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The Dark Side Of The Legal Marijuana Boom

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One day this past February, David, 29, who asked to be identified only by his middle name, sat in an office on a military base in Afghanistan. As a contractor for the Department of Defense, he worked about 90 hours a week. The rest of his time was devoted to researching investments online. "There wasn't much else to do," he tells Business Insider.

On that day, David came across a YouTube video of a radio show featuring FusionPharm (FSPM), a Denver-based company formed in 2011 that sells PharmPods, or "professional self-contained cultivation solutions," as CEO Scott Dittman explained on the program. Put plainly, FusionPharm makes steel trailers for indoor agriculture. Marijuana growers can also use them as mobile greenhouses, and the concept piqued David's interest. "The product seemed like a good idea because [marijuana] laws are still really murky," he says. "If a company got into a trouble with their state, they could just up and move, so their plants didn't get confiscated by the police."

David had known about Wall Street's green rush since 2010. He understood the dangers that went withinvesting in a potential bubble, like over-valuation and pump-and-dump schemes. But he kept watching FusionPharm's video. As Dittman, a ruddy-faced blond in a casual button-up, explained the company's products and business model, his ten-dollar words would have reassured any inexperienced investor. He noted that FusionPharm planned to undergo auditing before the end of the year and expand to Massachusetts and Washington, both considered medical marijuana hubs. "We're going to ship more PharmPods in the next 45 days," Dittman said on screen, "than we have since the beginning." Washington started selling recreational weed on July

At that point, David knew he wanted to invest in FusionPharm. "If a company plans on getting an auditor, it means they're legit," he says. "For a penny stock, that's pretty important." In February, David bought a couple thousand dollars of the stock from his desk chair in the desert.

"All of the stocks surrounding pot just exploded in anticipation of it becoming a more legal industry," he explains. "I wanted to get in early on the investment." At one point, David's stake in FusionPharm hit $7,500.

When David returned home to D.C. several weeks later, he quit his defense job to become a day trader. "I just thought I might want to try something new," he says. "I liked the idea of being my own boss, making my own hours."

David now describes his stake in FusionPharm as an "eye-opening experience." Just a month after watching Dittman's interview on YouTube, David was out $4,500. "It was huge," he says. "I'm not rich."

Experiences like David's were exactly what the SEC was trying to avoid when it issued an investor alert on marijuana-related stocks in mid-May. That day, the agency suspended trading in FusionPharm, having already done the same to four other marijuana-related companies: Canna Business Group, focusing on real estate for the marijuana industry; GrowLife, a hydroponics provider; Advanced Cannabis Solutions, which also leases growing space for licensed marijuana-growers; and PetroTech Oil and Gas, a natural resources company that recently expanded into cannabis and hemp.

All of these stocks currently trade or have traded at the penny-stock level, meaning the shares usually trade below $5 and not on major exchanges. Because of their volatility and illiquidity, penny stocks already pose heightened risk to investors. And aside from their tickers' positions at the less-regulated microcap level — and their focus on the nascent legal-cannabis industry — the companies shared several other characteristics the SEC tends to consider red flags: reverse mergers, reverse stock splits, and low initial public offerings.

Note: Business Insider is not implying the companies mentioned engage in unlawful practices, only that this market lends itself to greater opportunities for fraud, as noted by the SEC.

FusionPharm's Demise

After rising from 25 cents to over $7 between the end of November 2013 and early February 2014, FusionPharm's stock started dropping. It's now down to 95 cents (as of July 11). The day before the SEC's suspension, the stock was trading at $2.89. Ten business days later, when trading resumed, it was at 82 cents.

During a suspension, the company's broker can't issue quotes in that stock, which makes buying and selling much more difficult. And when the SEC suspends trading to communicate concerns about the stock, the price will likely decrease, professor of securities law at the University of Toledo Eric Chaffee tells Business Insider. While the move harms investors who didn't sell the stock quickly enough, the SEC considers those losses the lesser of two evils. Before reinstatement, companies must file a 15c211 form, which FINRA will review and approve. "It's very difficult for the stock to trade again," Brenda Hamilton, founder of Hamilton & Associates Law Group, tells Business Insider. "Very few companies recover from these suspensions." And she would know the process. "As a law firm, we represent lots of whistleblowers, and we represent investors who have lost money in these types of stocks," Hamilton explains. "So yes, when the facts are present that support it, we refer it to the SEC, we refer it to the FBI, and sometimes, there are other agencies."

Luckily, David sold his final shares before the SEC stepped in. "Unlike some investors, I wasn't burned by the suspension," he says. "I was burned by the stock's price decline before that." When he noticed his investment faltering in March, David started thoroughly researching Fusion Pharm. "Since I was now trading for a living, I had time to do that," he said. "A regular investor might not." And he quickly discovered glaring issues with the company's public image.

First, although Dittman said in his YouTube interview that the company planned to undergo auditing, Fusion Pharm filed a disclosure statement on March 31 indicating it had no auditor or accountant. In fact, Dittman, an ex-CPA, handles FusionPharm's financial documents himself, according to an attorney letter from December 2013. Worse, OTC Market's banned the company's legal counsel, Guy-Jean Pierre, in 2010, and the SEC later charged him with issuing fraudulent attorney opinion letters that resulted in more than 70 million shares of microcap stock becoming available for unrestricted trading.

On June 2, a few days after FusionPharm's trading reinstatement, the company released a document explaining the origins of the SEC's investigation: failure to disclose the company's relationship with Williams Sears, Dittman's brother-in-law. Sears is an officer at two companies, Vertifresh and Meadpoint Ventures, with which FusionPharm has done considerable business. In 2007, Sears pleaded guilty to federal charges involving securities fraud and bribery. He and his wife encouraged their clients, many of whom were retired, to invest substantial amounts of their savings in high-risk securities while failing to disclose that obvious risk, according to the SEC's complaint.

"If you're a small company, and the people involved have a history of stock scamming," David says, "I don't think they have the best interests of their investors in mind." The company's press release also mentions that as part of the investigation for potential securities law violations, the federal authorities raided FusionPharm on March 16, seizing records, computers, and about $200,000 in funds from the company's bank accounts. "It's not a good company," David adds.

Dittman declined to comment.