SEC

Office of Investor Education and Advocacy

Broken Promises:

Promissory Note Fraud

A promissory note is a form of debt – similar to a loan or an IOU – that a company may issue to raise money. Typically, an investor agrees to loan money to the company for a set period of time. In exchange, the company promises to pay the investor a fixed return on his or her investment, typically principal plus annual interest.

While promissory notes can be legitimate investments, those that are marketed broadly to individual investors often turn out to be scams. The SEC and state securities regulators across the nation have joined forces to combat the fraudulent sale of promissory notes to investors. But we can't stop every fraud.

That's why you should ask tough questions – and demand answers – before you consider investing in a promissory note. Be sure you understand how they work and what risks they pose. These tips will explain how promissory note fraud can occur and will help you to spot the scams.

Promissory note scams often target the elderly, bilking them of their retirement savings at a time when they can least afford to lose it.

Anatomy of a Promissory Note Fraud

Fraudsters across the nation have recently begun to use promissory notes as vehicles to defraud investors out of hundreds of millions of dollars. Most promissory note scams follow predictable, fraudulent fact patterns:

- The fraudsters – who may or may not be affiliated with the company – persuade independent life insurance agents to sell promissory notes, luring them with lucrative commissions of up to twenty or even thirty percent. These agents often do not have a license to sell securities. And in selling the notes, they frequently rely solely on the information the company gives them – which later proves to be false or misleading.

- Investors purchase the promissory notes, enticed by the promise of a high, fixed-rate return – up to fifteen or twenty percent – with a very low level of risk. The promissory notes may appear all the more attractive because the seller falsely claims that they're "guaranteed" or insured. And few investors ask tough questions about these investments because they know and trust the sellers, insurance agents with whom they've done business in the past.

- The fraudsters use a portion of the money they collect from investors to pay the sellers their commissions. But they typically abscond with the rest, squandering it on personal expenses or high-flying life styles.

- They may also use some of the proceeds to support an elaborate "Ponzi" scheme in which money coming in from the sale of new notes pays the interest on older notes. Some fraudsters try to avoid repaying investors' principal by convincing investors to "roll-over" their promissory notes upon maturity. These investors may, for at least a time, continue to receive interest payments – but they rarely get their principal back.

Promissory note scams often target the elderly, bilking them of their retirement savings at a time when they can least afford to lose it. But no one is immune. Fraudsters rarely discriminate when it comes to separating investors from their money. And most investors don't even realize their investment dollars are at risk until it's far too late.

Tips To Avoid Promissory Note Scams

Here's how you can avoid the costly mistake of investing in a sham promissory note:

- Bear in mind that legitimate corporate promissory notes are not usually sold to the general public. Instead, they tend to be sold privately to sophisticated buyers who do their own "due diligence" or research on the company. If someone calls you up or knocks on your door trying to sell you a promissory note, chances are you're dealing with a scam.

- Find out whether the investment is registered with the SEC or your state securities regulator – or whether it's exempt from registration. Most legitimate promissory notes can easily be verified by checking the SEC's EDGAR database or by calling your state securities regulator, which you can find at the website of the North American Securities Administrators Association (www.nasaa.org). If the promissory note is not registered, you'll have to do your own thorough investigation to confirm whether the company has the ability to pay its debt.

Make sure the seller is properly licensed. Insurance agents can't sell securities-including promissory notes-without a securities license.

- Be skeptical if the seller tells you that the promissory note is not a security. The types of promissory notes involved in promissory note scams usually are securities and must be registered with either the SEC or your state securities regulator – or they must meet an exemption.

- Make sure the seller is properly licensed. Insurance agents can't sell securities – including promissory notes – without a securities license. Call your state securities regulator, and ask whether the person or firm is licensed to sell securities in your state and whether they have a record of complaints or fraud. You can also get this information by calling FINRA's public disclosure hotline at (800) 289-9999 or by visiting their website (www.finra.org).

- Beware of promises of "risk free" returns. These claims are usually the bait con artists use to lure their victims. Always remember that if it sounds too good to be true, it probably is.

- Watch out for promissory notes that are supposedly "insured" or "guaranteed," especially if a foreign insurance company is involved. Be sure to call your state insurance commissioner to find out whether the foreign insurance company can legally do business in the United States.

- Compare the rate of return on the promissory note with current market rates for similar fixed-rate investments, long-term Treasury bonds, or FDIC-insured certificates of deposit. If the seller promises an above-market rate on a short-term note, proceed with caution.

What To Do If You Run into Trouble

If you believe you've invested in a promissory note scam, act promptly. By law, you only have a limited time to take legal action.

Contact the SEC's Office of Investor Education and Advocacy. You can send us your complaint by using our online complaint form. Or you can reach us as follows:

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Office of Investor Education and Advocacy
100 F Street, N.E.
Washington, D.C. 20549-0213
Fax: (202) 772-9295

You should also contact your state securities regulator and, if an insurance agent sold you the promissory note, your state insurance commissioner.

Learn More About Promissory Notes

For more information, visit the website of FINRA, where you can read an alert on Promissory Notes Can Be Less Than Promised.

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