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SUPER HIGHWAY ROBBERY: THE SEC AND THE EVOLUTION OF ONLINE SECURITIES FRAUD

Sean A. Kennedy¹

I. INTRODUCTION:

The Security and Exchange Commission (“SEC”) was formally created and empowered through Section 4 of the Securities Exchange Act of 1934 (the “’34 Act”)² as well as the 1933 Securities Act (the “’33 Act.”)³ One of the main purposes of the SEC is to regulate the registration and sale of securities in the primary and secondary markets.⁴ The SEC was created as a response from the government to the Great Depression of 1929.⁵ Thus, it is unsurprising that the legislators who passed these Acts did not foresee the radical changes that the creation of the internet and onset of the digital age would bring to the securities market.

In 2011, over 2.4 billion people across the world accessed the Internet.⁶ Moreover, it is estimated that “users access about 100 billion web pages **every day**.”⁷

¹ The author would be remiss without formally expressing his thanks and gratitude to E. Judson Jennings, Professor of the Legal Issues in Online Communities Writing Seminar. This paper would not have been possible without his patience, understanding, and encouragement.

² See generally, *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, available at: <http://www.sec.gov/about/whatwedo.shtml>.

³ *Id.*

⁴ *Id.*

⁵ *Id.*

⁶ Trautman, Lawrence James, *The SEC & the Internet: Regulating the Web of Deceit* (October 29, 2011). Consumer Finance Law Quarterly Report, Vol. 65, 2011. Available at SSRN: <http://ssrn.com/abstract=1951148>.

⁷ *Id.* (citing Rod Beckstrom, President & CEO, Internet Corp. for Assigned Names and Numbers, Keynote Address at TUTED World Telecom Day: ICANN and the Global Internet (May 17, 2011) (transcription available at,

This increase in Internet usage has facilitated the ability to commit securities fraud. To illustrate, as of 2001 the SEC had brought a total of 209 internet related enforcement actions for fraud.⁸ Last year alone, the SEC brought 735 enforcement actions against corporations and individuals.⁹ It is estimated that over two-thirds of all the current cases brought by the SEC are related to some type of internet-based fraud.¹⁰

Initially, SEC regulators had split opinions regarding the impact the Internet would have in the future of securities fraud enforcement. Some at the SEC believed that the current system of enforcement laws would be sufficient safeguards to handle the expansion of internet fraud, while others perceived this expansion as a threat to consumer safety.¹¹ In 1997, John Stark, the Chief of the SEC's Office of Internet Enforcement ("OIE,") expressed his belief that the SEC did not need to promulgate any new laws in order to combat internet fraud.¹² Specifically, he stated

Most of the SEC's rules and regulations apply equally over the Internet as they would to any new medium. There is at present no desire on the behalf of the Division of Enforcement, or really as the SEC as a whole, for any new broad or overreaching types of regulations but from the enforcement side, the current antifraud provisions will do just fine.¹³

<http://www.icann.org/en/presentations/beckstrom-speech-izmir-turkey-17may11-en.pdf>) (emphasis added).

⁸ Richard H. Walker & David M. Levine, *"You've Got Jail": Current Trends in Civil and Criminal Enforcement of Internet Securities Fraud*, 38 Am. Crim. L. Rev. 405, 409 (2001).

⁹ See generally Press Release, *Agency's Fiscal Year Totals Show Most Enforcement Actions Filed in Single Year*, <http://www.sec.gov/news/press/2011/2011-234.htm> (last updated Nov. 9, 2011).

¹⁰ *Id.*

¹¹ Compare, *infra*, note 12; *infra*, note 14.

¹² Michael J. Kaufman, 26 Sec. Lit. Damages §5:12 (updated September 2012)

¹³ *Id.*

Conversely, in 1999 the Director of the SEC's Office of Enforcement, Richard Walker, noted "policing the Internet is unquestionably our greatest enforcement challenge today."¹⁴

This paper will take an in-depth look at the increase of securities fraud perpetrated over the Internet and the SEC's response to these newfound threats in an effort to determine which of the divergent views expressed by the respective Directors was more accurate. Part II of this paper will provide a background of the SEC's enforcement ability framework that is used to bring actions against individuals that commit securities fraud. Part III of this paper will look at the former and current trends in online securities fraud transactions. Finally, Part IV of this paper will conclude by evaluating the internal effectiveness of the SEC as well as look at a privately funded program that can be used to identify and report online securities fraud schemes.

II. HISTORICAL FRAMEWORK OF THE SEC'S ENFORCEMENT ABILITY:

In order to fully understand the impact the evolution of the Internet has had upon the SEC, it is necessary to first look at the current legal framework that is used to bring enforcement actions against perpetrators of securities fraud. The SEC has the ability to bring enforcement actions against individuals or companies that violate various portions of the '33 and '34 Acts, which relate to issuances and misrepresentations concerning securities.¹⁵ Collectively, these Acts protect both the initial issuance of securities when

¹⁴ Byron D. Hittle, *An Uphill Battle: The Difficulty of Deterring and Detecting Perpetrators of Internet Stock Fraud*, 54 Fed. Comm. L.J. 165, 167 (2001) (quoting, Richard Walker).

¹⁵ *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, *supra*, note 2.

companies first attempt to register and sell them in the market, as well as the subsequent resale of these securities on the secondary market by traders and investors.¹⁶

A threshold issue that courts consider during this process is determining what exactly constitutes a security. The term “security” is defined broadly in both the ’33 and the ’34 Acts.¹⁷ Further, in *SEC v. W.J. Howey*, the Supreme Court stated that an investment contract, or, security, under the ’33 Acts is “a contract, transaction, or scheme, whereby a person invests money in a common enterprise and is led to expect profits solely from the efforts of the promoter or third party.”¹⁸ Courts have relaxed the “solely” requirement of the *Howey* test and consider stocks to fall under the both the ’33 and ’34 Acts definition of a security when they have “(i) the right to receive dividends contingent upon an apportionment of profits; (ii) negotiability; (iii) the ability to be pledged or hypothecated [sic]; (iv) the conferring of voting rights in proportion to the number of shares owned; and (v) the capacity to appreciate in value.”¹⁹

¹⁶ *Id.*

¹⁷ Both Acts define a security as “any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization [sic] certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.” 15 U.S.C.A. § 77b; 15 U.S.C.A. § 78c.

¹⁸ *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

¹⁹ *Robinson v. Glynn*, 349 F.3d 166, 173 (4th Cir. 2003).

Again, the SEC generally brings enforcement actions for violations involving these securities under both the '33 and '34 Acts.²⁰ Specifically, the '33 Act is used to regulate conduct in the primary market wherein the impetus of the violation is the initial issuance of a security.²¹ Under Section 11 of the '33 Act, the SEC may bring an action against any signee of a registration statement who makes a material misrepresentation or omission relating to the issuance of a security.²² Misrepresentations and omissions relating to the resale of securities on the secondary market are regulated by the '34 Act.²³ The main antifraud provision used by the SEC to pursue violations under the '34 Act is the 10(b)-5 provision.²⁴ This provision states that

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.²⁵

Courts have determined that the requisite elements to bring a 10(b)-5 claim include: (1) a material misrepresentation or omission by the defendant; (2) *scienter*; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6)

²⁰ See, *supra* note 2.

²¹ *Id.*

²² 15 U.S.C.A. § 77k.

²³ 15 U.S.C.A. § 78b.

²⁴ Trautman, *supra* note 6, at 39.

²⁵ 15 U.S.C. § 78j(b).

loss causation.²⁶ However, courts have recently placed the greatest emphasis on proving the element of materiality.²⁷

The Tenth Circuit weighed in on the determination of the materiality requirement under 10(b)-5 in cases involving online fraud. In *S.E.C. v. Curshen*, an investor omitted the fact the he was being paid to promote a stock for a company.²⁸ Further, the investor was making anonymous postings online with the intention of getting unsuspecting people to purchase the company's stock he was being paid to tout.²⁹ The court stated

[t]hus, a voluntary statement invokes a duty to disclose only if it is material. A statement or omission is only material if a reasonable investor would consider it important in determining whether to buy or sell stock” and if it would have significantly altered the total mix of information available to current and potential investors.³⁰

The court determined that a reasonable investor would consider the motivation of the individual posting the information online as a “significant factor” in making a decision to invest and found the Defendant's actions sufficient to rise to the level of material.³¹

Once the SEC believes that it has enough facts to satisfy the materiality requirement it will proceed to bring a suit against alleged fraudsters. However, the SEC only has the authority to bring civil suits against perpetrators of securities fraud.³² In order to bring criminal actions the SEC must cooperate with agencies such as the U.S

²⁶ *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2184, (2011).

²⁷ *Basic Inc. v. Levinson*, 485 U.S. 224, 246, (1988) (finding ‘Fraud on the Market’ acceptable to prove reliance on a material misrepresentations); *see also* Elieen Smith Ewing, *Fraud on the Cybermarket: Liability for Hyperlinked Misinformation Under Rule 10b-5*, 56 Bus. Law. 375, 383 (2000) (“More recent decisions, however, have witnessed a certain telescoping of the necessary elements—only materiality appears to remain a requirement.”)

²⁸ *S.E.C. v. Curshen*, 372 F. App'x 872, 874 (10th Cir. 2010).

²⁹ *Id.*

³⁰ *Id.* at 880 (internal citations and quotations omitted).

³¹ *Id.* at 881.

³² Hittle, *supra* note 14, at 187.

Attorney's Office, the Federal Bureau of Investigations or state enforcement agencies and convince those agencies to bring criminal charges.³³ However, a criminal violation under 10(b)-5 requires a higher degree of culpability than a civil infraction.³⁴ In order to establish a criminal violation, "the Government must prove that a person willfully violated the provision," whereas a civil action only requires the Government to prove mere recklessness.³⁵ This is the established framework used by the SEC when it brings charges against individuals. The following section will analyze cases brought by the SEC in order to determine if this current framework is adequate to protect investors from fraud in the modern internet age.

III. TWO MAIN CATEGORIES OF INTERNET BASED SECURITIES FRAUD:

The two main categories of internet based securities fraud are (1) market manipulation and (2) offering frauds.³⁶ This section will explain in detail how these schemes operate as well as the devastating monetary effects they have on unsuspecting victims. In addition, cases will be used to illustrate how the SEC initially responded to these violations during the beginning of the internet era and will be followed by cases examining how it currently responds to the modern versions of these schemes. Importantly, all of the actions by the SEC discussed in this Section are based upon the enforcement framework outlined in Section II.

³³ *Id.*

³⁴ Walker, Levine, *supra* note 8, at 416-17.

³⁵ *United States v. O'Hagan*, 521 U.S. 642, 665 (1997).

³⁶ Walker, Levine, *supra* note 8 at 410.

A. Market Manipulation:

Market manipulation is generally defined as “the illegal practice of raising or lowering a security's price by creating the appearance of active trading.”³⁷ The Supreme Court elaborated stating

[Market manipulation] is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.³⁸

Online market manipulation falls into two general categories: (1) the “Pump and Dump” and (2) the “Cyber-smear.”³⁹ Both categories focus on the manipulation of already issued stock on the secondary market and the SEC generally prosecutes those who perpetrate these frauds for 10(b)-5 violations in connection with their participation in these schemes.⁴⁰

1. Pump and Dump Schemes

First, in a “pump and dump” scheme, the fraudster will purchase so-called “penny stocks”⁴¹ and begin to circulate false and misleading information across the Internet in order to drive up the price of the security.⁴² Fraudsters will make use of various pseudonyms and anonymous postings in order to create “buzz” for these otherwise worthless stocks.⁴³ Once the price of the stock increases, the fraudster will sell his

³⁷ Manipulation, Black's Law Dictionary (9th ed. 2009).

³⁸ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

³⁹ Walker, Levine, *supra* note 8 at 411.

⁴⁰ *Id.*

⁴¹ A penny stock as “an equity security that is not traded in established markets, represents no tangible assets, or has average revenues less than required for trading on an exchange. Typically, a penny stock is highly speculative and can be purchased for less than \$5 a share.” Stock, Black's Law Dictionary (9th ed. 2009).

⁴² Hittle, *supra* note 14, at 169.

⁴³ *Id.*

interest in the stock, after it rises to a high point in order to turn a profit.⁴⁴ Generally, after the fraudster sells his interest the stock, the price of the stock crashes and innocent investors suffer significant losses due to the rapid decline of the stock price.⁴⁵ Enforcement actions brought by the SEC generally are contingent upon the type of misrepresentations made by the fraudsters and the severity of the damage caused.⁴⁶

In 1999, Jonathan Lebed committed one of the first newsworthy online “pump and dump” schemes when he was only fifteen years old.⁴⁷ Lebed purchased various penny stocks and immediately begin spamming message boards on both Yahoo! Finance and Silicon Investor in order to manufacture demand for the stocks.⁴⁸ In one instance, Lebed purchased 18,000 shares of a stock called MSHI for roughly \$1.30 per share and immediately began to spam various message boards claiming it was “the most undervalued stock in history.”⁴⁹ Shortly after, the stock price rose to roughly \$4 per share and Lebed made nearly \$34,000 in profits.⁵⁰

The SEC brought a 10(b)-5 action against Lebed and relied upon various actions taken by Lebed in order to bolster its position in establishing the materiality requirement.⁵¹ Specifically, the SEC focused on Lebed’s postings under various anonymous names and pseudonyms that were used to create the illusion that many

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ Walker, Levine, *supra* note 8, at 412.

⁴⁷ *In re* Jonathan G. Lebed, Exchange Act Release No. 34-43307, 2000 WL 1353040, 1 (Sept. 20, 2000).

⁴⁸ *Id.* at 2.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.*

people, instead of just Lebed, were promoting the stock.⁵² Lebed insisted that his claims were innocuous and on par with what investors do everyday, but the Commission decided enough evidence existed to pursue a violation under the '34 Act.⁵³ This is important because it is indicative of what actions taken by fraudsters may rise to the level of materiality under 10(b)-5, instead of mere puffery, which is non actionable by the SEC.⁵⁴

Ultimately, Lebed settled out of court with SEC, admitted no fault, and forfeited \$272,826 of profit.⁵⁵ However, the SEC settlement only pertained to 11 out of 26 trades made by Lebed and it is believed that after litigation he earned over \$500,000 in profit from these schemes.⁵⁶ The Lebed case highlighted numerous problems the SEC initially faced with the rampant expansion of online securities fraud. While the SEC was successful in pursuing litigation and ultimately reached a settlement with Lebed, the fraudster ended up retaining 65% of the earnings he procured through an illegal “pump and dump” scheme.⁵⁷

The use of websites is another popular way to perpetrate “pump and dump” schemes.⁵⁸ These websites are sometimes referred to as “momentum trading” websites.⁵⁹ These website generally have misleading statements regarding a track record of stock predictions and will generate baseless claims regarding penny stocks the fraudsters are

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Howard v. Haddad*, 962 F.2d 328, 331 (4th Cir. 1992) (holding that puffery “lacks the materiality essential to a securities fraud allegation.”)

⁵⁵ Hittle, *supra* note 14, at 187.

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ Walker, Levine, *supra* note 8, at 425.

⁵⁹ *Id.*

trying to inflate.⁶⁰ One example of this specific type of a “pump and dump” scheme involved law students creating a fraudulent website called, “Fast-Trade.com.”⁶¹ In the Fast-Trade.com case, the students used the website to manipulate the price of penny stocks leading some stocks to have upwards of a 700% increase in value.⁶² When the SEC discovered the fraud the students had already earned \$345,000 in profit.⁶³ The SEC brought charges against the students under section 10(b)-5 of the ’34 Act.⁶⁴ Similar to the Lebed Case, the SEC focused on the specific actions of the student in creating the website to establish the 10(b)-5 materiality element.⁶⁵ However, the SEC was not able to prove a high enough degree of intent to garner support for any criminal prosecution of the students.⁶⁶

Currently, “pump and dump” schemes are still widely utilized by fraudsters who commit securities fraud using the Internet. One of the most popular ways to engage in “pump and dump” schemes is through targeting email spamming.⁶⁷ A study conducted in order to determine the effectiveness of spam accounts found that “unsolicited e-mail accounts for over 80 percent of all Internet e-mail traffic, which amounts to over 1.6 billion messages per week.”⁶⁸ It is estimated that 15% of all current spam mail is related

⁶⁰ *Id.*

⁶¹ In The Matter Of Kenneth Terrell, Jason Wyckoff, Adam Altman And Joanne Colt, Exchange Act Release, No. 34-42483, 2000 WL 248549, 1 (March, 2, 200).

⁶² *Id.* at 2.

⁶³ *Id.*

⁶⁴ *Id.* at 9.

⁶⁵ *Id.*

⁶⁶ *See generally, id.*

⁶⁷ Laura Frieder, Jonathan Zittrain, *Spam Works: Evidence from Stock Touts and Corresponding Market Activity*, 30 *Hastings Comm. & Ent L.J.* 479, 480 (2008).

⁶⁸ *Id.*

to “pump and dump” stock schemes.⁶⁹ In other words, nearly 240 million spam messages per week are sent out attempting to defraud legitimate investors.

In a recent “pump and dump” case, two brother created a website called *doublestocks.com* to advertise a newsletter containing stock picks made by a “stock picking robot.”⁷⁰ In reality, there was no “stock-picking robot” and the stocks listed in the newsletter consisted of penny stocks that were hand picked by the brothers.⁷¹ In addition, the brothers were paid by stock promoters to increase the value of various penny stocks.⁷² In total the brothers were paid over \$1.8 million by various stock promoters for this service.⁷³ The SEC brought a 10(b)-5 claim against the brothers and ordered them to disgorge all of their profits from the scheme.⁷⁴

The importance of this recent case is that it highlights how the SEC has not changed its course in pursuing internet fraudsters. The allegations and enforcement action brought against the brothers in the “stock picking robot” case are identical to the allegations brought against Jonathan Lebed in 2000, nearly 12 years ago. As will be discussed in Section IV, the SEC has attempted to make internal changes to keep pace with the vast increase in fraud cases, however, its enforcement actions remain the same and it still cannot bring independent criminal actions against internet fraudsters.

⁶⁹ *Id.*

⁷⁰ *SEC v. Thomas Edward Hunter And Alexander John Hunter*, Lit. Release No. 22339, 2012 WL 1894183, 1 (April 20, 2012).

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.*

2. “Cyber-Smear” Schemes:

A close relative to the “pump and dump” scheme is the “cyber-smear” scheme. A “cyber-smear” scheme for all intents and purposes is the inverse of a “pump and dump” scheme.⁷⁵ In a “cyber-smear” scheme the fraudster will anonymously post false and misleading statements that will decrease the value of a particular stock in order to engage in a “short sale”⁷⁶ and turn a profit.⁷⁷ These schemes are prosecuted in a nearly identical manner to “pump and dump” schemes and involve the SEC bringing civil actions under the ’34 Act.⁷⁸ Notably, “cyber-smear” schemes cases generally have a higher likelihood of criminal liability attaching because the cases involve a great deal of effort and intent on the part of the fraudster.⁷⁹

One early case that demonstrates the significant affect a “cyber-smear” attack has on unsuspecting companies is *United States v. Mark Simeon Jakob*.⁸⁰ Initially, Mr. Jakob lost nearly \$80,000 attempting various short sales of Emulex stock.⁸¹ In order to compensate himself for this loss he orchestrated a fake press release that claimed the CEO of Emulex was being investigated by the SEC and was about to resign from his

⁷⁵ Walker, Levine, *supra* note 8, at 412.

⁷⁶ A short sale is “[a] sale of a security that the seller does not own or has not contracted for at the time of sale, and that the seller must borrow to make delivery. Such a sale is usu[ally] made when the seller expects the security's price to drop. If the price does drop, the seller can make a profit on the difference between the price of the shares sold and the lower price of the shares bought to pay back the borrowed shares.” Sale, Black's Law Dictionary (9th ed. 2009).

⁷⁷ Walker, Levine, *supra* note 8, at 412.

⁷⁸ *Id.*

⁷⁹ *Id.* at 420.

⁸⁰ *United States v. Mark Simeon Jakob*, Lit. Release No. 16857, 2001 WL 15535, 1 (Jan. 8, 2001).

⁸¹ *Id.*

position.⁸² The result of this press release was immediate and enormous. It was estimated that Emulex lost over \$2 billion in market share in less than a half an hour.⁸³ While the error was eventually fixed, countless investors lost money when the stock price began to free-fall.⁸⁴

The SEC brought a civil suit against Mr. Jacob and coordinated with the United States Attorneys Office (“USAO”) in order to bring criminal charges.⁸⁵ Because of the impact of the damage to Emulex as well as the level of planning Mr. Jakobs put into the scheme he plead guilty to both the civil and criminal charges.⁸⁶ Mr. Jakobs was sentenced to a “maximum prison term of 25 years, a maximum fine equal to two times the \$110 million in investor losses and an order of restitution up to \$110 million payable to the victims of his scheme.”⁸⁷

While this case provides a good example of how the SEC is able to successfully coordinate with another governmental entity in order to bring criminal charges against fraudster, this level of cooperation is not always possible. In fact, certain courts have expressed concern that this type of dual investigation into a single defendant can run afoul of due process protections. In *United States v. Stringer*, the Ninth Circuit considered a case where the SEC brought an action against a defendant while the USAO conducted a parallel investigation.⁸⁸ Ultimately, the court determined that “there is nothing improper about the government undertaking simultaneous criminal and civil

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Jakob, supra* note 80.

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *United States v. Stringer*, 535 F.3d 929, 933 (9th Cir. 2008).

investigations.”⁸⁹ However, the court mentioned certain “rare” circumstances where these parallel investigations can interfere with defendants’ due process rights. The court stated

[T]o the extent that the individual defendants may have been led through trickery or deceit to turn over documentary or physical evidence in their possession or to use their official authority to turn over evidence in the possession of the corporation, the defendants could state a claim under the Fourth Amendment. A government official must not affirmatively mislead the subject of parallel civil and criminal investigations into believing that the investigation is exclusively civil in nature and will not lead to criminal charges.⁹⁰

Here, the SEC and the USAO cooperated within the proper framework when conducting the parallel investigations into Mr. Jakob. However, it easy to see how these due process concerns can cause apprehension on the part of the SEC to involve other agencies into potential securities fraud investigations and vice-a-versa. To surmise, in addition to having to keep up with the growing rate of internet based “pump and dump” and “cyber-smear” schemes committed by individuals, the SEC has to also attempt cooperate within a specified framework so as to not violate defendants due process rights and allow them to escape liability.

B. Offerings Frauds:

An offerings frauds involves a type of scheme where an individual will set up a website or other mechanism in order to sell fraudulent securities.⁹¹ In a majority of these schemes, the securities never actually exist.⁹² Offerings frauds can originate from numerous other platforms. As the Director of the SEC’s Office of Enforcement, Richard

⁸⁹ *Id.*

⁹⁰ *Id.* at 940 (internal quotations and citations omitted).

⁹¹ Walker & Levine, *supra* note 8, at 423.

⁹² *Id.*

Walker, stated, “[t]hese scams are often exotic. For example, we have seen interests pitched in eel farms, coconut plantations, and, my personal favorite, projects to explore near earth asteroids.”⁹³

The Internet has streamlined this process, enabling operators of the scheme to be self-sufficient by simply setting up websites that offer fraudulent securities.⁹⁴ In 1998, Matthew Bowin orchestrated one of the first offerings fraud schemes conducted entirely on the Internet.⁹⁵ Bowin created a website to launch an IPO for a company named IPS.⁹⁶ This stock offering garnered over \$190,000 from over 150 different investors.⁹⁷ Bowin never issued any stock and instead spent all of the money on personal expenses such as groceries, electronics and bills.⁹⁸ The SEC successfully brought a civil enforcement action against Bowin who was convicted on 54 different counts including fraud and grand theft.⁹⁹ In addition, state law enforcement successfully pursued criminal charges that resulted in a 10-year prison sentence.¹⁰⁰

Perhaps the most commonly known type of offerings fraud is a Ponzi scheme.¹⁰¹ The general function of a Ponzi scheme involves the payment of alleged returns to

⁹³ Richard H. Walker, *Remarks at the National Press Club: A Bull Market in Securities Fraud?* (Apr. 5, 1999), available at <http://www.sec.gov/news/speech/speecharchive/1999/spch265.txt>.

⁹⁴ Hittle, *supra* note 14, at 169.

⁹⁵ *SEC v. Interactive Products and Services, Inc., and Matthew P. Bowin*, Lit. Release No. 15700, 1998 WL 159331, 1 (Apr. 8, 1998).

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *California v. Matthew P. Bowin*, Lit. Release No. 16029, 1999 WL 18570 (Jan. 19, 1999).

¹⁰⁰ *Id.*

¹⁰¹ Walker & Levine, *supra* note 8, at 423.

current investors through the funds collected by new investors in the scheme.¹⁰² The operator of the scheme will use the money collected from the new investors in order to create the illusion of high, fixed returns.¹⁰³ This requires a constant inflow of funds to keep the façade of earnings present or else the scheme collapses on itself.¹⁰⁴ The Ponzi scheme derives its name from the infamous confidence man Charles Ponzi who defrauded numerous investors in the 1920s by promising a 50% return on an investment based upon international reply coupons for postage stamps.¹⁰⁵ This return was 45% higher than any bank that invested in a similar security.¹⁰⁶ Once the cash flows slowed down, Ponzi was unable to pay current investors and the whole operation fell apart.¹⁰⁷

Currently, offerings fraud cases result in greatly increased damages to investors. In 2011, the SEC brought down a Ponzi scheme operating entirely online that lost nearly \$600 million.¹⁰⁸ In that case, Paul Burks and his company Rex Venture Group, used the website *ZeekRewards.com* to lure investors into purchasing securities that did not exist.¹⁰⁹ The website claimed that investors would receive 50% of the company's earnings through a profit sharing system.¹¹⁰ In reality, all of the funds were collected and distributed using the classic Ponzi scheme model. When the SEC discovered the fraud,

¹⁰² See generally, *Ponzi Schemes: Frequently Asked Questions*, <http://www.sec.gov/answers/ponzi.htm>.

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ Press Release, *SEC Shuts Down \$600 Million Online Pyramid and Ponzi Scheme*, <http://www.sec.gov/news/press/2012/2012-160.htm> (modified Aug. 21, 2012).

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

the scheme was on the brink of collapse.¹¹¹ In one month alone, the website had \$162 million incoming from investors and nearly \$160 million that needed to be paid out to investors.¹¹²

The SEC investigation revealed that there is currently \$225 million still outstanding.¹¹³ Burks has reached a private settlement with the SEC that required him to pay a \$4 million fine, relinquish his interest in Rex Venture Group, and work with a court appointed receiver that will “collect, marshal, manage and distribute remaining assets for return to harmed investors.”¹¹⁴ Interestingly, this settlement with the SEC allowed Burks to claim no wrongdoing in connection with the scheme.¹¹⁵

This case illustrates the main issue with the SEC’s current ability to protect investors from becoming victims of online securities fraud. While the SEC can successfully bring enforcement actions and cooperate with state and federal authorities in pursuing criminal actions, these are all “after the fact” remedies. Whether it is a “pump and dump” scheme, a “cyber-smear” campaign or a classic Ponzi scheme, the SEC is taking reactive steps while fraudsters collect larger and larger profits from engaging in the same schemes they have perpetrated for years.

IV. THE SEC’S INTERNAL EVOLUTION AND PROGRAMS IT SHOULD CONSIDER ADOPTING:

The final section of this paper will address the internal changes the SEC has made in order to keep pace with the growth of the internet and will suggest certain programs

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ *SEC Shuts Down \$600 Million Online Pyramid and Ponzi Scheme, supra, note 108.*

¹¹⁵ *Id.*

used by private parties to detect internet fraud that the SEC should look into adopting. While the regulation currently enacted by the SEC does not impede its ability to prosecute fraudsters, a close look into the internal process of the SEC's enforcement divisions should shed light on how efficiently the SEC can detect these schemes before fraudsters can harm investors.

A. EDGAR:

The SEC's first response to the growing popularity of the Internet was its creation of a centralized database used to gather information on filings required by corporations in securities trading.¹¹⁶ This program is called the Electronic, Data Gathering, and Analysis Retrieval System ("EDGAR").¹¹⁷ The SEC has stated that

[EDGAR's] primary purpose is to increase the efficiency and fairness of the securities market for the benefit of investors, corporations, and the economy by accelerating the receipt, acceptance, dissemination, and analysis of time-sensitive corporate information filed with the agency.¹¹⁸

In 1993, the SEC began a phase in process that moved EDGAR from being a voluntary process to the more familiar current day requirement for many, but not all, filings for domestic public companies to ensure compliance with SEC filing regulations.¹¹⁹ Regulation S-T governs the requirements and instructions for what must be filed electronically, including the application for hardship exceptions, as well as instructions for compliance and is available in the EDGAR Filer Manual.¹²⁰

¹¹⁶ See generally, *Important Information About EDGAR*, <http://www.sec.gov/edgar/aboutedgar.htm> (last modified 2/16/2010).

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ Trautman, *supra* note 6 at 15.

¹²⁰ *Id.* at 18.

However, the EDGAR system does have inherent drawbacks. Certain documents cannot currently be posted on EDGAR due to internal SEC policies.¹²¹ Further, a number of documents on EDGAR are voluntary, not mandatory, leading to inconsistent filings from one company to another depending upon which documents certain companies are able to afford, or choose, to put online.¹²² While this was the correct initial step for the SEC to take in order to adapt to the oncoming internet based culture, it has failed to keep the system progressing with the current state of the internet and its users.

B. The Office of Internet Enforcement:

The SEC's next major move in response to the increase of internet fraud cases was the establishment of a specialized enforcement division the OIE.¹²³ The goal of this division was to facilitate a "concentrated effort in investigating Internet security fraud and act as a civil-enforcement agency, usually looking for fines and injunctions."¹²⁴ Initially the OIE had nearly 70 attorneys and staff members working to detect internet schemes through simple internet searches.¹²⁵ This division was nicknamed "Cyberforce" and grew to include well over 200 SEC attorneys conducting independent searches for fraudulent activity online.¹²⁶ While this program relied heavily on volunteers and manual searches, Richard Walker, the Director of the OIE, touted the programs initial success.¹²⁷ By late 2001, the Cyberforce sweeps had accounted for 209 enforcement actions brought

¹²¹ *Important Information About EDGAR*, *supra* note 116.

¹²² *Id.*

¹²³ Kaufman, *supra* note 12.

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ Hittle, *supra* note 14 at 173.

¹²⁷ Walker, *supra* note 93.

by the SEC against internet fraudsters.¹²⁸ Although this type of program worked well in the early years of the internet it is doubtful that manual searches will be able to keep pace with current activity. For example, there are nearly 240 million “pump and dump” email scams sent every week.¹²⁹

In addition to the manual searches, the SEC put great emphasis on educating investors and having the OIE cooperate with the Office of Investor Education and Assistance (“OIEA”).¹³⁰ In 2000, Laura Unger, a Commissioner with the SEC stated

We believe that an educated investor provides the best defense -- and offense-- against securities fraud. Investors who know what questions to ask and how to detect fraud will be less likely to fall prey to con-artists. And, because they are more likely to report wrongdoing to the SEC and their state securities regulators, educated investors serve as an important early warning system to help regulators fight fraud.¹³¹

One of the main functions of the OIE in furthering this goal was to operate the Enforcement Complaint Center, where so-called “cyber-sleuths” have the ability to report securities fraud directly to the SEC.¹³² The SEC claims to utilize other programs to assist in the search for cyber fraud, however, it has not provided outlines of these programs to the public.¹³³

¹²⁸ Walker & Levine, *supra* note 8.

¹²⁹ Frieder, Zittrain, *supra*, note 67.

¹³⁰ Kaufman, *supra* note 12.

¹³¹ Laura S. Unger, *Speech by SEC Commissioner: Empowering Investors in an Electronic Age*, IOSCO Annual Conference, <http://www.sec.gov/news/speech/spch380.htm> (modified Jun. 9, 2000).

¹³² Hittle, *supra* note 14 at 173.

¹³³ Jake van der Laan, Brodie Shannon, & Christopher Baker, *Identifying Internet Mediated Securities Fraud: Trends and Technology*, http://journal.webscience.org/367/2/websci10_submission_71.pdf (last visited Nov. 28, 2012).

In 2010, the SEC's Enforcement Division underwent its most massive internal reorganization since its inception in 1972.¹³⁴ The OIE was reorganized under the newly formed Office of Market Intelligence ("OMI").¹³⁵ Accordingly, it was noted that the OMI "will assume the responsibilities of the Internet enforcement unit and add new duties, such as handling tips and referrals."¹³⁶ The reorganization is not entirely surprising as the increase in internet usage for securities transactions is significantly greater than when the department originated.¹³⁷ Much like the EDGAR program, the SEC initially took the correct step to keep up with the increase consumer utilization of the internet.

The difference in this situation is that the SEC appeared to understand that internet usage and securities transactions were so intertwined that the OIE needed to be retooled to keep pace. Unfortunately, because the SEC has not made any information available to the public regarding its current tools used to track internet schemes before investors are damaged, it remains unknown if the current department has upgraded its searching capabilities from the currently outdated ideas such as Cyberforce.

C. Scamalyrz—A Private Solution Worth Looking Into:

While the SEC encourages "cyber-sleuths" to report potential online fraud to its Enforcement Complaint Center, private parties have taken online fraud detection one-step

¹³⁴ Press Release, *SEC Names New Specialized Unit Chiefs and Head of New Office of Market Intelligence*, <http://www.sec.gov/news/press/2010/2010-5.htm> (modified Jan. 13, 2010).

¹³⁵ Doug Cornelius, *SEC Rearranges its Enforcement Program*, <http://www.compliancebuilding.com/2010/01/13/sec-rearranges-its-enforcement-program> (Jan. 13, 2010).

¹³⁶ *Id.*

¹³⁷ *Agency's Fiscal Year Totals Show Most Enforcement Actions Filed in Single Year*, *supra*, note 9.

further. Scamalyzr is a privately funded and designed “word based text classification tool” that is currently used by the New Brunswick Securities Commission.¹³⁸ It operates by searching “a corpus of continuously updated new website instances (retrieved from the web) for prevalence of a pre-determined set of relevant words and then ranks them based on the presence and frequency of these words.”¹³⁹ This software has led to investigations of suspicious website in numerous countries, including the United States, Canada and England.¹⁴⁰ To date, Scamalyzr has searched over 13 million domains.¹⁴¹

However, this software is not without its own set of problems. Due to the text base searches based on buzzwords used in fraudulent schemes the software has a tendency to produce false positives.¹⁴² In fact, in certain instances the Scamalyzr produced upward of 80% false positive results.¹⁴³ Some of the false positive results are attributed to the fact that the programmers are unable to identify what captured sites are truly fraudulent until the government brings a fraud action against the individuals operating the particular site.¹⁴⁴ While the results are “far from perfect”¹⁴⁵ it is a step forward in combating online securities fraud that the SEC has not publicly taken yet.

The SEC made initial attempts to adapt to the rapid expansion of the internet through the installation of the comprehensive online securities registration program EDGAR as well as by establishing the OIE to conduct internet sweeps for fraudulent

¹³⁸ Laan, Shannon, & Baker, *supra* note 133 at 3.

¹³⁹ *Id.*

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² *Id.* at 4.

¹⁴³ Laan, Shannon, & Baker, *supra* note 133 at 3.

¹⁴⁴ *Id.* at 5.

¹⁴⁵ *Id.*

activity and increase investor education of potential risks.¹⁴⁶ However, the SEC needs to be more aggressive in keeping up with internet growth. Programs like Scamalyzr, while not without their own faults, are clearly the way of the future of fraud detection in the internet. Simply because of the sheer amount of internet traffic on a daily basis, manual web searches and electronic tip centers will be insufficient to proactively track internet fraudsters before they are able to execute their schemes and severely damage innocent investors.

V. CONCLUSION:

The SEC has been entrusted to regulate the exchange and sales of securities in both the primary and secondary markets. In the late 1990s, Richard Walker, and John Stark expressed different view points on the effect the Internet would have on the SEC's ability to effectively keep up with the evolving technology. Mr. Walker believed that the statutory scheme of enforcement would be more than enough to secure the SEC in bringing enforcement actions against online fraudsters while Mr. Stark believed the internet posed a great threat to investor security.¹⁴⁷ Nearly 15 years later it is clear that while the SEC has the ability to prosecute internet fraud under the current regulatory scheme of the '33 and '34 Acts, it is doing so from an increasingly reactionary position.

With the total amount of web pages accessed per day nearing 100 billion, the increase in attempted fraud has been significant. Whereas the SEC had brought enforcement actions against a total 209 individuals up to the year 2001, it is estimated

¹⁴⁶ See, Section IV's discussion of EDGAR and the OIE, *supra* at pp. 18-22.

¹⁴⁷ Kaufman, *supra* note 13; Hittle, *supra* note 14.

that currently 240 million “pump and dump” emails are sent out per week.¹⁴⁸ Additionally, the amount of damage done to investors by fraudsters has increased along with the number of schemes attempted. Just this year the SEC came across an internet based Ponzi scheme that lost \$600 million of investors money.¹⁴⁹

Adding to the SEC’s hardship is its inability to independently bring criminal actions against individuals or entities. Instead, it must work cooperatively with state and federal agencies to bring criminal actions against fraudsters.¹⁵⁰ This requires a great deal of coordination between the SEC and other agencies and adds additional due process concerns into the framework.¹⁵¹

Moreover, the SEC’s internal policies have not done much to keep pace with the internet’s expansion. The creation of EDGAR does require many companies to file financial documents online, however numerous documents cannot be published through EDGAR and companies can get around this mandate through hardship exemptions.¹⁵² Even its publicly available investigation methods seem outdated. In 2001 the Cyberforce, a group that consisted of attorneys and volunteers, manually scanned the internet searching for potential fraud schemes.¹⁵³ Currently, the SEC would be better served by implementing technology like Scamalyzr, which uses automated text searches to flag potential fraud schemes.¹⁵⁴

¹⁴⁸ Laan, Shannon, & Baker, *supra* note 133.

¹⁴⁹ *SEC Shuts Down \$600 Million Online Pyramid and Ponzi Scheme*, *supra*, note 108.

¹⁵⁰ *United States v. Stringer*, 535 F.3d 929, 933 (9th Cir. 2008).

¹⁵¹ *Id.*

¹⁵² *Important Information About EDGAR*, *supra* note 117.

¹⁵³ Hittle, *supra* note 14 at 173.

¹⁵⁴ Laan, Shannon, & Baker, *supra* note 133 at 3.

While Mr. Walker may have been correct in stating that the regulatory scheme would hold up fine against the onset of internet securities fraud, it appears that Mr. Stark's concerns regarding the internet being the SEC's greatest enforcement challenge accurately reflects the SEC current inability to get in front of online perpetrators of securities fraud. Until the SEC is able to keep up with the rapidly evolving technology, it will be playing catch up to fraudsters who will continue to reap incredible profits at the expense of innocent investors.