

FSA steams up over boiler rooms

Emma King and Richard Burger assess the FSA's attempts to tackle boiler rooms

IN BRIEF

- Swift and robust FSA enforcement action to protect consumers.
- FSA led civil recovery for boiler room victims.
- Protection for innocent parties inadvertently associated with boiler rooms.

Historically, to create a veneer of respectability, US fraudsters would rent the boiler room of a Wall Street office block. From their "Wall Street office", the fraudster would sell worthless shares to the general public. The boiler room was born. The term now usually describes overseas operations that use high-pressure, cold-call sales techniques to persuade UK investors to purchase shares, which are often over-priced, have little or no resale value, or are even non-existent. The boiler room will then often vanish, leaving the investor out of pocket.

"Boiler room fraud is so widespread, the FSA receives around 6,500 consumer enquiries a year"

Boiler rooms are often based in Spain, Switzerland or the US and generally have small sales teams (a maximum of about 20 personnel) working together at sales desks. The junior "brokers" or "analysts" (these terms do not necessarily signify professional qualifications nor registration with a financial regulator) are young, paid on commissions and egged on by more experienced senior brokers.

Boiler room fraud is so widespread that the Financial Services Authority (FSA) receives around 6,500 consumer enquiries a year on this subject. The City of London police (COLP) have responded to the extent of the problem by setting up a national

intelligence reporting system for boiler room fraud known as Operation Archway.

Under the Financial Services and Markets Act 2000 (FSMA 2000) selling shares to UK investors is a regulated activity and therefore a firm requires authorisation by its home state regulator, in the case of a UK firm, the FSA. Undertaking a regulated activity without the appropriate authorisation is known as a breach of the "general prohibition", which is a criminal offence (FSMA 2000, s 23). Similar restrictions and penalties apply to the unauthorised promotion of securities (FSMA 2000, ss 21 and 25).

Firms will only be authorised if they can show that they meet certain threshold conditions. Authorised firms must be ready, willing and able to comply with the FSA's regulatory requirements. Even for authorised firms the selling of shares through cold calling is prohibited under the FSA's Conduct of Business Rules. Invariably boiler rooms do not seek authorisation and, as most are based outside the UK, the FSA is usually unable to take direct action to shut them down.

THE INDIVIDUAL VICTIM

The most common victims of boiler room fraud are experienced investors, usually middle-aged men whose names fraudsters find on share registers. A survey by the FSA in 2006 showed that the average victim of a boiler room fraud typically loses around £20,000. However, for some the losses can be greater; three individuals (out of 100 who took part in the survey) reported losses in excess of £100,000 and 13% had been conned by more than one boiler room.

The profile of the average victim and the extent of the loss may sound surprising but the fraudsters are knowledgeable and persistent, often calling a victim several times with offers of research, discounts on stocks in overseas companies, or shares in a firm that

is about to float. Boiler rooms often utilise UK-based companies and even professionals, such as solicitors and accountants, as a front to give an air of propriety.

Sometimes a victim can be targeted twice by the same boiler room; once when sold the original worthless shares, and again by offering to find a buyer for the shares in return for a sizable up-front fee (known as recovery room fraud). In some cases, targeted victims who initially agree to purchase shares but later try to back out can be threatened with unspecified legal action or even violence.

The victims of boiler rooms are not entitled to compensation under the Financial Services Compensation Scheme (FSCS) nor the right of complaint to the Financial Ombudsman Service. Both are statutory schemes that offer consumers a degree of protection but only when dealing with authorised firms. Sometimes offshore boiler rooms will use a UK company as an "escrow agent" and investors will be encouraged to take comfort in the fact that they are transferring their money to a UK company, wrongly believing that they are covered by statutory protections, while the UK-based company is in fact transferring substantial sums of their money to an overseas boiler room operator.

INVESTIGATION AND PROSECUTION

Although the fact that boiler rooms tend to be based overseas is an inherent problem for prosecuting authorities, often convictions are secured by focusing on the UK link. On 6 June 2008, following a Serious Fraud Office (SFO) prosecution, Njall Hardarson pleaded guilty to one count of fraudulent trading. Hardarson ran a company called COL Systems Limited. Despite poor sales he allowed shares in his company to be sold, via Spanish-based boiler rooms using high-pressure telesales techniques, to UK investors. Hardarson received over half a million pounds in investors' funds. He paid 90% of this money to the boiler room while retain-

ing 10% to sustain COL.

Although prosecution of boiler room frauds has traditionally been the province of the SFO, the FSA has power under FSMA 2000 to undertake criminal investigations. In October 2007, two men were arrested as part of the FSA's first criminal investigation into boiler room activities. Jonathan Phelan, head of retail enforcement at the FSA, said:

"This is the first time we have taken this action and it shows that we will not hesitate to use our powers to protect consumers, including launching criminal investigations where appropriate."

CORPORATE AND REGULATED VICTIMS

There is a possibility that UK listed companies could be unwittingly involved with boiler rooms, particularly when they are seeking to raise finance. The FSA has warned companies that they should be aware of the dangers of dealing with unauthorised firms and individuals, because of the adverse publicity if the FSA has to intervene to protect investors.

Authorised firms can also inadvertently fall foul of boiler rooms. No longer does the fraudster need to rent the boiler room of a City office, they will simply use a name that is similar to that of a recognised and trusted authorised firm. The boiler room may even go as far as establishing a website which

mirrors that of the authorised firm.

Should an authorised firm have its identity effectively stolen it must act quickly to protect its reputation and regulated status. The firms should immediately report the suspected boiler room to the FSA and the COLP, consider a press release to distance itself from the boiler room, seek interim injunctions against the boiler room for "passing off", and formally request the internet service providers, hosting the mirror image website, to suspend it.

CIVIL RECOVERY

The FSA may also pursue civil proceedings against those involved in boiler room frauds. This includes seeking orders in the High Court to recover victims' losses, freezing orders, and winding up petitions.

In February 2007, after the presentation of a FSA winding petition the High Court placed the Inertia Partnership LLP into compulsory liquidation after it had assisted overseas boiler rooms by acting as an escrow agent.

Often the fact that boiler rooms are based overseas frustrates attempts to recover victims' losses. However, in March 2008 the FSA helped around 150 UK investors to recover over £1m, which represented about 90% of their losses. The investors had been sold shares in companies and sent their money to North America where the companies were based. The FSA worked with Canadian regulators to freeze the

funds and make arrangements for the return of the investors' funds.

PUBLIC AWARENESS

The FSA has realised that its strongest tool in the fight against boiler room fraud is to raise awareness of the fraud. Protecting consumers and promoting public understanding of the financial system are two of the FSA's statutory objectives. To that end the FSA (together with the Institute of Chartered Secretaries and Administrators Registrars Group) has produced a leaflet on boiler room frauds.

The leaflet provides useful information on how to identify a boiler room and what people should do when they are contacted, warning potential investors to check that any firm is authorised by the FSA and stressing that, when dealing with an unauthorised firm, there is no eligibility for payment under the FSCS. The FSA is writing to individual listed companies to encourage them to send out the leaflets.

The regulator also has such information on its consumer website, "Money Made Clear". The FSA encourages those offered shares through cold calls to report this to them and maintains a list of known unauthorised firms which consumers can check.

There is no doubt that the offshore nature of most boiler rooms has proved to be a real obstacle when it comes to enforcement action. However, the FSA has demonstrated that co-operation with foreign regulators can yield good results. Of course, there is nothing stopping boiler rooms simply moving to jurisdictions with less stringent regulatory regimes. Therefore, for the moment, raising public awareness seems to be the FSA's first line of attack to stem the level of losses.

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