2012 Top Investor Threats

New Threats

Crowdfunding and Internet Offers. The 2012 JOBS Act makes significant changes to the methods startup businesses and entrepreneurs may employ to bring their ventures to the investing market, and investors must be wary of the attendant risks. Also, many more rules and mechanisms must be put into place for those changes to actually take effect. For example, the relaxed rules governing registration of relatively small securities deals, public solicitation for private funds, and disclosure of information to investors over the Internet are not yet written. So the JOBS Act provisions related to crowdfunding, a much-publicized method for startups seeking capital, are not yet available – and will not be until sometime in 2013 – to legitimate businesses. Even when the relaxed rules and registration exemptions are effective, they will not make investments in small businesses less risky – just more prevalent. And the JOBS Act provisions do not eliminate fraud, an unfortunate common feature of Internet securities activity.

Many states and provinces report a recent increase in active investigations or recent enforcement actions involving Internet fraud, and JOBS Act-triggered activity is likely to elongate this trend. Investors must remember that small startups are among the riskiest of investment categories under the best of situations. The crowdfunding and Internet investing marketplaces in North America will develop and undergo major changes in the next year, and investors should monitor this emerging capital formation community with a wary eye.

Inappropriate Advice or Practices from Investment Advisers. The Bernie Madoff case opened a number of eyes and ears to the problems that could exist undetected in an investment advisory firm. Investment advisers are licensed to give specific investment advice and owe their clients a fiduciary duty, unlike brokers that may merely effect suitable securities transactions for their clients. The regulatory environment for investment advisers is shifting, and Madoff has led to increased scrutiny from both state regulators and the U.S. Securities and Exchange Commission. The 2010 Dodd-Frank Act laid the groundwork for a major regulatory shift, transferring thousands of mid-sized investment advisers to primary supervision by state regulators, rather than the SEC. The states have already begun working with these mid-sized investment advisers, assisting them in complying with state registration requirements and applying already robust examination programs.

State enforcement actions increased as well: in 2011, state actions against investment adviser firms nearly doubled over the previous year, and focused both on compliance in the firms' general business practices and advice to clients. As the states implement regular examination schedules and analyze investment advisers that have not been audited in many years, more problems are likely to be discovered. The increased frequency of exams will benefit investors, however, as state regulators will work to ensure that investors have access to investment advisers who meet their fiduciary duty and cure discovered deficiencies.

Scam Artists Using Self-Directed IRAs to Mask Fraud. Scam artists, forever on the lookout for new ways to entice investors, are using self-directed IRAs to increase the appeal of their fraudulent schemes. State securities regulators have investigated numerous cases where a self-directed IRA was used in an attempt to lend credibility to a bogus venture. Fraud promoters pushing a Ponzi scheme or other investment fraud can misrepresent the responsibilities of self-directed IRA custodians to deceive investors into believing that their investments are legitimate or protected against losses. While a scam artist may suggest that self-directed IRA custodians analyze and validate investments, those custodians only hold the assets in a self-directed IRA and generally do not evaluate the quality or legitimacy of any investment.

Fraudsters also exploit the tax-deferred characteristics of self-directed IRAs, and know that the financial penalty for early withdrawal may cause investors to be more passive or to keep funds in a fraudulent scheme longer than those who invest through other means. Self-directed IRAs also allow investors to hold alternative investments such as real estate, mortgages, tax liens, precious metals, and private placement securities; financial and other information necessary to make a prudent investment decision may not be as readily available for these alternative investments. While self-directed IRAs can be a legitimate way to hold retirement assets, investors should be mindful of potential fraudulent schemes when considering investments for their self-directed IRA. Custodians and trustees of self-directed IRAs may have limited duties to investors, and generally will not evaluate the quality or legitimacy of an investment or its promoters.

EB-5 Investment-for-Visa Schemes. An immigration program linked to job-creation is growing in popularity, but investors must beware of promoters who falsely claim that an investment in their venture is safer or guaranteed due to an influx of foreign cash. The EB-5 immigration category is a 20-year-old program that grants a U.S. visa to foreign nationals who invest a minimum of $500,000 into a new commercial enterprise (The equivalent Canadian system, the Immigrant Investor Program (IIP), requires a C$800,000 investment). This job-creation effort has attracted investors from around the world, and as with any investment approach, increased interest has been accompanied with new challenges. All investments with an EB-5 component are subject to traditional securities laws, and investors need to be alert to the foreign-funding feature. Unscrupulous promoters may seek to prop up the plausibility of their scheme by highlighting a connection with a federal jobs program. Similarly, investors may be intrigued by the prospect of big funding from investors in China or other foreign countries with traditional or growing economic power.

In a recent case, the developer of a failed artificial sweetener factory planned for a small Missouri town sought Chinese investors through the EB-5 program, and made that a key component in pitching and then selling the underlying government bonds issued for the project. While the existence of Chinese funding may have seemed promising to the city issuing the bonds and the investors who bought them, the developer defaulted on the first bond payment, leaving the city and investors out millions of dollars. Investors considering any enterprise with an EB-5 or IIP feature should make sure to obtain full information on every component of the venture, including all funding sources and the background of all promoters.

<u>Persistent Threats</u>

Gold and Precious Metals. The hype surrounding gold, silver and other precious metals continues despite both the fact that these investments are just as vulnerable to risk as others, and signs that some precious metal markets are declining or increasingly turbulent. The promise of continuing increases in value pitched by high-profile celebrities on television, radio or the Internet too often lure unsuspecting investors into any number of scams.

Often, scams begin with an unsolicited communication such as an email or telephone call offering to sell investors gold coins, bullion, bars or other forms of the precious metal that the promoter will hold in safekeeping for the investor. Far too often, the gold simply does not exist. Increases in the value of precious metals during the recession have led unwary consumers to believe that the value will perpetually increase. Like any risky investment, there are no guarantees. In fact, gold declined by 15 percent between March and June of 2012 (a drop in value of more than $200 per ounce), settling at its lowest point since July of 2011.

Risky Oil and Gas Drilling Programs. Investors considering alternatives to traditional securities may be attracted to the lucrative returns often associated with investments in oil and gas drilling programs. These investments may also appeal to those who are frustrated with the volatility of the stock market or skeptical of the culture of Wall Street. Unfortunately, energy investments often prove to be a poor substitute for traditional retirement planning. Investments in oil and gas drilling programs typically involve a high degree of risk and are suitable only for investors who can bear the loss of the entirety of their principal. Moreover, some promoters will conceal these risks, using high pressure sales tactics and deceptive marketing practices to peddle worthless investments in oil wells to the investing public.

In a recent survey of the states, oil and gas fraud was ranked as the fourth most common product or practice leading to investigations and enforcement actions. There are active investigations into suspect oil and gas investment programs in over two dozen states and in every region of the U.S. and Canada. Investors should therefore conduct thorough due diligence and appraise their own tolerance for considerable risk when considering the purchase of interests in oil and gas programs.

Promissory Notes. Promissory notes are often promoted as a safe and secure way for investors to earn returns in excess of those prevailing on conventional investments. Promoters flaunt high returns from private loan agreements, interim short term financing or startup capital opportunities. Investors must be wary of promises of security and liquidity in these promissory notes, which are very often false or overstated. Investments of this nature are highly speculative and the risk of total loss of the funds invested is high. But issuers often use notes and prior relationships with investors to downplay the true nature and risk of these investments.

Sales of promissory notes are very often the favored investment vehicle for Ponzi schemes. In a recent survey, 20 states identified promissory notes as one of the top five most common products or features in fraudulent schemes, and notes are a commonly reported violation to Canadian regulators. Promissory notes, for the most part, are securities and are subject to state and provincial regulation. As with all investment opportunities, investors are encouraged to do their due diligence, ask questions and check with state or provincial regulators.

Real Estate Investment Schemes. As news of a possible bottom being reached in the U.S. housing market has spread, the popularity of investment offerings involving distressed real estate has continued to increase. While legitimate real estate investments can be an important component of a diversified portfolio, investors should be aware that schemes related to buying, renovating, flipping or pooling distressed properties are also popular with con artists. In a recent survey of the states, real estate fraud was ranked as the third most common product or practice leading to investigations and enforcement actions.

Even with legitimate real estate investments, there are substantial risks with properties that are bank-owned, pending short-sale, or in foreclosure. And the field is littered with non-legitimate scam artists intent on fleecing middle-class investors. In October 2011, Utah regulators took action against a man that solicited $4 million from investors to purchase and refurbish properties and provide a “diversified portfolio” of hard-money loans. Investors were given personal guarantees and promised minimum returns of 18 percent per year in an investment with risk that was “literally zero,” but in reality, the funds were directed to a single, highly leveraged, development project that went bust. As with all investments, careful vetting and due diligence is a must with real estate investments.

Regulation D Rule 506 Private Offerings. In the most recent survey of state securities regulators, fraudulent private placement offerings were ranked as the most common product or scheme leading to investigations and enforcement actions. These offerings also are commonly referred to as Regulation D Rule 506 offerings (the exemption in federal securities laws that allows private placements to be sold to investors without registration). By definition these are limited investment offerings that are highly illiquid, generally lack transparency and have little regulatory oversight.

While Regulation D Rule 506 offerings are used by many legitimate companies to raise capital, these investment offerings are high-risk and may not be suitable for many individual investors. The 2012 JOBS Act significantly relaxed the restrictions on the manner in which Regulation D Rule 506 offerings can be marketed to the general public, eliminating the previous ban on general solicitations (advertising). Once the rules implementing this change are finalized by the SEC, investors will begin to see a variety of advertisements related to private placement offerings, even though only a very small percentage of the population will be eligible to invest.

Unlicensed Salesmen Giving Liquidation Recommendations. As in years past, the liquidation of securities by insurance-licensed firms or agents who are not registered to sell securities is a significant source of complaints and inquiries for the states. Fifteen states pursued actions against insurance companies or agents in 2011, with the most common issue being liquidation of traditional securities holdings to fund annuity purchases. With losses in their retirement funds due to market fluctuations, senior investors are often enticed to shift their investments from traditional securities to annuities sold with the promise of guaranteed income and a mechanism for easy transfer of the value of the annuity to beneficiaries upon death. While annuities may be appropriate retirement products for some, they are not suitable for all investors and the liquidation of securities holdings is not always the best approach to funding an annuity purchase.

Insurance agents who are not also licensed securities professionals do not have the training and have not demonstrated the expertise necessary to determine the suitability of liquidating securities products to fund the purchase of an insurance product. A specific license is required before anyone can recommend the purchase *or sale* of securities. Being licensed as an insurance agent is not a substitute for a securities license. Investors should demand to see proof that a salesperson is licensed to make a recommendation to sell securities before agreeing to any transaction involving securities.

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