

"It's not a Security"

INVESTMENT SCAMS

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In the wake of the recent stock market decline we have seen a spike in investment scams aimed at investors seeking an alternative to the stock market. Some of the most insidious are marketed through trusted financial advisors, such as financial planners, insurance agents and accountants. How do honest financial professionals get sucked into these schemes? How are the supervisory functions of broker/dealers and life insurance companies circumvented? The common denominator is the claim by scam promoters that "It's not a security." Let's use "INAS" as a shorthand reference to these schemes.

Claiming that an investment product is not a security is the rationale underlying several other spurious assertions by INAS scam promoters.

Since it's not a security, the product offering does not have to be registered with the S.E.C. and state securities commissions, avoiding all those legal costs and delays. You don't have to have a securities license to sell it. If you do happen to have a securities license, you

don't need to get this product approved by your broker/dealer. The problem is that many of these products really are securities, so the other assertions fail. You discover the awful truth after you have been selling this product to your best clients for six months and then learn that the issuer has been shut down by the S.E.C. and has filed for bankruptcy and you are being investigated by securities and insurance licensing authorities.

You realize that your professional reputation has been mortally wounded and your business is on the line. Then things get really interesting. Your clients go to lawyers and the lawsuits start coming in.

You report the lawsuits to your E&O carrier and discover you have no coverage.

INAS scams come in quite a variety of forms. Forms we have seen recently include corporate promissory notes, substandard auto loan pools, viatical settlement pools and pay telephone leasing ►



14³/₈ 30¹/₄ 42³/₈ 24⁷/₈ 15⁵/₈

arrangements. There is no limit on the creativity of scam promoters, so we expect to see more varieties in the future. There are three characteristics that are common to most. First, of course, is the claim that this investment is not a security. Second is the product purports to provide a “guaranteed” high fixed rate of return ranging anywhere from 10% per annum to 30% per month. The high fixed rate of return is the “hook” to snag It is amazing how little thought investors give to insolvency risk. The third telltale characteristic is the unusually high selling commission, typically 8%-12%.

Let's look at a couple of these issues in greater depth. There are sound investments that are not securities. A prime example is the whole life insurance policy. Insurance, however, is heavily regulated by other agencies to protect the public. There are also securities offerings that are properly registered and turn out to be bad investments. On the federal level securities registration is based on a disclosure standard, not an investment quality standard. INAS scam promoters do not want to register their offerings because they do not want to disclose all the material facts about the investment. Facts such as the following: the business scheme is totally unproven and involves significant risks of failure; the promoters lack any track record of conducting successful businesses in the past; the business plan involves such high management fees to the promoters that profitable operation is virtually impossible; and there are no audited financials.

Many INAS schemes appear to be successful at first. They are making the promised distributions to enthusiastic investors. As a result, existing investors recommend it to their friends who become new investors. It often turns out that the distributions to early investors are being funded out of money put in by new investors. In other words, they are Ponzi schemes. The false appearance of early success also causes those who sell the product to recommend it to their professional colleagues. Financial professionals who get sucked into these schemes typically say that they thought the product was legitimate because it was recommended by a respected colleague.

The legal consequences of selling an INAS scam can be quite severe. Participating in the illegal distribution of an unregistered security results in absolute liability under both federal and state law. It is no defense that you relied in good faith on the representations of others that “it's not a security.” INAS schemes also typically involve sale by means of fraudulent representations. You can find yourself in really deep trouble despite your good intentions. You can lose your licenses. You risk criminal prosecution.

Perhaps the most devastating consequence is that your E&O coverage will provide little or no protection from claims by your clients who lost money in an INAS product you sold. Since the INAS scheme really is a security, you need to see when your E&O policy will cover claims arising out of the sale of a security. This will vary from policy to policy, but we can make some general observations. If you have a life agent E&O policy, you may not have any securities coverage at all. If you do, it is likely to be quite limited (e.g. only for mutual funds registered with the S.E.C.). If you have a security broker/dealer registered representative policy, your coverage is probably limited to securities approved by and sold through the broker/dealer with whom you are registered. In most of the cases we see, the INAS product was not approved by the broker/dealer and the claim is not covered because it arises from “selling away.”

Broker/dealers have a significant risk exposure in connection with the sale of unapproved products by their registered representatives. The legal theory is that the broker/dealer has a duty to supervise its registered representatives and should take adequate steps to prevent them from selling unapproved products. We have had some success in defending these claims where the investor never had an account with the broker/dealer. We have not had good results when the rep sells both approved and unapproved products to a customer who has an account with the broker/dealer. The question of E&O coverage for the broker/dealer in a case of failing to supervise selling away is difficult and very much dependent upon the terms of the particular policy. Some policies provide no coverage for such claims. Others provide the coverage but subject to very high retentions.

What can you do to protect yourself? First, do not sell investment products which are not approved by the life company or broker/dealer you represent. If you have any doubts, consult with your company's compliance department. Do not rely on claims that an investment product is not a security and you don't need approval to sell it. Contact regulatory authorities to check out an investment product before selling it, including the S.E.C. and your state securities commission. A lot of information about current scams appears on these agencies' web sites, but it is a good idea to make a telephone inquiry. You may learn about investigations or enforcement actions which have not yet been publicly announced.



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