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HOW TO TELL IF AN INVESTMENT OPPORTUNITY IS A FRAUD

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How do you know whether an investment opportunity is really just a scam? Outside of the regulated stock markets,[1] investment opportunities present themselves on Main Street every day and in every form of media. These "alternative" investment opportunities are often not registered with state or federal securities commissions,[2] and may not be required to be registered.[3] Discerning bona fide off-Wall Street investment opportunities from fraudulent offerings is not always easy. This report is designed to offer the prospective investor a distillation of certain common scenarios designed to aid in avoiding fraudulent offerings, and is presented in a format of questions that the reader could ask himself or herself. This report can never be a complete list of all circumstances to be aware of, nor can any report substitute for the prospective investor's own research and professional guidance. The report is provided with these caveats.

This report focuses on certain hallmarks of fraud in unregistered investment offerings.[4] Off-Wall Street investment offers are often referred to as "Reg D" or "Reg S" investments or offers, "private placements," "alternative investments," or "investment opportunities." Investment opportunities in private or unregistered offerings are not necessarily illegal, fraudulent, or without merit. However, offers of such opportunities are often communicated to unsophisticated prospective investors through mass media or in private conversations with friends and associates. These are the offers that are the subject of this report.

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[1] Detection of financial statement and disclosure fraud in documents filed with the U.S. Securities and Exchange Commission (SEC) oftentimes is expensive and difficult for the average investor. A discussion of how to investigate SEC reporting violations is beyond the scope of this report.

[2] Lack of registration does not mean that the offer is fraudulent. It means that publicly available information on the enterprise making the offer is not available and may also mean that a state securities commission merit review of the offer did not occur.

[3] This may be because the opportunity qualifies for a statutory exemption from registration, or the opportunity may be one not offered in compliance with applicable securities laws.

[4] Federal law makes it illegal for anyone to offer an investment opportunity to anyone in the United States unless the offer is registered with the SEC or meets certain criterion to be exempt from registration on a transaction or permanent basis. In addition, most states require some type of filing if a state resident purchased a security in an offering made by the issuer of the investment or its broker dealer underwriter. Also, all individuals that offer investments as an occupation must be licensed by appropriate authorities. Because the requirements for registering an offer with the SEC are time consuming, deeply revealing, and expensive for many enterprises, many choose to seek capital from investors using less regulated alternative means.

Thus, while all investment opportunities carry with them varying degrees of the risk of loss, discernment of the bona fides of an investment opportunity starts by considering whether the opportunity and its salesperson are registered appropriately, the means by which the opportunity was communicated, the attributes of the investment, and the reasons why you are enticed by the opportunity. Most hallmarks of a fraudulent investment opportunity can be revealed through an evaluation of these factors.

1. How Did You Learn About the Investment Opportunity?

If you learned about the opportunity through any means other than directly from your licensed securities salesperson, licensed investment adviser representative, or from your own research, [5] that is a sign that you need to do much more homework.

Investment scams are communicated effectively through both mass media means and word-of-mouth sources. While one would think that people would be on guard when being exposed to mass media communications such as emails, chat room communications, free lunch seminars, faxes, direct mail, television advertisements, television infomercials, billboard advertisements, social media, and web sites, almost every day an opportunistic investor will fall victim to a fraudulent offer communicated using one or more of these means. Mass media publications such as newspaper articles (but not newspaper advertisements), finance magazines, and financial e-zines, on the other hand, may, but cannot be guaranteed to be, more credible sources.[6]

Investors are confronted everyday with investment opportunities communicated via mass media. In many situations the advertising of an investment opportunity cannot in the space provided disclose all risks and biases and therefore may be misleading, and in other circumstances the advertising may violate the requirements of exemptions from securities offering registration.[7] In addition, newspapers publishers, and television and radio networks typically do not screen their advertisers. Direct mail, e-mail, fax blasts, social media chatter - all of it is unregulated and inexpensive to utilize, fraudulent offers are easily communicated in this impersonal manner. You should use extreme

[5] Distinction is drawn for licensed securities industry personnel, who by statute are required to be supervised and typically are limited to recommending only firm-approved investments.

[6] News reporters and financial media organizations from time to time have been accused of illegal insider trading or the reporting of inaccurate statistical ratings of securities.

[7] In special situations advertised securities offerings are or will be permitted, such as offerings limited to the residents of a single state, and offerings limited to accredited investors.

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caution before acting on a solicitation communicated through mass media without substantial further inquiry.

Possibly more dangerous is the trust or credibility placed by investors in word-of-mouth sources such as co-workers, friends, relatives, religious organizations, social clubs, and community organizations. Because such communications are privately conducted, the scams that are communicated through this means of communication often go undetected by regulators until enough investors complain. Just because no one has complained or sued does not mean that the opportunity is safe for you. Take your time and research the opportunity.

Some of the largest and most devastating investment scams have been perpetrated without any advertising. These situations start with one person telling a friend about their great investment returns, and then that person invested without doing any research, and then that person told their friend who then invested, and so on. Later on it is inevitably revealed that the returns were non-existent and that the “interest” or “dividends” paid out was not, in fact, a return on investment based upon a distribution of net profits but was, in fact, funds invested from subsequent investors. Some courts have allowed suits to reclaim the early “returns” from the investors who received them to put them on an equal loss level with the later investors.

In all cases, when a person places their trust on a third-person’s report, one does so typically presuming, but without actually knowing, whether the source performed any analysis whatsoever or whether the source was paid or is biased. If a friend or relative says she invested, what investigation did she conduct? Before investing, ask yourself whether you each have the same finances, investment portfolio, and risk tolerance? Regardless of these answers, do your own research.

Other questions to ponder include: where is the company located that is offering the investment? Have you visited its office? Do you personally know the company’s officers or directors? Is the company offering a service or does it make or intend to make a product? Answer these basic questions before proceeding. The less you know the more reason to avoid the investment opportunity.

2. Who Is Offering or Recommending the Investment and Why Is It Being Offered to You?

If you know the person who introduced you to the opportunity, how well do you know their investment track record (and their work experience and court history)? What is their connection to the investment? People typically and naturally overlook the bona

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fides of close relatives and people that they know through religious and civic organizations, social clubs, and co-workers. While people you know may have invested in the investment that they are telling you about, investigate the opportunity anyway. Countless people every year are victimized because they knew someone who invested and then they did so themselves. Indeed, your friends, family, and others may have your best interests in mind and are trying to benefit you by including you in the circle of soon-to-be wealthy insiders. They may unintentionally financially harm you instead.

If you do not know the person who introduced you to the opportunity, check out their background.

Determine whether the introducing person is appropriately licensed. All securities brokerage firms and salesman must be members or associates of a self-regulatory organization. Most are members and associates of FINRA (the Financial Regulatory Authority). In addition, all securities salespersons also must be licensed in each state where they solicit investments. The website www.NASAA.org has a chart with contact information for each state's securities commission under the tab "Contact Your Regulator." Information supplied by a state securities commission is likely to be a career long history, but it will not be instantly available to you. However, the "Broker Check" feature on the FINRA website (www.FINRA.org) will immediately provide the registration status and disciplinary history of all persons currently registered and for persons whose registration expired within the last two years. You will need the person's first and last name and the name of their brokerage firm to locate them using Broker Check.

Personnel of the company issuing the investment opportunity, usually the officers or directors, are not required to be registered in most states. However, selling securities cannot be their full-time job, nor can they be compensated based on the securities they sold. Ask what their relationship to the investment issuer is. Ask yourself, why are they offering this opportunity to me if they do not know me?

If the salesperson is not licensed, and you do not have a pre-existing relationship with this person, and they are not officers or directors of the investment issuer, this is not a good sign. This is a good reason to avoid the opportunity.

Additional questions to ask the salesperson include, how are you being compensated? How soon can I sell my investment? How do I sell? At what price must I sell to profit after transaction expenses and commissions? Exactly to what uses will my investment money be placed by you and the company? What percentage of my investment money pro rata will be used to compensate the management? How long has the company been in business? Who is its independent audit firm? In what state is

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the company incorporated in? Tell them to put these answers in writing and to send them from the company fax number or email to you using a company email address.

If the salesperson does not have time to get you these answers, you do not have time to part with your money.

3. Is the Offer Registered?

Determine whether the enterprise offering the investment files reports with the SEC. At www.SEC.gov, search the company name under the tab “Filings.” If the company has reports and/or a registration statement filed, and the reports or registration statements are less than one year old, this is a good sign. Read the reports and the registration statement. The registration statement will be noted as “S-1” if it is a small company while the annual, quarterly, and periodic reports will be noted as “10-K,” “10-Q,” or “8-K.” Amendments are noted as “__/A.”

If there is only a filing noted as “D” or “D/A,” this could be a good sign if the notice is less than one year old. Read the notice. For the purposes of this report, the filing of a Regulation D notice is an indication that the company is aware of certain legal compliance obligations, but it does not mean that the offering itself is legally compliant or transparent. Further investigation is required.

If there are no recent reports, registrations, or notices filed with the SEC, this may be a bad sign. However, Regulation A securities registrations are not available on the SEC website. To confirm that no public documents are available, you also need to contact your state securities commission. Ask whether there is a filing made by the securities issuing company. In any event, extreme caution should be used if you proceed further.

> NOTE: Regulation S or “Reg S” Transactions. No notice is required to be filed with the SEC if a company is conducting an offering under Regulation S. Therefore, the absence of a notice filing for a “Reg S” transaction is to be expected, unless you, the offeree, are a U.S. citizen or are a person resident in the United States at the time of the “Reg S” solicitation. In such case, the “Reg S” offer is not bona fide as the Regulation S exemption applies only to offers made to non-U.S. persons residing offshore.

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4. What Is Being Offered?

There is both business risk and market risk associated with every investment opportunity. Typical opportunities to avoid are the proverbial “too good to be true” investment opportunities. Other extreme danger signs include sales pitches or advertising offering:

a) A must-act-now opportunity, such as: the treat of being excluded (“You will not be called again” or “You are too small and I am doing you a favor”); scarcity (“Only a few shares left); or an opportunity that only the wealthy share or only industry insiders have access to such as private placements, letters of credit; or prime bank notes;
b) High returns with low or undisclosed or unknown risk;
c) A unique or obscure market situation; or
d) A tax free and/or offshore investment opportunity.

If you allowed yourself time to research the opportunity before you accepted the need-to-act-now offer, you may likely discover that:

a) Your attorney or accountant would advise against accepting the opportunity;
b) The opportunity is overpriced or obsolete compared to its competition;
c) Information on the investment’s bona fides is difficult or impossible to obtain;
d) The opportunity is illegally offered;
e) The opportunity is not insured or actually guaranteed;
f) The promoters have undisclosed criminal or investment-related black marks in their careers;
g) The opportunity is subject to foreign laws and courts that you have no easy or inexpensive access to; and/or
h) Similar offers have resulted in complaints of identity theft and bank account theft.

Even if you cannot understand what is being offered, avoid investing in it.

5. What Documents Describing the Investment Opportunity Does the Salesperson Have?

The documents supporting many fraudulent offerings are oftentimes so poorly prepared and presented that the documents alone are the telltale clue for the investor to run away. Poor quality photocopies, spelling mistakes, a description of potential investment returns but little other disclosure other than where to send your money, cut

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and pasted legal opinions and engineering reports; all of these are hallmarks of a scam. There is no other description because the scammer knows that it is the above-market return that the victim seeks. Victims do not care about the details and never read the disclosure documents.

However, prospective investors who may not read voluminous SEC-filed disclosure documents may well take a short time to parse the quality and completeness of the salespersons' investment description. If the materials provide little information on the risks of the investment, backgrounds of the management, and how the investment proceeds will be used, it is probably wise not to invest. If you are uncertain whether the disclosure materials are typical or atypical, you would be wise to consult an experienced securities attorney or public accountant. Experienced professionals can easily recognize the obvious shortcomings of a poorly prepared disclosure document or investment advertisement.

6. Why Do You Want to Accept the Offer?

Consider your reasoning. If you are rationalizing the purchase because:

a) Your friends or family made money and you think you can also;
b) It sounds like a good deal and you do not want to miss the opportunity;
c) Your lifestyle will change for the better with the profits you will make; or
d) You will give to the family or to charity with your excess profits, then

You are dreaming of easy money instead of researching the potential for investment loss.

CONCLUSION

A well-executed, professional looking, scam may deceive even the most seasoned professionals, and this report cannot encompass all of the ways that investment scams can be perpetrated. However, most alternative investment opportunities offered to the public will reveal their true colors if the prospective investor does his or her homework. Hopefully, this report will give the prospective investor additional tools and perspective. When in doubt, consult a qualified professional.

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Russell C. Weigel, III, practices securities law nationwide from his Miami, Florida office. Mr. Weigel was a branch chief and special counsel at the U.S. Securities and Exchange Commission and served during the years 1990-2001. Mr. Weigel's law firm specializes in counseling securities issuers in SEC securities offering registration and reporting compliance matters, in preparing private offering documents, and defending issuers and other securities industry participants from SEC FINRA enforcement actions and customer arbitrations.

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