

Midwest Securities Law Update

Vol 5 Issue 1

About the Firm

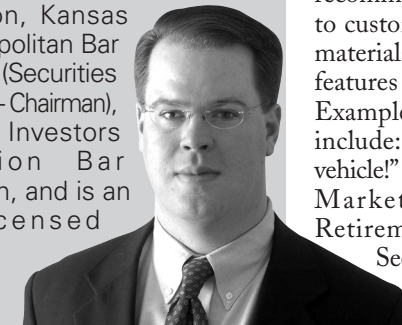
Our sole focus is securities arbitration and litigation. We do not seek out personal injury cases, criminal appointments, domestic matters, or corporate defense work. All day, every day, our practice is devoted to representing investors. Because of that focus, we can provide superior advice in this specialized area.

Within the securities industry, we are strongly committed to raising the standard of conduct among financial professionals. We work closely with the Kansas and Missouri Securities Commissioners' Office in local and state government, and local, state, and national bar associations.

Our office, located in metropolitan Kansas City, represents investors ranging from young adults to elderly retirees; and from blue-collar workers to corporate executives. Every public citizen is entitled to the protection of state and federal securities laws, and every investor deserves to be protected from rogue brokers and unethical sales practices employed by brokerage firms across the nation.

Our office is committed to giving clients thoughtful advice about their investment situations. The office often joins forces with locally and nationally-recognized securities experts in order to provide the best representation for each client.

Jeff Kruske is currently a member of the Kansas Bar Association, Kansas Trial Lawyers Association, Johnson County Bar Association, Kansas City Metropolitan Bar Association (Securities Committee – Chairman), the Public Investors Arbitration Bar Association, and is an NASD-licensed arbitrator.



the Law Office of
Jeffrey S. Kruske, P.A.
7111 W. 98th Terrace, Suite 140, Overland Park, Kansas 66212

IN Focus: Equity Indexed Annuities Part 2

Equity-Indexed Annuities are financial instruments in which the issuer, usually an insurance company, guarantees a stated interest rate and some protection from loss of principal, and provides an opportunity to earn additional interest based on the performance of a securities market index. Equity-Indexed Annuities (EIA) have characteristics of both fixed and variable annuities. Their return varies more than a fixed annuity, but not as much as a variable annuity. EIAs theoretically give you more risk than a fixed annuity, but less risk than a variable annuity. According to one recently published estimate, in 2005 sales of EIAs increased over 50%, from \$14 billion in 2003 to an estimated \$25 billion.

EIAs are complex investments. Many EIAs permit investors to participate in only a stated percentage of an increase in an index. Many of these investments also impose a "cap rate" that represents the maximum annual account value percentage increase allowed to investors. EIAs have other features that contribute to their complexity such as minimum guarantees and fees and expenses, including surrender charges, premium bonuses, and multiple premium payment arrangements. In addition, investors may assume mistakenly that EIAs provide the same returns as an index mutual fund.

Particular concern with EIAs should be directed to the sales practices employed in recommending these investments to customers. Typically, the sales materials do not fully disclose the features and risks of the product. Examples of EIA sales materials include: "A win-win investment vehicle!" "Growth Potential *without* Market Risk" "How Your Retirement Funds Can Have: Security of Principal, Higher

Than CD Rates of Interest, Opportunity for Growth (No Losses)."

One of the most important factors about EIAs is that they are not mutual funds or variable annuities, meaning that they are not regulated as strictly as traditional securities. The direct consequence in this difference in regulatory treatment is that investors in EIAs cannot trace back through returns in the markets the returns their investments may realize. As a result of the lack of regulatory oversight, EIA investors cannot determine the costs they are incurring. However, EIA salesmen can quickly determine that they commissions paid on EIAs are as high as 10% and above - much higher than mutual funds and variable annuities. Other important factors include the long surrender or holding periods that investors must endure. The average surrender period for EIAs is ten years, with some extreme examples being as high as eighteen years.

In 2005, NASD issued a *Notice to Members* on the supervision of the sale of unregistered equity-indexed annuities by registered representatives. The Notice describes some of the potentially misleading marketing claims used to sell equity-indexed annuities and encourages broker-dealers to adopt enhanced supervisory procedures for the sale of equity-indexed annuities by their registered representatives. The Notice also advises broker-dealers that any recommendation to liquidate securities to purchase an equity-indexed annuity requires a determination that the equity-indexed annuity was suitable for the investor, even if the annuity is not a registered security. For a broker to determine that an equity-indexed annuity is suitable, he or she must understand the hidden costs generated within equity-indexed annuities' complex

(continues next page)

THE LOOKOUT

In this issue (page 3), we provide some tips for what you can look out for on a few of the more common investment abuses, including:

- Ponzi Schemes
- Promissory Notes
- Affinity Fraud
- Prime Bank Schemes

Want to be an NASD Arbitrator?

- The success of securities arbitration depends on the quality of the arbitrators who hear and decide the dispute presented by the parties. There is a need for new applicants in Kansas and Missouri to serve as NASD arbitrators.

- Arbitrators are carefully selected from a broad cross-section of people, diverse in culture, profession, and background. If you have at least five years of business or professional experience, you may qualify to serve. Please contact the Law Office of Jeffrey S. Kruske if you are interested in applying to become an NASD arbitrator.

This newsletter is intended for informational purposes only, as a way for investors to gain a better understanding of their rights. The information contained within this newsletter is not legal advice and should therefore not be relied upon as such.

If you do not wish to receive this mailing, please contact the Law Office of Jeffrey S. Kruske.

Midwest Securities Law Update

Vol 5 Issue 1

- » **In Focus:**
Equity Indexed Annuities Part 2
- » **The Lookout**
Common Investment Abuses to Look Out For
- » **News**
 - Overland Park Resident Sentenced to 32 Months for Securities Violations and Theft
 - Regulators Urge Investors to Carefully Check Credentials of 'Senior Specialists'
 - Carnahan Spotlights Inappropriate Sale of Variable Annuities
- » **About the Firm**

We've Moved
Please Make Note of Our
New Address & Phone Number!

7111 W. 98th Terrace, Suite 140
Overland Park, Kansas 66212

Phone: 913.652.6762
Fax: 913.648.5875

MHAE 114.06 MNY 913 LAW 652.6762 JSK

913.652.6762

Devoted to Representing Investors in Securities Disputes

913.652.6762

Devoted to Representing Investors in Securities Disputes

About The Firm

Types of Claims Typically Handled

Unsuitability

Customer alleges that the broker recommended investments that were not appropriate for his or her investment goals, or even his age and investment objectives.

Material Misrepresentations or Omissions

Customer alleges that the broker intentionally misled him or failed to disclose a material fact about an investment.

Failure to Diversify

Customer alleges that the broker over concentrated their portfolios in minimal sectors.

Variable Annuities and Equity-Indexed Annuities

Carry very high expenses, and earn brokers very large commissions.

Churning

Customer alleges that the broker purchased and sold securities solely to generate commissions, without regard to the customer's investment objectives or goals.

Unauthorized Trading

Customer alleges that the broker entered transactions into the account without the customer's knowledge or approval.

Breach of Fiduciary Duty

Customer alleges that the broker breached his duty (position of trust and confidence) to a client.

Negligence

A claim for negligence is that the broker failed to use reasonable diligence in handling the affairs of the customer, and did not act as a reasonable and prudent broker would have acted.

Selling Away

This often occurs in situations where the broker is not reporting a particular transaction to his or her employer.

Margin Violations

Failure to fully inform the customer of margin risks can result in liability for any losses caused as a result.

Life Insurance

Not unlike securities, the sale of life insurance generally imposes a duty of determining suitability on the selling agent. Most state insurance codes require "fair dealing" with customers and a duty of determining an appropriate recommendation. If the product is variable, it may be considered a security and is subject to NASD rules in addition to any state codes and regulations.

Commodities/Futures

Litigation and arbitration involving futures contracts, derivatives, and over-the-counter (OTC) trading

Equity Indexed Annuities Part 2*(continued)*

structures. However, most brokers fail to explain this important factor to their clients.

Most existing equity-index annuities are too complicated for retail investors to understand. The complicated structures allow insurance companies to sell investments which are much more costly and much less liquid than available alternative investments. If brokers are required to understand equity-indexed annuities in the same way brokers must understand stocks, bonds or options, equity-indexed annuities must become simpler and more transparent.

In addition to the 2005 *Notice to Members*, NASD issued an Investor Alert last summer warning potential investors about equity-indexed annuities. Combined with the *Notice to Members*, the Investor Alert makes clear that the NASD has determined

that registered representatives who recommend that retail investors sell securities including variable annuities in order to buy equity-indexed annuities must do a thorough job explaining the features of the equity-linked annuity. It is also apparent that the NASD believes that broker dealers must supervise registered representatives, who send out sales material on equity-indexed annuities to ensure that the materials are not misleading and that any subsequent sale of an equity-indexed annuity is suitable.

Because of the complexity of variable annuities and EIAs, and the costly features that may or may not benefit an investor, these products should be analyzed thoroughly to determine if an investment professional made a suitable recommendation for the investor.

In the News**Eric Rabicoff, Overland Park Resident Sentenced to 32 Months in Prison for Securities Violations and Theft**

Overland Park, Kansas – Eric Rabicoff was sentenced on January 19, 2007, in Johnson County District Court by Judge James Franklin Davis, to 20 months in prison for sale of securities by an unregistered agent and 12 months in prison for theft by deception. The judge ordered the sentences to run consecutively, for a total sentence of 32 months.

Judge Davis recommended that the defendant be required to pay restitution of \$140,000 as a part of his 24 month supervision period when released from prison.

Chris Biggs, Kansas Securities Commissioner, said, "This is a case where the law presumes the sentence be prison and not probation." He added, "Many property crimes result in probation for the first time offender, but this case involved a substantial loss of money and a violation of fiduciary trust." Rabicoff, between October 2003 and February 2004, obtained \$140,000 from an Overland Park resident by misrepresenting that he would use the money to renovate distressed properties.

The investor was told that the investment was secured by the property to be renovated. Rabicoff was not registered to sell securities as required by Kansas law.

Regulators Urge Investors to Carefully Check Credentials of 'Senior Specialists'

Washington, DC – The North American Securities Administrators Association (NASAA) urged seniors to carefully check the credentials of individuals holding themselves out as "senior specialists."

"Individuals may call themselves 'senior specialists' to create a false level of comfort among seniors by implying a certain level of training on issues important to the elderly. But the training they receive is often nothing more than marketing and selling techniques targeting the elderly," said NASAA President and Wisconsin Securities Administrator Patricia D. Struck. "These sales people and the alphabet soup of letters after their names can be confusing, and in some cases, may even be deceptive to seniors," Struck said.

Struck said securities regulators have opened 26 cases in the past year involving "senior specialists" in the eastern half of the United States alone. Most of the cases involve securities recommendations by individuals who are not properly licensed by state securities regulators. Struck said bogus senior specialists commonly target senior investors through seminars where the specialist reviews seniors' assets, including securities portfolios. Typically, the specialist recommends liquidating securities positions and using the proceeds to purchase indexed or variable annuities products the specialist offer.

A recent enforcement action by Massachusetts securities regulators against Investors Capital Corp. illustrates how a "senior specialist" designation can be used to hoodwink seniors. According to state regulators, one of the firm's representatives stated during a seminar that his "Certified Senior Adviser" (CSA) designation – received by taking a three-day course or a home course, followed by a multiple-choice exam indicated that he had been specifically trained to manage and solve financial problems facing seniors. According to the state, the seminar steered investors toward investing in equity-indexed annuities as the best way to participate in stock market gains without risk. Equity-indexed annuities are complex insurance products with high

Featured in the Next Issue of MSLU...**A Primer on CMOs and Support-Class CMOs**

Mortgage-backed securities in their simplest form are pools of actual home mortgages collected and "securitized" into certificates guaranteed by their quasi-government issuers. As such, they are among the safest investments behind treasury securities. Risks associated with mortgage-backed investments are directly related to interest rates. With falling interest rates, mortgage prepayment rates rise. Changes in interest rates, whether up or down, pose significant risk for securities whose value is derived from pools of mortgages.

Unlike traditional mortgage-backed securities such as Fannie Mae, Ginnie Mae, or Freddie Mac, CMOs (Collateralized Mortgage Obligations) collect the payments of principal and interest from the likes of Fannie Mae investments, and distribute these payments selectively on a priority basis among classes or "tranches" of the CMO investment. Because of their complexity, it is very difficult for investors to evaluate these investments. The next issue of MSLU will highlight these products, how NASD regulates them, and how many investors are being fraudulently sold these products as safe investments.

commissions and long holding periods (as well as stiff penalties for early withdrawals), which make them unsuitable for many older investors. In November, the state charged the firm with misleading investors, especially seniors, into buying equity-indexed annuities.

"Before doing business with any investment professional, all investors, especially senior investors, should check with their state securities regulator to determine whether the individual is properly licensed and if there have been any complaints or disciplinary problems involving the individual or his or her firm," Struck said.

Carnahan Spotlights Inappropriate Sale of Variable Annuities

Jefferson City, Missouri – Secretary of State Robin Carnahan's Commissioner of Securities Matt Kitzi entered into consent orders with Jolee Martin of St. Charles, Missouri and her employer, World Group Securities, Inc., based in Duluth, Georgia concerning \$1.2 million in unsuitable investment recommendations by Martin and lack of supervision by her employer in the sale of variable annuities to Missouri investors.

According to the first order, Martin recommended that eight Missouri residents between the ages of 72 and 87 invest in variable annuities. The Missourians invested approximately \$1.2 million with Martin, resulting in commissions to World Group Securities of approximately \$98,000, some of which was paid to Martin. While the investments paid large commissions to Martin and her employer, they were not suitable for her clients.

Because variable annuities include long-term commitments of money that are subject to high fees, surrender penalties and frequently higher levels of risk, they are inappropriate for many investors, especially seniors.

Two of these investors were living in nursing homes at the time of the sale. One of the sales was made to an 87 year-old Missourian, despite a policy by the annuity's producers against the sale of the annuity product to individuals over the age of 75.

"Variable annuities are complex investments that are not suitable for everyone," said Carnahan. "It is important for investors, especially those over 65, to understand how long their money will be tied up, as well as the fees and commissions associated with an investment before they hand over their hard-earned money or retirement savings."

According to the consent orders, Martin's registration was suspended for four months, and she is prohibited from selling variable annuities or handling accounts for individuals over the age of 65 for five years. She was also fined \$25,000.

World Group Securities agreed to redistribute the commissions it received from Martin's sales to the Missouri investors. The company will also pay \$125,000 in fines and payments.

**THE LOOKOUT
Common Investment
Abuses to Watch Out For** **Ponzi Schemes**

This is an old scam named for Charles Ponzi, a swindler from the early 1900s who conned \$10 million from investors by promising 40% returns. His scam has been copied by countless crooks. The formula is simple: promise high returns to investors and use their money to pay previous investors. Ponzi scammers often blame government intervention for the failure of their system.

 Promissory Notes

These are short-term debt instruments often sold by independent insurance agents and issued by little-known or nonexistent companies. They typically promise high returns, upward of 15% monthly, with little or no risk.

 Affinity Fraud

Taking advantage of the tendency of people to trust others with whom they share similarities, scammers use their victim's religious or ethnic identity to gain their trust and then steal their life savings. The techniques range from "gifting" programs at churches to foreign exchange scams.

 Prime Bank Schemes

Con artists promise investors triple-digit returns through access to the investment portfolios of the world's elite banks. Purveyors of these schemes often target conspiracy theorists, promising access to the "secret" investments used by Saudi royalty. In an effort to warn investors, the Federal Reserve pointed out that these don't exist. Unfortunately, that government denouncement just feeds into the conspiracy mindset linked to this scam.

Did You Know?

The Securities and Exchange Commission (SEC) has approved amendments to the subpoena rule in the NASD Code of Arbitration Procedure to allow only arbitrators to issue subpoenas, whether for discovery in arbitration or for appearance at a hearing before the arbitrators. The changes will become effective on April 2, 2007, and will apply to subpoenas issued on or after that date, regardless of when the case was filed.

The SEC also approved the NASD Codes of Arbitration Procedure for Customer and Industry Disputes. The Customer and Industry Codes reorganize the dispute resolution rules into separate procedural codes, simplify the language of the NASD Code of Arbitration Procedure, codify current practices and implement several substantive changes. The Customer and Industry Codes will become effective on April 16, 2007, and will apply to claims filed on or after the effective date.