

# “WITH FRIENDS LIKE THESE . . .”: TOWARD A MORE EFFICACIOUS RESPONSE TO AFFINITY-BASED SECURITIES AND INVESTMENT FRAUD

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*Defend me from my friends; I can defend myself from my enemies.*<sup>1</sup>

According to the United States Securities and Exchange Commission (SEC), members of various churches in rural Kansas, Nebraska and Missouri convinced hundreds of their fellow parishioners to invest in a non-existent prime bank trading program by giving their investment funds names with biblical connotations, by suggesting that investing in these funds would fulfill a religious duty and, most importantly, by relying on the high degree of trust among church members.<sup>2</sup> By the time the SEC filed an emergency order designed to halt the fraudulent investment scheme, church members had been defrauded out of approximately \$7.4 million.<sup>3</sup>

In Maryland, an African-American man persuaded several other African Americans, including members of his church, to invest in highly speculative, and in some cases nonexistent, partnerships by appealing to their ethnicity and vowing to make more “Black Millionaires.”<sup>4</sup> When the Maryland attorney general filed a

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<sup>1</sup> JOHN BARTLETT, FAMILIAR QUOTATIONS 372, n.1 (Justin Kaplan ed., 16th ed. 1992) (attributing quotation to Claude Louis Hector, Duc de Villars).

<sup>2</sup> Oracle Trust Fund, Lit. Rel. No. 16355, 71 SEC Docket 211 (Nov. 16, 1999), available at <http://www.sec.gov/litigation/litreleases/lr16355.htm>.

<sup>3</sup> *Id.*

<sup>4</sup> Jeanne Dugan, *Broken Trust: A Young Man's Talk of Stock Riches Lures Host of Regular Folks*, WALL ST. J., Sept. 12, 2000, at A1.

complaint against the architect of the scheme, investors, some of whom lost as much as \$1 million, claimed that his appeal to their ethnicity caused them to participate in the investment program when they otherwise may have been more cautious.<sup>5</sup>

California securities officials have been investigating Asian commodity dealers who targeted members of various Asian communities to make bogus investments in foreign currency and precious metals.<sup>6</sup> These dealers advertised in Asian newspapers and at seminars ostensibly held for "training," touting the investments as "no-risk" moneymaking opportunities.<sup>7</sup> Instead, investors lost hundreds of thousands of dollars.<sup>8</sup>

In New York, the SEC issued an order to restrain a German-speaking Austrian after he fraudulently obtained approximately \$5.8 million from at least forty other German-speaking Europeans for investment in the securities, commodities and foreign exchange markets.<sup>9</sup> According to the SEC, the defendant used false and misleading statements to induce investors to participate and then diverted their funds for his own use.<sup>10</sup>

To paraphrase one prominent securities regulator, "You can trust me because I'm like you" is a siren song that has been used in recent years to defraud many investors.<sup>11</sup> The security investment schemes that rely on such songs are examples of fraudulent conduct securities regulators have termed "affinity fraud,"<sup>12</sup> which targets members of a particular group and is perpetrated either by mem-

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<sup>5</sup> *Id.*

<sup>6</sup> North Am. Sec. Adm'rs Ass'n, *Affinity Fraud: Beware of Swindlers Who Claim Loyalty to Your Group*, at [http://www.nasaa.org/nasaa/scripts/prel\\_display.asp?rcid=41](http://www.nasaa.org/nasaa/scripts/prel_display.asp?rcid=41) (last visited Oct. 5, 2001) [hereinafter *Beware of Swindlers*].

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> Christian Schindler, Lit. Rel. No. 15684, 66 SEC Docket 1990 (Mar. 26, 1996), available at <http://www.sec.gov/litigation/litreleases/lr15684.htm>.

<sup>10</sup> *Id.*

<sup>11</sup> Mark J. Griffin, Remarks at the Columbus Club, Union Station Press Conference, at [http://www.nasaa.org/nasaa/scripts/fu\\_window\\_display.asp?usid=0&ref=118](http://www.nasaa.org/nasaa/scripts/fu_window_display.asp?usid=0&ref=118) (Nov. 12, 1997) [hereinafter *Remarks*].

<sup>12</sup> See SEC, *Affinity Fraud: How to Avoid Investment Scams that Target Groups*, at <http://www.sec.gov/investor/pubs/affinity.htm> (last modified Mar. 15, 2001) (defining affinity fraud) [hereinafter *Affinity Fraud*]. Regulators also refer to these schemes as affinity group fraud or affinity scams. See, e.g., *id.* (affinity scams); *Remarks*, *supra* note 11 (affinity group fraud). This Article uses these terms interchangeably.

bers of that group or by those claiming to advance its interests.<sup>13</sup> Those who conduct these schemes focus their efforts on members of religious, racial, or ethnic groups and rely on the trust shared among members of those groups.<sup>14</sup> As with other forms of investment-related securities fraud, perpetrators of affinity scams often promise that the investments will yield high returns with relatively no risk to the investors.<sup>15</sup> In reality, the programs often either do not exist or represent highly speculative investments, and the investment architects typically misappropriate much of the investors' money.<sup>16</sup> Affinity fraud differs from other forms of securities fraud because perpetrators establish their credibility and the credibility of their investment programs by appealing to the trust that group members share, often promising that some of the invested funds will be used to assist the group's church or ethnic community.<sup>17</sup> This reliance on group trust and sense of community persuades otherwise cautious people to participate in many fraudulent investment schemes.<sup>18</sup>

This reliance also has catapulted affinity fraud into the spotlight of securities regulators.<sup>19</sup> As an initial matter, the sheer amount of money involved in some of these affinity-based securities fraud schemes may have brought this crime to the attention of securities regulators. For example, in one recent affinity fraud case, two investment firms may have defrauded investors out of as much as \$475 million.<sup>20</sup> In another fraudulent scheme, securities officials

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<sup>13</sup> See sources cited *supra* note 12; see also *Officials List Most Common Investment Scams*, HOUS. CHRON., Mar. 30, 1998, at 2, available at 1998 WL 3568782.

<sup>14</sup> *Affinity Fraud*, *supra* note 12.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> *Id.* See also *Beware of Swindlers*, *supra* note 6 (noting once swindlers have won over some group members, they can earn trust of other group members simply by naming those already won over).

<sup>18</sup> *Beware of Swindlers*, *supra* note 6.

<sup>19</sup> See *Remarks*, *supra* note 11 (referring to affinity fraud as "widespread, pernicious problem"). Regulators have also referred to affinity fraud as a problem of "growing proportions." *Id.* See also *Beware of Swindlers*, *supra* note 6 (describing affinity fraud as "widespread problem"); David R. Sands, *Fleeced in the Land of the Free: Con Artists Show Affinity for Ripping Off Their Own*, WASH. TIMES (D.C.), Nov. 10, 1991, at A13 (noting rise in affinity fraud), available at 1991 WL 5575512.

<sup>20</sup> *Affinity Fraud*, *supra* note 12.

estimate that victims were defrauded out of more than \$200 million.<sup>21</sup>

In addition to the large amounts of money involved in these scams, regulators have expressed concern about the rise in the frequency of affinity fraud. In 1998, state securities regulators identified affinity fraud as the biggest investment problem facing their departments, and since then such securities fraud has remained among the top five most problematic securities schemes.<sup>22</sup>

Securities regulators have utilized a variety of different techniques to respond to affinity scams. Officials have instituted educational campaigns to warn various ethnic and religious groups about the dangers of affinity fraud.<sup>23</sup> Coupled with these educational efforts, both the SEC and the North American Securities Administrators Association (NASAA), the world's oldest investor protection agency, whose membership includes state securities administrators from all fifty states and the District of Columbia, have established websites designed to alert investors to the dangers of affinity fraud.<sup>24</sup> In addition, securities officials have increased their investigation and prosecution of these affinity securities crimes.<sup>25</sup> Those who commit affinity fraud violate a host of federal securities laws aimed at curbing fraudulent investment practices.<sup>26</sup> Pursuant to these laws, federal securities officials have filed a series of actions prosecuting instances of affinity fraud.<sup>27</sup> Moreover, at least twelve states have brought similar actions against people who

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<sup>21</sup> Hal Mattern, *Fleeing the Faithful? Frauds Target Christians*, ARIZ. REPUB., Oct. 13, 1999, at A1, available at 1999 WL 4201921.

<sup>22</sup> Bryan Virasami, *Investment Heartache: Immigrants Say Shared Heritage Made Them Targets*, NEWSDAY, July 2, 2000, at A07, available at 2000 WL 10022501. As of May 2001, the North American Securities Administrators Association (NASAA) referred to affinity fraud as the second most common investment fraud in the country. Susan Sachs, *Welcome to America, and to Stock Fraud*, N.Y. TIMES, May 15, 2001, at A1 ("only the unlicensed sale of securities is more prevalent").

<sup>23</sup> The president of the NASAA hosted a press conference during which he publicized cases in several states and warned members of affinity groups about ethnic and religious affinity fraud. *Remarks*, supra note 11.

<sup>24</sup> *Affinity Fraud*, supra note 12 (SEC); *Beware of Swindlers*, supra note 6 (NASAA).

<sup>25</sup> See *Beware of Swindlers*, supra note 6 (listing states taking action against affinity fraud).

<sup>26</sup> See infra notes 147-67 and accompanying text.

<sup>27</sup> See *Affinity Fraud*, supra note 12 (stating SEC has investigated and taken "quick action" against scams involving church members, senior citizens, and minorities).

have targeted ethnic or religious groups when promoting fraudulent investment schemes.<sup>28</sup>

Securities regulators believe that the frequency of occurrence of these crimes has increased because of the susceptibility of the targeted victims and because the close-knit nature of many of the targeted groups makes these crimes difficult to detect and effectively investigate.<sup>29</sup> Very often the perpetrators of these crimes prey on the charitable impulses of investors by promising them that a portion of their invested funds will be used to assist their affinity group.<sup>30</sup> In other instances, affinity fraud takes advantage of the trust people have in members of their own affinity group and uses this trust to legitimize an investment scheme and the person who presents it.<sup>31</sup> Reliance on this trust makes it less likely that an investor will monitor and investigate the perpetrator's activities, thereby making these crimes difficult to detect and harder to resolve.<sup>32</sup> The combination of these harms makes affinity fraud difficult for securities regulators to deter and differentiates affinity fraud from other forms of securities fraud.

This Article asserts that the increased frequency and magnitude of harm associated with affinity fraud justifies increased punishment for its perpetrators; securities officials should exercise their discretion to seek enhanced civil and criminal penalties.<sup>33</sup> Because charitable impulses reflect an important value in our society, those who exploit such urges deserve severe sanctions. Charitable giving is important because people who give to charity help fund services and programs that otherwise would require governmental resources. Additionally, several scholars have commented that community spirit, reflected by the willingness of its members to make charitable

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<sup>28</sup> See *Remarks, supra* note 11 (announcing actions by Alabama, Arizona, Ohio, Washington, California, Florida, Kansas, Maryland, New York, Texas, Utah and Wisconsin attorneys general).

<sup>29</sup> *Affinity Fraud, supra* note 12.

<sup>30</sup> See, e.g., *Beware of Swindlers, supra* note 6 (asserting members often want to "give back" to community to help others like themselves).

<sup>31</sup> See, e.g., *id.* (warning of scam theme, "You can trust me, because I'm like you. . .").

<sup>32</sup> See, e.g., *id.* (stating victims forego police help but instead try to solve problems within group).

<sup>33</sup> See *infra* notes 183-322 and accompanying text.

donations, is a necessary component of a democratic society.<sup>34</sup> For these reasons, schemes that prey upon charitable impulses are more destructive and are therefore more deserving of increased sanctions.

People who abuse a relationship of trust similarly deserve to receive enhanced punishment. Members of groups that foster high-trust relationships tend to rely more heavily on each other's good faith, and hence are particularly vulnerable to abuse. To protect the participants in these relationships, the law should, and in many cases, does, impose higher obligations on such participants and more severe sanctions for breaches of their obligations.<sup>35</sup> The imposition of increased sanctions is based on the notion that such conduct is more deserving of harsh penalties, not only because it is easier to commit than other wrongful activity, but also because it does greater damage to important societal values.<sup>36</sup> Several scholars, including Francis Fukuyama and Robert Putnam, have

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<sup>34</sup> See, e.g., Mark Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1395 (1988) (stating tax deductions serve as reward for selfless behavior); Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 843 (1980) (pointing out importance of charitable giving to society).

<sup>35</sup> The imposition of these obligations and sanctions can be found in the law of fiduciary obligation, which regulates the conduct of people within relationships that involve a high level of trust. See, e.g., J.C. SHEPHERD, *LAW OF FIDUCIARIES* 47-49 (1981) (discussing duties of loyalty and care); ERNEST VINTER, *HISTORY AND LAW OF FIDUCIARY RELATIONSHIP AND RESULTING TRUST* 1 (3d ed. 1955); Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 812 (1983) (discussing sanctions that may terminate relationship or contract, assert direct control through agency regulation, or monitor activities); J.C. Shepherd, *Towards a Unified Concept of Fiduciary Relationships*, 97 LAW Q. REV. 51, 79 (1981) (asserting understanding of fiduciary relationships is achieved by recognizing they are based on transfers of power); L.S. Sealy, *Fiduciary Relationships*, 1962 CAMBRIDGE L.J. 69, 69-81 (exploring background, definition, and classification of fiduciary relationships). The law related to fiduciary obligations and relationships applies in a variety of contexts, from agreements between coventurers to relationships between a patient and physician, but is premised upon the notion that parties in these relationships must maintain a higher standard of conduct than those within an arms-length transaction. In addition to fiduciary law, the United States Sentencing Guidelines (the "Guidelines") allow a sentencing adjustment for crimes which abuse certain trust relationships. U.S. SENTENCING GUIDELINES MANUAL § 3B1.3 (2000). The Commentary to the abuse of trust provision of the Guidelines states that persons who occupy a position of trust have the ability to conduct their offense without easy detection and that persons who abuse such trust are viewed as more culpable. *Id.* at cmt. background. The Guidelines further state that the provision would apply to the embezzlement of a client's funds by an attorney serving as a guardian. *Id.* at cmt. n.1. Presumably, such an attorney has considerable discretion and is able to commit his crime without fear of detection.

<sup>36</sup> See, e.g., *United States v. Isaacson*, 155 F.3d 1083, 1087 (9th Cir. 1998) (Fernandez, J., dissenting) (noting people who abuse position of trust deserve enhanced punishment because they "do serious damage to the ties that bind us together").

pinpointed the importance of trust to the social, political, and economic health of society.<sup>37</sup> This trust may be even more important within racial and ethnic minority groups because legal, economic and social barriers to traditional sources of capital cause members of these groups to rely more heavily on community and affinity groups for economic resources.<sup>38</sup> From this perspective, fraudulent economic schemes that undermine the trust relationships of these affinity groups may be seen as even more harmful because they may disproportionately limit the groups' opportunity to achieve wealth and economic prosperity. The fact that affinity fraud takes advantage of these and other trust relationships and exploits charitable impulses warrants the imposition of enhanced penalties.

This Article begins by defining affinity fraud and outlining the typical schemes used to conduct an affinity scam.<sup>39</sup> Part II of this Article then identifies the primary reasons why members of particular groups fall victim to such crimes and affinity fraud has been increasing.<sup>40</sup> Part III provides an explanation of the securities laws violated by affinity fraud and the current sentencing structure for punishing such conduct.<sup>41</sup> Part IV of this Article explains why offenses like affinity fraud that exploit a person's benevolence and

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<sup>37</sup> Francis Fukuyama and Robert Putnam are part of a small, but growing, group of scholars who believe that communities need "social capital"—society's sense of cooperation, trust and reciprocity transmitted through cultural, voluntary and community associations—in order to prosper socially, economically and politically. *See, e.g.*, FRANCIS FUKUYAMA, *TRUST: THE SOCIAL VIRTUES AND THE CREATION OF PROSPERITY* 48-57 (1995) (arguing social capital, rather than ideology or state-imposed social engineering, should be primary focus of successful society); ROBERT D. PUTNAM, *MAKING DEMOCRACY WORK: CIVIC TRADITIONS IN MODERN ITALY* 167-85 (1993) (stating social capital refers to features of social organization that can improve efficiency of society by facilitating coordinated actions). *See also* JAMES S. COLEMAN, *FOUNDATIONS OF SOCIAL THEORY* 302-07 (1990) (generally defining "social capital" as productive, intangible result of accumulated social relationships); Kenneth Newton, *Social Capital and Democracy*, 40 *AM. BEHAVIORAL SCIENTIST* 575, 575-86 (1997) (surveying and evaluating three different definitions of "social capital" and its importance to democracy); Stephen Knack and Philip Keefer, *Does Social Capital Have an Economic Payoff? A Cross-Country Investigation*, 112 *Q.J. ECON.* 1251, 1252-55 (Nov. 1997).

<sup>38</sup> *See, e.g.*, Philip Borden, *An Asian-American Business Profile; Asian Alliance*, *LOS ANGELES BUS. J.*, Mar. 28, 1994, at 4B ("Asian-American small businesses, which most often must borrow from banks that speak their language or have some community roots, lack access to capital in about the same degree as other minorities. Such businesses tend to grow more by internal funding than their mainstream counterparts.").

<sup>39</sup> *See infra* notes 44-94 and accompanying text.

<sup>40</sup> *See infra* notes 95-140 and accompanying text.

<sup>41</sup> *See infra* notes 141-82 and accompanying text.

violate a special trust relationship merit increased punishment.<sup>42</sup> This Article concludes by asserting that the harms associated with many kinds of affinity fraud, individually and in the aggregate, highlight the need for greater efforts at curtailing this conduct and the need to impose more severe punishment on those responsible.<sup>43</sup>

### I. DEFINING AFFINITY FRAUD AND THE SCHEMES USED TO COMMIT SUCH FRAUD

Commentators have defined "affinity fraud" as securities and investment fraud that targets members of an identifiable group perpetrated by a member within the group or someone claiming a desire to assist group members.<sup>44</sup> This definition is quite broad and can be applied to securities fraud that targets many different kinds

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<sup>42</sup> See *infra* notes 183-322 and accompanying text.

<sup>43</sup> See *infra* note 323 and accompanying text.

<sup>44</sup> Some commentators have limited the definition of affinity fraud to apply only to conduct perpetrated by a person who is a member of the targeted group. As the discussion in this part reveals, this definition may be too narrow. Many schemes have also been conducted by someone who is not a member of the group, but who is able to gain the trust of certain prominent group members and then use such members to pitch the investment to the entire group. See Jay Perlman, *Securities Fraud: Affinity Fraud*, at [www.tool.com/specials/2000/sp000223fraud4.htm](http://www.tool.com/specials/2000/sp000223fraud4.htm) (Feb. 23, 2000); *Affinity Fraud*, *supra* note 12. Moreover, there may be some constitutional difficulty in proposing to increase the penalty for group members who commit a particular crime, while excluding those outside of the group who commit the same crime. Laws that single out a particular racial or ethnic group for different treatment may violate the Equal Protection Clause of the Constitution. See U.S. CONST. amend. XIV § 1 ("No state . . . shall deny to any person within its jurisdiction the equal protection of the laws."); *Korematsu v. United States*, 323 U.S. 214, 216 (1944) (noting all laws that make classifications on basis of race are suspect and subject to strict scrutiny). Thus, laws that heighten punishment only for those who commit security fraud against members of their own racial group may violate the Equal Protection Clause. By comparison, the Supreme Court declared that a statute imposing harsher penalties on offenders who commit criminal acts out of racial, ethnic or religious prejudice against their victims was constitutional under the First Amendment. See *Wisconsin v. Mitchell*, 508 U.S. 476, 486-88 (1993) (stating it was permissible for sentencing court to consider defendant's racial animus). While the Court specifically declined to reach the equal protection issue, see *id.* at 482 n.2 (noting equal protection issue had not been fully developed), some believe such hate-crime statutes will next be challenged under equal protection grounds. See, e.g., George P. Choundas, *Neither Equal Nor Protected: The Invisible Law of Equal Protection, the Legal Invisibility of Its Gender-Based Victims*, 44 EMORY L.J. 1069, 1076 (1995) (noting "it seems likely that the next wave of challenges [to hate-crime laws] will emphasize the equal protection aspects of the statutes.").



of groups. The NASAA website describes affinity fraud in these terms:

Everyone, in some way or another, is connected to a group or association. Our interests, backgrounds, and other factors will naturally lead us to those organizations or affiliations that serve our needs. Race, culture, and religious beliefs also play a role in identifying us as members of unique groups that we often come to trust—sometimes to our detriment.<sup>45</sup>

Thus, the definition of affinity fraud includes fraud that targets members of any organization or affiliated group including professional associates, as well as racial, ethnic and religious groups. This Article primarily focuses on affinity scams that target racial, ethnic and religious groups because securities regulators have identified these scams as being uniquely problematic.<sup>46</sup>

The definition of affinity fraud also applies to many different forms of fraudulent investment practices.<sup>47</sup> Despite this fact, all of these scams share at least two common elements: (1) a fraudulent investment practice that is (2) targeted towards an identifiable group by a member of the group or someone claiming to want to help them.<sup>48</sup> This section will discuss both of these elements.

#### A. TYPICAL SCHEMES USED TO COMMIT AN AFFINITY FRAUD

At its core, affinity fraud, like other types of securities fraud, involves some form of misrepresentation with respect to an investment opportunity.<sup>49</sup> In general, the engineers of these schemes

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<sup>45</sup> *Beware of Swindlers*, *supra* note 6.

<sup>46</sup> *Id.*

<sup>47</sup> *See id.* (suggesting fraud that targets persons based on membership in certain groups or associations is affinity fraud); *see also Affinity Fraud*, *supra* note 12 (defining affinity fraud as scams that “prey upon members of identifiable groups”).

<sup>48</sup> *Affinity Fraud*, *supra* note 12.

<sup>49</sup> *See supra* note 44 and accompanying text. This Article begins with the supposition that the affinity fraud at issue has already been proven, and the only issue is the form and measure of sanctions and remedies to be applied. Also, in light of the potential implications for guideline sentencing posed by the Supreme Court’s decision in *Apprendi v. New Jersey*,

present some bogus investment opportunity that falsely offers particularly high returns with a very low risk to the investors. These opportunities range from investments in foreign currency and precious metal to interests in oil wells.<sup>50</sup> In most cases, those who commit affinity fraud promise that the investment opportunity will yield unusually high returns. For example, promoters of at least two scams told potential investors that they could expect to receive as much as a three hundred percent return on their investment.<sup>51</sup> In addition to these high returns, most schemers maintained that the investor's principal was at a very low risk or fully guaranteed.<sup>52</sup> Despite these claims, often neither the investment company nor the investment opportunities existed.<sup>53</sup> If they did exist, the opportunities, and the companies offering such opportunities, were much more speculative than the perpetrators represented them to be.<sup>54</sup>

Many of the affinity scams rely on the "Ponzi" or pyramid scheme in which payments are made to initial investors with funds from subsequent investors to give the false illusion that the investment is profitable.<sup>55</sup> This method causes the earlier investors to become

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530 U.S. 466, 490 (2000) (holding except for prior convictions, any fact used to increase sentence beyond maximum allowed must be proven to jury beyond reasonable doubt), this Article further presumes that the conduct forming the basis for enhancements discussed herein would be charged in the indictment and proved at trial beyond a reasonable doubt.

<sup>50</sup> See Zach Schiller, *Be Skeptical, Investigate to Avoid Investment Fraud*, PLAIN DEALER, Feb. 15, 1999, at 6S (foreign currency); Richard Verrier, *Financial Schemes Get State's Attention*, ST. PETERSBURG TIMES, May 17, 1999, at 1 (precious metals and oil wells).

<sup>51</sup> Chelsea Assoc., Lit. Rel. No. 16312, 70 SEC Docket 1684 (Sept. 28, 1999), available at <http://www.sec.gov/litigation/litreleases/lr.16312.htm>; World Fin. & Inv. Co., Lit. Rel. No. 16368, 71 SEC Docket 467 (Nov. 23, 1999), available at <http://www.sec.gov/litigation/litreleases/lr16368.htm>.

<sup>52</sup> Chelsea Assoc., *supra* note 51.

<sup>53</sup> World Fin. & Inv. Co., *supra* note 51.

<sup>54</sup> *Id.*

<sup>55</sup> A "Ponzi" scheme takes its name from Charles Ponzi who conducted an elaborate investment scheme in the early 1900's in which he promised significantly high returns to investors, but made no investments of any kind. See *Cunningham v. Brown*, 265 U.S. 1, 7-9 (1924) (describing operation of Ponzi's scheme and litigation related thereto). Today, a Ponzi scheme refers to an investment scheme unsupported by an underlying business venture. See, e.g., Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157, 158 (1998) (surveying statutory authority created to discourage Ponzi schemes). By contrast, a pyramid scheme generally refers to a scheme that requires its participants to bring in additional investors. BLACK'S LAW DICTIONARY 1251 (7th ed. 1999). Although some pyramid schemes can be Ponzi schemes, other pyramid schemes may involve a legitimate business venture. *Id.*

unwitting spokespersons for the scam because they believe that their investment was successful.<sup>56</sup> In one scheme, the SEC found that some early investors obtained tremendous returns, including one person who earned \$23,800 in profits from an investment of \$4,166.<sup>57</sup> In another scam, to insure the continuance of additional investors, the perpetrator offered a “finder’s fee” to investors who convinced new people to invest at least \$2,000 in the program.<sup>58</sup> Eventually, the scheme collapsed because of a lack of new investors.<sup>59</sup> When this collapse occurred, investors realized that the investment programs were bogus or highly speculative and that most of their money has been misappropriated for the personal benefit of the perpetrator.<sup>60</sup>

Fraudulent investment schemes are not new.<sup>61</sup> What separates them from other forms of securities fraud is that the perpetrators target particular groups and rely on the trust inherent in the group to establish their credibility and promote their scam.

#### B. METHODS OF TARGETING SPECIFIC GROUPS

In order to lure a more susceptible audience, perpetrators of affinity-based securities fraud target their schemes towards members of identifiable groups, most often members of religious, racial or ethnic groups.<sup>62</sup> The scams aimed at religious groups tend to reach a large audience and involve especially large sums of money. As stated in the introduction to this Article, several individuals targeted members of Christian churches in rural Kansas, Nebraska and Missouri and defrauded them out of more than seven million dollars (the “Oracle Trust scheme”).<sup>63</sup> Unfortunately, this scheme merely represents the tip of the iceberg of religious-based affinity scams. Indeed, in March 2001, five members

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<sup>56</sup> McDermott, *supra* note 55, at 158.

<sup>57</sup> World Fin. & Inv. Co., *supra* note 51.

<sup>58</sup> Louis Lavelle, *Somerset County, N.J., Man Charged in Investment Scam*, KNIGHT-RIDDER TRIB. BUS. NEWS, Oct. 1, 1999, available at 1999 WL 22019935.

<sup>59</sup> *Id.*

<sup>60</sup> *Affinity Fraud*, *supra* note 12.

<sup>61</sup> See *supra* note 55 (describing Charles Ponzi and his activities in early 1900’s).

<sup>62</sup> *Affinity Fraud*, *supra* note 12; *Beware of Swindlers*, *supra* note 6.

<sup>63</sup> Oracle Trust Fund, *supra* note 2.

of an evangelical group in Tampa, Florida were found guilty of operating a \$448 million pyramid scheme whose participants included more than seventeen thousand fundamentalist Christians from rural communities in various states, including Florida, Pennsylvania, Ohio and Virginia (the "Tampa scheme").<sup>64</sup> In a similar scam, members of an Arizona-based foundation targeted Baptists in several different states, including Arizona and Alabama, convincing more than thirteen thousand members from various churches to invest an estimated \$530 million in their scheme (the "Arizona scheme").<sup>65</sup> These schemes, in terms of their participants and the amount of money involved, represent the biggest affinity fraud schemes uncovered by securities officials.<sup>66</sup>

In addition to schemes aimed at members of church communities, architects of affinity scams also target members of various racial and ethnic groups. For example, a Maryland-born African-American man targeted about one hundred fellow African Americans in Washington, D.C., Maryland and Virginia for participation in his investment program (the "Maryland scheme").<sup>67</sup> Similarly, the SEC obtained a \$4 million disgorgement order against another African-American defendant who targeted nearly two thousand African-American investors for participation in his fraudulent scam (the "First Zurich scheme").<sup>68</sup> In yet another case, the SEC brought actions against Hispanics who targeted more than two hundred members of Houston's Hispanic community and fraudulently raised

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<sup>64</sup> *5 Guilty in Bilking Based on a Ministry*, N.Y. TIMES, Mar. 14, 2001, at A12.

<sup>65</sup> Alan D. Fischer, *In God We Trust: Day Two of a Two Day Series of the Baptist Foundation of Arizona*, ARIZ. DAILY STAR, Sept. 27, 1999, at 6A, available at 1999 WL 5725082.

<sup>66</sup> See Mattern, *supra* note 20 (pointing out securities officials have described Florida and Arizona cases as extreme examples of affinity fraud and represent biggest and most egregious examples of this fraud).

<sup>67</sup> Dugan, *supra* note 4.

<sup>68</sup> First Zurich Nat'l U.S.A., Lit Rel No. 15848, 67 SEC Docket 1799 (Aug. 14, 1998), available at <http://www.sec.gov/litigation/litreleases/lr15848.htm> [hereinafter First Zurich III]; see also First Zurich Nat'l U.S.A., Lit. Rel. No. 16011, 68 SEC Docket 2560 (Dec. 29, 1998) (ordering payment of funds to charity), available at <http://www.sec.gov/litigation/litreleases/lr16011.htm> [hereinafter First Zurich IV]; First Zurich Nat'l U.S.A., Lit. Rel. No. 15645, 66 SEC Docket 1215, (Feb. 18, 1998), available at <http://www.sec.gov/litigation/litreleases/lr15645.txt> (amended complaint) [hereinafter First Zurich II]; First Zurich Nat'l U.S.A., Lit. Rel. No. 15639, 66 SEC Docket 1058 (Feb. 10, 1998), available at <http://www.sec.gov/litigation/litreleases/lr15639.txt> (original complaint) [hereinafter First Zurich I].

approximately \$1.5 million (the "Houston scheme").<sup>69</sup> The SEC has also been investigating the actions of several Asian commodities dealers in California who allegedly defrauded thousands within the Asian community (the "California scheme").<sup>70</sup> In addition to these schemes, the SEC has uncovered fraudulent investment programs aimed at immigrants from the Dominican Republic and other Caribbean islands,<sup>71</sup> individuals of Middle Eastern descent<sup>72</sup> and German-speaking Europeans.<sup>73</sup>

In many cases, the perpetrator of an affinity scam is a member of the group he targets and relies upon his affinity with other group members to convince them to participate in his scheme.<sup>74</sup> If the architect of the scam is not a member of the group, he will often "lull members into a misplaced trust by selling first to a few prominent members."<sup>75</sup> He then uses these members "to pitch the investment to the group as a whole."<sup>76</sup> After members of the initial group become participants, perpetrators can expand their efforts to entice other members in the group at-large.

Perpetrators reach their intended audience through a variety of venues. One of the easiest methods of targeting an identifiable group is by making a pitch to church congregations. For example, perpetrators of the Arizona scheme began by making presentations to their fellow church members and then sent promotional materials to members of other Baptist churches.<sup>77</sup> Perpetrators of the Tampa

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<sup>69</sup> Bernard Taalib-Din Hasan, Lit. Rel. No. 16699, 73 SEC Docket 724 (Sept. 14, 2000), available at <http://www.sec.gov/litigation/litreleases/lr16699.htm>.

<sup>70</sup> *Beware of Swindlers*, *supra* note 6.

<sup>71</sup> World Fin. & Inv. Co., *supra* note 51.

<sup>72</sup> Barry J. Goodman, Lit. Rel. No. 16875 (Jan. 30, 2001), available at <http://www.sec.gov/litigation/litreleases/lr16875.htm>.

<sup>73</sup> Christian Schindler, Lit. Rel. No. 15684, 66 SEC Docket 1990 (Mar. 26, 1998), available at <http://www.sec.gov/litigation/litrlease/lr15684.htm>. Prosecutors and securities regulators assert immigrants increasingly have been the targets of affinity fraud. See Sachs, *supra* note 22 (pointing to rise in affinity fraud targeted at immigrant groups such as scam perpetrated on Indian immigrants in Texas, another directed at Russian immigrants in Massachusetts and still another aimed at Korean immigrants in New York).

<sup>74</sup> *Beware of Swindlers*, *supra* note 6.

<sup>75</sup> *Id.*; see also Jay Perlman, *Securities Fraud, Affinity Fraud*, at <http://www.fool.com/specials/2000/sp000223fraud4.htm> (Feb. 23, 2000) (noting con artists who are not members of group lure members into blind trust by selling to prominent members).

<sup>76</sup> Perlman, *supra* note 75.

<sup>77</sup> See Fischer, *supra* note 65.

scheme and the Oracle Trust scheme similarly used their churches as mechanisms for luring investors, then accessed the church mailing list to make distributions to members of other churches who shared their faith.<sup>78</sup>

In addition to reaching members of a particular religious community, some people who orchestrate these schemes use the church to target racial and ethnic groups. For example, architects of the First Zurich scheme addressed thirty thousand African Americans attending a Baptist conference, many of whom eventually participated in their investment program.<sup>79</sup> This kind of targeting is effective particularly because it relies on two types of affinities, one based on race and the other based on religion.

In addition to utilizing these church communities, perpetrators reach their intended audience through word of mouth and other venues that focus on their specific group. An African-American New Jersey man invited several other African Americans to his house to hear him present an investment opportunity that he claimed would specifically help African Americans (the "New Jersey scheme").<sup>80</sup> These invitees contacted other African Americans interested in investment opportunities geared towards the African-American community.<sup>81</sup> With this kind of targeting, the perpetrator of the New Jersey scheme convinced more than 375 other African Americans to participate in his fraudulent investment program.<sup>82</sup>

Mirroring this approach, the architects of the First Zurich scheme distributed sales and promotional materials to African Americans and held regular meetings at local restaurants to target a particular audience.<sup>83</sup> Along these same lines, the two Latinos who orchestrated the Houston scam reached fellow members of their group through advertisements on Latin radio stations, special seminars, and community-based websites.<sup>84</sup> Perpetrators of the California scheme similarly advertised in Chinese newspapers to

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<sup>78</sup> Oracle Trust Fund, *supra* note 2; 5 *Guilty in Bilking Based on a Ministry*, *supra* note 64.

<sup>79</sup> First Zurich II, *supra* note 68.

<sup>80</sup> *Affinity Fraud*, *supra* note 12.

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

<sup>83</sup> First Zurich II, *supra* note 68; First Zurich I, *supra* note 68.

<sup>84</sup> Taalib-Din Hasan, *supra* note 69.

solicit investors.<sup>85</sup> Through such targeted marketing efforts, engineers of these affinity schemes entice group members to participate in their investment programs.

Perpetrators also have been using the Internet to lure group members. “[T]he Internet has made [affinity fraud] more efficient, more effective, and cheaper. Getting in touch with members of a specific group is very easy now that there are websites, bulletin boards, newsgroups, and chatrooms devoted to specific races, religion, ethnic backgrounds, cultures, and other identifiable groups.”<sup>86</sup>

In this way, perpetrators have used the Internet to select and target members of an identifiable group. Securities regulators predict that the Internet will enable the continued expansion of affinity fraud.<sup>87</sup> As SEC Commissioner Laura Unger noted, “[i]t seems likely that online communities will be an inviting venue for those [affinity fraud] cases to migrate to the Internet.”<sup>88</sup> Indeed, by using their shared heritage to target these communities, perpetrators may be able to create an illusion of safety for investors to overcome the fears of some Internet users and thereby convince many more investors to participate in their schemes.<sup>89</sup> In this way, the Internet promises to make the reach of affinity fraud even more expansive, particularly as gaps in groups’ access to technology narrow.<sup>90</sup>

Affinity fraud schemes seem to affect victims of all economic levels because perpetrators of these investment offenses target group members based on their shared religious, racial or ethnic affiliation without regard to their economic status.<sup>91</sup> In describing the people who were targeted in the New Jersey scheme, an SEC

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<sup>85</sup> *Beware of Swindlers*, *supra* note 6.

<sup>86</sup> Perlman, *supra* note 75.

<sup>87</sup> SEC Commissioner Laura S. Unger, Investing in the Internet Age: What You Should Know and What Your Computer May Not Tell You . . . , Remarks at the Association of Retired Persons National Legislative Council Annual Meeting, at [www.sec.gov/news/speech/spch342.htm](http://www.sec.gov/news/speech/spch342.htm) (Feb. 3, 2000).

<sup>88</sup> *Id.*

<sup>89</sup> *Id.*

<sup>90</sup> *Id.*

<sup>91</sup> Lavelle, *supra* note 58.

official noted that “[t]he victims of the alleged scam represented a cross-section of the African-American community.”<sup>92</sup>

The amount of funds various victims invested in these scams reflects this cross-section, as the amount of money invested may vary widely even within the same investment program. For example, invested funds in the New Jersey scheme ranged from \$1,000 to \$150,000,<sup>93</sup> and the California scheme involved individual investments ranging from \$15,000 to \$300,000.<sup>94</sup> Although not a precise indicator, these investment patterns reveal that affinity fraud targets both the sophisticated and less sophisticated investor. These patterns highlight the fact that these investors are not targeted for their economic status or even their relative sophistication, but rather for that common bond among targeted investors their group identity.

## II. “FLEECING THE FAITHFUL,”<sup>95</sup> WHY IT IS SO EASY AND SO SUCCESSFUL

Securities regulators believe that the fact that “[a]ffinity groups make excellent targets”<sup>96</sup> stems from four factors common to most forms of affinity fraud. First, perpetrators use their group affiliation to establish the trust of the other group members and lend credibility to their investment program.<sup>97</sup> This conduct convinces otherwise cautious investors to participate in an affinity scheme.<sup>98</sup> Second, many people are unfamiliar or uncomfortable with securities markets and consequently rely on people and groups they believe they can trust in order to evaluate the validity of an investment opportunity.<sup>99</sup> Third, group members are less likely to

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<sup>92</sup> *Id.* (quoting Ronald Long, SEC's district administrator in Philadelphia).

<sup>93</sup> *Id.*

<sup>94</sup> *Beware of Swindlers*, *supra* note 6.

<sup>95</sup> See Mattern, *supra* note 20 (describing religious affinity fraud as “Fleecing the Faithful”).

<sup>96</sup> Richard L. Stern & Lisa Gubernick, *The Smarter They Are, the Harder They Fall*, *FORBES*, May 20, 1985, at 38, 39.

<sup>97</sup> *Beware of Swindlers*, *supra* note 6.

<sup>98</sup> *Id.*

<sup>99</sup> *Id.*



report affinity schemes.<sup>100</sup> This is because such members often desire to resolve the scam internally and because some groups have a negative impression of law enforcement which perpetrators exploit to deter members from notifying the authorities of a fraud.<sup>101</sup> Fourth, by exploiting the desire to help the community, perpetrators of affinity scams make the investment programs more desirable than other investment opportunities.<sup>102</sup>

According to securities officials, affinity fraud owes much of its success to the fact that its architects are able to overcome investor skepticism by appealing to the trust found within an identifiable group.<sup>103</sup> "These scams exploit the trust and friendship that exist in groups of people who have something in common."<sup>104</sup> Those who conduct an affinity scam establish their credibility by appealing to the shared experience and commonality of the group.<sup>105</sup> This can be done at a superficial level by providing an investment vehicle or organization with names that have religious or ethnic significance to the group. Thus, in the Oracle Trust scheme, scam artists established the Jubilee Trust Fund, the Elkosh Trust Fund and the Oracle Trust Fund.<sup>106</sup> Using a similar tactic, a Utah resident who targeted members of his church not only named his company Making Good Choices, Inc. but sold bogus investments in inventions such as the Vice Script, an automobile theft prevention engraving program.<sup>107</sup>

At a more fundamental level, some perpetrators appeal to the common bond within a group by claiming that their shared background and ethnicity provides them with a unique ability to help other members of the group. The engineer of the New Jersey scheme convinced people to invest at least \$2.8 million in very speculative or nonexistent schemes by suggesting that his common experience gave him the ability to understand the plight of members of the African-American community and to assist African Americans

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<sup>100</sup> *Affinity Fraud*, *supra* note 12.

<sup>101</sup> *Id.*

<sup>102</sup> *Remarks*, *supra* note 11.

<sup>103</sup> *Beware of Swindlers*, *supra* note 6.

<sup>104</sup> *Affinity Fraud*, *supra* note 12.

<sup>105</sup> *Beware of Swindlers*, *supra* note 6.

<sup>106</sup> Oracle Trust Fund, *supra* note 2.

<sup>107</sup> *Beware of Swindlers*, *supra* note 6.

in taking advantage of the burgeoning capital markets.<sup>108</sup> His pitch stressed a desire to create wealthier African Americans.<sup>109</sup> This emphasis on shared ethnicity enables those who operate these schemes to garner the trust of members of their community and establish the legitimacy of their enterprise. More importantly, these swindlers bypass the normal safeguards people may have in place by suggesting that they *deserve* to be trusted because they share a common heritage or religion. "Once the connection to the group is understood, the natural skepticism of the individual member is overcome . . . ."<sup>110</sup>

Experts believe that investment scams that rely on this kind of group trust also are especially effective because many group members are unfamiliar with the workings of the capital market and are seeking someone upon whom they can rely for investment advice.<sup>111</sup> When the economy booms, many people are more interested in making profits through investments. However, many of the people targeted by affinity fraud do not know how to research an investment opportunity or the person presenting it.<sup>112</sup> Even targeted group members with an advanced educational background may forego the typical due diligence when presented with an opportunity by one with whom they have an affinity.<sup>113</sup> Observations of securities regulators support this phenomenon.<sup>114</sup> When it comes to investing money, "many people feel the need for a shorthand way of knowing who to trust."<sup>115</sup> For this reason, people often fall back on the groups and organizations to which they belong and with whom they already feel a sense of trust.<sup>116</sup> One scholar has opined that some people who commit these crimes prey on certain minority communities that are perceived as having a significant amount of wealth, but little sophistication regarding the securities

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<sup>108</sup> Chelsea Assoc., *supra* note 51.

<sup>109</sup> *Id.*

<sup>110</sup> *Beware of Swindlers*, *supra* note 6.

<sup>111</sup> Sachs, *supra* note 22.

<sup>112</sup> *Id.*

<sup>113</sup> Stern & Gubernick, *supra* note 96, at 39.

<sup>114</sup> *Beware of Swindlers*, *supra* note 6.

<sup>115</sup> *Id.*

<sup>116</sup> *Id.*

markets.<sup>117</sup> This combination of lack of knowledge and a high degree of trust among group members makes these groups easy targets for affinity-related investment schemes.<sup>118</sup>

Additionally, investigators and prosecutors reveal that affinity fraud presents a problem because it is both harder to detect and harder to resolve.<sup>119</sup> Because of the high level of confidence people place in those who operate these schemes, affinity fraud schemes tend to continue longer than other types of investment schemes.<sup>120</sup> Indeed, people are not only less likely to investigate the schemes initially, but they will be less suspicious of their investments even when such investments fail to yield the promised returns.<sup>121</sup> Members of affinity groups are generally reluctant to believe that other members of their group have defrauded them.<sup>122</sup> Consequently, they will wait for a longer period of time before giving up hope that the investment will be profitable.<sup>123</sup>

Securities regulators also have found that, even when investors accept that they have been defrauded, they are reluctant to notify authorities.<sup>124</sup> Instead, victims frequently attempt to resolve the problem within the group.<sup>125</sup> Many of these investors are motivated by the genuine belief that these problems should be resolved internally. Others are reluctant to come forward out of fear that the group will ostracize them.<sup>126</sup> Further, members of some affinity groups share a general distrust of law enforcement officials, which makes group members reluctant to report suspicious conduct.<sup>127</sup>

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<sup>117</sup> Virasami, *supra* note 22 (quoting Columbia University Professor Z. John Zhang, who noted this perception may be driving scams targeting members of some Asian communities).

<sup>118</sup> *Remarks, supra* note 11.

<sup>119</sup> *Affinity Fraud, supra* note 12.

<sup>120</sup> See *Blind Faith in Friendship is Promoting 'Affinity Fraud,' State Regulator Says*, SEC. WK., Feb. 7, 2000 at 9, available at 2000 WL 14733456 [hereinafter *Blind Faith*] ("The blind confidence that the victim often has in these personal relationships means that the con artist can operate a scam longer without the person getting suspicious.")

<sup>121</sup> *Id.*

<sup>122</sup> *Id.*

<sup>123</sup> See *id.* (noting that group affinity allows con artist to operate longer without targeted individuals becoming suspicious).

<sup>124</sup> *Beware of Swindlers, supra* note 6.

<sup>125</sup> *Id.*

<sup>126</sup> *Mattern, supra* note 22.

<sup>127</sup> See Michael Fechter & Morris Kennedy, *Ministries Program Fitched Scripture*, TAMPA TRIBUNE, Mar. 14, 1999, at 1 (indicating that government bias has often been unifying

Architects of these schemes exploit this distrust.<sup>128</sup> One commentator has noted that many perpetrators of religious fraud use as a rallying tool the notion that the government is persecuting their group and its leaders.<sup>129</sup> For example, members of some groups “conjure up a ‘them-against us’ mentality” which unifies the group and permits the engineers of the scam to characterize any legal action as government persecution.<sup>130</sup> In some cases, prosecutors have had difficulty uncovering information with respect to the fraudulent conduct because the perpetrators imply that governmental intervention would prevent investors from obtaining their money.<sup>131</sup>

Finally, affinity fraud often holds a special appeal by claiming to enable members of the group to use some of their investment to “give back” to their community.<sup>132</sup> Because members of minority groups who have accumulated a small amount of wealth are motivated by the desire to assist their community, they are inclined to seek investments that claim to promote their particular group and help others with similar backgrounds achieve success.<sup>133</sup> SEC officials note that this inclination makes these group members “sitting ducks for deceitful con artists.”<sup>134</sup>

As an illustration, in another Maryland case, an African-American man convinced African-American members of the community to purchase shares in his company.<sup>135</sup> He claimed that this investment would benefit the community by providing health and other social services.<sup>136</sup> Investors acknowledged that while they sought to make money, they were also lured by the chance to improve their community.<sup>137</sup>

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concept in certain religious groups).

<sup>128</sup> *Id.*

<sup>129</sup> *Id.*

<sup>130</sup> *Id.*

<sup>131</sup> Mike Shermow, *Ministries Accused of \$500,000 in State Scams*, MONTGOMERY ADVERTISER, Aug. 24, 1999, at 6B.

<sup>132</sup> *Beware of Swindlers*, *supra* note 6.

<sup>133</sup> *Id.*

<sup>134</sup> *Id.*

<sup>135</sup> *Id.*

<sup>136</sup> *Id.*

<sup>137</sup> *Id.*

For members of a religious group, whose duties include giving back to their church and community, these scams are persuasive because they allow the faithful to “do good while doing good.”<sup>138</sup> Indeed, victims of several of these affinity scams have indicated that they were particularly attracted to the investment opportunity because it enabled them to contribute to charitable work as well as earn a profit.<sup>139</sup> Some investors were assured that their money would be used to do “God’s work.”<sup>140</sup> In this way, the architects of many affinity frauds not only exploit a community trust, but also exploit members’ desires to improve their community.

### III. CURRENT RESPONSES TO AFFINITY SCAMS

The foregoing factors have increased the prevalence of affinity fraud and, as a consequence, have triggered reactions by state and federal securities officials. As noted earlier, affinity fraud topped NASAA’s 1998 list of top ten scams, ranked in order of seriousness or prevalence, and has remained in the top three since then.<sup>141</sup> This section will discuss some of the tools securities officials have available to combat this problem.

In an effort to warn various communities about the dangers of affinity fraud, federal and state agencies have established websites and hosted other informational sessions.<sup>142</sup> These websites define affinity fraud and give specific examples of this conduct. Such sites not only provide tips about how to detect and avoid these crimes, but also give important contact information for those who believe that they may be the victims of affinity fraud.<sup>143</sup> In addition to the

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<sup>138</sup> See Randall Smith, *Loss-Plagued Baptist Foundation of Arizona Undergoes Investigation by Regulators in State*, WALL ST. J., Sept. 1, 1999, at C1 (quoting promotional materials of Baptist Foundation of Arizona).

<sup>139</sup> Fischer, *supra* note 65; Mattern, *supra* note 20.

<sup>140</sup> Mattern, *supra* note 20.

<sup>141</sup> See *supra* note 22 and accompanying text.

<sup>142</sup> See *supra* note 23-24 and accompanying text. The SEC’s website was established in November of 1999 in connection with an investor alert that was issued on the same day the SEC announced actions against those who conducted the Oracle Trust scheme. Oracle Trust Fund, *supra* note 2.

<sup>143</sup> See, e.g., *Affinity Fraud*, *supra* note 12 (providing links and addresses for state securities regulators).

information available on the Internet, in 1998 state and federal securities regulators identified affinity group fraud as the top issue they were facing and highlighted its dangers in nationally televised town hall meetings, investment seminars and programs at shopping malls.<sup>144</sup> In addition to these outreach efforts, federal and state governments have brought actions in several affinity fraud cases and expect to bring many more.<sup>145</sup> Those who commit affinity fraud violate a host of federal securities laws aimed at prohibiting fraudulent investment practices.<sup>146</sup> Both the Securities Act of 1933, as amended ("Securities Act"), and the Securities Exchange Act of 1934, as amended ("Exchange Act"), prohibit any person from engaging in fraudulent or deceptive conduct in connection with the offer or sale of a security.<sup>147</sup> The Ponzi and pyramid schemes that are used to defraud investors in connection with an affinity scam

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<sup>144</sup> See NASAA, *State Securities Cops Release New List of "Top Ten Investment Scams,"* at [http://www.nasaa.org/nasaa/scripts/pre\\_display.asp?rcid=118](http://www.nasaa.org/nasaa/scripts/pre_display.asp?rcid=118) (May 24, 1999). While these educational efforts are encouraging, securities officials may need to expand their outreach campaign. Posting information and warnings on Internet websites are necessary components to preventing this fraudulent conduct, especially given that some perpetrators of these scams utilize such venues. However, these postings may not adequately reach those who may fall prey to affinity scams because they depend on prior knowledge of such sites. In addition, these postings may have a limited impact in communities without Internet access. Given these limitations, securities regulators should host more informational sessions targeted at groups securities officials believe are most likely to fall prey to these schemes. If securities regulators partner with community leaders, such leaders could assist the regulators in notifying group members of the dangers of affinity scams.

<sup>145</sup> The president of NASAA claimed that "many states are actively investigating or preparing to prosecute ethnic affinity group frauds." *Remarks, supra* note 11.

<sup>146</sup> Although state laws are an important component in the fight against affinity fraud, this Article focuses on the limitations of federal law to the application of affinity scams. However, the justifications for increasing sanctions for this conduct apply equally to state actions.

<sup>147</sup> Section 17(a) of the Securities Act makes it unlawful for any person in the offer or sale of any securities, by use of any means or instruments of commerce, to "employ any device, scheme, or artifice to defraud," or "to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." 15 U.S.C. § 77q(a) (1994). Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder contain a similar prohibition against such practices in connection with the purchase or sale of a security. See 15 U.S.C. § 78j(b) (1994) (covering fraud in sale of securities); 17 C.F.R. § 240.10b-5 (2001) (covering both offers and sales of securities). The substantive difference between the acts is that the Securities Act covers fraud in the sale of securities, while the Exchange Act covers both offers and sales of securities. In addition, the Supreme Court has held that scienter must be proven under Rule 10b-5. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). However, with respect to certain actions under § 17(a), the SEC need only prove negligence. *Aaron v. SEC*, 446 U.S. 680, 701 (1980).

fall within the definition of a "security" as defined by such laws and hence are covered by these prohibitions.<sup>148</sup> Affinity scams may also violate the provision of the Securities Act requiring that a security be properly registered prior to its offer or sale to the public.<sup>149</sup> In addition to these violations, affinity fraud may also violate federal wire and mail fraud statutes prohibiting anyone from engaging in a fraudulent scheme through the use of wire communications or the mails.<sup>150</sup> Additionally, the activities of some of the promoters of these schemes may violate the Investment Company Act of 1940, as amended ("Investment Company Act"), and the Investment Advisers Act of 1940, as amended ("Investment Advisers Act"), which prohibit certain fraudulent conduct related to investment companies and their advisors.<sup>151</sup> Finally, some affinity scams may violate the Racketeer Influenced and Corrupt Organizations Act (RICO).<sup>152</sup>

Each of these acts provides the SEC with a variety of civil remedies. The SEC can seek an injunction ordering a wrongdoer to refrain from present and future violations.<sup>153</sup> Coupled with this injunctive power is the equitable authority to seek disgorgement of any ill-gotten gains.<sup>154</sup> In 1990, the SEC was granted even broader

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<sup>148</sup> Federal securities laws define the term "security" broadly to cover a wide range of instruments. See Securities Act § 2(a)(1) (1933), 15 U.S.C. § 77b(a)(1) (2000) (including in definition not only investment instruments commonly known as securities, such as stocks and bonds, but also including unique instruments such as interests in pyramid or Ponzi schemes). Such instruments are generally classified as "investment contracts." The Supreme Court has interpreted the term investment contract to apply to any scheme that involves an investment of money in a common enterprise with profits to come from the efforts of others. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946). Such a definition would include the Ponzi and pyramid programs described herein and hence such conduct may be regulated as a security under the various securities laws.

<sup>149</sup> The Securities Act makes it unlawful for any person to use the mail or any means of interstate commerce to offer for sale a security that is not properly registered under the Securities Act. 15 U.S.C. § 77e(a)(1) (1994).

<sup>150</sup> 18 U.S.C. §§ 1341, 1343 (1994).

<sup>151</sup> See 15 U.S.C. § 80a-7(a) (1994) (codifying relevant sections of Investment Company Act of 1940); 15 U.S.C. §§ 80b-6(1)-(2) (1994) (codifying relevant sections of Investment Adviser Act of 1940).

<sup>152</sup> 18 U.S.C. §§ 1961-1968 (1994 & Supp. V 1999).

<sup>153</sup> Securities Act of 1933 § 20(b), 15 U.S.C. § 77t(b) (1994); Securities Exchange Act of 1934 § 21(d), 15 U.S.C. § 78u(d) (1994 & Supp. V 1999); Investment Company Act, § 9(f), 15 U.S.C. § 80a-9(f) (1994); Investment Advisers Act, § 203(k), 15 U.S.C. § 80b-3(k) (1994).

<sup>154</sup> Alan R. Palmiter, *SECURITIES REGULATION* 367 (1998) ("Disgorgement of defendants' ill-gotten gains to the U.S. Treasury is a frequent, and lucrative, remedy in SEC injunction actions.") (citations omitted).

authority to impose civil remedies pursuant to the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 ("1990 Act").<sup>155</sup> This Act allows the SEC to order disgorgement in an administrative proceeding.<sup>156</sup> The 1990 Act also enables the SEC to issue cease-and-desist orders upon anyone who violates or is about to violate one of the federal securities laws.<sup>157</sup> These orders are similar to an injunction but can be issued by an administrative law judge in an administrative proceeding instead of by a court.<sup>158</sup> Moreover, the 1990 Act allows the SEC to impose monetary penalties on persons who violate the federal securities laws.<sup>159</sup> The penalties vary depending on whether there is fraud or deceit and whether there is substantial loss to other persons.<sup>160</sup>

Violations of the federal securities laws also may trigger criminal liability. Each of the securities acts includes a provision making it a criminal offense to willfully violate any of their provisions.<sup>161</sup> Additionally, violations of the mail and wire fraud statutes, as well as violations of RICO, carry criminal sanctions.<sup>162</sup> Criminal violations of these statutes are prosecuted by the Department of Justice at the federal level<sup>163</sup> and allow for monetary penalties, imprisonment or both.<sup>164</sup> RICO allows the imposition of treble

<sup>155</sup> Pub. L. No. 101-429, 104 Stat. 931 (codified in scattered sections of 15 U.S.C. (1994)).

<sup>156</sup> Securities Exchange Act of 1934 § 21C(e), 15 U.S.C. § 78u-3(e) (1994); Securities Act of 1933 § 8A(e), 15 U.S.C. § 77h-1(e) (1994); Investment Company Act § 9(e), 15 U.S.C. § 80a-9(e) (1994); Investment Advisers Act § 203(j), 15 U.S.C. § 80b-3(j) (1994).

<sup>157</sup> Securities Act of 1933 § 8A, 15 U.S.C. § 77h-1 (1994); Securities Exchange Act of 1934 § 21C, 15 U.S.C. § 78u-3 (1994); 15 U.S.C. § 80a-9(f) (1994); Investment Advisers Act § 203(k), 15 U.S.C. § 80b-3(k) (1994).

<sup>158</sup> Securities Act of 1933 § 8A, 15 U.S.C. § 77h-1 (1994); Securities Exchange Act of 1934 § 21C, 15 U.S.C. § 78u-3 (1994); Investment Company Act § 9(f), 15 U.S.C. § 80a-9(f) (1994); Investment Advisers Act § 203(k), 15 U.S.C. § 80b-3(k) (1994).

<sup>159</sup> Securities Act of 1933 § 20(d), 15 U.S.C. § 77t(d) (1994); Securities Exchange Act of 1934 § 21(d)(3), 15 U.S.C. 78u(d)(3) (1994); Investment Company Act § 9(d), 15 U.S.C. § 80a-9(d); Investment Advisers Act § 203(l), 15 U.S.C. § 80b-3(l) (1994 & Supp. V 1999).

<sup>160</sup> Securities Act of 1933 § 20(d), 15 U.S.C. § 77t(d) (1994); Securities Exchange Act of 1934 § 21(d)(3), 15 U.S.C. 78u(d)(3) (1994); Investment Company Act § 9(d), 15 U.S.C. § 80a-9(d); Investment Advisers Act § 203(l), 15 U.S.C. § 80b-3(l) (1994 & Supp. V 1999).

<sup>161</sup> Securities Act of 1933 § 24, 15 U.S.C. § 77x (1994); Securities Exchange Act of 1934 § 32(a), 15 U.S.C. § 78ff(a) (1994).

<sup>162</sup> See 18 U.S.C. § 1343 (1994) (Wire Fraud); 18 U.S.C. § 1963 (1994) (RICO).

<sup>163</sup> See 28 U.S.C. 515(a) (1994) (giving Justice Department authority to conduct criminal proceedings).

<sup>164</sup> See *supra* notes 161-62 and accompanying text.



damages for certain violations.<sup>165</sup> In addition, the United States Sentencing Guidelines (the "Guidelines") enable judges to enhance the sentences of defendants under situations where their criminal conduct is considered to be more blameworthy.<sup>166</sup>

Securities officials also have the authority under these acts to pursue civil sanctions,<sup>167</sup> and securities officials have used their discretion to impose increased civil sanctions on those who commit affinity fraud. Reported cases reveal that the SEC has used each of the available civil remedies in its efforts to combat affinity fraud, from ordering disgorgement of profits to imposing civil monetary penalties.<sup>168</sup>

In the criminal context, some prosecutors and judges have enhanced the sentences of those who commit affinity investment crimes, but others have not.<sup>169</sup> Reported cases reveal that prose-

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<sup>165</sup> 18 U.S.C. § 1964(c) (1994). The Private Securities Litigation Reform Act of 1995 amended RICO to severely limit the extent to which law enforcement officials could rely on conduct that constituted securities fraud as a basis for a civil RICO violation. 18 U.S.C. § 1964 (1994 & Supp. V 1999). Indeed, a person must be convicted of a criminal violation in connection with securities fraud in order to initiate a civil RICO action based on such fraud.

<sup>166</sup> See *infra* notes 191-92 and accompanying text (highlighting, as example, section of Guidelines providing adjustment to sentence where crime is targeted at group). *Id.*

<sup>167</sup> See, e.g., Securities Exchange Act of 1934, 15 U.S.C. § 78o(b)(4)(D) (1994) (authorizing civil sanctions for willful violations).

<sup>168</sup> See, e.g., Taalib-Din Hasan, *supra* note 69 (settlement consenting to permanent injunction and final judgment ordering disgorgement); World Fin. and Inv. Co., *supra* note 51 (seeking permanent injunctions, disgorgement and civil penalties); First Zurich II, *supra* note 68 (final order for injunction and \$4 million disgorgement).

<sup>169</sup> See, e.g., United States v. Castellanos, 81 F.3d 108, 112 (9th Cir. 1996) (rejecting vulnerable victim enhancement applied to Hispanic man who convinced many Hispanics to participate in his fraudulent investment scheme by advertising extensively in Spanish-language media and promoting his company as "proudly Hispanic"). Cf. United States v. Omori, 107 F.3d 18, unpublished table decision, 1996 WL 726647, at \*\*4 (9th Cir. 1996) (upholding vulnerable victim enhancement for Japanese-American bank manager who conducted "variation of an affinity scam," by convincing more than twenty-four of her Japanese customers to invest over \$3.2 million in bogus certificates of deposit). The defendant pled guilty to violating several federal banking laws. *Id.* at \*\*1. She conducted her scheme for more than 15 years, earning over \$2.3 million. *Id.* See also United States v. Medrano, 241 F.3d 740, 741 (9th Cir. 2001) (upholding enhancements for Hispanic bank teller who embezzled money from Hispanic and Spanish-speaking customers). Both cases were based on Section 3A1.1 of the Guidelines which allows a judge to increase the punishment of a defendant by two levels if the defendant knew or should have known that a victim of the offense was unusually vulnerable due to age, or physical or mental condition, or was otherwise particularly susceptible to the defendant's criminal conduct. U.S. SENTENCING GUIDELINES MANUAL § 3A1.1 (2000). According to the *Omori* court, the difference between the two cases was English was not the native language of the victims in *Omori*, victims had

cutors have often sought to increase the criminal sanctions of those found guilty of affinity fraud.<sup>170</sup> In fact, there are some provisions of the Guidelines that appear to specifically provide for sanctioning the kind of behavior associated with affinity fraud. Significantly, the Guidelines allow adjustments for defendants who abuse a position of trust.<sup>171</sup> Some judges have been willing to apply this provision to affinity fraud while others have not.<sup>172</sup> This unwillingness on the part of some judges to enhance penalties for affinity fraud stems not only from the fact that some appellate judges have interpreted the Guidelines in a manner that prevents their application to affinity fraud, but also from the fact that the Guidelines as currently written do not appear to apply to many of the cases of affinity schemes. Indeed, the Guidelines, as written and interpreted, may limit the application of this provision to people who occupy or purport to occupy a formal position in an organization.<sup>173</sup> The text of the Guidelines states that adjustments apply to defendants who abuse a "position" of trust.<sup>174</sup> Courts interpret this to mean that those who do not occupy such a position are not covered by this provision.<sup>175</sup> Thus, this provision as interpreted is underinclusive, as it fails to account for the fact that many people

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infrequent contact with the bank, and customers did not understand banking laws. *Omori*, at \*\*2. The court reasoned this provision could apply only if it was proved that the victims need special protection because they lack education or knowledge of United States laws. *Id.* This Article does not focus on the vulnerable victim provision of the Guidelines because I believe that there are other provisions of the Guidelines that better capture the harms associated with affinity fraud.

<sup>170</sup> *United States v. Luca*, 183 F.3d 1018, 1024 (9th Cir. 1999); *United States v. Lilly*, 37 F.3d 1222, 1227 (7th Cir. 1994).

<sup>171</sup> U.S. SENTENCING GUIDELINES MANUAL § 3B1.3 (2000).

<sup>172</sup> *Compare Lilly*, 37 F.3d at 1227 (upholding upward adjustment for abuse of position of trust) *with Luca*, 183 F.3d at 1026-27 (refusing to uphold sentence enhancements for abuse of position because evidence did not support finding victims were susceptible to falling for scheme).

<sup>173</sup> *See* U.S. SENTENCING GUIDELINES MANUAL § 3B1.3 (abuse of trust provision applies to those who abuse "position" of trust; charitable impulse provision applies to those who misrepresent they hold position in connection with charitable organization).

<sup>174</sup> *Id.*

<sup>175</sup> *See, e.g., Lilly*, 37 F.3d at 227-28 (suggesting in order for enhancement to apply, defendant must hold some formal position with respect to such investors); *see also United States v. Iannone*, 184 F.3d 214, 223 (3rd Cir. 1999) (calling defendant's formal position within company most "critical").

other than those who hold positions of trust within an organization commit affinity crimes.<sup>176</sup>

The provision of the Guidelines that relates to abuses of charitable impulses is also written in a manner that prevents its application to affinity fraud. This provision requires an adjustment for those who misrepresent that they are acting on behalf of a charitable organization.<sup>177</sup> Affinity crimes do not typically involve such a misrepresentation, precluding the application of this provision. This may explain why no reported cases have referred to this charity-based provision of the Guidelines. However, Part IV will argue that while these provisions of the Guidelines, as written and interpreted, may not apply to many forms of affinity fraud, the rationale behind the Guidelines supports enhancing sentences of those who commit affinity scams.<sup>178</sup>

Increased sanctions should be employed both in order to deter affinity scams and to signal the increased culpability of affinity scare perpetrators. It should be noted that there is a debate between those who argue that increased penalties should serve to deter undesirable conduct and those who maintain that enhanced sanctions should be imposed on those who engage in more culpable conduct.<sup>179</sup> In fact, although the United States Sentencing Commission (the "Commission") purported not to choose between these theories of punishment, many commentators believe that the Guidelines' primary purpose is retribution as opposed to deterrence.<sup>180</sup> Regardless, this retributive motivation, if true, does not negate the fact that increased punishment can also deter

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<sup>176</sup> See *Beware of Swindlers*, *supra* note 6 (noting some swindlers con members of groups by deceiving prominent members first and then using those names in their sales pitch).

<sup>177</sup> U. S. SENTENCING GUIDELINES MANUAL § 2F1.1(b)(3)(A) (2000).

<sup>178</sup> See *infra* notes 183-322 and accompanying text.

<sup>179</sup> See, e.g., Steven P. Lab, *Potential Deterrent Effects of the Guidelines*, in THE U.S. SENTENCING GUIDELINES: IMPLICATIONS FOR CRIMINAL JUSTICE 32, 33 (Dean J. Champion ed., 1989) (noting divergent views); John Garry, Note, *Why Me? Application and Misapplication of 3A1.1, The Vulnerable Victim Enhancement of the Federal Sentencing Guidelines*, 79 CORNELL L. REV. 143, 150 (1993) (noting tension between those who advocate "just deserts" principle of criminal sanctioning and those who believe sanctions should serve as deterrent). See generally RICHARD G. SINGER, JUST DESERTS: SENTENCING BASED ON EQUALITY AND DESERT (1979) (discussing "just deserts" principle).

<sup>180</sup> Lab, *supra* note 179, at 33; Garry, *supra* note 179, at 149-50.

criminal behavior.<sup>181</sup> Punishment may have a dual purpose.<sup>182</sup> Therefore, enhancing sanctions for those who commit affinity fraud can serve both as a deterrent and as a method of signaling that those who commit affinity-based crimes are more culpable.

#### IV. "THAT'S WHAT FRIENDS ARE FOR?": TOWARD A JUSTIFICATION FOR INCREASED SANCTIONS FOR AFFINITY FRAUD

Many of the factors that contribute to the success of affinity fraud justify enhancing the penalties for those who commit such offenses. First, many forms of affinity fraud prey upon the victim's generosity.<sup>183</sup> Because our society values charitable impulses, we should impose harsher penalties on those who exploit these impulses. Second, many forms of affinity fraud involve relationships of high trust.<sup>184</sup> The law generally imposes greater responsibilities and more severe consequences on people who violate such relationships because participants in special trust relationships are less cautious and, therefore, more vulnerable and because these relationships enable their participants to commit crimes that are more difficult to detect and resolve.<sup>185</sup> Additionally, some relationships of trust serve important economic functions that deserve legal protection through heightened penalties for their violations.<sup>186</sup> Many of the relationships exploited by affinity fraud exhibit these qualities and thus justify increased sanctions. After briefly discussing why securities fraud that targets specific groups may deserve more serious attention, this Part will elaborate on these rationales.

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<sup>181</sup> See, e.g., UNITED STATES SENTENCING GUIDELINES MANUAL § 1A3 (2000) (suggesting enhancements will satisfy objectives of both theories); Steven Shavell, *Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent*, 85 COLUM. L. REV. 1232, 1244 (1985) (stating deterrence theory suggests punishment should increase as crime's harmful effect increases).

<sup>182</sup> See, e.g., RICHARD A POSNER, *ECONOMIC ANALYSIS OF LAW* § 7.2, at 225 (4th ed. 1992) (arguing severity of punishment should reflect criminal's responsiveness to punishment and social cost of punishment).

<sup>183</sup> See *Remarks*, *supra* note 11 (noting victims often are seeking "to 'give back' to the community from which they came").

<sup>184</sup> *Beware of Swindlers*, *supra* note 6.

<sup>185</sup> *Affinity Fraud*, *supra* note 12.

<sup>186</sup> Such relationships arguably serve important social and religious functions as well.

## A. FRAUD AIMED AT GROUP

The fact that affinity fraud may impact such a large number of people justifies the imposition increased sanctions on perpetrators of these schemes. In the Tampa scheme, more than seventeen thousand people fell victim to an affinity fraud, which preyed upon their religious affiliation.<sup>187</sup> Although some note that this case is an extreme example of affinity fraud,<sup>188</sup> other affinity fraud schemes also reach a large number of people. More than a thousand investors lost money in the Texas scheme, and approximately two thousand investors were affected by the First Zurich scheme.<sup>189</sup> Perpetrators have a ready-made, large group of victims within the targeted demographics and the cohesiveness within the group provides perpetrators with easy and rapid access to their targeted community.

Securities regulators pay particular attention to affinity fraud precisely because it can have such a wide impact.<sup>190</sup> The Guidelines also provide for an adjustment for crimes that are aimed at groups of people.<sup>191</sup> According to the Commentary to the Guidelines (“Commentary”), this adjustment reflects the belief that criminals who target many victims intend do considerable harm and hence are more blameworthy.<sup>192</sup>

Of course many forms of securities fraud, particularly those involving pyramid schemes, arguably target and impact a great number of victims. Thus, this fact alone may not distinguish this affinity fraud from other forms of securities fraud. Nonetheless, it should serve as another basis for augmenting the sentences of those who conduct these scams. For this reason, judges should utilize this

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<sup>187</sup> Mattern, *supra* note 20.

<sup>188</sup> *Id.*

<sup>189</sup> *Affinity Fraud, supra* note 12; *First Zurich II, supra* note 68.

<sup>190</sup> *See, e.g., Virasami, supra* note 22 (quoting regulator Eric R. Dinnallo). According to Dinnallo, the chief of New York’s Bureau of Investor Protection and Securities (an office which logs complaints from fraud victims) emphasized that “[w]e take [affinity scams] pretty seriously because they obviously impact a lot of people.” *Id.*

<sup>191</sup> *See U.S. SENTENCING GUIDELINES MANUAL* § 2F1.1(b)(2) (2000) (providing adjustment for scheme that defrauds more than one victim).

<sup>192</sup> *See id.*, cmt. background (giving policy justification for sentencing adjustment).

provision when determining the sentences of perpetrators of affinity fraud.

It should be noted that, by arguing that defendants found guilty of affinity fraud should qualify for adjustments based on these criteria, this Article does not mean to assert that a defendant can be held liable for conduct that impacts a large number of people without proof that such defendant intended to target such a group. Indeed, one may object to increasing sanctions for affinity fraud if it criminalized behavior merely because such behavior impacted a particular group. In fact, as noted above, in order to be criminally liable under the federal securities laws, it must be proven that the defendant acted willfully.<sup>193</sup> Therefore, it is not enough to show that the defendant's act had an undesirable, or even heinous, outcome.

Courts have maintained that this intent requirement also must be present for application of the Guidelines.<sup>194</sup> For example, the Seventh Circuit stated, "In a fraud case where the defendant issues an appeal to a broad group, the court should focus on whom the defendant targets, not on whom his solicitation happens to defraud."<sup>195</sup> In the context of affinity fraud, there is ample evidence to suggest that these crimes not only impact a large number of people, but that the defendant intends such an impact.<sup>196</sup> Courts have recognized that evidence of such intent can be found in the manner in which the victims are solicited.<sup>197</sup> Thus, when a defendant sent solicitation materials to members of an identifiable group and "used terms designed specifically to entice such individuals to respond," the Ninth Circuit found that the defendant had intentionally targeted a group of victims sufficient to justify application of the Guidelines.<sup>198</sup> When engineers of an affinity scam send promotional

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<sup>193</sup> 15 U.S.C. § 77x (1994); 15 U.S.C. § 78ff(a) (1994). These provisions have been interpreted to mean that it must be proved that a defendant voluntarily undertakes an illegal action. See, e.g., Paul Marcus, *The Use of Criminal Statutes to Regulate Financial Markets in the United States*, 46 AM. J. COMP. L. 589, 599-600 (Supp. 1998) (noting intent is required for criminal sanctions under Securities Act of 1933 and Securities Exchange Act of 1934).

<sup>194</sup> See, e.g., *United States v. Sutherland*, 955 F.2d 25, 26 (7th Cir. 1992) (focusing on defendant's intentional act).

<sup>195</sup> *Id.*

<sup>196</sup> *Beware of Swindlers*, *supra* note 6.

<sup>197</sup> *United States v. Peters*, 962 F.2d 1410, 1417-18 (9th Cir. 1992).

<sup>198</sup> *Id.* at 1418.

materials to members of specific groups and hold sessions addressing specific segments of the population, their actions can be seen as targeted. The evidence of their intentional targeting appears even stronger when these engineers entice members of a community by stressing a shared religious affiliation, heritage, or culture. Such targeting should be sufficient to prove intent for purposes of augmenting their criminal sentences.

#### B. CHARITABLE MISGIVINGS

The fact that affinity fraud often preys on the charitable impulses of investors should serve as a basis for augmenting criminal sentences as well. The exploitation of charitable motives is an integral component of securities fraud that targets religious groups. For example, the seven officials who operated the Tampa scheme relied on the biblical quote “[G]ive, and it shall be given unto you” to defraud thousands of Christian fundamentalists.<sup>199</sup> Their promotional materials appealed strongly to church members’ faith, calling the scheme a “tremendous opportunity to be found faithful” and a chance to “do good while doing good.”<sup>200</sup> In the Oracle Trust scheme, the SEC alleged that the defrauders proclaimed their status as born-again Christians and suggested that investment would fulfill a religious duty.<sup>201</sup>

In some schemes, perpetrators claim that parishioners’ investments will be used to underwrite missionary and charity work. For example, in *United States v. Luca*,<sup>202</sup> a defendant was convicted of securities fraud after claiming that his investment plan would enable church members to raise money for their church while providing them with a reliable investment.<sup>203</sup> In another case, a pastor of a church was found guilty of securities fraud when he sold certificates of deposit to members of his church by representing that

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<sup>199</sup> See, Mattern, *supra* note 20 (“[I]nvestors were assured that their money would be used to do ‘God’s work.’”); see also *Blind Faith*, *supra* note 120 (noting investors were told tax laws did not apply to these investments).

<sup>200</sup> Smith, *supra* note 138.

<sup>201</sup> Oracle Trust Fund, *supra* note 2.

<sup>202</sup> 183 F.3d 1018 (9th Cir. 1999).

<sup>203</sup> *Id.* at 1027.

proceeds from the certificates would be used to finance church improvements.<sup>204</sup> These appeals to charity have a special allure for members of religious groups because such members often view charitable giving as a duty associated with group membership. Indeed, people are encouraged to invest in order to prove their faith. Many victims of such schemes reported that this technique convinced them to participate, while other victims suggested that they felt compelled to invest.<sup>205</sup> In this way, affinity fraud that targets a religious audience severely violates charitable impulses and is worthy of substantial punishment.

Perpetrators of affinity scams that target racial groups also suggest that investment will serve a charitable purpose. As noted in Part I above, some of these scams target racial groups through their churches.<sup>206</sup> Affinity scams that target racial groups by using religious affiliations include appeals to charity that have both racial and religious dimensions.<sup>207</sup> When these schemes incorporate a charitable message, they prey on two kinds of charitable impulses and hence are even more destructively appealing to group members. As in religious-based affinity scams, these fraudulent investment practices prey on the religious duty people feel to contribute money to their church and surrounding community.<sup>208</sup> Additionally, many members of a particular racial or ethnic community are encouraged to give back to their group in order to improve the community's economic plight.<sup>209</sup> Securities regulators have found that affinity fraud holds a special appeal for group members who desire to assist their group, noting that "[s]ome members of other long-established minority groups have accumulated savings and achieved a certain standard of living through years of hard work. Often, they want to 'give back' to the community in order to help others like themselves."<sup>210</sup>

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<sup>204</sup> *United States v. Lilly*, 37 F.3d 1222, 1225 (7th Cir. 1994).

<sup>205</sup> See *Mattern*, *supra* note 20 (noting church members tended to embrace these kinds of schemes).

<sup>206</sup> See *supra* notes 77-79 and accompanying text (noting effectiveness of targeting racial groups through church organizations).

<sup>207</sup> See *Affinity Fraud*, *supra* note 12 (explaining various types of affinity scams).

<sup>208</sup> *Beware of Swindlers*, *supra* note 6.

<sup>209</sup> *Id.*

<sup>210</sup> *Id.*



Additionally, there has been an effort within the African-American community to encourage members of the community to support each other economically by contributing to African-American charities and supporting African-American businesses.<sup>211</sup> These efforts may unintentionally induce more African Americans to participate in schemes that promise to assist their community. Thus, perpetrators of affinity fraud prey on laudable elements of these targeted communities—their religious duty to be charitable and their desire to enhance the economic well-being of their community.<sup>212</sup>

The charitable appeal may be less compelling in the context of fraud that targets a racial group without appeal to religious duty. However, by emphasizing that part of their investment will be used to improve the community, architects of these schemes are often able to attract investors with a purely secular appeal to community spirit.<sup>213</sup>

The fact that these affinity scams prey on people's charitable impulses justifies penalizing them more severely. While many victims undeniably participated for the opportunity to make large sums of money,<sup>214</sup> the fact that investors also were convinced to participate for more altruistic reasons makes these crimes more egregious than fraud that relies solely on participants' greed. Our culture values people's willingness to make charitable donations, a kind of generosity that is important to the prosperity of society in general. Our tax laws recognize the importance of charitable giving through its exemptions for charitable organizations and deductions for charitable donations<sup>215</sup> that foster important societal concepts of voluntarism and pluralism.<sup>216</sup> Furthermore, charitable organiza-

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<sup>211</sup> See Dugan, *supra* note 4 (quoting Patricia Turner, professor of African-American Studies at the University of California at Davis).

<sup>212</sup> See *Beware of Swindlers*, *supra* note 6 (noting swindlers use ethnicity and religious belief to take advantage of victims).

<sup>213</sup> See Dugan, *supra* note 4 (discussing effects of "affinity scams" on racial and ethnic groups).

<sup>214</sup> See *id.* (noting victims tend to believe they will "get rich quick").

<sup>215</sup> For example, § 501(a) of the Internal Revenue Code provides that certain charitable organizations shall be exempt from taxation. I.R.C. § 501(a) (1986). There is also a deduction allowed for payments made to charitable organizations. I.R.C. § 170(a)(1) (1986).

<sup>216</sup> See Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 628-29 (1990) (discussing theories of tax exemption for altruistic nonprofit organizations).

tions instill communitarian values that are important to the social, political, and economic growth of our society.<sup>217</sup> Several scholars have recognized that it would be difficult for a democratic society to prosper without fostering a sense of altruism in its citizens.<sup>218</sup> Indeed, participating in charitable endeavors develops important social skills that increase one's sense of community and political efficacy.<sup>219</sup> Contributions to charity further imply a person's willingness to participate in collective endeavors. Given that government and individuals have scarce resources and cannot provide all of the needed services, this participation is critical to the prosperity of any community. Exploiting someone's desire to participate may have damaging consequences.

Additionally, many social, religious and civic organizations rely on charity for their existence; hence, conduct that preys on charitable giving may threaten the survival of such groups and the services they provide. Some scholars have pointed out that these kinds of organizations play an important role in our society by providing valuable services for which the government may have otherwise been responsible.<sup>220</sup> Thus, in addition to supporting charitable donations, federal tax laws recognize the value of the services provided by these organizations through its system of exemptions.<sup>221</sup>

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<sup>217</sup> See BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 6 (5th ed. 1987) (stating society benefits from voluntarism fostered by charities); Dean Pappas, Note, *The Independent Sector and the Tax Laws: Defining Charity in an Ideal Democracy*, 64 S. CAL. L. REV. 461, 462 (1991) (noting giving to charity serves pluralistic concerns that distinguish our democratic society).

<sup>218</sup> HOPKINS, *supra* note 217, at 6; Pappas, *supra* note 217, at 462.

<sup>219</sup> Pappas, *supra* note 217, at 470-71.

<sup>220</sup> Several scholars assert that donative organizations facilitate the production of public goods. See, e.g., JAMES DOUGLAS, *WHY CHARITY? THE CASE FOR A THIRD SECTOR* 129-30, 145 (1983) (noting most important effect of charities may be broader range and diversity of public goods); Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 FLA. L. REV. 419, 430 (1998) (explaining subsidy theory of tax exemptions as based upon notion "charitable organizations relieve the government of burdens by providing essential goods and services that the government otherwise would be responsible for delivering"); Gergen, *supra* note 34, at 1397-98 (stating "charities provide public goods which we wish to have provided without charge to their beneficiaries"); Hansmann, *supra* note 34, at 848 (discussing nonprofit organizations as price-market producers of public goods); William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 314 (1972).

<sup>221</sup> See Crimm, *supra* note 220, at 425 (espousing tax exemptions as means to compensate charities "for undertaking the provision of 'inherently risky' public goods and services"); see

Thus, actions that exploit benevolence put added pressure on the government by jeopardizing the well-being of charitable organizations, potentially reducing the availability of the beneficial services they provide. In light of this, religious-based affinity fraud may be particularly troublesome because the organizations connected to such scams rely on charity in order to exist and continue their operations. By diverting funds, exploiting donative impulses in this context may serve to cripple these organizations, or at the very least, make it more difficult for them to operate. This impact may be felt not only by the individual members who were defrauded, but also by those in the larger community who may be more hesitant to contribute to such institutions.

Because altruistic impulses are important to society in general, and many charitable and religious organizations in particular, affinity fraud that preys upon these motives deserves to receive more severe punishment. Although the provision of the Guidelines related to charity only applies to those who occupy or pretend to occupy a position within a charitable organization,<sup>222</sup> the Commentary to this provision provides a compelling justification for imposing additional punishment on anyone who takes advantage of a person's generosity.<sup>223</sup> According to the Commentary, "[t]aking advantage of a victim's self-interest does not mitigate the seriousness of fraudulent conduct. However, defendants who exploit victims' charitable impulses . . . create particular social harm."<sup>224</sup> Mirroring this reasoning, the Tenth Circuit has argued that conduct intended to fall within the scope of the Guidelines included actions which "induce victims to act upon their charitable or trusting impulses."<sup>225</sup> Those who commit affinity fraud without holding a formal office take advantage of such impulses in the same manner as those who occupy a formal position. Thus, all of these perpetrators should be subjected to heightened punishment.

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also H.R. REP. NO. 75-1860, at 19 (1938) (indicating exemption for charitable organizations is based upon theory government should compensate these organizations for providing services for which it would otherwise have to allocate financial resources).

<sup>222</sup> U.S. SENTENCING GUIDELINES MANUAL § 2F1.1(b)(4)(A) (2000).

<sup>223</sup> *Id.* § 2F1.1, cmt. background.

<sup>224</sup> *Id.*

<sup>225</sup> *United States v. Frazier*, 53 F.3d 1105, 1113 (10th Cir. 1995).

With this in mind, judges either should adopt a more expansive view of the charitable provision of the Guidelines or the Commission should modify such provision to allow judges to take into account defendants who abuse charitable impulses of their victims, regardless of the defendant's status within an organization. Such a change would enable this provision to be applied to those affinity scams that exploit a victim's generosity.

### C. EXPLOITING RELATIONSHIPS OF HIGH TRUST

In addition to preying on the generosity of its victims, affinity fraud may deserve to receive heightened sanctions because it abuses the trust shared among the targeted group members. Fiduciary law imposes higher obligations on those who participate in relationships characterized by a high degree of trust,<sup>226</sup> and has historically imposed increased penalties for those who exploit such relationships.<sup>227</sup> For example, a corporate director who violates his responsibility to the corporation by engaging in insider trading may be subject to severe penalties that are not imposed on someone who is not involved in a similar relationship of trust.<sup>228</sup> Similarly, the Guidelines allow for a two-level adjustment when a defendant

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<sup>226</sup> In the classic words of Judge Cardozo, "[a] trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior." *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928).

<sup>227</sup> See, e.g., Eillen A. Scallen, *Promises Broken vs. Promises Betrayed: Metaphor, Analogy, and The New Fiduciary Principle*, 1993 U. ILL. L. REV. 897, 911-12 ("The damages for breach of fiduciary duty encompass a far greater range of remedies than are traditionally available for breach of contract."). These increased damages are illustrated by the fact that we tend to punish breaches of fiduciary duty through the use of punitive damages. See, e.g., *id.* at 912 n.62 (noting punitive damages available where breach of fiduciary duty is malicious or wanton). For example, although there is a general rule against punitive damages for breach of contract, a breach of a fiduciary duty will give rise to punitive damages. See RESTATEMENT (SECOND) OF CONTRACTS § 355 (1981) (stating punitive damages only available where breach of contract is tortious). The exceptions to the general prohibition against punitive damages are reserved for relationships characterized by a high degree of dependence and trust. See William S. Dodge, *The Case for Punitive Damages in Contracts*, 48 DUKE L.J. 629, 636 (1999) (citing examples).

<sup>228</sup> See, e.g., STEPHEN M. BAINBRIDGE, *SECURITIES LAW: INSIDER TRADING* 120 (1999) ("Woe unto those who violate the insider trading prohibition, for the penalties are many, cumulative, and severe.").

abuses a position of public or private trust.<sup>229</sup> As explained below, the rationale behind this provision appears to support its application to affinity fraud even if current judicial interpretation may not.

Exploiting a relationship of trust deserves increased sanctions both because such conduct is more blameworthy and because crimes that violate trust relationships are easier to commit and hence, need additional deterrence. Abusing a relationship of trust damages the social fabric of our society. Although the abuse of trust provision of the Guidelines has not been interpreted to apply to many cases of affinity fraud, judges agree that the provision reflects this concern.

By viewing as especially culpable persons who “abuse” their positions of trust, the guideline also recognizes the time-honored legal concept that theft by deceit is to be dealt with more harshly than simple theft. Whereas ordinary theft is by and large an impersonal act, theft by deceit, like its cousin fraud, is entirely personal.<sup>230</sup>

Additionally, breaches of high-trust relationships deserve increased penalties because such relationships provide an ample opportunity for abuse. Indeed, the more people within a particular relationship trust one another, the easier it is to exploit that trust. Strict penalties may serve to deter any tendency to exploit. As one scholar notes, the ability to abuse these relationships as well as the “difficulty with discovering abuses highlights the need for more stringent standards of liability to discourage those who might be tempted to abuse their great power.”<sup>231</sup>

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<sup>229</sup> U.S. SENTENCING GUIDELINES MANUAL § 3B1.3 (2000).

<sup>230</sup> *United States v. Ragland*, 72 F.3d 500, 503 (6th Cir. 1996). Other judges have mirrored this sentiment. “In creating the Guidelines, the Sentencing Commission no doubt perceived that a person who violates a trust may well do serious damage to the ties that bind us together in this complex society and may, therefore, be more reprehensible than, say a pickpocket or a sneak thief.” *United States v. Isaacson*, 155 F.3d 1083, 1087 (9th Cir. 1998) (Fernandez, J., dissenting). Judge Fernandez went on to remark that “people who violate a trust placed in them often do more damage to the social fabric and are more culpable than those who steal outright.” *Id.* at 1089-90.

<sup>231</sup> Gregory S. Alexander, *A Cognitive Theory of Fiduciary Relationships*, 85 CORNELL L. REV. 767, 777-78 (2000).

Of course, not all relationships that involve trust warrant increased sanctions. Instead, a distinction must be made between those relationships that confer a higher degree of trust meriting increased protection and those that do not. The law of fiduciary obligations provides some guidance for distinguishing a relationship of high-trust from other relationships. Fiduciary law traditionally has recognized two categories of high-trust relationships: a traditional or conventional fiduciary relationship<sup>232</sup> and a relationship of confidence or special trust.<sup>233</sup> The first category includes specifically identified relationships such as those between a trustee and beneficiary, co-partners of a general partnership and corporate directors and their shareholders.<sup>234</sup> The mere status of the parties in these relationships serves as proof that such relationships involve a significant amount of trust, and courts automatically apply enhanced sanctions to participants who exploit these relationships.<sup>235</sup> Relationships in the second category arise when a court determines that a given relationship shares the characteristics of a conventional fiduciary relationship, thereby qualifying for additional protection and sanctions.<sup>236</sup> Once a court makes such a determination, it treats these special trust relationships like fiduciary relationships.<sup>237</sup> Unfortunately, scholars do not agree precisely on the qualities that make conventional fiduciary relationships worthy

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<sup>232</sup> GEORGE G. BOGERT & GEORGE T. BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 482 (2d rev. ed. 1978) (noting formal fiduciary relations are those between trustee and beneficiary, executor or administrator and creditors, guardian and ward, principal and agent, attorney and client and corporate director and corporation). *See also* Scallen, *supra* note 227, at 905 n.22 (including bailor to bailee); Frankel, *supra* note 35, at 795-96 (including union leaders to workers and physicians to patients).

<sup>233</sup> Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 879.

<sup>234</sup> BOGERT & BOGERT, *supra* note 232, § 482.

<sup>235</sup> *See, e.g.*, 1 AUSTIN W. SCOTT & WILLIAM F. FRATCHER, *SCOTT ON TRUSTS* § 2.5 (4th ed. 1987) (noting conventional fiduciary relationships and obligations related to them arise as matter of law).

<sup>236</sup> *See, e.g.*, DeMott, *supra* note 233, at 879 ("Judicial opinions in this well-established tradition first identify paradigm cases in which fiduciary obligation applies and then examine whether the relationship involved in the litigation is sufficiently like those in the paradigm cases to support an extension of the obligation to that relationship.")

<sup>237</sup> *See, e.g.*, *Barrett v. Bank of America*, 229 Cal. Rptr. 16, 20-21 (Cal. Ct. App. 1986) (noting once "special relationship" established between bank and borrower, borrower allowed to proceed under constructive fraud theory).

of protection and more severe penalties and hence, it is difficult to determine when special trust relationships arise.<sup>238</sup>

However, scholars have advanced several different theories to explain the particular qualities that differentiate these relationships from others that do not merit protection. Some have asserted that a special trust relationship is one in which a party voluntarily undertakes to act in the best interests of another.<sup>239</sup> Others maintain that a special trust relationship can be characterized by the fact that one person exercises a high degree of discretion on which another person relies.<sup>240</sup> Consistent with this theory, some courts have interpreted the Guidelines to require the imposition of significant discretion in order to apply the abuse of trust provisions.<sup>241</sup> A version of this reliance theory has been used by scholars outside of fiduciary law, who note that certain homogenous groups exhibit a high level of reliance that distinguishes their associations from other voluntary associations.<sup>242</sup> As a third theory, some federal circuit judges have interpreted the Guidelines to define a special trust relationship as one in which one party is able to commit a crime without fear of detection.<sup>243</sup> This section will examine each of these positions in order to assess the extent to

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<sup>238</sup> In fact, most scholars agree that determining what constitutes a fiduciary relationship is very difficult. See, e.g., Lisa J. McIntyre, *A Sociological Perspective on Bankruptcy*, 65 IND. L.J. 123, 134 (1989) ("While there is widespread agreement that 'trust' is important in society, there is at the same time a lack of agreement on what exactly constitutes trust."); DeMott, *supra* note 233, at 879 (noting "[f]iduciary obligation is one of the most elusive concepts in Anglo-American law").

<sup>239</sup> See *infra* notes 244-46 and accompanying text.

<sup>240</sup> See Scallen, *supra* note 227, at 917-18 (noting one frequent expression of nature of fiduciary relationship emphasizes reliance of one party over another while another theory focuses on party's ability to exercise discretion over other).

<sup>241</sup> It should be noted that federal courts do not agree on the qualities that define a relationship of trust meriting enhancement under the Guidelines. Compare, *United States v. Hill*, 915 F.2d 502, 506 (9th Cir. 1990) (explaining hallmark of abuse of trust enhancement "is the extent to which the position provides the freedom to commit a difficult-to-detect wrong"), with *United States v. Lilly*, 37 F.3d 1222, 1227 (7th Cir. 1994) (defining position of trust as characterized by defendant's "access or authority over valuable things") (internal citations omitted), and *United States v. Tribble*, 206 F.3d 634, 637 (6th Cir. 2000) (finding "level of discretion accorded an employee" defines trust position), and *United States v. Jolly*, 102 F.3d 46, 48 (2d Cir. 1996) (holding abuse of trust enhancement applies only where defendant has abused discretionary authority entrusted to defendant by victim).

<sup>242</sup> See *infra* notes 279-85 and accompanying text.

<sup>243</sup> See *infra* notes 288-94 and accompanying text.

which the relationships violated in the context of affinity fraud can be described as involving high trust meriting increased protection and sanctions.

1. *Voluntary Undertaking of a Duty.* In the context of fiduciary law, some scholars have adopted Professor Austin Scott's theory that a fiduciary relationship arises when one person voluntarily undertakes to act in the best interests of another.<sup>244</sup> According to this theory, the imposition of a fiduciary obligation is justified because a person who voluntarily accepts her role should be held accountable for violation of the responsibilities inherent in that role.<sup>245</sup> Therefore, by accepting the office of trustee, director or partner, traditional fiduciaries voluntarily agree to manage the affairs of a particular person or entity consistent with his or its best interests. Outside of the traditional fiduciary context, this theory has been used to characterize the relationship between an investment adviser and her clients as one of special trust because such advisers are engaged based on the understanding that they will manage any money entrusted to them in the best interests of their clients.<sup>246</sup> Acceptance of these various roles implies acceptance of their inherent special obligations and consequently justifies the imposition of heightened penalties for any breach of duty. Such an imposition is justified further because people voluntarily accept these roles and their consequences.

This theory applies to affinity fraud because perpetrators voluntarily undertake to act on behalf of the investors whom they eventually defraud. Indeed, those who commit these schemes freely

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<sup>244</sup> See Austin W. Scott, *The Fiduciary Principle*, 37 CAL. L. REV. 539, 540 (1949) ("Who is a fiduciary? A fiduciary is a person who undertakes to act in the interest of another person. It is immaterial whether the undertaking is in the form of a contract. It is immaterial that the undertaking is gratuitous.").

<sup>245</sup> According to one author, "[a] party should be bound by fiduciary ties to another only if the party has voluntarily assumed the fiduciary role. Fiduciary power cannot be imposed on a party against its will, or without its knowledge." Niels B. Schaumann, *The Lender as Unconventional Fiduciary*, 23 SETON HALL L. REV. 21, 56 (1992).

<sup>246</sup> Courts have noted that a financial advisor serves in a position of trust. See, e.g., *United States v. Gottlieb*, 4 F.3d 987, unpublished table decision, 1993 WL 341086, at \*2 (4th Cir. Sept. 8, 1993) (stating one charged with management of another's money "certainly occupies a position of trust"). One court indicated that a financial advisor "virtually by definition" occupies a position of private trust. *United States v. Tardiff*, 969 F.2d 1283, 1289 (1st Cir. 1992).



enter into a relationship with their investors and convince such investors that they will make investment decisions in a manner that will be beneficial to all participants. In this way, many of the relationships are similar to the special trust relationships between an investment adviser and her client, and hence, breaches of that trust warrant the same consequences. In fact, increased sanctions can be further justified because these perpetrators had the option of choosing *not* to undertake their role. Thus, Scott's theory is clearly applicable to the relationships established in affinity fraud schemes.

Unfortunately, although this theory holds some appeal, it seems both overinclusive in some respects and underinclusive in others. Scott's formulation can be criticized in that it fails to account for traditional fiduciary relationships that arise without any express agreement between the parties. Most notably, a general partnership, which falls into the category of a conventional fiduciary relationship, can arise without an express agreement and can arise whether or not the parties intended to form such a partnership.<sup>247</sup> Thus, the law imposes very stringent fiduciary obligations and harsh penalties on some parties even when they do not voluntarily undertake to participate in a specific relationship.<sup>248</sup> This also means that parties are held accountable even when they do not appreciate the scope of their responsibilities, a fact which undermines the strength of Scott's theory because a fiduciary obligation arises even without a completely "voluntary" undertaking.<sup>249</sup> Moreover, in the context of securities fraud, this formulation seems to encompass every relationship abused by fraudulent activity because, at a basic level, the perpetrators of all forms of fraud "voluntarily" undertake (or at least purport to undertake) to act on

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<sup>247</sup> For example, under the Uniform Partnership Act, a general partnership is created when two or more people associate as co-owners in a business for profit. It does not require the filing of formal documentation. UNIF. PARTNERSHIP ACT § 202 (1994), 6 U.L.A. 27 (1995).

<sup>248</sup> See, e.g., *Kaufman-Brown Potato Co. v. Long*, 182 F.2d 594, 600 (9th Cir. 1950) (determining parties were partners despite written agreement negating intent to form partnership).

<sup>249</sup> See, e.g., Scallen, *supra* note 227, at 906 n.29 (noting many courts "dodge" question of voluntariness as applied to some relationships in which fiduciary obligation has been imposed from outside such as those between majority shareholder and other owners of corporation); DeMott, *supra* note 233, at 910-11 (noting Scott's theory fits "awkwardly, at best" to some relationships such as between controlling and minority shareholders, while it is difficult to apply to others such as partnerships).

behalf of those they eventually defraud. Hence, all perpetrators of fraud would qualify as fiduciaries under Scott's theory. Because of this flaw, while the notion of voluntary assumption may be a necessary factor for imposing a fiduciary duty on certain participants in a relationship, it cannot be dispositive in the determination of whether a special trust relationship exists.

2. *Reliance and Discretion.* Some scholars maintain that fiduciary relationships are characterized by a high degree of discretion and reliance on the part of the participants and that these qualities justify increased protection and heightened punishments. Indeed, the Guidelines note that a high-trust relationship can be characterized as one in which a person has substantial discretionary judgment that is ordinarily given considerable deference.<sup>250</sup> This discretion creates a power imbalance such that one party is in a position of domination while the other maintains a passive, more vulnerable role. This vulnerability supports the fiduciary obligation.<sup>251</sup> Moreover, the power imbalance created by the increased reliance and discretion provides ample opportunity for abuse.<sup>252</sup> For these reasons, a relationship characterized by a high degree of reliance and discretion needs protection through fiduciary obligations and heightened penalties.

The traditional fiduciary relationship between directors and shareholders in a corporation typifies the kind of reliance and discretion that merits this protection. Shareholders have very little ability to interfere with the management of the corporation. By contrast, directors have "discretionary authority to manage or supervise the management of the corporation's business."<sup>253</sup> Because of this discretionary authority, shareholders rely and depend upon the directors of the corporation. As a consequence, the law imposes a high duty on corporate directors and imposes severe

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<sup>250</sup> U.S. SENTENCING GUIDELINES MANUAL, § 3B1.3, cmt. n.1 (2000).

<sup>251</sup> DeMott, *supra* note 233, at 902 (noting that "one party's vulnerability to the fiduciary's abuse of power or influence conventionally justifies the imposition of fiduciary obligation."); see also Scallen, *supra* note 227, at 913 (pointing out people in fiduciary relationships are uniquely vulnerable as result of their transfer of power and enhanced reliance).

<sup>252</sup> See Alexander, *supra* note 231, at 777 (stating discretion means relationship "is rife with opportunities for abuse.").

<sup>253</sup> DeMott, *supra* note 233, at 881.

sanctions when they breach that duty.<sup>254</sup> Additionally, the director-shareholder relationship provides directors with an ample opportunity to operate the corporation in a manner that may harm the shareholders. The imposition of a fiduciary obligation is necessary to deter this kind of improper conduct.

Outside of the conventional fiduciary relationship, the Supreme Court has maintained that the relationship between an accountant and a corporation could be one of special trust because the accountant has substantial discretion with respect to the corporation's funds and because corporate officers rely on the accountant's good faith.<sup>255</sup> A similar relationship could potentially arise between a corporation and an independent contractor who is provided with confidential information and has an understanding with the corporation that he will not use such information to harm the corporation or its shareholders.<sup>256</sup> If such relationships are characterized as fiduciary in nature, participants will be subject to the many penalties that can be imposed for insider trading.<sup>257</sup> These relationships are not only characterized by a high degree of discretion and reliance, but are rife with opportunities for abuse.

Similar elements of reliance and discretion are present in many forms of religious-based affinity fraud. Some courts have found the relationship between clergy and parishioner to be a fiduciary one because of the high degree of discretion and reliance inherent in these relationships.<sup>258</sup> These opinions suggest that affinity fraud

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<sup>254</sup> See *Smith v. Van Gorkom*, 488 A.2d 858, 874 (Del. 1985) (holding directors liable breach of their duty to shareholders in connection with merger approved by directors who failed to adequately investigate offer).

<sup>255</sup> See, e.g., *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983) (noting for purposes of securities fraud violation, special confidential relationship could be basis for recognizing accountants and other "outsiders" such as underwriters or consultants, have fiduciary relationship to company when they are given access to information and expected to hold such information in confidence). In fact, the Supreme Court has revealed a willingness to broaden the type of nontraditional relationships that may be subject to fiduciary obligations. See, e.g., *United States v. O'Hagan*, 521 U.S. 642, 650 (1997) (adopting misappropriation theory which holds noninsiders liable for breaches of trust and confidence owed to people who entrust such persons with confidential information).

<sup>256</sup> *Id.* at 652.

<sup>257</sup> See BAINBRIDGE, *supra* note 228, at 120-24.

<sup>258</sup> See, e.g., *Moses v. Diocese of Colorado*, 863 P.2d 310, 321-22 (Col. 1993) (affirming bishop's use of position to compel parishioner's silence was breach of fiduciary duty); *F.G. v. MacDonell*, 677 A.2d 258, 265 (N.J. Super. Ct. App. Div. 1996), *aff'd in part and rev'd in part*,

conducted by high-ranking religious officials violates fiduciary-like relationships and hence deserves enhanced sanctions akin to those imposed by fiduciary law. Some circuit court judges have accepted the notion that there is a heightened degree of trust between the members and leaders of a religious group which justifies the imposition of increased punishment. For example, in *United States v. Lilly*,<sup>259</sup> the Seventh Circuit upheld an abuse of trust enhancement applied to the pastor of an Indiana church convicted of fraudulently selling over \$1.6 million worth of certificates of deposit to several investors including almost thirty members of his church.<sup>260</sup> The court pointed out that the enhancement was warranted because of two features of the relationship. First, the pastor's congregation relied heavily on him both as a spiritual leader and as the sole manager of their finances.<sup>261</sup> Indeed, the pastor's position gave him sole authority over the church bank account from which he transferred funds into his personal account.<sup>262</sup> Second, as the church's financial decisionmaker, the Pastor had discretion over the church's finances which enabled him to secretly misappropriate the funds he received.<sup>263</sup> Because of these factors, the Seventh Circuit concluded that the pastor's relationship with his church members was one of special trust that warranted a sentence enhancement.<sup>264</sup>

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696 A.2d 697 (N.J. 1997) (holding parishioner could bring suit for breach of fiduciary duty against rector who engaged in sexual relations with her). Some courts agree that a fiduciary relationship exists, but argue that the First Amendment bars claims related to a breach of fiduciary duty between clergy and parishioners. *See, e.g., Sanders v. Casa View Baptist Church*, 134 F.3d 331, 337-38 (5th Cir. 1998) (stating conduct otherwise breach of fiduciary duty would be protected by First Amendment if rooted in religious belief); *Doe v. Evans*, 718 So.2d 286, 293 (Fla. Dist. Ct. App. 1998) (concluding First Amendment bars fiduciary duty claim against church); *Amato v. Greenquist*, 679 N.E.2d 446, 454 (Ill. App. Ct. 1997) (declaring it "imprudent" for courts to entertain fiduciary duty claims against clergy). These First Amendment concerns are important. However, at present the circuit courts have not expressed concern over the application of the sentencing enhancements for religious leaders who exploit a relationship of trust with their church members. *See infra* notes 260-69 and accompanying text. This Article does not address those concerns.

<sup>259</sup> 37 F.3d 1222 (7th Cir. 1994).

<sup>260</sup> *Id.* at 1225-27.

<sup>261</sup> *Id.* at 1227.

<sup>262</sup> *Id.*

<sup>263</sup> *Id.*

<sup>264</sup> *Id.* at 1228.

Similarly, in *United States v. Luca*,<sup>265</sup> a minister convinced his church members to invest in a bogus investment scheme purportedly aimed at improving their church building.<sup>266</sup> At oral argument, both the government and defense counsel indicated that the minister's actions warranted the application of the abuse of trust enhancement.<sup>267</sup> In that case, the trial court noted that the defendant minister was given substantial discretion over church members and their finances, and that church members relied on the minister's ability to make decisions regarding finances and other matters related to the church.<sup>268</sup> One church member claimed that because the defendant used religion in his appeal, he "turned off his internal alarms" and lowered his guard to the fraud.<sup>269</sup> This claim indicates that the church member relied on the minister's good faith in a manner that requires increased protection. Because of this, his relationship contained the discretion and reliance typical of a special trust relationship and his violation of that relationship should enable courts to augment his punishment.

Some of the qualities of a special trust relationship are also present in affinity scams conducted by members of a particular religious community who do not occupy a position within the church. While it can be argued that the special-trust relationship is weaker in these situations, and while the Guidelines appear to predicate the enhancement on some formal position of trust,<sup>270</sup> this focus fails to examine the nature of a particular relationship. Although a person's position may suggest that she is involved in a relationship of heightened trust, it is not dispositive. In fact, there may be some pastors who have a minimal role in their church and thus do not have a relationship of trust despite their position. By the same token, church members may rely more heavily on other church members who do not occupy particular positions in the church, forming relationships that involve greater trust than the relation-

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<sup>265</sup> 183 F.3d 1018 (9th Cir. 1999).

<sup>266</sup> *Id.* at 1027.

<sup>267</sup> *Id.* at 1028 n.7.

<sup>268</sup> *Id.* at 1026.

<sup>269</sup> *Id.* at 1027. Church members claimed that the defendant's use of religion effectively lowered their guard to the fraud. *Id.*

<sup>270</sup> Section 3B1.3 of the Guidelines allows an adjustment for a defendant who abused a "position" of public or private trust. U.S. SENTENCING GUIDELINES MANUAL § 3B1.3 (2000).

ship between a pastor and her congregation. Whether or not someone holds a position within an organization should not determine the existence of a trust relationship.

Indeed, securities regulators note that, once entrusted with funds, church members exercise a significant amount of discretion over the funds of other members.<sup>271</sup> As an example, the perpetrators of the Oracle Trust scheme were members of the Christian community who did not occupy any formal position.<sup>272</sup> Despite their lack of a formal position, they were able to enlist members of various church communities and exercised unfettered discretion over their funds.<sup>273</sup>

The Oracle Trust scheme makes clear that scam artists need not exercise positions of power to take advantage of religious affinity. SEC officials note that the church members who participated in the Oracle Trust scheme “invested in the trading programs on trust and faith, rather than adequate information.”<sup>274</sup> Investors sucked in by these schemes rely on the good faith of their fellow church members in a manner that they would not with members of society at large, the relationship, then, is essentially one of “blind faith.”<sup>275</sup> This characterization underscores the notion that because religion is faith-based, people are much more likely to have faith in other members of their church and hence be more willing to participate in their investment schemes without doubting their motivation.<sup>276</sup> Consistent with this notion, some investors in these affinity scams were persuaded to invest in securities on the strength of the church’s name even when such securities appeared to be risky.<sup>277</sup> In fact, some church members may feel compelled to participate in these schemes because they may see participation in a religiously

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<sup>271</sup> See Fechter & Kennedy, *supra* note 127 (indicating higher trust results in greater discretion afforded to swindlers).

<sup>272</sup> Oracle Trust, *supra* note 2.

<sup>273</sup> *Id.*

<sup>274</sup> *Id.*

<sup>275</sup> Perlman, *supra* note 75.

<sup>276</sup> See Fischer, *supra* note 65 (quoting director of Arizona Corporation Commission’s securities division who pointed out use of religious connection to get money from people makes them more comfortable and hence more likely to invest).

<sup>277</sup> See *id.* (giving reasons people put money into religious foundation that allegedly defrauded investors).

motivated investment program as “[putting their] faith to the test.”<sup>278</sup> Similar to shareholders who rely on the good faith of the directors they have elected, church members rely on the good faith of their fellow members. In fact, church members’ reliance may be higher than that between shareholder and director because directors and shareholders are bound by ties of corporate law, whereas church members are bound by religious affiliations. This kind of reliance makes their relationships more like a fiduciary or special trust than a non-fiduciary, arms-length relationship.

In the context of racial groups in a nonreligious setting, there is also a high degree of reliance that may warrant enhanced protection through greater sanctions. As in religious affinity fraud, members of racial and ethnic affinity groups display a “blind faith” in their relationships that makes them susceptible to affinity fraud.<sup>279</sup> This blind faith illuminates the heightened level of trust among racial and ethnic group members, which surpasses the level of trust common within other associations. One study attempting to measure the degree of trust within various groups found that trust levels varied depending on the homogeneity of the group and the extent to which members of the group shared a common heritage or background.<sup>280</sup> This study revealed that reliance and therefore trust among groups who share the same faith, or who share the same culture and background is higher than that among members of other groups.<sup>281</sup> For example, while a group of lawyers or other professionals may tend to trust each other by virtue of their shared profession, the trust among these professionals is not as high as compared with members of the same religious or ethnic group who share the same history or value system.

Other scholars have noted this difference among various groups in American society, pointing out that the reliance among members of ethnic, racial, and religious groups is stronger than among other

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<sup>278</sup> Mattern, *supra* note 20 (quoting Alabama Securities Commissioner).

<sup>279</sup> See *Blind Faith*, *supra* note 120 (citing newsletter published by Pennsylvania Securities Commission); see also Fechter & Kennedy, *supra* note 127 (quoting Philip Feigin, executive director of NASAA). According to Feigin, “[t]rust is higher among [people with religious affinity connection] and that’s why the fraud is successful.” *Id.*

<sup>280</sup> Knack & Keefer, *supra* note 37, at 1278.

<sup>281</sup> See *id.* (noting indicators of trust increase significantly for ethnically homogeneous associations and individuals who share common backgrounds exhibit higher degrees of trust).

groups.<sup>282</sup> These scholars attribute the increased reliance to shared history, experiences, culture, and ethnicity.<sup>283</sup> This reliance is further augmented when groups have been subjected to hostility from the larger community.<sup>284</sup> Some judges also have noted the shared history and experience among members of certain groups may foster increased reliance and trust. For example, in a case involving an affinity fraud targeted towards Hispanics, the Ninth Circuit accepted the possibility that “because of some cultural affinity Hispanics are more likely to become victims to a fraud perpetrated by a Hispanic defendant making an appeal to ethnic pride.”<sup>285</sup>

Because this increased trust implies that members of a particular group may rely more readily on scams perpetrated by other members of the group, exploiting these relationships deserves enhanced sanctions. Like other traditional fiduciary relationships, this high degree of reliance not only provides a greater opportunity for abuse, but also can be distinguished from that found in other groups who do not share cultural and historical ties. Although not a typical fiduciary relationship, on the continuum of such relationships, these affinity-based relationships more closely resemble fiduciary relationship than an arms-length relationship. On that basis, they deserve the imposition of fiduciary-like principles.

Of course one could argue that such relationships should not receive heightened sanctions because it cannot be proven that all the members of a particular group trust one another. For example, at least one scholar has observed a lesser degree of trust among members of the African-American community as compared to members of some Asian communities stemming from a greater

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<sup>282</sup> FUKUYAMA, *supra* note 37, at 296.

<sup>283</sup> See Lan Cao, *Looking at Communities and Markets*, 74 NOTRE DAME L. REV. 841, 882 (1999) (noting such high levels of trust are possible because of “preexisting social ties”); see FUKUYAMA, *supra* note 37, at 296 (noting shared history and ethnicity of racial groups in America translates into closeness not enjoyed by surrounding community); see Linda J. Wong, *The Role of Immigrant Entrepreneurs in Urban Economic Development*, 7 STAN. L. & POLY REV. 75, 81 (1991) (observing shared culture and experience of minority communities in Los Angeles fosters higher degree of trust); Wong notes “the glue” that allows their economic network to flourish “comes from a common culture” shared by group members. *Id.*

<sup>284</sup> FUKUYAMA, *supra* note 37, at 301.

<sup>285</sup> *United States v. Castellanos*, 81 F.3d 108, 110 (9th Cir. 1996).



connection to their homeland among members of the latter group.<sup>286</sup> While it is undeniable that the levels of trust differ among various racial and ethnic groups, scholars agree that the trust among all racial and ethnic groups is higher than that displayed by other groups within society.<sup>287</sup> Exploitation of this higher trust should be enough to apply warrant increased sanctions.

3. *Freedom to Perpetrate a Difficult-to-Detect Crime.* According to the Ninth Circuit, “the primary trait that distinguishes a person in a position of trust from one who is not is the extent to which the position provides the freedom to commit a difficult . . . to . . . detect wrong.”<sup>288</sup> Several other circuits have adopted this rationale.<sup>289</sup> These courts point to the Commentary of the Guidelines in support of their position.<sup>290</sup> According to these courts, such a freedom

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<sup>286</sup> FUKUYAMA, *supra* note 37, at 296.

<sup>287</sup> See Knack & Keefer, *supra* note 37, at 1277-78; FUKUYAMA, *supra* note 37, at 290.

<sup>288</sup> *United States v. Hill*, 915 F.2d 502, 506 (9th Cir. 1990). This rationale also may be consistent with the economic model of optimal deterrence, which states that optimal sanctions depend, in part, on the probability of detection. David A. Dana, *Rethinking the Puzzle of Escalating Penalties for Repeat Offenders*, 110 YALE L.J. 733, 741 (2001); Richard Craswell, *Deterrence and Damages: The Multiplier and Its Alternatives*, 97 MICH. L. REV. 2185, 2211-12 (1999). The economic model suggests that in order to achieve optimal deterrence, our legal system should provide greater sanctions for violators who have an easier opportunity to commit a crime or whose behavior is less likely to be audited. Dana, *supra* at 740. Because of this, Professor Dana suggests that first time offenders should receive the greatest sanctions while repeat offenders should receive fewer penalties, because people with records have a higher probability of having their offenses detected. *Id.* at 742. Thus, to the extent perpetrators of affinity fraud have the freedom to commit a difficult-to-detect crime, we would achieve optimal deterrence by enhancing their sanctions. Of course, others disagree that optimal deterrence supports criminalizing corporate or white-collar crime. See, e.g., Daniel R. Fischel & Alan O. Skyes, *Corporate Crime*, 25 J. LEGAL STUD. 319, 319 (1996) (arguing “that there is no need for corporate criminal liability in a legal system with appropriate civil remedies”).

<sup>289</sup> See, e.g., *United States v. Iannone*, 184 F.3d 214, 223 (3d Cir. 1999) (noting whether defendant’s position allows commission of difficult-to-detect wrong is one of three factors in determining positions of trust); *United States v. Garrison*, 133 F.3d 831, 838 (11th Cir. 1998) (stating primary concern of abuse of trust provision “is to penalize defendants who take advantage of a position that provides them freedom to commit or conceal a difficult-to-detect wrong”); *United States v. Queen*, 4 F.3d. 925, 928 (10th Cir. 1993) (setting forth freedom to commit difficult-to-detect wrong as one of several factors to determine position of trust).

<sup>290</sup> The Commentary states “[f]or this adjustment to apply, the position of public or private trust must have contributed in some significant way to facilitating the commission or concealment of the offense (e.g., by making the detection of the offense or the defendant’s responsibility for the offense more difficult).” U.S. SENTENCING GUIDELINES MANUAL § 3B1.3, cmt. n.1 (2000).

reveals a high degree of trust.<sup>291</sup> Indeed, a relationship that enables a defendant to commit a difficult-to-detect wrong suggests that the victim did not feel compelled to monitor the activities of the defendant closely, if at all.<sup>292</sup> Such an act deserves greater sanctions simply because it is easier to commit. Perpetrators will gravitate towards these scams because they can carry them out with little fear that either their victims or law enforcement officials will detect their criminal behavior. As Judge Posner explains:

Frauds at the top of the range are harder to pull off and it is there that we would like defrauders to concentrate their efforts—beating their heads against a stone wall most of the time. Frauds at the bottom of the range are easier to pull off and less likely to be detected and punished, and so we want a higher than average punishment for these defrauders. . . .<sup>293</sup>

Based on this rationale, because crimes that exploit a relationship of trust are easier to commit, they require greater deterrence through the use of increased sanctions.

Penalizing many forms of affinity fraud more harshly is consistent with this rationale. Securities regulators have found affinity crimes aimed at religious groups to be the most difficult to resolve.<sup>294</sup> Illustrative of this point, the pastor in *Lilly* conducted his scheme without detection for almost ten years.<sup>295</sup> In another case, church members continued to contribute to a fraudulent investment scheme run by church officials even after authorities uncovered their scheme and indicated these for securities fraud.<sup>296</sup> Addition-

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<sup>291</sup> See, e.g., *Hill*, 915 F.2d at 506 (“If one party is able to take criminal advantage of the relationship without fear of ready or quick notice by the second party, the second party has clearly placed a level of trust in the first.”).

<sup>292</sup> As the Third Circuit notes: “where the defendant occupies a position of trust, his victims are less likely to discover his fraud because they will not investigate the matter as thoroughly as they would in an arm’s-length transaction.” *Iannone*, 184 F.3d at 224.

<sup>293</sup> *United States v. Grimes*, 173 F.3d 634, 638 (7th Cir. 1999).

<sup>294</sup> *Affinity Fraud*, *supra* note 12.

<sup>295</sup> *United States v. Lilly*, 37 F.3d 1222, 1225 (7th Cir. 1994). The pastor began selling the certificates in the early 1980s and resigned from his church in 1989. As of 1992, he still owed investors approximately \$1.3 million. *Id.* at 1224-25.

<sup>296</sup> *Fischer*, *supra* note 65.

ally, as Part II notes, securities fraud that targets insular ethnic or racial groups has been successful because it is so difficult to detect and resolve.<sup>297</sup> In fact, some members of these groups believe they should not alert authorities even when they do detect a crime.<sup>298</sup> Thus, the SEC notes, “[b]ecause of the tight-knit structure of many groups, it is usually more difficult for regulators or law enforcement officials to detect an affinity scam.”<sup>299</sup> The difficulties confronted by securities officials suggest that these crimes rely on high-trust relationships merit greater sanctions.

Many of the relationships exploited by affinity fraud contain the characteristics of a high-trust relationship, such as reliance, discretion, the ability to commit a difficult to detect wrong, as well as an element of voluntariness. Because of these characteristics, courts should interpret the Guidelines more expansively to account for exploitation of these relationships. If necessary, the Commission should modify the Guidelines either to delete the reference to “position” or to include additional text in the Commentary making it clear that this term should not be used to preclude the application of the high-trust enhancement to relationships that confer high trust without the benefit of a formal title.

#### D. EXPLOITING RELATIONSHIPS OF ECONOMIC IMPORTANCE

Even if the relationships of trust typical of those being exploited by affinity fraud do not embody all of the qualities of a special trust relationship, such relationships may deserve greater protection because of their economic importance to minority and ethnic affinity groups. This section will explore some of the economic justifications for increasing the sanctions for perpetrators who violate some of these affinity-based relationships.

Several authors have studied the importance of social trust to the maintenance and preservation of economic institutions more generally. Francis Fukuyama has pointed out that social trust is

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<sup>297</sup> See *supra* notes 119-27 and accompanying text.

<sup>298</sup> See *supra* notes 124-27 and accompanying text.

<sup>299</sup> *Affinity Fraud*, *supra* note 12.

important because it facilitates economic development.<sup>300</sup> Fukuyama further states that a robust economy is indicative of a society in which there is a high degree of trust among its participants.<sup>301</sup> In the same vein, Robert Putnam refers to the trust and cooperation among certain organizations as “social capital” and argues that it is essential to the success of economic institutions.<sup>302</sup> Thus, relationships of trust enable members of society to pool their resources and generate a more efficient and prosperous economy.

Such trust is particularly important to minority communities. As one scholar notes, “access to capital is a crucial factor in the operation of small businesses, which in turn is essential to community economic development . . . .”<sup>303</sup> Passage of legislation such as the Community Reinvestment Act reveals that many in the federal government have come to recognize that the availability of credit is linked with the economic viability of lower income, mainly minority communities.<sup>304</sup> However, for various reasons, including market imperfections and discriminatory lending practices, members of immigrant and minority communities have been unable to access mainstream sources of financing.<sup>305</sup> Indeed, recent studies have shown that mainstream banks do not lend to minorities at the same rate as their white counterparts.<sup>306</sup> Some of this inequity can be attributed to the fact that many minority groups and immigrants lack the resources and the credit history demanded by banking institutions in the formal economy forcing them to rely on community mechanisms.<sup>307</sup> Other studies have suggested that discrimina-

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<sup>300</sup> See, e.g., FUKUYAMA, *supra* note 37, at 43-68 (describing social trust and how it relates to economic development).

<sup>301</sup> See *id.* at 8 (giving examples from 1900's).

<sup>302</sup> See, e.g., Putnam, *supra* note 37, at 163-85 (discussing social capital as it relates to economic success); see generally Robert D. Putnam, *Bowling Alone: America's Declining Social Capital*, 6 J. DEMOCRACY 65 (1995) (examining trends in social connections).

<sup>303</sup> Cao, *supra* note 283, at 844.

<sup>304</sup> See *id.* at 845 (citing Congressional hearings related to Community Reinvestment Act).

<sup>305</sup> *Id.* at 846.

<sup>306</sup> One critical mortgage study revealed that minorities are about sixty percent more likely to be turned down for a mortgage loan than whites. See ALICIA H. MUNNELL ET AL., FEDERAL RESERVE BANK OF BOSTON, MORTGAGE LENDING IN BOSTON: INTERPRETING HMDA DATA 2-3 (Fed. Reserve Bank of Boston, Working Paper No. 92-7, 1992) (finding lenders were more willing to overlook flaws for white applicants with same imperfections as minority applicants who were more likely to be turned down).

<sup>307</sup> Cao, *supra* note 283, at 848.

tory lending patterns explain the difference between the white community and minority communities' ability to obtain funding from major lending institutions.<sup>308</sup>

Regardless of the reason, because they cannot obtain money from traditional sources, these community members rely more heavily on informal relationships of trust to establish and maintain their business enterprises.<sup>309</sup> As one commentator explains, these communities use their social cohesiveness to "bypass formal barriers in the open market."<sup>310</sup> In agreement, Fukuyama has noted the importance of social trust to the economic betterment of minority communities in America, pointing out that these groups rely more heavily on group and community networks to gain capital to ensure their economic development.<sup>311</sup> These groups participate in informal credit associations and other endeavors pursuant to which they pool their resources in order to create capital for group members.<sup>312</sup> For example, members of some ethnic communities, particularly the Korean and Ethiopian communities, have developed rotating credit associations so that group members may have access to cash that would normally have been unavailable to them.<sup>313</sup> These credit associations depend upon a high level of trust.<sup>314</sup> Through these

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<sup>308</sup> See, e.g., MUNNELL, *supra* note 306, at 2; Paulette Thomas, *Boston Fed Finds Racial Discrimination in Mortgage Lending is Still Widespread*, WALL ST. J., Oct. 9, 1992, at A3 (detailing discrimination in loan approval process).

<sup>309</sup> FUKUYAMA, *supra* note 37, at 297-304; Wong, *supra* note 283, at 78-82.

<sup>310</sup> Cao, *supra* note 283, at 846.

<sup>311</sup> FUKUYAMA, *supra* note 37, at 297-304.

<sup>312</sup> Cao, *supra* note 283, at 879.

<sup>313</sup> "Historically, rotating credit associations have been crucial for the economic development of immigrant communities in the United States, especially because mainstream, majority-owned banks are reluctant to lend to low-income communities." Cao, *supra* note 283, at 879. One scholar notes that Chinese, Vietnamese, Japanese, Ethiopians, West Africans, Central Americans and Caribbean blacks all participate in credit associations, but that Koreans have the most systematic practice. Joel Garreau, *For Koreans, "Keh" is Key to Success*, WASH. POST, Nov. 3, 1991, at B6 (estimating that 80% of Korean households in United States belong to at least one revolving credit association). See also Sandra Sugawara & Elizabeth Tucker, *New Firms Backed by Family, Friends*, WASH. POST, Dec. 16, 1987, at A1 (noting Ethiopian immigrants who lack access to formal credit resort to revolving credit associations); David J. Jefferson, *Neighborhood Financing: Lending Clubs Offer Social Support and Quick Capital to Asian Immigrants*, WALL ST. J., Feb. 24, 1989, at R13 (explaining role of revolving credit associations in revitalization efforts in Korean and Vietnamese neighborhoods).

<sup>314</sup> See Cao, *supra* note 283, at 882 (explaining "[t]rust makes it possible for members of rotating credit associations to take on the commitment to adhere to group norms . . ."). See

kinds of associations and endeavors, these groups pool their funds to support businesses and their economic activities.<sup>315</sup>

Because of the barriers these minority groups face to traditional financing, it is likely that many of these investment activities could not have existed without these nontraditional resources. As one scholar observed, "the cohesion that [certain minority communities] have been able to forge from social and kinship ties has been transferred to the economic arena."<sup>316</sup> In this way, the trust among minority groups significantly impacts their economic prosperity.

Because of its economic significance, the trust relationship within many affinity groups should be protected in the form of greater sanctions for those who abuse it. Violating the trust among these communities may have a very broad economic impact. As Fukuyama asserts, to the extent trust and solidarity are undermined, economic advancement will be compromised.<sup>317</sup> Indeed, strong social cohesion is necessary to ensure the continuation of the economic pooling and credit arrangements among these communities.<sup>318</sup> Without such trust, these arrangements will be jeopardized. Given that these groups rely heavily on these associations for their economic well being, violations of such trust deserve to be sanctioned more harshly. Further, this may suggest a reason for protecting trust among all groups, even those that exhibit relatively lower levels of trust. If their trust is more fragile, violations of such trust may be even more problematic.

Some may argue that increasing the sanctions for violations of trust within those groups who rely on their trust relationship for economic endeavors is not necessary because such groups employ social and extra-legal sanctions to guard against these kinds of violations. These groups use a variety of enforcement mechanisms to insure that their members do not exploit the high trust within the

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also FUKUYAMA, *supra* note 37, at 301 (noting ties of kinship and geography make high levels of trust possible).

<sup>315</sup> FUKUYAMA, *supra* note 37, at 300.

<sup>316</sup> *Id.* at 319. Wong notes that a distinct and visible ethnic enclave economy has emerged in Los Angeles that relies on the social trust among members of the same ethnic group. Wong, *supra* note 309, at 77. She also found that a high degree of trust shapes the economic relationships among the various communities. *Id.*

<sup>317</sup> See FUKUYAMA, *supra* note 37, at 296.

<sup>318</sup> *Id.* at 301.

group, such as shaming and ostracism.<sup>319</sup> Groups use these measures to protect themselves, and these safeguards are critical to the success of the various pooling and other arrangements among insular groups.<sup>320</sup> Indeed, the magnitude of these social sanctions, especially if the violators are first time offenders, may be especially great.<sup>321</sup> This is particularly true if the group is ethnically homogeneous, as is the case with many victims of affinity fraud.<sup>322</sup> For these reasons, it is arguable that the existence of these measures obviates the need for any additional penalties.

However, securities regulators cannot and should not rely on the effectiveness of these enforcement measures to combat affinity fraud. As an initial matter, the prevalence of these schemes suggests that these mechanisms are not serving to deter the exploitation of these important relationships. Perhaps the perpetrators of this fraud need the threat of outside sanctions, such as those provided by securities officials and courts, to deter their improper behavior. Also, because many victims of affinity fraud are less likely to uncover the fraudulent conduct, these groups may not have adequate opportunity to exercise their own group remedies.

Furthermore, even if these internal mechanisms were reliable, securities regulators *should not* rely on them to enforce securities laws. Securities regulators themselves have a duty to enforce the law and should not rely on any group to assume this role. It is important that law enforcement officials acknowledge how problematic affinity fraud is and signal their willingness to assist these communities when they are being singled out for abuse. Therefore, securities officials should increase the sentences of those who commit these offenses without regard to the availability of a particular groups' internal enforcement measures.

The fact that the relationships exploited by affinity fraud may be important for economic reasons provides an additional reason for

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<sup>319</sup> See, e.g., Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 119-24 (1992) (describing how New York diamond dealers use clubs and informal network to maintain trust).

<sup>320</sup> *Id.* at 121 n.10.

<sup>321</sup> See, e.g., Dana, *supra* note 288, at 773 (noting social sanctions for misconduct tend to decrease in magnitude with each successive offense).

<sup>322</sup> See, e.g., Bernstein, *supra* note 319, at 140 (noting social extra-legal sanctions work best with groups having geographical concentration and ethnic homogeneity).

enhancing the sanctions for those who conduct these schemes. It also supports a more expansive view of the Guidelines to take into account relationships of trust that serve important functions in society. With this in mind, courts should be empowered to utilize this factor in their determination of whether a relationship of trust warranted increased sanctions.

#### V. CONCLUSION

One author has posed the question "Should We Trust in Trust?"<sup>323</sup> The prevalence of affinity fraud suggests that we should not and cannot. Affinity schemes unacceptably undermine the trust among group members. Affinity scams that target members of identifiable religious, racial or ethnic groups pose the most serious problems because the trust among group members is especially high. The undermining of this trust is magnified when the scam is orchestrated by a high-ranking official in the group or when those who commit the scam rely on the combination of religion and race. When this conduct is aimed at racial or ethnic groups, it abuses a trust that is economically important and may undermine the ability of these group members to access capital. Moreover, affinity schemes that prey upon charitable tendencies do great damage to the charitable impulse, which is an important value in our society. Charitable donations represent an integral part of a religious community and thus fraudulent investment schemes that claim to benefit a church or its community will find a uniquely vulnerable audience. Along these lines, the desire felt by many members of racial and ethnic groups to assist others like themselves may cause such group members to more readily fall prey to scams that promise to make an investment in their community. These factors reveal why affinity fraud has been successful and why it merits increased sanctions.

Each of these justifications can serve as an independent basis for increasing the sanctions against those who commit these scams. Moreover, the aggregation of these abuses may make some schemes worthy of additional protection. Thus, securities regulators and

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<sup>323</sup> Daryl Koehn, *Should We Trust in Trust?*, 34 AM. BUS. L.J. 183, 183 (1996).



judges should impose higher sanctions on those who commit affinity fraud, and to the extent the Guidelines would hinder such an imposition, they should be adjusted accordingly.

Generosity and trust are qualities that are not only shared among friends, but also extend to members of affinity groups. These qualities are important to the economic, social and political health of our society. For this reason, we should support friendships, even in the context of groups, by severely penalizing those who would exploit the trust and benevolence within such relationships through the commission of affinity fraud.

