

OF KIDS & COWBOYS:

SEC Enforcement Outside EB-5 Parallels Inside EB-5



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WHAT DO THE FOLLOWING SECURITIES ENFORCEMENT ACTIONS HAVE IN COMMON?

1. *SEC Obtains Asset Freeze and Appointment of Receiver in Fraudulent Real Estate Investment Scheme* – A U.S. district judge entered an asset freeze and appointed a receiver over a company that the Securities and Exchange Commission (“SEC”) brought charges against for defrauding 50 investors in a commercial real estate investment scheme using false statements on the company’s website and in its written offering materials as to amount of return, use of escrow, and that investments were “bonded.”¹
2. *SEC: Oil and Gas Promoter Misappropriated Investor Funds* – The SEC complaint charged a promoter with recycling offering documents from prior (failed) projects, falsely addressing commingling of funds, and falsely claiming government licensure allowing the promoter to misappropriate most of the funds raised from

investors on a project to rework and recomplete an oil and gas well, spending those funds on personal expenses, including \$236,000 for gambling charges and cash withdrawals and \$240,000 on house and car payments, vacations, dining and shopping, and jewelry.²

3. *FINRA Charges Broker Over Misleading Offering Docs* – FINRA brought a complaint alleging that a California broker obtained \$1.6 million from 23 of his retail customers for interests in a pooled investment fund that he both created and controlled through a false and misleading PPM, which misrepresented and failed to disclose material information to investors about potential fees, costs and risks associated with the fund, including those relating to the individual controlling their capital, who was engaging in bank fraud and fraudulent trading in another unrelated pooled investment program at the same time, enabling the unrecoverable transfer of **\$650,000 to a third-party financier.**³

ANSWER: NOT ONE OF THEM INVOLVES AN EB-5 PROJECT.

They may sound like the high-profile EB-5 securities cases that have attracted considerable attention, but not one of them has anything to do with EB-5. Instead, they are “garden variety” securities law enforcement actions of the sort witnessed across the over 80 years of the SEC’s existence, yet collected just from the month of April 2017. There are many more from April—and, of course, thousands upon thousands during those over 80 years.

Since 2013, the EB-5 industry has witnessed an increasing number of litigation matters, including civil enforcement actions, regulatory proceedings, and criminal prosecutions, brought by the SEC, U.S. Attorneys of the Department of Justice, and state and financial industry regulators to catch, halt, and punish securities law violations by issuers, regional centers, brokers, lawyers, and other actors in the industry.

Some of those actions have involved large and complex deals involving scores and even hundreds of investors and tens of millions of dollars, while others have been more modest. (Compare the Jay Peak case,⁴ \$350 million raised from

¹ SEC v. 4D Circle LLC a/k/a Enoetics, LLC, et al., No. CV 4:17-cv-0321 (N.D. Tex. Filed Apr. 13, 2017) per SEC Litigation Release No. 23806, April 14, 2017 <http://www.sec.gov/litigation/litreleases/2017/lr23806.htm>.

² SEC v. Matthew W. Fox and Wayne Energy, LLC, No. 4:17-cv-271 (E.D. Tex.) per SEC Litigation Release No. 23809, April 19, 2017 <http://www.sec.gov/litigation/litreleases/2017/lr23809.htm>.

³ FINRA Dept. of Enforcement v. Robert R. Tweed, Disciplinary Proceeding No. 2015046631101, April 27, 2017 <http://disci->

primaryactions.finra.org/Search/ViewDocument/68737.

⁴ SEC v. Quiros, Case No. 1:16-cv-21301 (S.D. Fla. Filed April 21, 2016).

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more than 700 investors, and the USANOW⁵, \$5 million raised from 10 investors, and Ireeco⁶, an unregistered broker-dealer case focusing on two entities.) In some matters, large companies have been the target, while in other cases the focus has been on individual attorneys. In still other cases, an initial civil action has been followed or accompanied by criminal prosecution (e.g., SEC v. Chicago Convention Center⁷, resulting in civil fines and penalties, then upon completion followed by U.S. v. Sethi⁸, culminating in a sentence of 3 years' imprisonment).

None of these cases are unique to EB-5, beyond their immediate facts and the industry in which they happen to arise.

In fact, EB-5 securities cases can be likened to private equity enforcement cases. Private equity funds share various similarities with the new commercial enterprises ("NCE") capitalized with EB-5 investor funds. Private equity funds are typically partnerships where the investors are limited partners and the general partner performs certain services in exchange for a management fee and a percentage of the profits. The general partners often engage in related party transactions by hiring related entities and persons to provide services to the fund or its portfolio companies. As for investors, they may not obtain a return on their investments for a decade or more and may be unable to easily withdraw their investments.⁹ Despite the potential conflicts of interest and the various fees involved, limited partnership agreements often lack clear descriptions of how fees and expenses are charged to portfolio companies and protocols regarding conflicts of interest and provide insufficient investor information rights. As a result, investors in private equity funds often lack the ability to monitor their investments. Like the EB-5 industry, private equity continues to grow: as of June 2016, the private equity market

was larger than ever, with \$2.49 trillion in assets under management by approximately 1,800 funds.¹⁰ As the size and number of private equity firms have grown, the SEC has been increasingly involved in regulating these firms, which had gone largely unregulated until 2012.

In 2012, the Dodd-Frank Wall Street Reform and Consumer Protection Act began to require private equity advisers with over \$150 million in assets to register with the SEC. Through its examinations, the SEC discovered that over half of advisers failed to fully comply with regulations involving fees and expenses.¹¹

It is certainly regrettable that these violations occurred in the EB-5 industry (as well as in the private equity fund arena) and needed to be uncovered, corrected and punished, with civil damages and also criminal sanctions. Ideally, all such misbehavior would be prevented in the first place, and the industry's active encouragement of best practices and support for the adoption of enhanced integrity requirements would wipe away the lingering misimpression (fostered by a media still wedded to focusing on the sensational) that EB-5 is an industry inhabited only by crooks and rip-off artists.

But, as demonstrated by the private equity cases described above, the fact that bad stuff happens, does not mean that only bad stuff is happening, nor that bad stuff only happens in EB-5. In fact, similarly to the SEC actions brought against EB-5 actors, almost all of the settled actions against private equity funds and their advisers have involved nondisclosure and misallocation of fees and expenses and insufficient disclosure of conflicts of interest.¹²

Those in (and out of) the EB-5 industry should thus keep in mind that the across its over 80-year history, the broader world of securities out-

side EB-5 has seen (and continues to see) very much the same reality we observe today in EB-5. Some portion of participants in every area of human endeavor, especially where people are trying to accomplish their goals using other people's money, has invariably included Kids and Cowboys—Kids, who do not know what they are doing (and should not be doing it), and Cowboys, who know they are doing wrong, and do not care. Kids and Cowboys are not just an EB-5 phenomenon; they are a significant (albeit greatly unwanted) minority of all those involved in the investor financing universe.

But as with the world outside EB-5, Kids and Cowboys are a minority inside EB-5. Their misbehavior draws headlines, just as outside. And just like outside, the many EB-5 success stories attract significantly fewer headlines. For example, consider these largely unsung EB-5 success stories:

- In 2015, a total of \$122 million was repaid to 244 investors involved in the financing of the Philadelphia Convention Center.
- Also in 2015, a \$100 million EB-5 loan used to fund film and television production for major film studio in Los Angeles was repaid to investors.
- In 2017, a \$60 million EB-5 loan used for redevelopment of the Brooklyn Navy Yard, New York City's largest industrial park was repaid to 120 investors.
- In 2017, a hotel project in Los Angeles is in the final stages of repaying 40 investors the \$20 million invested.

Ultimately, the "securities misbehavior" portrait of the EB-5 industry tracks that of the broader investing world. No doubt this is why SEC representatives appearing at EB-5 industry conferences consistently answer the question, "Is EB-5 worse than non-EB-5?" with the reply, "It's the same." ■

5 SEC v. Ramirez, Civil Action No. 7:13-cv-00531 (S.D. Tx. Filed Sept. 30, 2013).

6 In the Matter of Ireeco, LLC, Adm. Proc. File No. 3-16647 (June 23, 2015).

7 SEC v. A Chicago Convention Center, No. 13-cv-982 (N.D. Ill. Filed Feb. 6, 2013).

8 U.S. v. Sethi, No. 1:14-cr-00485-1 (N.D. Ill. April 3, 2017).

9 Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement, speech by Andrew Ceresney, Director, SEC Division of Enforcement, May 12, 2016, <https://www.sec.gov/news/speech/private-equity-enforcement.html>.

10 2017 Preqin Global Private Equity and Venture Capital Report—Sample Pages, <https://www.preqin.com/docs/reports/2017-Preqin-Global-Private-Debt-Report-Sample-Pages.pdf>.

11 Spreading Sunshine in Private Equity, a speech by Andrew Bowden, Director, Office of Compliance Inspections and Examinations, May 6, 2014, <https://www.sec.gov/news/speech/2014-spch05062014ab.html>.

12 Todd Ehret. Insight: SEC Delivering on Promise to Scrutinize Private Equity Firms. Thomson Reuters Regulatory Intelligence, Sept. 15, 2016, <http://blogs.reuters.com/financial-regulatory-forum/2016/09/15/insight-sec-delivering-on-promise-to-scrutinize-private-equity-firms/>.