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Investment Opportunity and Risk of Fraud in Private Placement Offers: A Case of Middle Eastern Investors Investing Outside the Middle East

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Abstract

This study raises the question about the level of misstatement risk and fraud associated with the Private Placement Memorandum. The reason for raising this question is that Private Placement Memorandum is circulated among potential investors without any regulatory approval to ensure the content. Individuals have tremendous wealth and liquidity in the Middle East region, particularly the six countries of the Gulf Cooperation Council; Hence, investment opportunities through Private Placement Offers are numerous for the investors in the region., The associated risk of fraud or misstatement, therefore, is equally high with Private Placement Memorandum due to lack of any regulatory bodies that control and monitor Private Placement Memorandum in the Middle East. A qualitative study approach was used with a questionnaire circulated among a selected population to secure direct feedback based on participants' experience. The results of the survey conclude the need for direct regulatory control on the Private Placement Memorandum with the goal to give better protection to investors in the region. The data collected suggests that the Private Placement Memorandum is not transparent mainly due to there being no direct monitoring of the content of Private Placement Memorandum from regulatory authorities in the region. Hence, the study achieved the objective of highlighting the need for statutory bodies to regulate and protect investors' interests in the region. This study could help authorities understand factors to be considered, while allowing private placement with best possible disclosure in Private Placement Memorandum, with legal and criminal consequences in case of intentional misstatement, misleading information, or lack of sufficient disclosures.

Keywords: High net worth individuals; Private placement memorandum; Private placement offers; Gulf cooperation council; Middle East; Risk of fraud; Risk of misstatement

Problem Statement

Investment opportunities through PPOs in the form of a Private PPM are numerous for the investors in the Middle East especially the GCC. Hence, the associated risk of fraud or misstatement is equally high in these PPMs due to lack of any regulatory bodies that control and monitor such PPMs in the Middle East. The available information and data often are skewed to suit the interest of the publisher or the agency that conducted the study on behalf of PPO. There is a lack of focused empirical study that covers this aspect of investment and fraud in the Middle Eastern context that would provide systematic, reliable, and authentic information to investors. This study examines investment opportunities through PPMs in the form of and the associated risk of fraud in these PPMs for Middle Eastern investors investing outside of Middle East.

Study Questions

The study analyzed and focused on the content of PPO/PPM and associated risks of fraud or misstatement in PPM. or any document that is circulated among the potential investors, by addressing the following questions:

1. How would regulatory authorities help in monitoring the content of PPM, to ensure that HNWI has reliable information on PPM before making investment decisions?

2. What impact would a regulatory body instituted in the Middle East have to contain and control fraud or misstatement in PPM?

3. What are the main factors HNWI should consider while evaluating the PPM and the degree of risk to be considered that are associated with investing in these PPMs?

4. Who is taking the responsibilities on PPM that it is not misstated and to what extent?

Research Methodology

The method adopted is qualitative by conducting the survey with the help of preset questionnaire that is circulated among HNWI, a Personal financial adviser to HNWI, investment bankers, and consultants with the goal to receive direct feedback based on each category personal and professional experience. One of the reasons for selecting this approach is that even though subject of study is complex due to involvement of different classes of people, from the preparation of PPM till the time investment is made by HNWI, which make it very critical to understand what and how is their experience at different level [1-3].

Population and Sampling Strategy

The data gathering method adopted was interviewing different categories of the audience by circulating a questionnaire for input and feedback. The target sample size for this exercise was 68 participants, which was calculated using the sample size Methodology (2015), as follows:

Sample Size=(Z-score)^2 *Std-DevStdDev*(1-StdDev)/(margin of error)^2 Here are the z-scores (2015) for the most common confidence levels:

- 90% – Z-Score=1.645

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- 95% – Z-Score=1.96
- 99% – Z-Score=2.326

At a confidence level of 90% with a confidence interval of ±10% the sample size came out to be 68. However as the questionnaire was circulated over 400, the response was received from 70 samples out of over 400 selected. The three separate data gathering methods were selected to get the answer and evidence to the study questions [4-8].

Data Collection Procedures

A request for input or completion of the questionnaire was made by email (via survey monkey.com). The questionnaire was sent to over 400 people covering HNWI, Investment bankers, personal financial advisors to HNWI, a financial consultant, and other financial experts. The questionnaire was sent via email with an introductory mail that clarified the purpose of the study, the process and the set of actual interview questions to address the study questions. Subsequently a follow-up mail was also sent with a note clarifying the purpose of the study, the process and the set of actual interview questions to address the study questions [9]. The feedback was received from 70 people from the mix of 400 different categories selected.

Data Analysis

The final feedback in the study was received from different respondent's categories, which can be seen in Table 1.

Demographic statistics: Data analysis and results

The survey was conducted and circulated amongst various types of individuals within a mixed group of fraternity including bankers, HNWI, financial advisors, and other finance professionals [10]. People from within and outside of the Kingdom of Saudi Arabia were contacted for their opinion and understanding on the subject. The feedback as received is presented below

Summary of feedback received from the survey

Q1. Would you like to disclose your name and other details?

Feedback: The survey results indicate that 63.77% of respondent preferred not disclosing their identity whereas 36.23% had no problem in disclosing their identity.

Q2. Who is responding to this questionnaire?

Feedback: The breakdown of the respondents is listed in Table 1.

Direct feedback from the HNWI and their personal advisors was almost 23%. If the 23% is clubbed with a financial consultant, who is also 23%, total feedback directly or indirectly from HNWI and their advisor was 46%.

Q3 and Q4. Is the Private Placement Memorandum or similar document circulated controlled by the regulatory authority in your country? If the answer to this question is "No", do you think some government agency should regulate it?

Respondent	No.	%
High Net Worth Individual (HNWI)	10	14%
Investment Banker	6	9%
Personal Financial Advisor to HNWI	6	9%
Financial Consultant	16	23%
Other	32	46%
Total	70	100%

Note: Refer to Appendix B Survey Questionnaire Responses for detailed analysis

Table 1: Summary of Responses to questionnaire.

Feedback: As seen from the detailed tabulation of the feedback (refer to Appendix B), 55% of the participants responded that the regulatory authority does not control PPM, and 45% replied that PPM is being regulated in their country. However, PPM is not being governed by the majority of Middle East country, and as answered in the next question 81.43% of the participants feel that the same should be regulated [11-14].

Q5. Have you made any private investment based on the Private Placement Memorandum (PPM) or similar document?

Feedback: 32 (45.71%) respondents made private investments based on the PPM or similar document and most of these private investments (54.29%) are made in Home country, 37.14% in the GCC and MENA, 20% are made in Europe, 15% in the USA along with in other regions or countries. The survey results indicate 55% do not participate in PPM, and out of the 45% participants, the majority of them are not directly investing in PPM. From the above survey; therefore, the PPM is not a very common mode of investment for common investors. It is circulated amongst HNWI or big corporate funding as this kind of investment is mainly in big denominations.

Q6. Most of the private investments are made in which country?

Feedback: The survey indicates the majority of the participants are interested in private placement either in their home country or Gulf Cooperation Council (GCC)/Middle East and North Africa (MENA).

Q7. What was the source of making the private investment?

Feedback: Direct connections accounted for 54.41% respondents source for these investments, 36.76% respondents came through friends and relatives, and the balance respondents through Investment Bankers and private circulation jointly. The survey indicates the major source of PPM is not only through investment bankers or through private circulation but jointly with direct contact due to trust among the relative and friends.

Q8. To whom do you consult before making any private investment?

Feedback: The survey results indicate 54.10% (33) respondents made evaluations on their own; 34.33% (21) respondents had their in-house financial advisor conduct evaluations, while balance respondents took the help of private consultants and Investment Bankers along with their evaluations. Hence, the response shows the majority of people prefer either their assessment or through their in-house financial advisor or probably even run through investment bankers but as seen in the above question, they prefer doing their study as well.

Q9. Preference of private investment in what type of investment opportunity?

Feedback: The survey results indicate 54.41% (37) respondents indicated a preference for investing in growing existing businesses, but 35% (24) respondent would go for any opportunity. Also, 29.41% (20) respondents had a preference for diversification, and 16.18% (11) respondents indicated a preference for start-up while some of them are open for any opportunity. This survey indicates the majority of respondents prefer to invest in existing projects with the expansion of existing business with prospects for growth. People are least interested in new startup projects, as a new start could be riskier. However, with higher risk, new projects with the right team and proper management

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support might have a better prospect than existing projects. So those who like to venture out may still be interested in new start-up projects.

Q10. Do you consider PPM to be a transparent document that gives a fair and true picture on the historical as well as future prospects?

Feedback: The survey results indicate 51% of the respondents agreed and 26% of respondents disagreed with respect to transparency of information provided in the PPM perspective. The information contained in a PPM is significantly detailed and is supported by due diligence reports and other details. The PPM is being reviewed by recognized reputed firms, and thus these documents are quite extensive and are considered reliable, which can be seen from the response to above survey. However even though these documents provide quite an extensive study, investors should perform evaluations, such as those mentioned in previous questions.

Q11. Are Private Placements preferred because it does not need any regulatory clearance?

Feedback: The survey results indicate 51% of respondents agreed with PPM not requiring regulatory clearance, which is in contradiction with Question 3 and 4, where the majority of respondents suggested regulatory authority should be controlled by the government. This reveals, investors prefer to invest with strong regulation control over the private placement. However, they also wish to have relaxed regulations on their side when doing investment in any projects and wherever these projects are.

Q12. Are Private Placements easy but do they bring high-risk regarding transparency? Feedback: The survey results indicate 62.32% (43) respondents agreed that PP is easy but carries high risk, 11.59% (8) respondents strongly agreed with this, 15 (21.74%) respondents disagree with this, 1.45% (1) respondent strongly did not agree with this and 2 (2.90%) respondents remained neutral. Therefore, the majority agreed with the above questionnaire that PPMs are high risk and high return kind of projects.

Q13. Do you agree that the private placement suffers from informational handicap? Feedback: The survey results indicate 52.17% (36) respondents agreed that private placement suffers from an informational handicap while 11.59% (8) respondents strongly agreed, and 23 (33.33%) respondents disagreed, and 2.90% (2) respondents remained neutral. The majority of the participant (52%) agrees with this question, which again contradicts with Question 10, where the majority of respondents noted that the PPM does not highlight the negative side of the PPM. Therefore, the responsibility is on the investors to do the due diligence in regards to the investments.

Q14. Who is responsible for disclosing material facts in a Private Placement Memorandum?

Feedback: The survey results indicate 53% (36) respondents agreed that it was the collective responsibility of the Management, Investment Bankers, and Accounting/Consulting firms, 42.62% (29) respondents felt the responsibility was of Management, 20.59% (14) respondents felt the responsibility was of the Investment Bankers, and (11.67%) respondents felt that the sole liability of investors is to conduct due diligence. Therefore, in response to a very specific question on responsibility, the majority, (i.e., 53% of the sample size) content the management, investment bankers and consulting firms are equally responsible for giving a responsible and insightful opinion on the investment.

Q15. Do you think in reality, irrespective of the technical competency, investors, are incapable of distinguishing between the different quality or risk levels within the population of private issuers? Do they all "look the same" to investors?

Feedback: The survey results indicate 49.28% (34) respondents agree that investors are incapable of distinguishing the risk levels, along with 4.35% (3) respondents who strongly agree, therefore, the survey results indicate a mixed opinion where the participants strongly agree as well as disagree on the above questions. However, in the majority of PPM cases with the limited information and resources, it can be concluded that investors might not be able to distinguish or identify all kinds of risk.

Q16. Do you consider that the risk of fraud in private equity placement is due to either lack of accountability by the promoter, banker, or consultants, or absence of regulatory control body or limitations in performing due diligence of PPM?

Feedback: The majority of the participants contented that risk of fraud is mainly on account of various factors, such as: Lack of accountability by the promoter, banker, or consultants

– Absence of regulatory control body

– Limitations in performing due diligence of PPM

Thus, there is a need for regulations that will manage and keep PPM in check.

Q17. Do you prefer private placement because it is comparatively less expensive?

Feedback: The survey results indicate 23.19% (16) respondents contented that they preferred PP because it is comparatively less costly, 28.99% (20) respondents disapprove of it and the majority 48% (33) respondents felt that private placement is not very expensive and does not make a big difference while making an investment decision.

Q18. Will you invest or advice to invest based on the clause that Investing based on the PPM involves risks, which is very general? (For example, refer to “Risk Factors” on page XYZ).

Feedback: The survey results indicate 13.43% (9) respondents indicated they will invest or advice on investments based on the general risk clause in the PPM; an almost equal number of respondents 41.79% (28) disapproved of it, while 44.78% (30) respondents indicated that this does not make any difference; therefore, the majority felt that it does not make a difference.

Q19. Will you still invest or advice to invest based on the very specific clause that you should not invest based on the PPM if you cannot afford the loss of your entire investment?

Feedback: The survey results indicate 17.39% (12) respondents contended they will invest or advice to invest based on the very specific clause in the PPM that you can lose your entire investment, 56.52% (39) disapprove of it and 26.09% (18) respondents indicated that this does not make any difference. The majority, therefore, can be interpreted as indicating they will not affect the decision even if this clause is being added.

Q20. From your personal experience, to what extent have your observed misstatement in PPM?

Feedback: The survey results indicate 53.03% (35) respondents observed 0~25% misstatement in the PPM, 37.88% (25) respondents observed 25%~50% misstatement in the PPM, 7.58% (5) respondents observed 50%~75% misstatement in the PPM, and 1.52% (1) respondent observed 75%~100% misstatement in the PPM. The response shows that the joint majority almost 86% (60) feel that misstatements in given PPM are within 0-50% that may be considered as alarming and need to be regulated to reduce the investors risk (Table 2). Of the 68 respondents, 8.82% (6) respondents consider themselves high-risk takers, 36.76% (25) respondents as moderate risk takers, 25% (17) respondents as conservative risk takers and 29.41% (20) respondent take risk depending upon the type of investment. The majority of the respondents, i.e., 82.61% (57) felt the need to institute a regulatory body in the Middle East to monitor the content of the PPM whereas, 19.67% (12) respondents felt no need for it.

Summary of the Results

1. The sample collection representation was composed of 48.38% financial experts and others at 51.62%, which is a good mix.
2. Survey results show that Private Placement Memorandums or similar documents circulated are controlled by the regulatory authority in 51.62% countries and of those, 48.39% countries have no control by the government, and the majority of the people (79.03%) are in favor of the regulatory authority to have control.
3. When it comes to investment in Middle East countries, the requirement of a regulatory body in the Middle East is strongly desired by (82%) respondents to monitor the content of PPM.
4. Private investments can be made at any place in the home country, MENA region, Europe, or Asia (unless specific restrictions are imposed on investment). Investments can be made based on direct connection, in some cases via friends and relatives and in exceptional circumstances connection with a professional financial advisor. However, whatever may be the source of lead to invest, the investors always look for details of the investment opportunity, in some form of teaser or PPM or PPO.
5. Investors, by and large, want to invest on safe avenues and do not wish to invest in new/start-up businesses, but rather prefer to invest in existing businesses at the expansion or growing stage.
6. Although most of the private investments are made in the home country (54.84%) but an investment made out the home countries is 45.16%, which is also quite significant. Interestingly, the investments are done via direct connection are also 53.33% However, many investors faces a situation where investors are willing to invest but do not possess a direct connection with investees.
7. In regards to the transparency of PPM majority of respondents believe PPM is a transparent document and gives a fair and true picture on the historical as well as future prospects. The 57.33% of respondent agree and the 6.56% strongly agree to the fairness of the document that means the 63.89 consider PPM as transparent document. The 52.9% of the respondents concluded that based on personal experience misstatements in PPM is not more that 25%. As a buffer, therefore, a PPM document can be considered a fair document.
8. When it comes to leading advice from friends and relatives in the investment decision based on PPM, the majority, or 52.46% of the respondents, contend they will not advise investing based on the PPM, and they are of the same opinion when it comes to self-investment. However, it is obvious that the relative friend or advisor, suggesting to invest or not to invest, has some information in the formal document like a PPM or teaser.
9. Private placements are preferred because they do not need any regulatory clearance, nor have the necessary information that guarantees the future performance of the underlying business, nor do they provide a safety net for investment value. In other words, private placements suffer from information handicap as reflected by responses from 52.46% of the respondents and bring high risk regarding transparency as reflected by responses from 60.66% of the respondents.

	Responses	
Answer Choice	No.	%
High risk-taker	6	8.82%
Moderate risk-taker	25	36.76%
Conservative risk-taker	17	25.00%
Depends on the type of investments	20	29.41%
Total	68	100.00%

Table 2: Responses towards risk appetite.

Discussion of Results

1A. How regulatory authorities would help in monitoring the content of PPM, to ensure that HNWI has reliable information on PPM before making investment decisions? PPM is regulated in some countries like the US under the Securities Act of 1933 and SEC rules. Even in the USA, the securities offered to get an exemption from registration requirements if the issuance of such securities conforms to an exemption from registrations under SEC rules and regulations. To some extent, PPM is being monitored even in the UK but the rest of the world it's regulated in bits and pieces including EU and GCC. However, even though such regulations are not in practiced in the Middle East, HNWI can conduct detailed analysis and study on PPM after considering various factors or criteria along with proper consultation and by challenging the assumption in PPM before they decide on the investment opportunity to some extent.

1B. What impact would a regulatory body instituted in the Middle East have to contain and control fraud or misstatement in PPM? Private placement refers to offering or selling shares in a company to a small group of buyers.

– These buyers are typically sophisticated investors such as banks, pension funds, mutual funds, insurance companies, very wealthy investors mainly HNWI.

– These above investors have the ability to do detailed study and perform their due diligence when buying shares in a private placement. Further, these kinds of investors come to negotiate and invest with much more bargaining power than an average investor, as a result, but still these investors do need protection in the form of some regulations which is being provided to another investors/shareholder in the case of public offerings.

2. What are the factors HNWI should consider while evaluating the PPM and the degree of risk to be considered that are associated with investing in these PPMs? Various factors that such HNWI should consider will evaluate PPM are

– Proper study and due diligence on the organization as well as promoters or fundraiser.

– The Economic and regulatory frame of the country in which an investment is being offered to evaluate or understand the investor's protection or security in public as well as private placement.

– Project feasibility study with sound reasoning on the future forecast is good enough or not.

3. Who is taking the responsibilities on PPM that it is not misstated and to what extent? The study adopted the qualitative approach relying on interviews and responses in the form of responses to a questionnaire as the means of collecting primary data, from which major findings were discussed, to arrive at logical conclusions. Such HNWI has a good background and with proper due diligence and bargaining power and have the capability to manage their funds. Therefore, the responsibility is on all those who are involved in preparing the PPM, but that does not mean that investors should not take the precautions.

Conclusion and Practical Recommendations

The selected empirical study method posed certain limitations to this study. The questionnaire method suffered from a low response rate as the survey request was circulated among over 400 target participants. Over five weeks' time, 70 responses were acquired. The analysis of the free format questionnaire with non-standardized response options gave the risk of wrong interpretations by the studier. This study was conducted among the investors and people from finance industries but was not discussed or circulated among the regulatory authorities. Study opportunities may exist to contrast the findings from this analysis with that of regulatory authorities in the GCC or other countries. Such a contrast would enable studiers to gain further insight into the effects of location upon corporate culture and thus upon merger success. Similarly, study could be conducted in other industries to learn whether the involved industries appear to generate different or similar results. Finally, this study may be helpful to HNWI individuals or angel investors who are considering the cross-border exposure and want to evaluate the investor's protection in the countries they are considering to invest in or in which have already made the investments.

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