Special Report: For private deals, no one is watching the watchdogs

**OMAHA, NEBRASKA** | BY [EMILY FLITTER](http://blogs.reuters.com/search/journalist.php?edition=us&n=emily.flitter&)

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Attorney Bryan Mick, whose law firm Mick & Associates provides due diligence reports, poses at his office in Omaha, Nebraska January 13, 2014.

REUTERS/ LANE HICKENBOTTOM

From 2006 to 2009, Provident Asset Management raised $485 million from 7,700 investors who were drawn to its promises of annual returns as high as 18 percent on oil and gas assets. Law firm Mick & Associates helped. Provident paid Mick to provide "due diligence" reports to help brokers decide whether to recommend the investments to their clients.

Brad Updike, a Mick energy-sector specialist, reviewed each of the 23 deals, known as private placements. In one of his reports, Updike wrote that while on a visit to the Dallas, Texas, company, Provident's founder "showed me several strategic-planning maps" where efforts were under way to drill and complete wells.

In a subsequent 2008 report, Updike said he wanted more information: "We would like to see audited financial statements or alternatively a report from an independent accounting firm that validates the information reported by Provident." Even so, Updike concluded that, based on the information Provident provided, the deal could allow investors "diversification within their natural resource portfolios."

Last year, in federal district court in Plano, Texas, Provident founder Brendan Coughlin and three other former principals were convicted of fraud related to the 23 oil and gas deals. The men were fined and received prison sentences of varying lengths for, among other things, using money from more recent investors in Provident's projects to pay earlier investors, according to the U.S. Justice Department. In effect, Provident was operating a Ponzi scheme.

Bryan Mick, the 49-year-old lawyer who heads the Omaha, Nebraska, firm that bears his name, said it isn't his job to catch frauds. He added that alerting regulators to any red flags raised in his reports would violate attorney-client privilege.

"If people out there that are raising capital from investors have larceny in their hearts, they'll find ways to defraud people, notwithstanding my best efforts," Mick told Reuters in a December interview.

He's right about his limited duties as a watchdog. Mick's firm and other third-party due diligence providers for private placements aren't covered by any regulatory regime that would require them to report suspicious activity to regulators, law enforcement officials or investors.

**SCANT REGULATION**

Private placements are a form of fund-raising whereby a company issues securities - shares, bonds, promissory notes and the like - to relatively few investors through private sales by broker-dealers, rather than through a general offering on a public exchange. Under U.S. law, these issues are exempted from the extensive financial reporting requirements that govern public offerings. One aim is to make it easier for small businesses to raise capital by selling securities or investment pools like Provident's.

In this corner of the investing world, oversight is light and risks are high. Issuers of private placements provide only basic information to the U.S. Securities and Exchange Commission, such as the issuer's address and the amount of money raised.

The Financial Industry Regulatory Authority, the industry's self-regulating body, requires that broker-dealers conduct "a reasonable investigation" of a private placement before selling it for the issuer. That's the due diligence. At a minimum, FINRA requires that for each new placement, the broker's investigation entail a review of the issuer and its management; its business prospects; assets it holds or plans to acquire; the intended use of proceeds from the offering; and claims made in any offering documents.

Some brokers lack the resources to cover all of that, so they rely on reports supplied by third-party due diligence firms. The reports are paid for by the issuer of the private placement. Brokers are meant to use the reports to help them decide whether to market the placements. They don't typically show the reports to clients.

The set-up constitutes what many see as a fundamental conflict of interest: Companies that raise money through private placements, such as Provident, are paying due diligence firms to review their deals so that broker-dealers will sell them. "They have to write these reports in such a manner that it's gotta be acceptable" to the issuer, said Michael Miller, a due diligence officer at Sigma Financial, a broker-dealer in Ann Arbor, Michigan.

"The point of due diligence is that it is supposed to be independent," said Barbara Roper, director of investor protection at the Consumer Federation of America, a nonprofit advocacy group. "If the due diligence provider is paid by the issuer, that independence is called into question."

Under FINRA guidelines, the broker-dealer is responsible for identifying and resolving any shortcomings in a report it relies on from a third-party due diligence provider. That may include pursuing documentation from the issuer that the due diligence firm didn't obtain. Failure to do so can lead to disciplinary action against a broker-dealer, as it did for many in the wake of the Provident case.

"FINRA remains focused on the due diligence requirements that firms have, whether conducted by the broker-dealer or provided by an outside third party," said FINRA spokeswoman Nancy Condon. "Areas of concern with third-party reports include whether the reports are independent and whether reasonable due diligence is conducted." She confirmed that FINRA does not have jurisdiction over third-party due diligence providers.

A spokesman for the SEC declined to comment on the third-party due diligence business, beyond noting that it does not fall under the agency's purview. The Consumer Financial Protection Bureau declined to comment.

Shamoil Shipchandler, the prosecutor who handled the Provident case in Texas federal court, said Mick & Associates reports "were used to lend legitimacy to the fraud. … The ‘something else' that corroborates the claim that the investors are going to make a lot of money was those outside reports." But, he said, the due diligence firm wasn't party to fraud. The law firm, unlike Provident, "didn't intend for the investors to lose money," he said. That still leaves open the question of whether the firm "should have done better due diligence."

**REALITY GAP**

The discrepancy between professional assessments by due diligence providers and the sometimes fraudulent reality has been repeated in scores of private placements in recent years.

Mick & Associates is the largest provider of these reviews. Reuters independently examined five of the Mick reports on Provident deals, including four offerings made in the year before Provident's collapse. In none of the five reports did Mick & Associates recommend to broker-dealers that they not sell the placements to clients.

Mick and other employees at his firm noted that some of their reports concluded with "negative" assessments of the deals. But they did not point to any reports showing an explicit warning to broker-dealers not to sell a deal. Typically, their "negative" reports ended with the statement that they "cannot unqualifiedly recommend" the investment.

Mick has delivered reports on about 200 deals from Provident and other companies later exposed as frauds, out of a total of nearly 2,000 reports the firm said it has written.

No one collects data on the frequency of fraud among private placements. The number of such deals overall has been rising, tracking the performance of the stock market. The SEC said it received roughly 18,000 proposals for private placements in 2012, compared with slightly fewer than 14,000 in 2009. These deals had a median amount raised of $1.5 million.

Now, the Jumpstart Our Business Startups Act of 2012 is making it easier for private placements to reach more investors.

Until recently, private placements could be marketed only through broker-dealers. But that's changing under the JOBS Act, which is intended to help small U.S. businesses raise money and thus boost hiring. The act contains a provision that, since September last year, has allowed issuers of private placements to advertise deals on TV, the Internet and other media. That means they can pitch directly to the smaller, less-sophisticated investors most likely to fall prey to fraud.

"You're expanding the universe of who's going to be affected," said Joseph Borg, director of the Alabama Securities Commission and a member of the board of the North American Securities Administrators Association. "If the private placements become more prolific, then I think there has to be more scrutiny on them."

In addition to Mick, three other firms dominate the business. Buttonwood Investment Services, in Littleton, Colorado, examined many of the same private placements Mick did. Buttonwood founder Dana Woodbury said his firm's Provident reports were so negative that Provident never distributed them to brokers. Buttonwood declined to provide Reuters with copies of the reports.

Another leading provider is FactRight, in Schaumburg, Illinois. FactRight's senior vice president in charge of due diligence, Chari Aweidah, said she wasn't aware that the firm had issued any reports on any fraudulent deals described in this article. Officials at Buttonwood and FactRight, both of which are consultants rather than law firms, said they would notify regulators if they found hard evidence of fraud.

The fourth major due diligence provider is law firm Snyder Kearney, in Columbia, Maryland. Its founder, Tom Snyder, declined to comment for this article. He said attorney-client privilege prevented him from talking about deals his firm reviewed. Snyder Kearney announced in early March that its principals and many employees would join RCS Capital Corp of New York to create a new research business.

**'SCRUBBING' DEALS**

In a squat, glass-fronted building on the western edge of Omaha, lawyers and other employees of Mick & Associates analyze private-placement proposals to determine whether investors stand a chance to make money on them. The analysts use paid databases and internet searches to delve into the histories and activities of clients. They call the process "scrubbing the deal."

Many Mick & Associates assessments don't gloss over causes for concern. But they typically stop short of recommending that broker-dealers not sell the deals to investors. Instead, the reports often hold out optimism that the issuing company will address the concerns raised by the due diligence.

"My approach … is to try to push sponsors to do things, to renegotiate structures when I get a chance to try to, you know, structure deals and change the economics when I can to try to enhance the investment for the ultimate retail investor," Mick said in October 2010, in testimony to Massachusetts securities regulators.

Updike, the firm's energy specialist, told Reuters that about half the private placements he reviews are "this kind of mediocre … B-minus to C-minus type product.… But if they do x, y and z and they maybe clean up their balance sheet and they get rid of some leverage, maybe they can get into that good category in two years."

According to a presentation Updike recently prepared, his firm has reviewed about 250 energy investment deals offered by roughly 80 separate investment companies over the past eight years. Updike rejected 20 of those proposals as unfit for investors. None of the rejections were for Provident deals.

In a subsequent email response to questions from Reuters, Updike said that based on what he knows now about Provident, he would, among other things, "have given less emphasis to the potential upside of the investment plan and demanded unconditional financial reporting transparency from day one."

Issuers of private placements pay Mick & Associates up front. But issuers do get a chance to see the reports before they are published. In at least one case, Mick & Associates changed the investment recommendation in a report to a more favorable one after the investment company's principals saw it. Later, that company collapsed in a case of fraud.

That was DBSI Inc, a real estate investment company in Meridian, Idaho. Between 2003 and 2008, DBSI raised $1 billion from investors in private placements of notes that it said would return as much as 7 percent a year on commercial property. In November 2008, DBSI told investors it was suspending payments to them. Soon after, it declared [bankruptcy](http://www.reuters.com/finance/deals/bankruptcy).

Gary Bringhurst, DBSI's chief operating officer, pleaded guilty in April last year to conspiracy to commit securities fraud and began cooperating with investigators. Four others, including DBSI's co-founders, are awaiting sentencing after each was found guilty in federal district court in Boise, Idaho, last week on 44 counts of securities fraud.

**SUBTLE CHANGE**

Joshua Hochberg, the appointed examiner in DBSI's bankruptcy in Delaware court, wrote in his 2009 report on the case: "Some e-mail communications evidence a familiar working relationship between Bryan Mick and DBSI personnel." Hochberg described a February 1, 2008, draft report on a DBSI offering that Mick showed to the DBSI principals before publication. The report, Hochberg wrote, "includes the concluding statement that Mick ‘cannot unqualifiedly recommend approval' of the offering. Handwritten notes on a copy of this report from bracketed that statement and wrote the word ‘Negative.' "

By the time the report was distributed to brokers, according to Hochberg, "the statement that Mick cannot unqualifiedly recommend approval was replaced with a qualified recommendation."

According to Hochberg's report, by the time DBSI went bankrupt in 2008, it had paid Mick $1.4 million for due diligence work.

Mick declined to explain why he changed the report. He said he doesn't allow issuers to suggest changes to his reports.

DBSI's principals declined to comment.

Buttonwood, one of the other due diligence firms, also came in for criticism from Hochberg for its DBSI work. Buttonwood's reports, he wrote, did not indicate that the firm "engaged in any considerable effort to verify or audit the information provided by DBSI."

Woodbury, Buttonwood's founder, said the examiner's finding didn't take into account his firm's first report on DBSI. That was a "sponsor report," which focuses on the business as a whole, rather than a particular deal. "We could not confirm a master lease list; we could not confirm whether funds were commingled or not," Woodbury said. "That was a concern that we listed in our sponsor report."

Reuters was unable to confirm the contents of the sponsor report.

Mick told Reuters that it was impossible to detect the fraud at DBSI. No one could have seen it without the help of forensic accounting, he said.

Nothing prevents due diligence firms from performing a forensic analysis of a client's deal, if the issuer agrees to submit to one. It is not the industry norm.

In its report on the DBSI 2008 Notes Corp private placement, one of DBSI's last issues before it collapsed, Mick & Associates did raise questions about the structure of the deal. The firm noted that DBSI planned to use almost half of the money raised to pay down debt owed to affiliates of the company.

The conclusion begins with similar warnings, and then wraps up with: "Other than as may be expressed above, we have no further concerns with the offering but can recommend approval of the same only upon the prospective recommendation that Note investors understand the financial conduction of and allocation of Note proceeds to the operating technology companies discussed herewith."

**THE INFLATION FACTOR**

Wording like that illustrates what critics say is the problem with many due diligence reports: Potentially alarming findings are often obscured in multiple pages of recondite language, with no definitive conclusions. "They're these long-winded things that bury things that might be important inside boilerplate disclosures," said Jennifer Johnson, a professor at Lewis & Clark Law School in Portland, Oregon, who has written extensively about the private-placement business.

Due diligence firms say their reports aren't designed to be read or understood by investors. Rather, they are meant to help brokers decide whether to recommend private placements to their customers. "Individual investors are not without guidance," Buttonwood founder Woodbury said.

Issuers of private placements are allowed to raise money from institutions and "accredited investors." These are defined under U.S. law as individuals with a net worth of more than $1 million, not including their primary residence, or an annual salary of $200,000 or more.

Consumer advocates point out that those defining parameters haven't changed since 1982. Adjusted for inflation, according to the Bureau of Labor Statistics, the same minimally qualified accredited investor today would have a net worth of at least $2.4 million or annual income of $487,000 or higher.

As a result, many people who qualify today aren't necessarily sophisticated investors. Some are retirees - small-business owners who have sold out, or professionals who saved for decades - with no experience in high-risk investing.

And brokers don't always check to ensure that their clients meet even the minimum standards. James Despot, a California nurse, lost about $150,000 of his savings in an oil and gas deal five years ago issued by Provident, the Dallas-based Ponzi scheme. Despot never did qualify as an accredited investor, according to his lawyer, who said Despot's broker never checked. The broker did not respond to requests for comment.

Despot, now 65, said his broker assured him he would be building up his savings with low-risk Provident private placements that other clients were snapping up. Despot said he put money into Provident "to feel like you weren't doing the wrong thing, when all these other people are doing this and that."

Despot never saw the Mick & Associates report on the Provident deal his broker sold him. It was about 60 pages long, single-spaced. Many of its paragraphs were stuffed with lists of numbers. It included sentences like this: "At that time, the company's liabilities were reported as $5.06 million, substantially all of which was attributable to inter-company payables." Elsewhere, the report provided slightly more clarity on that point: "It is difficult to appropriately discern the actual asset and liability positions due to the presence of inter-company transactions that need to be adjusted."

Updike's conclusion suggested that Provident "develop financial statements that are more transparent and user-friendly to broker-dealers and interested parties." But he balanced his warnings with positive points about the company's leadership and its increasing experience in the field of gas well operations. He noted that he "would generally view Provident's prior experience in dealing with key industry stakeholders … as a positive development."

**SLEW OF BANKRUPTCIES**

The broker-dealer firm that sold Despot the investment was Omaha-based QA3 Financial. It went out of business three years ago along with a slew of others. They were wiped out by litigation costs associated with selling investment products from Provident and a company called Medical Capital Holdings.

That Tustin, California, business for six years claimed it was raising money from investors to buy discounted medical debt. MedCap, as it was known, turned out to be a Ponzi scheme, too. By the time it collapsed in 2009, MedCap had collected $2 billion from 20,000 individual investors. Joseph J. Lampariello, former president, pleaded guilty to wire fraud in May 2012 and faces up to 21 years in federal prison. He is scheduled to be sentenced in December.

Buttonwood co-founder Woodbury said his firm's reports on MedCap were "so negative" that "none of the broker-dealers taking Buttonwood's reports, to Buttonwood's knowledge, signed any selling group agreements" to market the investments for MedCap.

Reuters could not verify Woodbury's account.

Mick & Associates reviewed MedCap deals, too. Johnson, the Lewis & Clark Law School professor, has read many of Mick's reports on MedCap. In general, she said, they "put a whole bunch of risk factors in but never say 'don't do it.' "

The conclusion to Mick's August 8, 2005, report on a MedCap issue called Medical Provider Financial Corporation III begins with this statement: "MCH is very experienced in the medical receivables factoring business and has contractually performed under its various securitized financing vehicles."

The rest of the section strikes a more cautious note. It advises broker-dealers to require from MedCap "monthly distribution checks or other regular communication," such as monthly reports on collateral levels for outstanding loans. The report warns that no investor should "concentrate a material amount of an income-oriented portfolio to this investment." And it suggests that brokers show the report to their customers to ensure they understand the risks involved.

Mick said his firm "had grave concerns that were expressed several times" about MedCap.

Trustees of the Provident and DBSI bankruptcies sued Mick & Associates and Mick himself to recover money paid by the schemers for due diligence reports. The trustees argued that Mick aided and abetted Provident and DBSI in their breaches of fiduciary duty to investors by failing to adequately warn brokers to avoid the deals. Updike said his firm recently settled with the Provident trustees; terms weren't disclosed.

Mick described the lawsuits as "specious" and said the trustees in both cases "are more abusive than the failed business plans of the sponsors."

In the December interview, he said: "You cannot approach this industry as, ‘Everybody out here's a guarantor, and if somebody loses money, it's somebody else's fault.' That's a problem we have in this country."