf Book
Skyhorse Publishing

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10 9 8 7 6 5 4 3 2 1

Library of Congress Cataloging-in-Publication Data

Ajamie, Tom.
Financial serial killers : inside the world of wall street money hustlers, swindlers, and con men / Tom Ajamie & Bruce Kelly.
p. cm.
ISBN 978-1-61608-031-0
1. Fraud--United States. 2. Swindlers and swindling--United States. 3. Investments--United States. I. Kelly, Bruce. II. Title.
HV6695.A35 2010
362.88--dc22
2010000144

Printed in the United States of America

CHAPTER EIGHTEEN

The Psychology Behind Why We Fall for Scams

There are many reasons why we fall for investment scams or make investment mistakes. We have to appreciate that we are human and our psychology can lead us to make the wrong investment decisions. As we understand and realize these factors, we are less likely to fall prey to the financial serial killer.

Dr. Robert Cialdini was Regents' Professor of Psychology and Marketing at Arizona State University. He has received the Scientific Achievement Award of the Society for Consumer Psychology, the Donald T. Campbell Award for Distinguished Contributions to Social Psychology, and the Peitho Award for Distinguished Contributions to the Science of Social Influence.

Cialdini says that the root cause of people falling victim to a financial fraud is their uncertainty about the details of the financial environment. When people feel uncertain about any decision, including financial ones, they frequently fail to look *to themselves* for answers as to what they should do, because they lack so much confidence and feel so uncertain. So they look outside themselves, and this sets them up for the fraud.

There are two classic places people can look for reassurance that will allow them to reduce their uncertainty. One is to those people who appear to be experts, or at least to those people who proclaim to be experts. Those individuals who have background and experience and credentials in the area. They will defer to those so-called experts under the circumstances. “Those individuals who can present themselves well as experts—who can provide the patina of authority and expertise—will get people to respond automatically to their recommendations and to defer to them,” Cialdini remarks.

“There was an interesting study that was done in Texas. Researchers took a man and had him cross the street several times against the light to see how many people would follow behind him. If he was wearing a suit and tie, 350 percent more people followed him into traffic against the light, which was against the law. They followed him because his appearance gave him a sense of authority and made him appear to be a type of an expert. This demonstrates that people will look outside of themselves to the legitimately constituted authorities.”

Besides a suit, or maybe a fancy office in a tall skyscraper, there are other symbols of authority that signify an “expert.” Things like certifications and diplomas. These kinds of trappings can be sometimes genuine, but are sometimes easily counterfeited to convince people that the holder of these items is somebody who knows what he or she is talking about.

Cialdini explains that “even in Madoff’s case, he sat on a governing commission that was designed to offer policing policies for the financial industry. So, he had the second component of what constitutes a great authority in the minds of an audience.

The first is expertise and the second is trustworthiness. Here is a guy who makes it appear that he is concerned about the ethical and proper way to deliver financial information. He sat on the committee that was designed to do that within the NASDAQ. All the while he was gaming the system."

The second place we look when we are uncertain is to people just like us. To our peers, to our contemporaries. "That's why so often these scams turn out to be affinity scams," says Cialdini. "Groups that share some kind of connection, some kind of affiliation. It can be a religious one. It can be an ethnic one. Charles Ponzi exploited other Italian American immigrants. We see cases where Baptists are being scammed by other Baptists. Mormons being scammed by other Mormons. Armenian-Americans being scammed by Armenian-Americans. People use these as a source of good information. 'What are the people like me doing and telling me to do? I can usually trust that.'"

Another compelling psychological factor that leads us to make an investment decision is the perceived scarcity of the investment opportunity. We want to jump into those situations where it appears that there is a restricted opportunity, or a dwindling opportunity, to get involved. "We are drawn to those opportunities that only a few are going to be allowed in, or you have to have a certain level of finances in order to be allowed in, or you have to know somebody to be allowed in. Madoff did that in spades and he had people clamoring to give him their money," explains Cialdini.

Exclusive opportunities, or limited-time offers, are always enticing. "Access to one of these opportunities if it's rare or scarce or dwindling in availability—it makes people a little crazy.

It unhinges their willingness to step back from the situation and think about it because they are being directed by emotional signals inside them rather than cognitive, fully considered approaches," Cialdini cautions.

These psychological impulses come from a number of human needs. We want to feel special. We want to be thought of as one-of-a-kind. We want exclusivity. Cialdini seconds this: "It is typically the case that those things that are rare, those things that are not widely available to people, are more valuable to people. That's why gold is valuable. That's why diamonds are valuable. That's why the purveyors, the miners of gold and diamonds, hold back these items from the market, because the less available they are the more attractive they become." The secretive, or exclusive, factor plays into our psychological need to feel special.

"People like the idea of being unique, being special, being different. Especially if that means that they are afforded certain benefits that others can't get. You can understand why that would be a very attractive proposition."

The irony with Madoff is that all the while he was giving the appearance of running an exclusive operation, he actually represented thousands of people, but he made everyone who was his customer feel like he or she was part of a very exclusive club. In this way, Madoff managed expertly this *illusion* of exclusivity. In this way he mastered the deception.

Madoff may have wanted to be more public about his fund and his supposed investment prowess. He might have even wanted to advertise. However, to the extent that he became more public about his investments and what he was supposedly accomplishing, he would have drawn more attention to his investment returns, which in turn would have likely drawn scrutiny. Someone would have more quickly realized that Madoff was not really bringing in these remarkable returns year after year, month after month.

Madoff's tack, and that of other fraudsters, was to keep his investment formula secret. He made his fund appear very restricted. Cialdini observes that "if anybody challenged him, he threatened to kick them out. So you weren't allowed to really think through all of the issues without potentially losing your ability to be one of the select few in his club."

These psychological needs go beyond the need to feel special or to feel a certain level of status. Cialdini explains this as "the need to be relatively advantaged in terms of resources. So it's not enough just to be doing well, we like the idea of doing better than our neighbors."

We want to feel like we have more than others have. There are two ways to get there: either we move up, or other people move down. Thus the reason why we gloat when others fail. "So you find people taking some kind of joy in seeing those around them fail," says Cialdini. "If they have failed, they like those around them to fail even more. And so it allows them the prestige of being less of a fool than everyone else."

People, including investors, also want consensus. They will follow the lead of those around them. Especially if the leaders appear authoritative, are similar to us, and make us feel special. When we feel like part of a group, then we are more likely to blindly follow.

Financial serial killers are skilled at establishing a connection with their victims. That will be either a pre-existing connection or a newly created connection. Cialdini explains, "The other thing is, of course, the idea of having an existing connection or friendship with the individual who is promoting the scam or some kind of association with people involved in it. Again, if we think about the Madoff case, he had emissaries of various sorts in various religious groups—Jewish congregations—but also in golf clubs. He had people who were selling access to his funds to the people they were friends with within those organizations. That's another thing that we have a weakness for. We tend to be willing to say yes to our friends, because we think they're steering us right, number one. But number two, it's very awkward to say no to a friend who comes to us with a great proposition, and who is staking his or her reputation and status on it. It's difficult to turn down a friend. So that's another aspect that is often part of these scams."

Often we decide to do business with our friends, or someone we know, as opposed to standing back and objectively looking at qualifications. We might have a friend who says he can manage our money, but if we really study his résumé we will come to realize that he is not the most qualified person. Then assume a stranger comes to us with a very qualified résumé and background, and he's proven that he can successfully manage money and has a track record of proven returns. Yet if we don't *know* him we are less likely to let him handle our money.

Cialdini says that this behavior derives from "the belief that we know about the trustworthiness of our friends more than we know about the trustworthiness of a stranger. So when we have a friend we think 'all right, I know this person, he or she knows me, I can trust the advice I get, because this isn't somebody who would consciously try to exploit me.'"

We must conclude here that an investor needs to be careful when doing business with people he or she knows. Keep in mind that your opinion of the person's ability to handle your money will be colored by your relationship with that person.

It's a better method to select a money manager by interviewing two or three candidates and narrowing the choice from there. Some studies conclude that we actually make our decisions based on our emotions and then rationalize them later. Cialdini says that we often do this "but sometimes our brains can actually cause us to evaluate the emotion—not just rationalize it—but catch ourselves. If we truly take a step back and try to be dispassionate about a decision because it's going to involve considerable resources, we can do a pretty good job of countering a purely emotional decision."

In making our investment decisions we need to avoid being gullible and follow a sensible approach to evaluating our choices. There are steps that we can take. Cialdini defines gullibility as "not just an action in a particular situation that turned out to be wrong, but a tendency across all situations in which a person finds him or herself to go along with the appeals or the persuasive communications with others without thinking through the merits of what that person is offering." In other words, being led by the fraudster and not objectively evaluating what he or she is saying to us.

Smart and cautious people can be snared in frauds. This happens often. The financial serial killer plays on our emotions and knows our human frailties. Cialdini knows this can happen to the most cautious of us: "I think that a lot of people who are not traditionally or normally gullible can get caught up in these scams, because it has to do with the distortion of—the undermining of—normally good decision-making principles that people apply. Those normal decisions get twisted in particular situations where they don't really apply. So most of the time, it makes sense to follow the lead of a genuine authority. But sometimes it doesn't because that authority has counterfeited the evidence. Most of the time, it makes sense to follow the lead of what many others like us have done, but sometimes it doesn't because many of those others have been tricked into moving in that direction. Most of the time, it makes sense to seize rare or dwindling opportunities for valuable resources, but some of the time it doesn't because those things have been manufactured or fabricated as rare or dwindling. They are not genuinely rare in the environment. So these normally good decision-making rules can be perverted by con artists and scam artists into tricks."

You first need to understand yourself and the human needs that can make you vulnerable to a fraud. Then you need to objectively evaluate the person who is coming to you and asking to handle your money. Cialdini warns that you need to avoid those people who try to push you into making a decision quickly. Steer clear of those who don't want you to look at or consider other options. Another warning sign is people who are unwilling to give you their background and credentials in ways that allow you to check their expertise in a particular arena. Be suspicious of people who are telling you that you have to act now, otherwise you will not be eligible or you will lose the opportunity.

Investors are even more vulnerable now following the credit crisis, the plunge in the stock market, and the decreased value of their 401(k) and other retirement plans. Everyone has been touched in one way or another by the financial problems of the last several years. The problems with the banks and the financial system are on the front page of the newspaper just about daily.

At first, the normal response to these financial calamities is to be cautious. Sometimes we just freeze. We take no action. At some point, as we emerge from our financial coma, we are faced with the reality of all the money we have lost. At some point many of us will be vulnerable to those magical financial wizards who proclaim that they can rapidly earn back all of our losses.

Cialdini says that there's a particular kind of influence—a certain type of sales pitch—that is likely to be employed, and he's already seen it. "It's likely to be working in the future as well, that will try to move people off the fence and try to get them away from their cautious stand."

Here is how the pitch goes: *This is the time, now is the time, to make your move. Prices have gone down too low. They've bottomed out. They can only go up. You want to get in on the ground floor right now.*

We are already seeing this tack in real estate. Prices have fallen 20 percent or 30 percent. So the experts tell us they can't fall any further. In some parts of the country that is probably true, and it may be time to buy, but in other parts of the country they have yet to hit bottom. We are not saying that prices never bottom out; of course they do. And then they head north. What we are saying is that you must be aware of this type of selling scheme that rushes you into making a financial decision based on the emotional appeal of "hurry, hurry, hurry."

Cialdini says that "it's the scarcity principle that will move people off the fence. When people are dealing with the recent experiences where they've not done well, they don't want to lose any more. So you can tell them that unless they move, they're going to lose the opportunity. It's going to be a lever to get them off the fence. So that's what I'm going to predict—you're going to see a lot of con artists, a lot of scam artists, using that scarcity lever."

They like to tell us: "You need to move quickly now, because the opportunity is going to be gone. You're never going to see low prices like this again, so hurry up and act now. This is a once-in-a-lifetime opportunity!"

In the context of stocks and bonds, you will find this sales pitch from the fraudster whenever the price of the financial instrument has dropped. At this point it can easily be said that the price used to be way up here, and now it's down here. Now it will reverse its course to the South Pole and head back North. Perhaps there's an argument that the company is poised to turn around, or there are signs that the economy is going to get better. In any event, the selling language will revolve around the urgency that "unless you move now, you're going to miss this opportunity."

So perhaps the great irony is that once you have lost money, you become even more vulnerable to losing money again. Once you have your first loss, or are scammed for the first time, you will eventually get to a psychological state of mind where you want to make up your losses. Anyone who can offer you the chance to recover those losses quickly will likely get your attention. So be aware: you are even more vulnerable to fraud after you have lost money.

Cialdini has experienced this firsthand: "I'm working with AARP in phone scams that they've been investigating. A lot of scammers try to operate on the elderly various types of scams where they can get in and buy gold or they can buy property. The elderly person gets burned and they are so ashamed of it that they become vulnerable to the next scam so that they can recoup their losses. They don't want to think of themselves as losers, and they don't want their family to think of them as fools and idiots financially. So they wind up getting in again and losing yet another chunk of their savings."

Certain types of investors have their self-esteem wrapped up in their financial status. These people may find themselves more vulnerable to the next scam because they need to act quickly before their family or friends learn that they've lost their money. They want to recoup their losses and show themselves and those around them that they are not dupes after all.

You need to recognize if you are one of these people. This requires some serious honesty about who you are in relation to your money, and how your perception of and ideas about money affect your understanding of yourself.

Lessons & Takeaways

- A financial serial killer is going to warm us up, and get to our heart and wallet, by making us feel special, unique, and different. Beware of this technique, which is intended to manipulate our emotions.
- We will naturally trust people who we perceive to be just like us. Keep in mind that simply because someone is from our neighborhood or hometown, or shares our same ethnic background, does not mean that the person necessarily has our best interests in mind.
- Simply because your children attend the same school as your broker's children, or you attend the same church or synagogue as him, does not mean that he is qualified to manage your money. Look objectively at his qualifications.
- Beware of the human need for status, and don't get involved in a financial investment solely because it makes you feel important or as though you are part of some type of elite group.
- Just because everyone else is in an investment does not mean that the investment is right for you. Think for yourself, and don't play "follow the leader." That game is for children.
- When choosing a money manager, interview two or three different candidates. Take emotion out of the decision and make an informed decision about who has the best qualifications and track record.
- Remember that once you have lost money, you are more vulnerable to losing money again. When people lose money, they want to hurry up and win it back. That makes them vulnerable to get-rich-quick scams. That emotional urge will also lead to bad investment decisions.