The Economist

Affinity fraud: Fleecing the flock

The big business of swindling people who trust you

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WITH a nudge from their pastor, the 25,000 members of the New Birth Missionary Baptist Church near Atlanta opened their hearts, and their wallets, to Ephren Taylor. And why not, given his glittering credentials? Mr Taylor billed himself as the youngest black chief executive of a publicly traded company in American history. He had appeared on NPR and CNN. He had given a talk on socially conscious investing at the Democratic National Convention. Snoop Dogg, a rapper, had tapped him to manage a charitable endowment.

So when Mr Taylor's "Wealth Tour Live" seminars came to town, faithful ears opened wide. Eddie Long, the mega-church's leader, introduced Mr Taylor at one event with the words: "[God] wants you to be a mover and shaker…to finance you well to do His will." Mr Taylor offered "low-risk investment with high performances", chosen with guidance from God.

Divine inspiration, alas, has given way to legal tribulation. For many investors, the 20% guaranteed returns proved illusory. Mr Taylor (whereabouts unknown) stands accused of fraud in a number of lawsuits. Bishop Long, a co-defendant, has urged Mr Taylor to "do the right thing" and cover any losses. The charges are not the first blot on the minister's reputation: last year he settled for an estimated $15m-25m claims that he had coerced young men into oral sex.

An essential element of Mr Taylor's approach was to make those he targeted want to invest in him personally, says Cathy Lerman, a lawyer representing some of the victims. "He was a master of creating a marketing presence. He would say: 'If you want to check me out, just Google me.'" He had no problem convincing them that he was an ordained minister, even though he had no formal seminary training, according to court documents.

It will take time to gauge the full extent of the losses, not least because it will require untangling a web of companies, some of them shells. Victims, many of whom entrusted their life savings to Mr Taylor, are still coming forward. Some call him "the black Bernie Madoff".

Let us prey

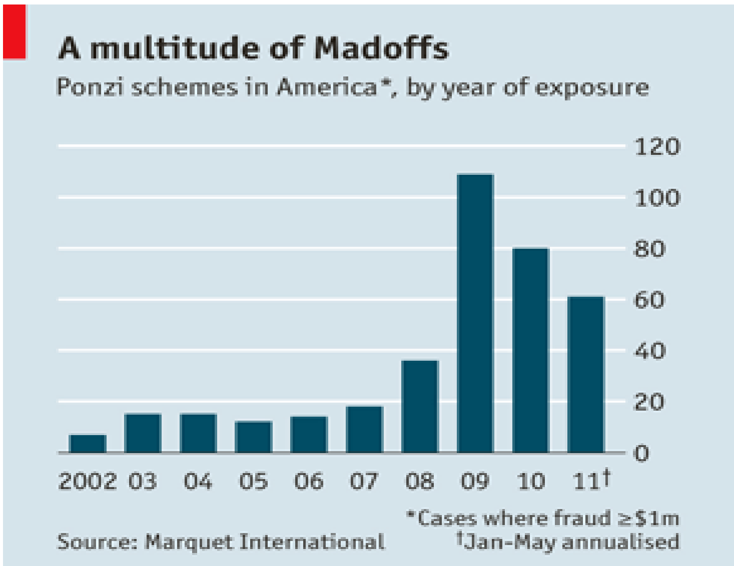
Mr Madoff, whose victims lost perhaps $20 billion, perpetrated the largest "affinity fraud" ever. The term refers to scams in which the perpetrator uses personal contacts to swindle a specific group, such as a church congregation, a rotary club, a professional circle or an ethnic community. Once the scammer gains their trust, his scam spreads like smallpox. Most affinity frauds are Ponzi schemes, in which money from new investors is used to repay old ones, or is siphoned off by the promoters.

The Madoff fraud fed on multiple affinity circles: wealthy Jews in Florida and Israel, country-club types and European old money, lured with help from marketers running "feeder" funds. The next-largest alleged investment fraud of recent years, the $7 billion collapse of Allen Stanford's empire, also concerned specific groups, including the Latin American and Libyan diasporas and Southern Baptists. Mr Stanford's trial began on January 23rd. He denies wrongdoing.

Beneath the mega-scams swirls a mass of smaller cons, spanning the world. Any close-knit community can be a target. Last August a South Korean pastor was indicted for misappropriating 2.4 billion Korean won ($2.3m) that the faithful had handed over to set up a Christian bank. In Britain, Kevin Foster's KF Concept targeted the former coal-mining towns of South Wales, bilking more than 8,000 victims with the help of glitzy roadshows.

The problem is a global one but best-documented in America. Besides the Madoff saga, Marquet International, a consultancy, has identified more than 300 sizeable Ponzi schemes from the past ten years, with combined losses for investors of $23 billion. It estimates that up to half of those were affinity-based. No one has a reliable number for smaller frauds over the same period, but guesses range from $5 billion to $20 billion. In all, affinity-fraud losses in America could be as much as $50 billion.

The FBI is probing some 1,000 cases of investment fraud, more than double the number outstanding in 2008. Six state securities commissioners contacted by *The Economist* all say the problem is growing.



The increase is partly a result of better detection, post-Madoff. The SEC filed more than twice as many Ponzi cases in 2010 as in 2008. The number of Ponzis exposed each month began to climb just as the financial crisis struck in 2007 (see chart). Frauds are more prone to collapse in a weak economy as investors try to pull money out to cover shortfalls elsewhere.

Bad times also make get-rich-quick schemes more tempting. Desperation breeds gullibility. The median annual return offered by scammers in the Marquet study was 38%. In a case in Montana, victims were promised 800% back in a week.

Mistrust of mainstream finance helps the scammers. The big guys on Wall Street have shown they can't be trusted, they say; better to go with someone you know. This was part of Mr Taylor's pitch in Georgia.

Brent Baker, a former SEC lawyer who now works on affinity-fraud cases, has seen ones involving "just about every type of community you can think of", including one where loyal listeners of a Persian-language radio show were bilked by its presenter. But religious fraud is particularly common, because people find it hard to imagine that the pastor is a perp. Joseph Borg, Alabama's securities commissioner, reckons half of all affinity frauds in the American South are faith-based.

The problem stretches across all types of belief, and ranges far beyond the Bible Belt. In September, a 77-year-old man from Ohio was indicted for allegedly defrauding 2,700 fellow Amish of $17m (though he had somehow resisted the temptation to trade his horse and cart for a Ferrari).

The hook of Mormon

The state thought to have the most affinity fraud per head is Utah, where 60% of the population are Mormons. In 2010, regulators and the FBI were investigating cases there with 4,400 victims and perhaps $1.4 billion (or $500 for every Utahn) in losses. The numbers have surely climbed since, with the three largest cases alone involving combined losses of up to $700m, says one investigator.

Mormons tend to be both trusting and welcoming of newcomers, says Keith Woodwell, head of Utah's Division of Securities. As soon as you pull up to your new house, neighbours appear to help you unpack. A scammer who gets his foot in the door can exploit this closeness.

LuElla Day, for example, lost $1.2m in a deal hatched by Daniel Merriman, a fellow Mormon she had known for four years. "He'd spoken at our meetings. When I sold my farm, he came and said the bishop had asked him to help me invest the proceeds," says the 81-year-old. He told her the money would go into government debt. The transaction was done on a handshake. Ms Day never got a penny back.

Credulousness is not confined to sweet old ladies. One of Ephren Taylor's victims was an electrical engineer with an MBA. A man in Utah was taken for $50,000 by his next-door neighbour, who offered a chance to invest in a new type of ice machine. Nothing remarkable there, except that the victim was a retired federal agent who had worked on white-collar fraud cases.

Why do such people let their guard down? “Everyone is looking for a shorthand way to judge character, and affinity settings offer that, at least in theory,” says Jeff Robinson, head of the Utah County Attorney's investigations bureau. Tribal ties foster trust, which is usually a good thing (see article). But it can be abused.

Another factor is the rise of “prosperity theology”, or the belief that God wants Christians to be rich as well as good. This idea has taken root fastest in black and Hispanic churches. The problem is that it puts pressure on congregations to invest successfully, which makes them more vulnerable, says Ole Anthony of the Trinity Foundation, which investigates church fraud.

Social media make affinity fraud quicker. Bonds that used to take years to establish can be forged in days on Facebook or Twitter. Fraudsters read potential victims' online profiles, and use the information they glean to refine their pitches. In a recent case, the SEC won a restraining order against a scam targeting users of chat sites popular with the deaf.

At a federal level, the American government's response has been inadequate. The SEC has launched some high-profile cases, but done little to educate investors. The agency “has chosen to stick some ambulances at the bottom of the cliff rather than build fences at the top,” as one former employee puts it.

American states have tried harder. Pennsylvania, for example, holds hundreds of meetings a year to teach investors how to be more careful. Utah ran a billboard campaign showing a series of respectable-looking types saying: “I'm your friend. I'm your neighbour. I'm a con man.” People should “be trusting but verify”, says Gary Herbert, Utah's governor.

A new law in Utah increased penalties for fraudsters who abuse a relationship of trust. Another pays whistle-blowers up to 30% of recoveries. (The SEC operates a similar scheme, but only for cases larger than $1m.) Both bills were sponsored by Ben McAdams, a state senator who returned to his native Utah from New York to help ensure that “as much energy went into shrinking the fraud economy as growing the ski economy.” In Utah, suspected fraudsters' property can be seized before charges are brought, if there is “probable cause” that a crime was committed.

Other ideas are percolating. Sean Reyes, a lawyer who is running for state attorney-general, supports the creation of a “fraudsters registry”, similar to the one for sex offenders. “It's amazing how many are repeat offenders,” he says. He also wants to explore the idea of reducing sentences for scammers who lead investigators to assets they have salted away. Most victims see a few pennies on the dollar returned, if that.

Investigators face strong headwinds. One is that victims are often reluctant to come forward. Some cannot admit to themselves what they have lost. Others don't want their families to know: older victims often fear being deemed unable to manage their lives and shoved in a home. In religious cases, there is often an unwritten rule that what happens in church stays there, with disputes handled by the church elders or the minister. Many frauds are dauntingly complex. One Ponzi, at the Baptist Foundation of Arizona, used 120 shell firms to extract $590m from members.

There is only so much governments can do to protect people from their own credulity. Mr Baker thinks that private groups are better-placed to build those fences on the cliff top. He has set up a “Fraud College” in Utah (and on the web) with help from Mr Reyes. This self-styled “neighbourhood watch” for fraud offers online advice and holds events to raise awareness. The next conference, on February 15th, will hear from state and federal fraudbusters, victims and, in a first, a senior figure from the Mormon church. Amen to that.

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