

## Promissory Notes

*Unscrupulous individuals sell bogus promissory notes to unsuspecting retail investors and promissory note schemes continue as a leading source of investor complaints. Members of the North American Securities Administrators Association (NASAA) recently reported 210 new investigations involving promissory notes, which led to 149 formal enforcement actions by state securities regulators last year.*

### What is a **promissory note**?

A promissory note is a written promise to pay (or repay) a specified sum of money at a stated time in the future or upon demand. Promissory notes are a form of debt similar to a loan or an IOU. Promissory notes generally pay interest, either periodically prior to the maturity of the note or in a lump sum at maturity.

### Who invests in **Promissory Notes**?

Companies may sell promissory notes to raise capital and usually offer them only to sophisticated or institutional investors.

These investors often possess the resources to research an investment to determine whether an issuer has the capacity to pay the promised interest and principal. Even investors who spend time and money on extensive research run the risk of losing some or all of their invested capital. Promissory notes also may be offered and sold to retail investors. Notes sold to retail investors generally must be registered with the Securities and

Exchange Commission and/or the state(s) in which they are sold. But not all promissory notes are sold in this way.

### What might a **Fraudulent Promissory Note Scheme** look like?

Suppose a business person you meet through a community networking event introduces an intriguing investment opportunity – a company he or she is connected with is looking to expand its business and needs to raise money.

Instead of borrowing money from a bank, the company is offering the opportunity to purchase “promissory notes” with a maturity of 12 months and an annual interest rate of 8 percent paid in monthly installments. As a purchaser, you have the option to take your money out after one year or renew the note.

The promoter emphasizes that this investment is better than other investments because it is not subject to market volatility, the principal and rate of return are guaranteed, and the company has never missed a payment to an investor. You may be pressured to move money quickly

from other investments into these notes, or to borrow from your home equity to invest.

### **Red Flags to Watch For**

The example you've just read exhibits many of the red flags state securities regulators see in promissory note schemes:

#### **Insured or guaranteed returns:**

Claims of guaranteed investment returns are usually a mirage. There are always risks when making an investment.

#### **A promise of above-market**

**returns:** Fraudsters often advertise investment returns well above prevailing market. Sometimes these claims are in the double digits, other times they are just enough above market-rates to entice investors.

**Risk-free notes:** The risk with promissory notes is that the issuer will not be able to make principal and/or interest payments. Risk and reward are intrinsically related when investing. There is no reward without some level of risk.

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### To learn more, contact:

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## Red Flags (continued)

**Short-term offers:** Fraudsters make short-term offers for two reasons. The first is to entice investors that their investment will not be tied up for long. The second is that some short-term notes may not be covered by federal or state securities laws. Investors should be cautious about promissory notes with durations of nine months or less, as these notes generally do not require federal or state securities registration. Such short-term notes have been the source of most (though not all) of the fraudulent activity involving promissory notes identified by state securities regulators. These short-term debt instruments may be offered by little-known (or perhaps even nonexistent) companies and extend promises of high returns – perhaps more than 15 percent monthly – at little to no risk.

**Unsolicited offers:** An unsolicited investment offer from anyone should set off alarm bells.

## How to Protect Yourself

- Check with the SEC's EDGAR Database or your local securities regulator to confirm that the notes are registered or legally exempt from registration.
- Research the company. Find out how it plans to generate returns to pay principal and interest, and the costs associated with promoting the notes (i.e., fees to brokers, marketing costs, etc.).
- Enlist the help of a financial professional, lawyer or accountant who is independent from the seller or company offering the notes.
- Be suspicious if the notes offer a high or double-digit interest rate with a guaranteed return.
- Ask the seller what they are getting paid in commissions. Steer clear of hidden or exorbitant commissions.
- Sellers may use high-pressure sales tactics. Walk away if you feel uncomfortable.

## The Bottom Line:

*Promissory notes are at the heart of many different types of investment scams. Investors may mistakenly believe the written guarantee is "proof" of the deal's legitimacy and that it offers the investor protections that other investments do not. Before making any financial decisions, ask questions, do your homework and contact the Kentucky Department of Financial Institutions, Securities Division, at 800-223-2579 with any questions about the product or the person selling it.*