



State of Rhode Island
Department of Business Regulation



**STATE OF RHODE SECURITIES DIVISION RELEASES “UNLUCKY 13” LIST
INVESTOR TRAPS FOR 2006**

May 4, 2006

Providence, RI-The Securities Division of the State of Rhode Island Department of Business Regulation today outlined a forecast of the 13 most common ways investors are likely to be trapped in 2006.

Before making any investment, investors are urged to ask the following questions:

- Are the seller and investment licensed and registered in Rhode Island?
Contact the Division at 222-3048 to verify license and registration.
- Has the seller given you written information that fully explains the investment?
- Are claims made for the investment realistic?
- Does the investment meet your personal investment goals?

2006 Investor Traps:

Affinity Fraud. Members of close Knit religious, political, or ethnic groups are targeted frequently by con artists. Their pitch is essentially, "since I am like you and believe like you, you can believe in me and in what I say." When an investment is presented in this context, the potential investor should be extremely wary. This pitch seeks to substitute an emotional appeal for careful analysis and critical thought.

Churning. An abusive sales practice in which unethical securities professionals make unnecessary and/or excessive trades in order to generate commissions. Most churning occurs when a broker has discretion to trade the account. In a discretionary account, it is not necessary that the broker receive prior approval from the client to complete a transaction.

Equity Indexed Certificates of Deposit. Remember the days of FDIC-insured, bank-issued certificates of deposit with guaranteed principal and interest? Equity Indexed CDs are **not** the same product. These complex, hybrid securities products offer a return that is calculated over a defined period of time and is based on the return of a stock market index, usually the S&P500. Returns are not FDIC insured. They are dependent on the performance of the stock market. A declining stock market means the possibility of no return on your investment. These products pose liquidity problems and are not suitable for seniors who may need the money for retirement living.

Oil and Gas Investment Fraud. High oil prices mean oil and gas scams will continue to attract victims. Oil and gas deals are complicated and generally require a significant investment. Increasingly, these deals are being promoted via the Internet with claims of attractive tax advantages. Sales materials with "official-looking" surveyor maps and "geologist" opinion letters touting the likelihood that the "managers" of the drilling enterprise will hit pay dirt are sent regularly to prospective investors more than 1,000 miles from the region being "prospected." Overall, these deals are highly risky, but the lure of high profits often proves irresistible to investors.

Personal Information Scams. The first step in separating a victim from his or her money is convincing the victim to divulge personal financial information. A starting point for this type of scam is often the "free" seminar on a topic such as estate planning or living trusts. The real purpose of the seminar is to schedule one-on-one meetings with attendees during which personal financial information will be obtained. A common outcome is a recommendation by a sales person to liquidate securities holdings and purchase an annuity product. For the con artist, obtaining personal financial information provides a comprehensive laundry list of assets available for the taking. Regulators also caution investors to check the credentials of sales people positioning themselves as "senior specialists" and claiming expertise on issues affecting seniors. The designations may be used as a tool to build trust and then extract personal information.

Prime Bank Schemes. These schemes often promise high-yield, tax-free returns that are said to result from "off-shore trades of bank debentures." Investors are told that normally only very wealthy people can get the benefit of these programs, but the promoter is able to make it available to the victim. Sometimes the victim is required to execute a "confidentiality agreement" in order to invest and is told not to consult an attorney, accountant or financial planner. In reality, there are no such programs, no such debentures and no such high-yield trades. These prime bank schemes are the securities equivalent of a purse snatch. Once the seller has your money, it's gone "off shore" forever.

Pump and Dump Schemes. Unethical broker-dealers frequently "pump" up the value of low-priced securities traded on the NASDAQ "pink sheets" and then "dump" the stock after naïve investors have purchased the stock at inflated prices. The balloon breaks when the promoters no longer maintain the myth that there is value in the shares and investors are left holding worthless shares. These schemes frequently appear through unsolicited e-mail messages, faxes, and "wrong-number" voice mail messages.

Recovery Rooms. Scam artists buy and sell the names and financial information of victims who have lost money to "recovery room" operators who promise, in return for a fee that the victim must pay in advance, to recover the money lost in a worthless investment. These "sucker lists" are bought by crooks who know that

people who have been deceived once are vulnerable to additional scams; especially scams that give hope of recovering lost money. If you have been the victim of a fraud, never give out your credit card or other personal information to someone who contacts you with a promise to recover your money. Remember, in the scam world this caller is known as a "reloader" and he is setting you up for a second round of losses.

Registered High-Interest Promissory Notes Publicly Advertised. Generally, the higher the return promised, the greater the risk to your money. A track record of paying high interest and repaying principal is not an assurance that you will get your money back if the company fails. These notes are not suitable for retirement funds.

Sale and Leaseback Contracts. In an attempt to avoid the investor protections of securities laws, some investments are structured to resemble the sale of a piece of equipment such as a payphone, ATM machine or Internet booth located at a remote venue where the investor cannot service and maintain the equipment and must enter into a servicing agreement. In order to make the deal more attractive, investors are told that after a given period the equipment can be sold back to the seller at the investor's original purchase price. The investor is also promised a specific rate of return. In a variant of this scheme, a real estate interest such as a long-term lease in a resort community is sold instead of physical equipment. Frequently the equipment or property does not exist and the seller lacks the financial capacity to keep the promise of repurchase.

Self-Directed Pension Plans. Many types of securities fraud require the victim to remove funds from legitimate investments such as stock brokerage accounts, mutual funds, insurance policies, deferred compensation plans and mutual funds so that they can be invested in a worthless scam. This scam may begin with advice to convert an employer-sponsored pension into a self-directed pension plan. While these plans may serve legitimate investment purposes, all too often they only serve to benefit the scam artist.

Unsuitable Recommendations. Just as every investor is different, so too are investments. What may be a suitable investment for one investor may not be right for another. Securities professionals must know their customers' financial situation and refrain from making investment recommendations that they have reason to believe are unsuitable. When securities professionals fail to live up to applicable ethical standards, great harm can be done to individual investors.

Variable Annuities. Variable annuities are tax-deferred investments that typically place mutual funds inside of an insurance wrapper for tax deferred potential investment growth. While these products are legitimate investments, regulators are concerned about their popularity in the sales community. Commissions paid to those who sell variable annuities are very high, which provides incentive for sellers to engage in inappropriate sales. The steep

penalties for early withdrawals make variable annuities unsuitable for short term investors, and variable annuities are generally not suitable for most seniors. Be especially wary of any broker who wants to sell you a variable annuity to hold inside a 401(k) or IRA. You are already getting tax-deferred growth in an IRA or a 401(k), and the variable annuity simply adds a layer of cost with no additional tax benefit.
