

# Private-placement due diligence 'sloppy'

Forensic accountant Gordon Yale blasts brokerage firms for past sins; some B-Ds vetting deals more closely

**By Bruce Kelly**

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Broker-dealers that sold billions of dollars in allegedly fraudulent private placements failed massively in their due-diligence responsibilities to investors.

That is the assessment of forensic accountant and expert witness Gordon Yale, who has worked on more than 50 legal claims brought by investors against broker-dealers stemming from the failed deals. The clients bought private placements issued by DBSI Inc., Medical Capital Financial Corp. and Shale (Provident) Royalties.

The Securities and Exchange Commission charged Medical Capital Financial and Provident Royalties with fraud in 2009; DBSI filed for bankruptcy protection in 2008.

Broker-dealers' due diligence showed incredible "sloppiness," said Mr. Yale, a certified public account and principal of Yale & Co.

"It was basically the same recklessness with which major investment banks conducted their mortgage-backed-securities business, but it was done by middle- or lower-tier firms and [with] a different set of products. You need to understand the underlying business and management's representations about the performance of that business, and then begin performing due-diligence procedures that are either going to corroborate those representations or not," Mr. Yale said.

"Another failure was that everyone seemed to rely on the fact that [MedCap] payments had been made in a timely way," he said.

## "PAY TILL THEY DON'T"

"The word was, 'They're paying.' So what? That's how all Ponzi schemes work. They pay till they don't," said Mr. Yale, who has served as an expert witness for a dozen different plaintiff's lawyers in lawsuits stemming from more than \$100 million in claims.

The overwhelming majority were settled, and Mr. Yale testified in only one.

The investor won that claim last year, with an award of \$1.2 million in damages and legal fees against [Securities America Inc.](#) and an affiliated broker.

Broker-dealers that sold \$3.6 billion in MedCap notes, Shale Royalties preferred shares, and DBSI tenant-in-common exchanges, partnerships and notes have said that they performed appropriate due diligence. In several regulatory actions that involved fines or restitution to investors, the B-Ds neither admitted nor denied the findings.

Regulators, however, recently have issued fines and sanctions that support Mr. Yale's assertion.

In September, for example, the Financial Industry Regulatory Authority Inc. levied a \$10,000 fine and a six-month suspension against Brian Boppre, former president of Capital Financial Services Inc. Capital Financial was a leading seller of both Medical Capital Financial and Provident Royalties, and Mr. Boppre “knew of an issuer's failure to make payments to its investors and was also aware of other indications of the issuer's problems but approved the offering as a product available for the firm's brokers to sell to their customers,” according to Finra.

Mr. Boppre agreed to the sanctions without admitting or denying Finra's findings.

Medical Capital Financial began to have trouble paying investors dividends in 2008. Some firms stopped selling the product, while others continued.

Mr. Boppre also “failed to conduct adequate due diligence of the offerings before allowing firm brokers to sell this security,” according to Finra.

## **"SEEING A SHIFT"**

Broker-dealers have made some changes in the wake of the private-placement failures and are working more closely with third-party due-diligence analysts, one due-diligence executive said.

“From an industry standpoint, we're seeing a shift in trying to bring some standards as it relates to how these deals should be structured,” said Anthony J. Chereso, president of FactRight LLC.

“It's an absolute necessity. There also needs to be some clarity as to what Finra and the regulators are expecting of the broker-dealers,” Mr. Chereso said. “We need to have the broker-dealers more involved in the process of managing the due diligence.”

“We encourage the broker-dealers to participate in the on-site visits [to companies issuing private placements] with us, to walk along with us in the due-diligence process. That way, they will know firsthand what some of the potential issues are,” he said.

Securities America sold almost \$700 million in MedCap notes, the most by any broker-dealer. Finra has fined several smaller broker-dealers that sold private placements but hasn't fined Securities America.

After the SEC in July 2009 alleged that Medical Capital and its leading executives had committed fraud, executives with Securities America insisted that they performed “industry-leading” due diligence on private placements that they sold.

“That's bulls#it; just utter cant,” Mr. Yale said.

“It's untrue, because basically what Securities America did, I believe, was to rely on management representations made by Medical Capital or rely on third-party due diligence that relied on management representations,” he said.

“Securities America continually enhances its policies and procedures in order to best serve its customers,” said Janine Wertheim, senior vice president and chief marketing officer of Securities America, who didn't directly address Mr. Yale's comments.

“One of the problems is that many of the firms relied on third-party due-diligence vendors,” Mr. Yale said.

“They viewed those reports as the end of the process, rather than the beginning. There’s a notice to [Finra] members, 05-48, that basically says you can outsource any function, but you can’t outsource your responsibility for compliance with federal securities laws or regulations,” Mr. Yale said.

“In many instances, the issuer paid those third-party due-diligence providers,” he said. “To believe that due-diligence functions stops with some independent — or purportedly independent — provider is a mistake.”

## **USING ACCOUNTANTS**

To perform true due diligence, firms must use accountants to dig into the offering documents, Mr. Yale said.

“Why didn’t Securities America impose a third-party, independent CPA firm to verify the results of the [MedCap] loan pool histories? That was supposedly the primary business,” he said. “Or why didn’t they hire a CPA to look at the loan files? That’s state-of-the-art due diligence.”

“That’s what any private-equity firm would do and a whole lot more,” Mr. Yale said. “Neither Securities America nor any other firm whose documents I’ve seen ever did that.”

One third-party due-diligence analyst who wrote reports about Medical Capital Financial was “almost wringing his hands over Medical Capital investments in health-care-related businesses, particularly owner-occupied real estate,” Mr. Yale said.

The analyst, whom Mr. Yale declined to identify, “stated in his reports that this was not their expertise. The next-most-obvious question is: What did the financial statement say about those investments, and how are they performing?” he asked.

“So you need to go look at the investments that are disclosed in the footnotes to the financial statements, and you see a bunch of them are delinquent. Where was the follow-up?” Mr. Yale said.

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