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Bulletin

No. G-03/92

- General

Questionable Shares Offered to Insurance Companies

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Insurance companies are warned to give careful scrutiny to shares being offered by potential investors or by unlicensed reinsurers as security for reinsurance transactions.

We are aware of several situations involving the attempted use in Ontario of securities which have the appearance of legitimacy, but which may in fact be worth much less than their apparent market value.

These situations involve shares of junior U.S. corporations that are listed on one or more of the smaller U.S. stock exchanges. Here are a couple of examples:

1. The shares of companies having little tangible net worth are subjected to high volumes of trading between directors and other non-arm's length parties, driving the price to extremely high multiples of actual net worth. The inside parties will attempt to find a market for their shares at the artificially high listed prices. Having disposed of their shares, the market will be allowed to collapse and the price will fall to near zero.
2. Officers and directors are issued large amounts of stock, supposedly as part of their compensation package. However, the shares are typically subject to trading restrictions which prevent them from being purchased or sold to a U.S. resident for several years after the issue date. There is nothing on the face of the certificates to indicate that this is the case. Therefore, the shares may be represented to unsuspecting parties outside of the U.S. as having their full value, when they could be extremely illiquid.

We have been alerted to these potentially fraudulent situations through U.S. regulatory bodies, who have indicated investors may be attempting to use such shares as seed money in the incorporation of new financial institutions outside of the U.S.; as capital to inject into existing non-U.S. financial institutions in return for voting rights; as security for loans from non-U.S. financial institutions; and as security used to back up reinsurance ceded to unlicensed insurers. In the latter case, the unlicensed reinsurer may not be able to meet its obligations and the security will turn out to have little real value.

In considering any specific transactions, companies should carry out their own due diligence in consultation with their legal and investment advisors. While Commission staff are not experts in securities fraud, we are certainly prepared to assist to the best of our ability or to make referrals to appropriate authorities in Canada or other jurisdictions.

We believe companies should give particular consideration to transactions where any of the following characteristics are present:

1. Securities of companies which are not familiar,
2. Securities where virtually all trading takes place through one broker,
3. Reciprocal shareholdings between affiliated companies,
4. Securities available for purchase at a substantial discount from quoted market price in exchange for vendor buy-back rights and an extended restriction on resale (such as five years), and
5. Securities being offered for little or not immediate consideration.

Companies should not overlook the possibility that the securities may be offered in good faith by someone who is not aware of the complete situation. Companies should also not rule out the possibility of sophisticated fraud or the involvement of criminal activity.

This advisory Bulletin is not intended to suggest all securities issued by United States corporations present these risks, nor that similar problems could not exist with securities issued anywhere in the world.

Donald C. Scott

Commissioner

February 24, 1992

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