

Sales of unregistered securities are a growing problem that's harming investors – and the industry

The practice is dangerous and giving the industry a black eye – so what can financial advisers do to stop it?

By **Bruce Kelly** | April 13, 2019 - 6:00 am EST

To an investor, Castleberry Financial Services Group's promise of up to a 12.2% annual yield on the alternative investment fund it was selling might have seemed awfully tempting. So might the assurance that your principal would be insured and bonded by well-known insurance companies CNA Financial Corp. and Chubb Group.

In promotional materials, Castleberry claimed to have invested almost \$800 million in local South Florida companies and to have a portfolio of real estate holdings that was generating \$2.8 million in rental income annually.

But in late February, the [Securities and Exchange Commission](#) went into court to shut the company down, claiming it was all a fraud, including the involvement of CNA and Chubb.

Before the SEC acted, though, it said that Castleberry had managed to raise \$3.6 million from investors, some of which was used to pay the personal expenses of its principals. Other funds were transferred to family members or other businesses the principals controlled, according to the SEC.

By all indications, the marketplace for all types of private, unregistered securities, including private placements sold to wealthy investors and institutions, is thriving. But what's growing alongside this legitimate, if risky, market is a seedy side of the financial advice industry. Investment funds promising above-market returns that employ networks of brokers, former brokers, insurance agents or others lurking on the fringes of the industry to sell their investments are taking advantage of unsuspecting investors.

\$3T amount raised through all private offerings in 2017

Add in the ability to offer private securities over the internet and solicit clients via social media, and unregistered, private securities being sold to less-than-wealthy investors, many of them senior citizens, are becoming increasingly dangerous. Fraudulent securities are damaging the reputation of the legitimate financial advice industry, and the industry itself might serve as the best solution to safeguarding the investing public.

"I'm seeing more of it: the spike in the sale of nontraditional investments," said David Chase, a former SEC staff attorney who's now in private practice and based in South Florida.

The proliferation of potentially fraudulent schemes comes at a time when the sale of legitimate private securities, which are exempt from having to be registered if they meet certain SEC guidelines, has taken off. While the annual amount of public stock offerings has remained relatively steady over the past decade, the sale of new private stock offerings has soared.

The most popular of these, known as Regulation D offerings, have more than doubled, from 18,295 in 2009 to 37,785 in 2017. Those deals, along with other types of private offerings, raised a total of \$3 trillion in 2017.

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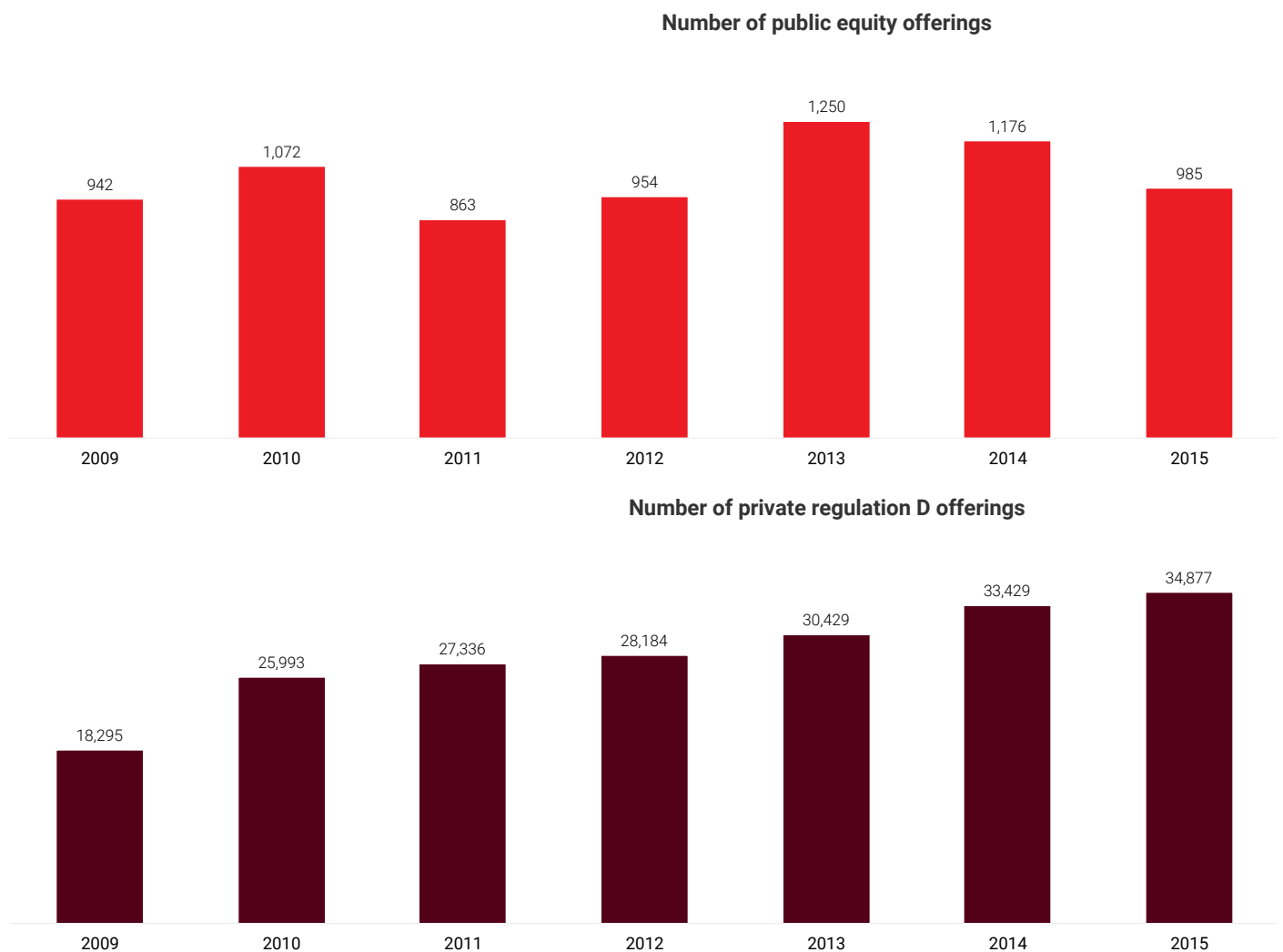
Brokers and advisers can sell private, unregistered shares to only the wealthiest clients; investors need a net worth of \$1 million or an annual individual income of \$200,000 to buy in. But the public disclosure is negligible, making the securities opaque, some sources said, and that is hazardous.

The game plan of the fraudulent unregistered securities schemes currently roiling the investment advice market is simple. An investment manager claims to have an alternative investment to the stock market that beats the return on bonds or bank deposits. The investments are heavily marketed with investment seminars, dinners, and ads on radio and in local newspapers.

James Park, securities professor at UCLA, said the internet is giving the promoters one more outlet to sell their fraudulent investments.

"It's now possible to get investors from everywhere," he said. "In the old days, brokers would have to call up people to convince them to invest or put on a road show. Now it's normalized with online platforms."

In one of the largest recent cases, the SEC said the owners of [Woodbridge Securities raised \\$1.2 billion](#) over a five-year period by claiming they were selling loans to real estate developers.



Source: North American Securities Administrators Association

Promising returns of 10%, the scheme reeled in 8,400 investors, many of them senior citizens, with the help of a network made up mostly of insurance agents and former stock brokers, according to the regulator. Woodbridge's owners kept the scam going, the SEC said, by using money from new investors to pay off old investors — a classic Ponzi scheme.

Without admitting or denying the allegations, Woodbridge and its former CEO Robert Shapiro settled with the SEC for \$1 billion in disgorgement and fines. Ryan O'Quinn, a lawyer for Mr. Shapiro, did not return a call seeking comment.

One of the reasons these cons take time to detect is because the agents selling them mostly work outside the supervision of licensed broker-dealers, who are under the purview of the Financial Industry Regulatory Authority Inc. This gives the fraud ample time to flower before the SEC or a state regulator gets a complaint from an investor, investigates and shuts it down.

"[The largest Ponzi schemes](#) in general are those that have tapped into a very successful and productive line of independent sales agents who typically have long-standing relationships with clients," Mr. Chase said. "They sell the deal, and clients get defrauded."

The SEC did a better job of shutting down what it said was a fraud in the case of Castleberry Financial Services Group after only a year in business. In February, the SEC was granted a temporary restraining order and temporary asset freeze against Castleberry and its principals.

Among other allegations, the SEC said the firm's president, T. Jonathon Turner, formerly known as Jon Barri Brothers, had falsely claimed to have had extensive finance industry experience, an MBA degree and a law degree, while concealing that he had served 18 years in prison for multiple fraud, theft and forgery felonies.

Attorneys for Castleberry Financial and its executives did not return calls seeking comment.

In 2017, state regulators reported that enforcement actions against unregistered brokers and salespeople increased at a faster pace than actions taken against registered individuals. That means the risk from salespeople on the fringes of the financial advice industry is growing. And they are the type of people who often sell scams that are being marketed as unregistered securities.

"[The] enforcement survey reflects a [large increase in enforcement](#) actions against unregistered individuals and firms," according to an October 2018 report from the North American Securities Administrators Association. Members of the group reported actions in 2017 against 675 unregistered individuals and firms — an increase of 24% over the prior year — and 647 registered individuals and firms — a 9% increase.

"The surge in cases against unregistered actors reversed a two-year trend in which registered individuals and firms in the securities industry, broker-dealers and investment advisers, had constituted the majority of respondents in state enforcement actions," according to NASAA.

Perhaps the poster boy for selling phony unregistered securities is [Barry Kornfeld](#), a leading seller of the Woodbridge Ponzi scheme.

The SEC barred Mr. Kornfeld from working as a broker in 2009. Regardless, he continued to sell private securities; he and his wife allegedly solicited investors at seminars and a "conservative retirement and income planning class" they taught at a Florida university, according to an SEC complaint.

From 2014 to 2017, he and his wife received \$3.7 million in commissions after selling more than \$60 million of the Woodbridge private securities, according to the commission. Mr. Kornfeld reached a settlement in January with the SEC, agreeing to be barred for a second time from the securities industry. Robert Harris, a lawyer for Mr. Kornfeld, did not return a call seeking comment.

Unregistered reps aren't the only ones selling fraudulent securities. Registered reps working at broker-dealers also are involved.

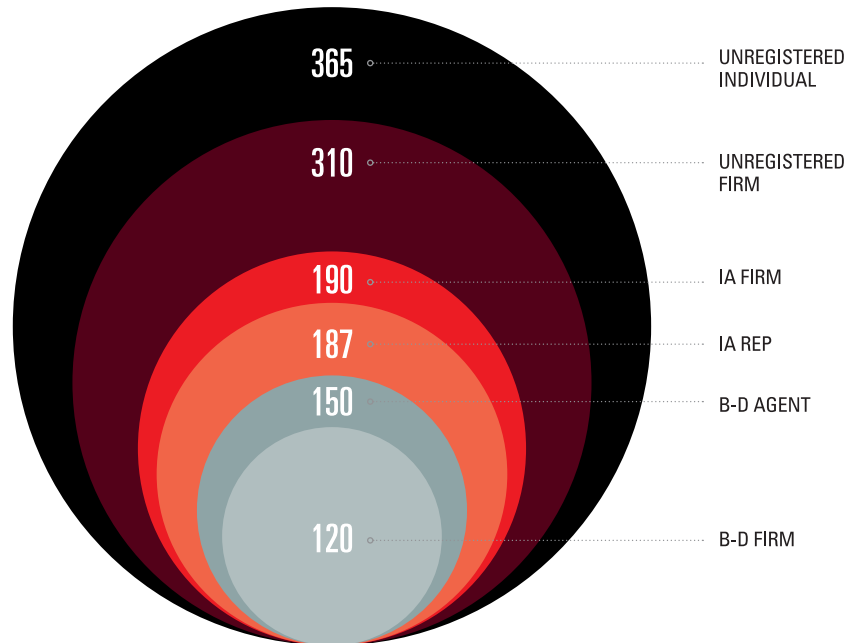
"We're starting to see more sophisticated means for registered reps within the broker-dealer space to get investors to invest in private securities," Thomas Drogan, senior vice president at [Finra](#), said in testimony last year about investor fraud before the SEC's Investor Advisory Committee. "The challenge in that space has been reps encouraging their customers, for example, to send money from their brokerage account to their bank account. And once the money gets to the bank account, instructing the

customer to then send the money to the individual reps' outside business activity. This creates a problem. This creates a very big challenge for broker-dealers to conduct surveillance on."

The practice, known as "selling away," can be grounds for disciplinary action if the broker-dealer employing the broker has not approved the broker's actions.

Enforcement targets

Unregistered firms and individual topped the list of disciplinary actions by state securities regulators in 2017



Source: North American Securities Administrators Association

Advisers at independent broker-dealers are commonly paid 7% commissions when selling private placements, clearly on the high end of a broker's pay scale.

"What's driving this?" asked Adam Gana, a plaintiff's attorney. "It's commissions, commissions, commissions. Brokers think they can get away with selling whatever they want on the side."

Even though these dubious private securities are creating havoc for investors and the financial advice industry, regulators may soon change the rules about how private securities transactions are supervised.

Last year, Finra proposed rule changes that are intended to simplify how broker-dealers supervise a hybrid rep's outside business activity and sale of private securities. The new rule focuses on the rep's RIA firm and decreases some of the responsibility the broker-dealer has to watch over that separate line of business. It would cut costs for the firm and the broker. But some think these changes could prove dangerous.

[William Galvin](#), secretary of the Commonwealth of Massachusetts and the most feared regulator in the securities industry, does not care for the Finra rule proposal.

"Finra claims that the proposed rule will strengthen investor protections, but it is not at all clear how investors will be protected by the removal of supervisory oversight," Mr. Galvin wrote in a comment letter last April about the proposed rule. "The absence of proper oversight of outside business activities will increase the risk of fraud and abuse."

Can financial advisers and the financial advice industry do anything to contain this problem?

Local investment advisers are often the best cops on the beat for detecting such frauds. Their knowledge often comes from clients who are being pitched such deals at "free" steak dinners that are provided to get them in the door for a presentation.

Advisers have the responsibility to report a suspicious private securities deal to their firm, said Mr. Chase, the former SEC attorney.

"If brokers get wind of these types of deals, they've got to go to the broker-dealer's compliance department and report to the SEC or Finra," he said. "They have the ability and obligation to report. There's nothing wrong with putting these suspicious deals in front of regulators."

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