

Financial Services Disputes and Enforcement

Busting the Boiler Rooms: The FSA raises the temperature for rogue brokers

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The phone rings. The caller explains that your financial adviser passed him your details. He is polite and well spoken. He knows that you and your spouse hold shares, and how many, and in what companies. He tells you that he is able to give you an exclusive chance to purchase shares under an IPO of a very profitable company. You discuss his proposal at length. He is convincing, persuasive, and persistent. You are impressed, and, eventually, you agree to transfer the minimum investment amount requested, with the prospect of immediate profit. It almost sounds almost too good to be true. It is. You have just been the victim of a boiler room.

The FSA, together with the Institute of Chartered Secretaries and Administrators ("ICSA") have announced renewed efforts to bust the boiler rooms by requesting that UK listed companies take the initiative to warn and protect their own investors.¹

This article examines the nature and extent of the boiler room problem, and evaluates the response by the FSA and the ICSA.

The blight of the boiler room

Boiler rooms have for decades preyed on UK investors. Often, boiler rooms will legally obtain share registers for listed UK companies in order to compile "lead books" of potential targets. Then, they will contact these investors and illegally promote and sell shares that are non-existent, non-tradable, or over-valued, using a variety of sales tactics in order to get investors to part with their money. Once the money is handed over, the boiler room vanishes.

Because boiler rooms are invariably situated outside the UK, it is difficult for the FSA to take direct enforcement action to close them down. Equally, because they are not FSA authorised, victims cannot turn to the Financial Services Ombudsman, or the Financial Services Compensation Scheme.

The evolution of boiler room tactics

A now standard tactic is that of the "loader". These boiler rooms will initially suggest that the investor just invests a small amount to see how he gets on. The boiler room will manipulate or fabricate impressive performance figures, and then encourage the investor to commit much larger sums.

Other boiler rooms reportedly contact existing shareholders in UK companies and dress up the purchase of the additional shares as a legal obligation on the part of the investor, with the threat of legal action and asset freezing if the investor refuses to purchase. Once paid for, the additional shares never materialise.

Similarly, others register companies in regulation-light jurisdictions such as the Bahamas, with the same names as desirable blue chip companies. The boiler rooms then sell these to UK investors, passing them off as the real thing. The shares are, obviously, worthless.

Probably the worst examples are "sloppers". These are boiler rooms that, once they have carried out their fraudulent programme of sales, transform themselves into so called "recovery rooms" under a completely different identity. They will then contact their victims a second time and offer to buy the shares they were sold, for an upfront lump sum commission. Once the commission is paid, the "recovery room" is never heard of again, and the fraudsters have successfully ripped the investor off for a second time.

The new victims: UK companies

Individual investors are not the only target that boiler rooms are interested in. Boiler rooms are starting to target small UK companies. An emerging method is for the boiler room to approach a small UK company and propose to raise capital by selling £100,000 of shares in that company on its behalf. The boiler room will take 60% of the £100,000 as their commission,

¹ FSA Press Release – Companies urged to help protect shareholders from 'boiler room' scams – 8 July 2008

leaving the company with £40,000 capital. The boiler room will cold call UK investors to sell the shares at up to 100% over the agreed price, take their commission, and vanish. In some cases, the shareholder may be able to seek a refund from the company. The company, however, is then required to refund to the shareholder the actual sum paid, leaving the company to carry the loss.²

The scale of the problem

The FSA receives approximately 100 calls relating to boiler rooms each month. Estimates as to total losses vary widely. However a City of London Police threat assessment in 2007 conservatively estimated that UK investors lose a total of £50 million per year. However, this was based on reported losses, and most analysts agree the figure in reality runs into hundreds of millions. A survey by the FSA found that the average loss suffered by victims was £20,000.³ Contrary to the assumption that victims are naïve and inexperienced, the assessment also found that victims tend to be male, middle-aged, experienced investors with a long history of investing.⁴

The FSA and ICSA Leaflet

Given that the vast majority of boiler rooms are based overseas, the FSA faces significant obstacles in bringing any effective investigation or enforcement proceedings against them. Consequently, together with the ICSA, it has announced a different tactic: putting the onus on listed companies to raise awareness amongst their shareholders.

Specifically, on 8 July 2008, the FSA and ICSA produced an updated free leaflet (the "Leaflet") containing bold warnings about boiler rooms that they will request all listed companies send to their shareholders. The Leaflet explains the common characteristics of boiler rooms, and what action an investor should take if contacted by one.⁵

Commentary

The hope is that all UK listed companies will send the Leaflet to their shareholders as part of their own established awareness

raising programmes. However, given the scale of the problem, the reality is that sending leaflets is not, on its own, enough. Many shareholders ignore much of the ancillary paperwork, including leaflets, sent through by the companies in which they hold shares.

The FSA needs to dedicate more resources to using its substantive powers, including cooperating with overseas regulators and police forces, in order to obtain asset freezing injunctions, compulsorily liquidate the entities, bankrupt the culpable individuals behind the entities, and initiate criminal investigations and prosecutions. These measures can work. In particular, in the last 18 months, the FSA has successfully used its powers against seven entities that operated as or assisted boiler rooms. In March 2008, the FSA worked with Canadian regulators to freeze and subsequently refund approximately £1.25 million to UK victims of several Canadian boiler rooms.⁶ Finally, in June 2008, the FSA bankrupted Mr Samuel Kahn, and wound up the two companies that he used to assist overseas boiler rooms in making £3.7 million by illegally selling shares to around 800 UK investors.⁷ The FSA needs to concentrate its efforts on these initiatives more than anything else, and needs to press for greater European level regulatory engagement with the issue.

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² FSA Press Release – FSA warns of new boiler room threat – 15 April 2005

³ FSA Press Release – Typical boiler room victim loses £20,000, warns FSA – 6 June 2006

⁴ FSA Financial Crime Newsletter – Issue No. 9 – October 2007

⁵ The Leaflet can be found at: http://www.fsa.gov.uk/pubs/other/scams_leaflet.pdf

⁶ FSA Press Release – FSA helps investors get £1 million back from boiler rooms – 6 March 2008

⁷ FSA Press Release – FSA bankrupts 'boiler room' accomplice – 26 June 2008