

# North American Securities Administrators Association

## 2010

# Enforcement Report



A Report to the NASAA Membership

Prepared by:

NASAA Enforcement Section

October, 2011

# About NASAA's Enforcement Section

State and provincial securities regulators have been protecting investors from fraud and abusive sales practices since the passage of the first "blue sky" law in Kansas in 1911 and since 1912 in Canada when Manitoba become the first province to approve securities legislation. In the United States, state securities regulation preceded federal securities laws, including the creation of the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA), formerly the NASD.

Organized in 1919, the North American Securities Administrators Association (NASAA) is the oldest international organization devoted to investor protection. NASAA is a voluntary association with a membership consisting of securities administrators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada and Mexico.

As the preeminent organization of securities regulators, NASAA is committed to protecting investors from fraud and abuse. NASAA members have a significant history of bringing enforcement actions, including criminal prosecutions. NASAA assists its members in coordinating enforcement efforts regarding multi-state frauds by facilitating the sharing of information and leveraging the resources of the states more efficiently.

NASAA's Enforcement Section acts as a point of contact for federal agencies and self-regulatory organizations, such as the SEC, the FBI, the Postal Inspectors and FINRA, and helps identify new fraud trends. The Enforcement Section oversees the activities of several project groups, including: Attorney/Investigator Training, Litigation Forum, Oil/Gas Ventures, Reg D Investigations and Enforcement Zones.

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## Executive Summary

The North American Securities Administrators Association (NASAA) began soliciting responses to its annual enforcement survey in the spring of 2011. This year, 45 U.S. NASAA members responded to the survey request, a response rate of 88 percent. The data, statistics and trends included in this summary give a general overview of the state of state enforcement efforts. This summary does not include enforcement statistics from every single state, and thus the numbers provided herein are necessarily conservative.

### Highlights

- State securities regulators conducted more than **7,000 investigations** in the 2010 reporting period.
- **Nearly 3,500 enforcement actions** were reported by the states, including **more than 1,100 criminal actions**.
- The reported enforcement actions for this year represent a **51 percent increase** over the total enforcement actions reported in the previous year's survey.
- States levied **fines or penalties in excess of \$170 million**. States ordered **more than \$14 billion dollars in investor restitution**, and enforced the actual, reportable return of more than \$12 billion dollars, or 90 percent, of that restitution in the same year.
- State regulators took important action to remove or bar unscrupulous actors from the licensed community. **More than 3,200 licenses were withdrawn, denied, revoked, suspended or conditioned due to state action**.
- **More than 1,100 years of jail time** were sentenced through the efforts of state securities regulators.
- The majority of fraud cases featured **unregistered individuals selling unregistered securities**. Nearly 900 reported actions involved unregistered securities, and almost 800 actions involved unregistered firms or individuals.
- Two specific products or investments were identified by state regulators far more than any other specific item: **Rule 506 or Reg D offerings** and **real estate investments or interests**.
- States reported **nearly 1,000 actions involving abuse of senior citizens**.

Enforcement Statistics at a Glance	
Investigations:	7,063
Enforcement Actions	3,475
Investor Restitution Ordered	\$14.1 billion
Fines & Penalties	\$171 million
Jail Time Sentenced	1,134 Years
Licenses Withdrawn, Denied, Revoked, Suspended or Conditioned:	3,242

## Overview

The North American Securities Administrators Association (NASAA) began soliciting responses to its annual enforcement survey in the spring of 2011. The survey traditionally gauges the extent and prevalence of enforcement efforts by state securities regulators, and identifies trends and issues in national investor protection.

This year, 45 U.S. NASAA members responded to the survey request. This is a strong response and the numbers generated thereby are an effective portrayal of nationwide enforcement efforts. The data, statistics and trends included in this summary give a general overview of the state of state enforcement efforts. Still, this report does not include enforcement statistics from every single state, and thus the numbers provided herein are necessarily conservative.

In every instance, the actual number of incidents, actions or resolutions is more than reported here; each of the non-responding states has some level of enforcement program, and thus the addition of their statistics would increase the overall numbers. Despite this small but relevant hole in the data, the statistics included herein remain a fine representation of the important, effective and widespread work of state securities regulators.

## About the Survey

The survey request asked each state administrator to provide statistics using that state's most recent full reporting year. A total of 45 U.S. NASAA members provided responses to the survey, an 88 percent response rate.

Survey Response Rate	
Reporting Year	Response Rate
2010	88 percent
2009	82 percent
2008	75 percent

Table 1: Survey Response Rate

Some states collect and report data on a calendar basis, while others collect data on a fiscal year basis. For this survey, 30 responding states reported statistics from the 2010 calendar year and 15 states provided numbers from the 2009-2010 fiscal year.

The survey requested responses in a number of categories or areas:

- the number of investigations and actions a state has conducted or initiated;
- information on penalties, payments, costs and restitution resulting from enforcement actions; and
- the type of actions brought, the most common products or practices prompting these actions, and the most common type of actors targeted by these efforts.

The survey also focused on senior citizen investor issues and asked administrators to anecdotally describe what they saw as the most common or pervasive trends in enforcement and threats to investors.

## Survey Highlights

### Investigations

In the 2010 reporting period, state securities regulators conducted 7,063 investigations. Based upon the survey question on this issue, these investigations are distinguishable from the thousands of other efforts made to informally resolve complaints, referrals or other items in the enforcement area.

Large population states reported up to 800 investigations, and more than 20 states reported conducting more than 100 investigations. The states were also active partners with other law enforcement agencies, reporting more than 600 identifiable enforcement referrals.

Annual Investigations by State Securities Regulators	
Reporting Year	Number of Investigations
2010	7,063
2009	7,086
2008	6,495

Table 2: Annual Investigations

### Enforcement Actions

These investigations led to an impressive number of formal enforcement actions initiated or assisted by state securities regulators. In the relevant reporting period, nearly 3,500 enforcement actions were reported by the states, including more than 1,100 criminal actions.<sup>1</sup>

The reported enforcement actions for this year represent a 51 percent increase over the total enforcement actions reported in the previous year's survey. In addition, nearly 200 injunctions or similar orders were secured from courts across the country.

Annual Reported Enforcement Actions by State Securities Regulators				
Reporting Year	Total	Administrative Actions	Civil Actions	Criminal Actions
2010	3,475	2,018	324	1,133
2009	2,294	1,604	306	384
2008	3,482	2,191	255	1,036

Table 3: Annual Enforcement Actions

### Investor Relief and Measures of Accountability

Investor relief and measures of accountability were at the center of these actions. The states levied fines or penalties in excess of \$170 million.<sup>2</sup> In addition and most important to investors, the states ordered more than \$14 billion dollars in investor restitution<sup>3</sup> and enforced the actual, reportable return of more than \$12 billion dollars, or 90 percent, of that restitution in the same year. Much of this restitution is attributable to repurchases of auction rate securities (ARS). The states also recovered or collected more than \$31.2 million in costs or expenses.<sup>4</sup>

<b>Investor Relief &amp; Measures of Accountability</b>		
<b>Reporting Year</b>	<b>Investor Restitution Ordered</b>	<b>Fines &amp; Penalties</b>
2010	\$14.1 billion	\$171 million
2009	\$4.7 billion	\$245 million
2008	\$1.9 billion	\$60 million

Table 4: Measures of Accountability

The states did not demand accountability solely in monetary form, however. Responding jurisdictions reported more than 1,100 years of incarceration sentenced through the efforts of state securities regulators.

<b>Years of Incarceration</b>	
<b>Survey Year</b>	<b>Years of Incarceration</b>
2010	1,134
2009	1,786
2008	1,330

Table 5: Years of Incarceration

State regulators also took important action to remove or bar unscrupulous actors from the licensed community. A total of 2,595 licenses were withdrawn due to state action, and 647 licenses were denied, revoked, suspended or conditioned.

<b>Licenses Withdrawn, Denied, Revoked, Suspended or Conditioned</b>		
<b>Reporting Year</b>	<b>Licenses Withdrawn</b>	<b>Licenses Denied / Revoked / Suspended or Conditioned</b>
2010	2,595	647
2009	3,353	531
2008	1,066	1,000

Table 6: Licenses Withdrawn, Denied, Revoked, Suspended or Conditioned

## Types of Cases

The survey also sheds light on the nature of those actions and the firms or individuals targeted in those actions.<sup>5</sup> The survey requested that states indicate the type of violation that triggered or was at the center of an action. In the relevant reporting period, more than 1,000 state enforcement cases involved fraud, traditionally marked by material misrepresentations, false statements or a scheme designed to defraud or deceive an investor.<sup>6</sup>

While these fraud cases could, and in many instances did, involve registered brokers or investment advisers (or their agents or representatives), it appears that the majority of these fraud cases featured unregistered individuals selling unregistered securities. Nine hundred reported actions involved unregistered securities, and more than 800 actions involved unregistered firms or individuals.

The fraud and unregistered cases reported in the current survey outpaced the totals reported in the previous year. Compared to the previous survey, securities fraud violations are up 10 percent nationwide, unregistered securities violations are up 9 percent and unregistered firms/individuals violations are up 24 percent.

The survey also indicates that the states took hundreds of actions against registered members of the securities industry. More than 350 cases were reported involving dishonest or unethical activity by a licensed firm or individual, the most common of the reported industry violations. In addition, 225 failure-to-supervise violations were reported, marking a 32 percent increase in such actions over last year’s survey. In addition, nearly 200 suitability actions were initiated. The states also reported dozens of cases triggered by violations in each of the following categories: books and records, unauthorized trading, selling away, and churning.

<b>Type of Non-fraud Industry Violation</b> (in order of frequency reported by states)	
1. Unregistered securities	6. Books & Records
2. Unlicensed individual or firm	7. Unauthorized Trading
3. Dishonest/unethical activity	8. Selling Away
4. Failure to Supervise	9. Churning
5. Suitability	10. Other

Table 7: Non-fraud charges

The most common type of actor in state securities enforcement actions was unregistered individuals. A total of 558 reported actions involved unregistered individuals, and 355 actions involved unregistered firms. This compares to 427 reported actions against registered broker-dealers and 264 actions against registered broker-dealer agents.<sup>7</sup> In addition, 208 actions were taken against registered investment adviser firms and 146 actions against investment adviser representatives.

<b>Actions by Type of Industry Participant</b>	
<b>Type of Non-fraud Violation</b>	<b>Number of Reported Actions</b>
Broker-Dealer Firms	427
Broker-Dealer Agents	264
Investment Adviser Firms	208
Investment Adviser Representatives	146
Insurance Agents	143

Table 8: Actions by Type of Industry Participant

Firms and individuals operating on the fringes of the securities industry also were the focus of hundreds of state enforcement efforts. Insurance agents, often also registered as securities agents, or their firms were parties to 143 enforcement actions in 20 states. Actions against finders or solicitors were reported in nine states, and seven states reported actions specifically involving individuals representing themselves as financial planners.

## Types of Products

State securities regulators also reported the most common products that led to or were at the center of enforcement actions.<sup>8</sup>

***Regulation D offerings and real estate investments were the most frequent source of cases handled by NASAA members.***

Two specific products or investments were identified by state regulators far more than any other specific item. States brought more than 250 actions involving Rule 506 or Reg D offerings,<sup>9</sup> and reported approximately the same number of cases involving real estate investments or interests.<sup>10</sup> More than 100 cases involving oil/gas investments or interests also were reported.

In the area of broker-based products, structured products were reported the most widely. There were also dozens of cases reported involving variable or equity indexed annuities, and 16 states reported a total of 68 actions involving hedge funds or private equity funds.

<b>Most Reported Products 2010</b> <i>(In order of frequency reported by states)</i>	
1. Rule 506 Offerings	6. Variable Annuities
2. Real Estate Investments or Interests	7. Viaticals or Life Settlements
3. Oil & Gas Investments or Interests	8. Precious Metal Commodities
4. Structured Products	9. Non-Precious Metal Commodities
5. Hedge Funds or Private Equity Funds	10. Equity Indexed Annuities

Table 9: Most Reported Products

The inclusion of these products in this summary is no surprise, as the items referenced above have led the list of most common products at the center of enforcement actions for years.

## Senior Fraud

The survey also sought data on the type and nature of enforcement actions involving senior citizen investors. The states reported more than 1,000 actions involving abuse of senior citizens.<sup>11</sup>

***States reported more than 1,000 actions involving investor fraud or abuse of seniors.***

As with many statistics reported herein, this figure is conservative and the actual number of cases involving senior abuse is undoubtedly greater.

Unregistered securities, in the form of promissory notes, private offerings or investment contracts, were clearly the most common product involved in senior abuse cases, outnumbering the reported cases involving “traditional securities” five to one.

Affinity fraud was a clear trend in the reporting of senior abuse cases, while variable annuities were the most commonly reported specific product. In fact, the states reported twice as many variable annuities cases involving senior investors in the current survey as they did in the previous year’s survey. Free lunch investment seminars continue to be a prevalent issue, as the states reported three times as many cases involving these events this year compared to last.

## Enforcement Trends

In addition to requesting statistics on the number of actions related to a list of specified products or practices, administrators were also asked to identify the top five trends or developments most relevant in their state in terms of securities enforcement actions. This was posed as an open-ended, subjective question.

*Promissory notes and variable annuities are trending products threatening to trap investors.*

Many of the same products that ranked at the top of the statistical reporting lists also appeared on the list of trends and developments. For example, real estate investments and oil/gas ventures easily had the highest number of reported violations, and were at the top of the “trends and developments” list, too. But just as many states reported promissory notes as a top trend or development as reported real estate or oil/gas (roughly one-third of the reporting states). Long a controversial product in terms of state securities regulation, variable annuities are a clearly trending product: 25 percent of responding states listed the product.

The following were each included by at least five states, as well: affinity fraud, foreign-exchange trading, gold and precious metals, Ponzi schemes, and viaticals/life settlements.

## 2010 Canadian Securities Administrators Enforcement Report

In February 2011, the Canadian Securities Administrators (CSA) released its 2010 Enforcement Report that outlines how Canadian securities regulators are working to detect and disrupt misconduct in Canada’s capital markets. One of the notable highlights in the report indicates that in 2010, more proceedings were concluded before provincial courts, which, in some cases, handed down jail sentences.

Under securities legislation, securities regulators can bring cases before an administrative tribunal or a provincial court where they can seek sanctions that can include jail terms for breaches of securities law. In 2010, the total number of cases of securities laws violations that CSA members concluded before courts increased by 83 percent. In these cases, courts ordered jail terms for 15 individuals, ranging from approximately three months to three years.

The report also indicates that illegal distributions of securities is the most common type of offence that CSA members detected, investigated and prosecuted, representing 66 percent of the total cases concluded in 2010.

Illegal distribution cases can involve Ponzi schemes, affinity fraud and boiler room operations that employ both traditional and online methods of communication to entice potential investors.

### Highlights of the 2010 CSA Enforcement Report

- Sixty-four of the concluded cases were court proceedings (up from 35 in 2009), which resulted in the courts ordering jail terms for 15 individuals ranging from approximately three months to three years
- One hundred and fifteen of the concluded cases involved illegal distributions, which represented the largest category of concluded cases.
- One hundred and seventy-four cases concluded involving a total of 207 individuals and 100 companies that resulted in:
  - Fines and administrative penalties of more than \$63 million;
  - Approximately \$58 million in restitution, compensation and disgorgement ordered or agreed to in a settlement;
  - Forty-one interim orders restricting trading against 98 individuals and 89 companies to protect investors while securities regulators investigated allegations of capital market misconduct;
  - Seventy-four orders by securities regulatory authorities or courts were reciprocated thereby extending the original sanctions to other jurisdictions; and
  - One hundred and seventy-eight matters commenced against a total of 301 individuals and 183 companies.

These are just some of the results found in the CSA’s 2010 Enforcement Report. To review the report, go to the CSA website at [www.securities-administrators.ca](http://www.securities-administrators.ca), as well as the websites of various CSA members.

The CSA is the council of the securities regulators of Canada’s provinces and territories. The CSA co-ordinates and harmonizes regulation for the Canadian capital markets.

## 2011 NASAA Top Investor Traps & Threats

<b>NASAA 2011 Top Investor Traps &amp; Threats</b> <i>(in alphabetical order)</i>	
<b>Products</b>	<b>Practices</b>
Distressed Real Estate Schemes	Affinity Fraud
Energy Investments	Bogus or Exaggerated Credentials
Gold & Precious Metals	Mirror Trading
Promissory Notes	Private Placements
Securitized Life Settlement Contracts	Securities and Investment Advice Offered by Unlicensed Agents

Table 9: Top Investor Traps

## Products

***Distressed Real Estate Schemes.*** Investment offerings involving distressed real estate have been on the rise following the collapse of the real estate bubble. While many legitimate investment offerings are tied to real estate, investment pools targeting distressed real estate have become increasingly popular with con artists as well as investors. Investments in properties that are bank-owned, in foreclosure, pending short sales or otherwise in distress inevitably carry substantial risks and should be evaluated carefully. Just like other securities, interests in real estate ventures also must be registered with state securities regulators.

***Energy Investments.*** Swindlers continue to attempt to trick investors by using high-pressure marketing tactics touting the mystique associated with untapped oil and gas reserves and bountiful production runs. Even genuine oil and gas investments almost always bear a high degree of risk. Investors must realize the distinct possibility that they could lose their total investment in legitimate ventures. Energy investments tend to be poor alternatives for those planning for retirement and should be avoided by anyone who cannot afford to strike out when trying to strike it rich.

***Gold and Precious Metals.*** Higher precious metal prices and the promise of an ever-appreciating, “tangible” asset have lured unsuspecting investors into a variety of scams. Many recent schemes are variations on old themes: a promoter seeking capital for extraction equipment to reopen a long dormant mine in exchange for a full refund plus interest and a stake in the mine. In another case, operators claimed to have special coins or nuggets that they can store or trade for investors in special markets for high profits and returns. Investors suffered heavy losses in each of these cases. And despite ubiquitous promises to the contrary, there are no guarantees with gold or precious metals, even in legitimate markets. In the spring of 2011, silver’s value declined by 30 percent in a single three-week period.

***Promissory Notes.*** Investors seeking safety in uncertain economic conditions or those enticed by the promise of big returns through a private, informal loan arrangement may suffer deep losses investing in unregistered or fraudulent promissory notes. These notes give investors a false sense of security with promises or guarantees of fixed interest rates and safety of principal. However, even legitimate notes carry some risk that the issuers may not be able to meet their obligations. Often initially pitched as personal loans or short-term business arrangements, most promissory notes and the persons who sell them must be registered with state securities regulators. Unregistered promissory notes are often covers for Ponzi schemes and other scams. Investors should check with their state regulator to determine whether a promissory note and the seller/borrower are properly registered.

***Securitized Life Settlement Contracts.*** Life settlement contracts are investments in the death benefits of insurance policies that insure the lives of unrelated third parties. Legitimate investments in life settlement contracts involve a high degree of risk, and investors may be responsible for routinely paying costly premiums for policies that insure people who outlive their life expectancies. Outside the legitimate offerings, crooks are embracing new schemes to deceive even cautious investors. For example, “securitized” life settlement contracts are increasingly popular investments that combine life settlement contracts with traditional securities, such as bonds that supposedly guarantee a fixed return on a fixed date, regardless of whether the insured outlive their life expectancies. This risk-reducing structure has too often proven fraudulent and left victims with nothing but worthless paper issued by a bonding company that does not maintain sufficient assets to fulfill the guarantee, operates in an unregulated overseas territory or simply does not exist.

## Practices

**Affinity Fraud.** Marketing a fraudulent investment scheme to members of an identifiable group or organization continues to be a highly successful and lucrative practice for Ponzi scheme operators and other fraudsters. A recent national study of Ponzi schemes over the past decade found that one in four were marketed to affinity groups to increase the scheme's credibility and build the fraud. The most commonly exploited are the elderly or retired, religious groups, and ethnic groups. Investment decisions should always be made based on careful evaluation of the underlying merits rather than common affiliations with the promoter.

**Bogus or Exaggerated Credentials.** State securities regulators have led the effort to prevent the misuse of credentials or designations intended to imply special expertise or training in advising senior citizens on financial matters. Since 2008, 29 states have adopted laws or rules preventing such misuse. Now, state regulators are noting an increase in the use of other bogus credentials or exaggerated designations. State securities regulators have encountered salesmen pitching financial services or products with nonexistent law degrees or CPA certificates and expired or nonexistent CRD numbers. Others have boasted of impressive sounding designations that prove to be meaningless. In every circumstance, investors should press for full disclosure and the meaning behind all designations, and should check with their state regulator if they have any suspicions about claimed credentials.

**Mirror Trading.** The securities market is constantly evolving to provide investors with new products, different platforms and a variety of choices. The latest evolution is "mirror trading," which is promoted as an automated trading platform that ensures investors will participate in real-time transactions placed or executed by a skilled and knowledgeable third party. Whenever the third party executes a trade in his or her account, the same trade is mechanically placed on behalf of the investor in the investor's account. Investors should not be lulled into a false sense of security, and they need to continue to objectively evaluate and carefully consider all new or popular investment platforms. They should also recognize that unscrupulous traders and promoters may use trendy platforms such as mirror trading as a way to launch fraudulent schemes or manipulate markets by lying about their qualifications, misrepresenting the success of their strategies, or concealing their motivations and conflicts of interest.

**Private Placements.** Investors should be aware that, even in the case of legitimate issuers, private placement offerings are highly illiquid, generally lack transparency and have little regulatory oversight. In the United States, the federal exemption for private placement offerings provided under Rule 506 of Regulation D continues to be abused by criminals. Although properly used by many legitimate issuers, unscrupulous promoters use Rule 506 to cloak an otherwise fraudulent offering in legitimacy.

**Securities and Investment Advice Offered by Unlicensed Agents.** State securities regulators have identified a consistent increase in investor complaints regarding salesmen unlicensed as securities brokers or investment advisers giving investment advice or effecting securities transactions. For example, insurance agents offering securities or investment advice without a securities license have not demonstrated sufficient expertise to legally recommend that an investor liquidate securities holdings in favor of insurance products. Investors are often unaware that their insurance agent may not be licensed to give investment advice, and these recommendations too often turn out to be unsuitable or result in investors placed in under-performing products or those with hidden fees or long lock-up periods. Investors should insist that any time anyone recommends or suggests any transaction related to an investor's stocks, bonds, mutual funds or other securities holdings, the person must produce a proper license.

## Reference Notes

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<sup>1</sup> Thirty-six states responded to the request for the number of criminal actions initiated in the relevant reporting period.

<sup>2</sup> Eight states that responded to the survey did not provide statistics on monetary fines or penalties; some jurisdictions do not have statutory authority to fine respondents.

<sup>3</sup> This figure, despite its large size, is likely conservatively low. Only 32 of the 46 reporting jurisdictions provided a restitution amount. This figure also does not account for unilateral and unreported returns to investors by firms or investigative targets, and many states did not report as restitution repurchases of auction rate securities by the dozen firms that agreed to global settlements requiring more than \$60 billion in buybacks.

<sup>4</sup> Twenty-three states reported costs charged and recovered and many jurisdictions do not have statutory authority to seek or recover costs.

<sup>5</sup> Because state securities enforcement actions are complex and often involve multiple issues, a single case might involve several different types of actions or respondents. Therefore, cases reflected in the states' responses to the 2011 Survey often fit into, and thus were recorded, in more than one category or case type.

<sup>6</sup> Section 501 of the 2002 Uniform Securities Act, titled "General Fraud," states that it is unlawful, in connection with the offer, sale or purchase of a security, to employ a device, scheme or artifice to defraud; to make an untrue statement of material fact; to omit to state a material fact; or to engage in an act, practice or course of business that operates as a fraud or deceit upon another person.

<sup>7</sup> As stated previously in this Summary, cases often involve multiple respondents or investigative targets, and many reported cases involve both a firm and one or more agents or individuals.

<sup>8</sup> Ten of the states that responded to the 2011 Survey did not report any products or practice information.

<sup>9</sup> This represents a 46% increase over the Rule 506 violations reported in the 2010 survey.

<sup>10</sup> It is possible and even probable that many of the reported cases involving a Rule 506 private offering were also counted in the real estate investments or interests category.

<sup>11</sup> Twenty-seven reporting states record or differentiate cases involving senior abuse.