

The need for a classification system

Financial fraud is a major problem for individuals and for society, but our understanding of the scope of the problem is hampered by a lack of official statistics. Key sources of crime statistics in the United States, including the Bureau of Justice Statistics's *National Crime Victimization Survey* (NCVS) and the Federal Bureau of Investigation's *Uniform Crime Reports*, have historically focused on traditional property crimes like burglary and larceny. While there is a recognized need to incorporate emerging crimes like financial fraud into these key surveys of crime, the first step is to create an agreed upon and operationalized definition of fraud.

Currently, there is a lack of a clear definition for the term “fraud.” Much of fraud research has focused on fraud against governments and organizations, which is distinct from fraud against individuals, both in its methods and in its players. The lack of a clear definition has allowed individual financial fraud to remain relatively overshadowed and overlooked.

Because no systematic categorization currently exists, researchers and practitioners have classified fraud types based on different characteristics, including communication method (e.g., cyber fraud, mail fraud), product marketed (e.g., lottery fraud, securities fraud), strategy employed (e.g., advance fee fraud, overpayment fraud), group targeted (e.g., elder fraud), and/or fraudster characteristics (e.g., employee fraud, occupational fraud). This has led to a proliferation of overlapping and often confusing definitions and categorizations that affect fraud prevalence estimates as well as our understanding of the mechanisms and consequences of fraud.

The Taxonomy of Fraud Project

Genesis of the Project & Tasks Accomplished to Date

To address the need for a fraud classification system, the Financial Fraud Research Center, a joint project of the Stanford Center on Longevity and the FINRA Investor Education Foundation (FINRA Foundation), collaborated with the Bureau of Justice Statistics to develop a standardized fraud classification scheme. The purpose was to group and organize fraud types meaningfully and systematically into a definitional framework that can be translated into survey questions and administered with the *National Crime Victimization Survey*. The survey will be used to determine the current prevalence of individual financial fraud and how prevalence rates change over time. As such, an initial filter for this project was to limit the classification to fraud types and attributes that could reasonably be identified and reported by victims or that are of interest to researchers and fraud investigators.

In addition to informing the development of a consumer fraud survey, the taxonomy has wider applications in the field. The standardized coding scheme will improve consistency in fraud measurement so that findings can reasonably be compared across time and across groups. The taxonomy can easily be modified to include additional attributes about fraud incidents that are important to law enforcement and fraud investigators. Researchers can also choose which code dimensions they are interested in analyzing for their own study purposes. Furthermore, the taxonomy is useful in helping to conceptualize the problem of fraud, delineate the boundaries between fraud and other types of misleading or deceptive financial transactions, and to evaluate how fraud evolves over time.

Although researchers and practitioners have long recognized the need for an individual financial fraud classification system, this specific project is an outgrowth of a conference supported by the FINRA Foundation and hosted by the Financial Fraud Research Center entitled, *The True Impact of Fraud – A Roundtable of Experts*¹ held in Washington, DC in the spring of 2014. At this conference, experts gathered to discuss ways to improve the measurement of fraud’s impact. One of the key themes of the conference was that a taxonomy of fraud would be extremely beneficial to the field.

The project began with a workshop-style meeting in Washington DC in January 2015 that focused on identifying the initial dimensions and organizational structure of the taxonomy. The *Taxonomy of Fraud* Working Group consisted of a small number of fraud and measurement experts representing government, academic, and nonprofit organizations. Over the course of the workshop and several conference-call discussions, the group developed the initial draft of the taxonomy described in this report.

The taxonomy and associated report were also evaluated by an extended review panel consisting of a wider scope of fraud and measurement researchers and practitioners. Input from the extended review panel helped refine the taxonomy by addressing potential areas of overlap or confusion. The panel also offered organizational suggestions to improve comparability and integration with existing typologies and classification schemes.

As a final validation step to assess comprehensiveness and applicability, the taxonomy was tested using consumer complaint data from the Federal Trade Commission’s (FTC) Consumer Sentinel Network database. Three-hundred consumer fraud complaint cases were classified using the taxonomy coding scheme. Attribute tags were applied if specific information about the victim, perpetrator, advertising method, and/or method of transfer was reported by the consumer. This validation step using FTC data identified gaps in the taxonomy and areas where clearer definitions were needed. The objective was to ensure that the taxonomy captured the full range of common scams against consumers and that the definitions reflected consumers’ experiences. Based on the consumer complaint data, parts of the taxonomy were reorganized and amended with additional fraud types.

Next Steps

In the next phase of the project, the FINRA Foundation will fund the development of survey items based on the taxonomy, with the goal of including these items in a supplement questionnaire to the core *National Crime Victimization Survey* (NCVS). The NCVS is administered biannually by the Bureau of Justice Statistics to over 90,000 households in the United States. The fraud supplement will be used to determine the annual prevalence of specific types of fraud and how these rates change over time.

This report and the associated victimization survey focus primarily on fraud targeting individuals. To expand the scope of the project, the Financial Fraud Research Center will collaborate with members of the Association for Certified Fraud Examiners (ACFE) to refine the taxonomy by creating a full classification scheme for fraud targeting for-profit and non-profit organizations, such as asset misappropriation and corruption, as well as fraud targeting government regulations and policies, such as

¹ Conference proceedings are available at: <http://fraudresearchcenter.org/2014/06/the-true-impact-of-fraud-a-roundtable-of-experts-washington-dc-2014/>

immigration fraud and welfare fraud. While these types of crime have a place in the current taxonomy, the section requires further development and input from experts in those areas.

II. Developing a Taxonomy of Fraud

This taxonomy is modeled after the international crime classification system proposed in the UN report, *Principles and Framework for an International Classification of Crimes for Statistical Purpose*,² prepared by the UNODC/UNECE task force on crime classification. The UN report outlines the main principles of an international crime classification scheme and provides an example framework. Wherever possible, we adopted the UNODC/UNECE guidelines and terminology.

General principles of classification

As noted in the UN report, a classification scheme is an “exhaustive and structured set of mutually exclusive and well-described categories.”³ The authors note that this definition references four distinct elements that serve as principles for classification:

- Exhaustiveness: The framework should include every possible manifestation of the phenomenon under study.
- Structure: The classification should include meaningful hierarchical organization, with similar values grouped together.
- Mutual exclusiveness: Each manifestation of the phenomenon under study should be assigned to one and only one category, precluding the possibility of overlaps.
- Description: Each incident must be described with enough detail to allow assignment to the appropriate category.

The principles were slightly modified for practical application, but serve as the basis for our Taxonomy of Fraud. Each principle and its application to the taxonomy are outlined in detail following the description of the framework elements.
