Key Points

Current Top Investor Threats

- An uninformed investor can be the best friend of a financial criminal. A fraud may succeed because people hear and believe the promises of the promoter and do not investigate the investment (or the person promoting it).

- To help educate investors, securities regulators of NASAA's Enforcement Section have identified the following financial products and practices as potential traps for the unwary:
    - Promissory Notes
    - Real Estate Investments
    - Ponzi/Pyramid Schemes
    - Oil and Gas Investments
    - Affinity Fraud
    - Variable Annuities

Promissory Notes

- In an environment of low interest rates, the promise of high interest promissory notes may tempt investors, especially seniors and others living on a fixed income.

- Promissory notes from legitimate issuers can provide reasonable investment returns at an acceptable level of risk, although state securities regulators have identified an unfortunately high number of promissory note frauds.

- Investors should be cautious about promissory notes with durations of nine months or less, as these notes generally do not require federal or state securities registration. Such ***short-term notes have been the source of most (though not all) of the fraudulent activity involving promissory notes*** identified by state securities regulators.

- Individuals considering investing in a promissory note should thoroughly research the investment – and the people promoting it.

FAST FACTS:

- Promissory notes were **identified by 74 percent of state securities regulators as a leading source of investor complaints or investigations**.

- State securities regulators reported **138 formal enforcement actions involving promissory notes** in 2016.

Real Estate Investments

- The promise of earning quick money through investments related to real estate continues to lure investors. ***Real estate investment scams are a perennial investor trap.***

- State securities regulators caution investors about real estate investment seminars, especially those marketed aggressively as an alternative to more traditional retirement planning strategies involving stocks, bonds and mutual funds.

- ***Two of the most popular investment pitches involve so-called "hard-money lending" and "property flipping."***

    - **Hard-money lending** is a term used to refer to real estate investments financed through means other than traditional bank borrowing. (This type of loan gets its name from the fact that it would be "hard to get" from a traditional lending source.)

    - Investors may be tempted by the opportunity to earn greater rates of return by participating on a hard-money loan and may (or may not) appreciate the potential risks, including as to the borrower's credit, the expected stability of income from the investment, or time constraints.

    - **Property flipping** is the practice of purchasing distressed real estate, refurbishing it, and then immediately re-selling it in hopes of earning a profit.

    - Property flipping financed through borrowed funds or outside investments can be done entirely lawfully, but it can also be a source for fraud. A scammer may, for example, defraud potential investors in the flip by misrepresenting the value of the underlying property or the expected profit potential on the flip.

    - Scammers may also misappropriate borrowed or invested funds or seek to use unwitting investors as "straw buyers" with outside banks or mortgage lenders, leveraging investors' names and credit scores to facilitate their scams.

FAST FACTS:

- Real estate-related investors were identified by 54 percent of state securities regulators as a leading source of investor complaints or investigations.

- State securities regulators reported 100 formal enforcement actions in 2016 involving real estate investments.

Ponzi/Pyramid Schemes

- A Ponzi scheme (named after 1920's swindler Charles Ponzi) is a ploy wherein earlier investors are repaid through the funds deposited by subsequent investors.

- Similarly, a pyramid scheme is a fraudulent multi-level marketing strategy whereby investors earn potential returns by recruiting more and more other investors.

    - Multi-level marketing strategies are not intrinsically fraudulent, and there are many legitimate multi-level marketing companies offering various consumer products and services.

    - What makes a multi-level marketing strategy into a fraudulent pyramid scheme is the lack of a genuine underlying investment enterprise or product upon which the strategy can hope to be sustained.

    - The scammers' emphasis is to get others to invest; victims' money gets filtered through the pyramid, and ultimately lost. ***Sooner or later, all pyramid schemes (like all Ponzi schemes) will collapse of their own weight, taking many investors down with them***.

FAST FACTS:

- Ponzi or pyramid schemes were identified by 54 percent of state securities regulators as a leading source of investor complaints or investigations.

- State securities regulators reported 80 formal enforcement actions involving Ponzi or pyramid schemes in 2016.

Oil & Gas Investments

- Many oil and gas investment opportunities, while involving varying degrees of risks to the investor, are legitimate in their marketing and responsible in their operations.

- However, as in many other investment opportunities, it is not unusual for unscrupulous promoters to attempt to take advantage of investors by engaging in fraudulent practices.

- Fraudulent oil and gas deals may be structured with a legal entity (such as a limited partnership) registered in one state but with operations and physical presence in a second state. Prospective investors in the venture may be solicited from still more states (with the obvious benefit to the perpetrators being a reduced chance an investor will ever seek to visit a well site or the organization's headquarters).

- Typically, in these types of scams, promoters invent false or misleading information about oil and gas properties to lure investors and keep them on the hook in bogus investments. The diffuse structure of such scams make it difficult for authorities and victims to identify them as frauds before it is too late.

- ***Because these ventures are so speculative, the potential for fraud is rife.*** Scammers may misrepresent the likelihood that an oil or gas well will be successful – or may not even ultimately drill a well at all. ***Fraudulent oil and gas schemes frequently take the form of Ponzi schemes,*** with investors' funds being "recycled" to keep the scheme going.

FAST FACTS:

- Oil and gas-related investments or interests were **identified by 50 percent of state securities regulators as a leading source of investor complaints or investigations**.

- State securities regulators reported **134 formal enforcement actions involving oil and gas-related investments** or interests in 2016.

Affinity Fraud

- In an affinity fraud, a con artist uses some sort of connection with the victim as the basis for the fraud.

- Affinity frauds may involve people who attend the same church, belong to the same club or association, or share a common hobby.

- The con artist knows it is often easier for victims to trust someone who seems to be like them. And once trust is gained, it is easier to exploit that trust to perpetrate a scam.

- Affinity fraud can not only be financially devastating to the victims, but often has the perverse effect of causing victims to lose trust in the group or affiliation that was previously a source of comfort or support. ***The psychological damage can be just as harmful as the financial damage.***

FAST FACTS:

- Affinity fraud was identified by 28 percent of state securities regulators as a leading source of investor complaints or investigations.

- State securities regulators reported 59 formal enforcement actions involving affinity fraud in 2016.

Variable Annuities

- Variable annuities are considered to be securities under federal law and the laws of some states. Certain states consider variable annuities to be strictly insurance products, while other states consider them to be both insurance and securities.

- In states where variable annuities are regulated by both the state's insurance and securities regulator, variable annuities must be registered with both state regulators. Individuals selling variable annuities also must be registered with their appropriate state regulator.

- ***While these products are entirely legitimate, they are not suitable for all investors and state securities regulators are concerned about the risks of sales practice abuses.*** Senior investors, in particular, should beware of the high surrender fees and steep sales commissions agents often earn when they move investors into variable annuities.

- Commissions to those who sell variable annuities are very high, which provides incentive for sellers to engage in inappropriate sales.

- Variable annuities also generally should not form more than a portion of an investor's portfolio, and many not be suitable for seniors because of the steep penalties for early withdrawals.

- Investors should be especially wary of any broker who wants to sell a variable annuity to hold inside a qualified retirement plan, such as a 401(k) plan or Individual Retirement Account (IRA), as these types of retirement account will already benefit from tax deferment. Putting a variable annuity into a 401(k) or IRA adds a layer of expense and investment restriction without any additional tax benefit.

FAST FACTS:

Variable annuities were **identified by 26 percent of state securities regulators as a leading source of investor complaints or investigations.**

State securities regulators reported **21 formal enforcement actions involving variable annuities** in 2016.

Emerging Investor Threats

- NASAA's Enforcement Section has identified three emerging threats that investors should watch for in 2018:
  - initial coin offerings (ICOs)
  - cryptocurrency contracts for difference (CFDs), and
  - identity theft for purposes of depleting investment accounts, especially among senior investors.
- Technology, and in some instances the criminal misuse of technology, is at the heart of each of the emerging threats investors are likely to face in the coming year.
- Mounting regulatory pressure on binary options, has led fraudsters to seek other products to pitch investors.
- State and provincial securities regulators believe that these fraudsters are launching a new wave of schemes involving ICOs and CFDs that use cryptocurrencies as the underlying investment.
  - **ICOs:** An Initial Coin Offering or a token sale is a sale of "tokens" in order to fund a (usually blockchain related) project. It is a form of crowdfunding.

    The "token" you buy likely has no value at the time you buy it. Some constitute, or may be exchangeable for a new cryptocurrency to be launched by the project, whereas others entitle you to a discount, or early rights to a product or service proposed to be offered by the project.
  - Cryptocurrencies have no inherent value, are not insured and not controlled by a central bank or other authority.
  - ***Investors need to be extremely careful. ICOs are very risky and are not suitable for many investors. You could lose all of your investment.***
  - In an ICO, investors may be buying nothing more than a promise by the business to develop something in the future. That means the business may not even exist yet, and investors may need to wait months or years before the tokens are usable, or yield profits or a benefit, if any.
  - To make it even more confusing, fraudulent ICOs may be targeting investors eager to "get in on the ground floor" of this new tech tool.
  - ICOs may be marketed as "Software presale tokens", "Donations", or "Crowdsales" to try and avoid securities regulations. Whatever the coin,

token or offer is called, it may be subject to securities regulations.

- The SEC has indicated that the offer and sale of digital assets by virtual organizations may very likely be subject to the requirements of federal securities laws, depending on the facts and circumstances. ***Just last week (December 4), the SEC's new Cyber Unit obtained an emergency asset freeze to halt a fast-moving ICO fraud that raised up to $15 million from thousands of investors since August by falsely promising a 13-fold profit in less than a month.***

- **CFDs** are complex financial instruments that enable an investor to speculate on the price of an underlying asset and can be highly leveraged, which multiplies the impact of price changes on profits and losses.

- **Cryptocurrency CFDs** allow investors to speculate on price changes in highly volatile cryptocurrency such as Bitcoin or Ethereum.

- CFDs are prohibited from being sold to U.S. citizens or residents. They are marketed through Internet platforms and regulators caution that some of these platforms can be fraudulent themselves.

- These speculative, high-risk products are prohibited in the United States for a reason; they are not suitable for investors. There are red flags waving everywhere.

Identity Theft

- Thanks in part to new laws requiring reporting of suspected senior financial exploitation, NASAA members are hearing about an uptick in suspected identity theft cases involving seniors and scammers who attempt to deplete their accounts.

- Since the enactment in 13 states this year and last of a new law requiring registered firms to report the suspected financial exploitation of vulnerable adults, the state securities regulators are receiving reports that describe the suspected financial exploitation of retirees, elderly persons and other investors.

- ***The Texas State Securities Board has noticed that it is receiving a considerable number of reports reflecting attempts by third parties to falsely assume the identity of clients to illegally gain access to their accounts.*** These third parties are using sensitive identifying information, such as client's dates of birth and Social Security Numbers, to create the appearance that the third party is actually the client.

- If a hacker or other criminal is able to gain access to the client's accounts, he or she may be able to liquidate holdings and transfer money anywhere in the world, essentially eliminating the possibility of recovery of the funds.

Arbitration

- Forcing investors to waive their legal rights and commit to arbitration before the facts and circumstances of a dispute are even understood is not fair. NASAA has had a longstanding concern with the widespread use of pre-dispute clauses that mandate arbitration in customer contracts and the aggressive steps some have taken to expand the reach of these clauses.

- Congress recognized that agreements mandating arbitration of disputes before the facts of the dispute are known may be unfair to investors when it enacted Section 921 of the Dodd-Frank Act, which gives the SEC the authority to prohibit or restrict forced arbitration if it finds that doing so protects investors and is in the public's interest. In the more than five years since the Dodd-Frank Act was signed into law, the SEC has not conducted rulemaking or begun to examine the impact of these clauses on the public or investors.

- NASAA believes that such clauses reduce investor confidence in fair and equitable recourse, which is critical to the stability of the securities markets and long-term investments by retail investors. It is a fundamental right of aggrieved investors have the option to submit their case to the judicial system to fairly resolve disputes with their investment professionals.

NASAA Position

- NASAA urges the Securities and Exchange Commission to exercise its authority under Section 921 of the Dodd-Frank Act by prohibiting the use of mandatory pre-dispute arbitration clauses in broker-dealer and investment adviser contracts, but in the absence of such action, supports Congressional action to codify Section 921.

- At a minimum, NASAA urges Congress to exercise its oversight authority and investigatory responsibility to require the SEC to gather quantitative and qualitative data that would establish the analytical foundation for future rulemaking.

- NASAA has supported federal legislation that would address the inequity of mandatory pre-dispute arbitration. Specifically, NASAA has supported the Investor Choice Act of 2015.

Expungement

- It is critical to maintain the integrity of CRD and IARD data. NASAA members rely upon this data to make licensing decisions and to screen bad actors and others who seek to harm investors.

- This gatekeeper function is one of the many ways NASAA members work to protect investors and bolster their confidence in financial markets and in the professionals who provide important financial services.

- Expungement of a broker's CRD record is an extraordinary remedy. If the remedy remains commonplace and continues to be routinely granted, it will contribute to a loss of confidence in the CRD system.

- Without significant reforms, the expungement process will continue to result in the deletion of critically valuable regulatory information from the CRD. If such information continues to be removed without meaningful consideration as to its regulatory value, regulators, industry, and investors can no longer trust that the data in the CRD contains all of the critical information necessary to make licensing and hiring decisions or to determine which financial professional to trust.

NASAA Position

- NASAA believes there should be no compromise in the integrity of the information housed on CRD and the IARD, and that significant changes must be made to the expungement process to limit the circumstances in which expungement is granted.