

# THE BUSINESS LAWYER

Section of Business Law • American Bar Association  
University of Maryland School of Law

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## EnforceNet Redux: A Retrospective of the SEC's Internet Program Four Years After Its Genesis

By John Reed Stark\*

*A new life awaits you in the Off-World colonies. The chance to begin again in a golden land of opportunity and adventure . . . New climate, recreational facilities . . . absolutely free. Use your new friend as a personal body servant or a tireless field hand—the custom tailored genetically engineered humanoid replicant designed especially for your needs. So come on America, let's put our team up there . . .*<sup>1</sup>

More than four years ago, together with the Securities and Exchange Commission's (SEC's or Commission's) Chief of the Office of Market Surveillance, I wrote an article for this publication outlining a program for the SEC Enforcement Division (Division) and the Internet.<sup>2</sup> Dubbed "EnForcenet," the article anticipated great changes in the Commission's enforcement program for the future and promised to tackle head-on any problems the widespread use of the Internet would engender for investors. Rather than simply reiterating the common themes among law enforcement agencies and lamenting about the magnitude of Internet fraud and the financial restraints that prevent federal agencies from effectively policing the Internet, EnForcenet set out to act immediately, using whatever resources were available.

By initiating a plan for the Internet without delay, the Commission hoped to discourage perpetrators of Internet fraud before they could find their niche. So now, after more than four years of its implementation, has that plan worked? Yes,

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1. The quotes contained in the headings of this Article are from the futuristic cult film *BLADE RUNNER* (Warner Bros. 1982), directed by Ridley Scott, produced by Michael Deelay and featuring Harrison Ford, about a jaded ex-cop forced out of retirement to hunt down a group of genetically engineered "replicants."

2. Joseph J. Cella III & John Reed Stark, *SEC Enforcement and the Internet: Meeting the Challenge of the Next Millennium; A Program for the Eagle and the Internet*, 52 *BUS. LAW.* 815 (1997).

it has—in fact, a careful study of the Commission's track record of the past four years reveals that the program has experienced success far greater than anyone originally anticipated.

After providing some background on the growth of the Internet, both as an investment resource and as a vehicle for securities fraud, this Article will: (i) discuss the overall history and development of the Commission's Internet program; (ii) examine some of the Enforcement Division's on-line surveillance methods; (iii) describe the most effective enforcement techniques the Division has employed to deter on-line securities law violations; and (iv) highlight some important cooperative enforcement efforts undertaken with outside agencies.

## BACKGROUND

*Replicants are like any other machine, they're either a benefit or a hazard, if they're a benefit, its not my problem.*

Before beginning any discussion of Internet fraud, it is important to note the many benefits that the Internet has created for investors—benefits that far outweigh any negative impacts on the investor community.

Quite simply, the Internet continues to have a profound effect on the way investors participate in the capital markets.<sup>3</sup> According to recent reports, there are approximately 160 on-line-trading broker-dealers servicing approximately 11.7 million on-line investors in the United States—nearly double the number of investors using on-line firms in 1999.<sup>4</sup> Through the second quarter of 2000, on-line brokerage accounts held approximately \$1.08 trillion in assets—a twelve percent increase from the last quarter of 1999.<sup>5</sup> Average on-line trading volumes for the second quarter of 2000 were approximately 1.1 million trades per day, a decrease of approximately twenty percent from the first quarter of 2000.<sup>6</sup> Since that time, average daily trading volume has remained above or around 900,000, but on-line trading firms are still spending money to update their technology and to attract new customers (reports anticipate growth in the number of on-line accounts from 24 million by the end of 2001 to 33 million in 2002, and 43 million in 2003).<sup>7</sup> Although some reports even show that the on-line trading system is losing established investors faster than it can replace them with new traders,<sup>8</sup> clearly, on-line broker-dealers have had a vastly heightened presence over

3. See SEC Chairman Arthur Levitt, Testimony Concerning Appropriations for Fiscal Year 2001 Before the House Subcommittee on Commerce, Justice, State and the Judiciary Committee on Appropriations (Mar. 30, 2000), available at <http://www.sec.gov/news/testimony/ts062000.htm>.

4. U.S. BANCORP PIPER JAFFRAY EQUITY RESEARCH, ONLINE FINANCIAL SERVICES UPDATE 4, 6 (Oct. 2000), available at [http://www.gotobanalysts.com/piperpublic/goto/internetconference/reports/online\\_fin\\_oct2000.pdf](http://www.gotobanalysts.com/piperpublic/goto/internetconference/reports/online_fin_oct2000.pdf).

5. *Id.* at 8.

6. *Id.* at 6.

7. Elizabeth Lamb, *Trading Takes a Breather*, RED HERRING, Sept. 15, 2001, at 30.

8. Press Release, J.D. Power and Assoc., Weakening Market Fuels Efforts by Online Brokerage Firms To Provide Consolidated Account Services (Sept. 10, 2001), available at <http://www.jdpa.com/presspass/pr/pressrelease.asp?ID=153>.

the last several years in terms of the number of firms offering on-line services, the number of accounts they handle, and the dollar value of these accounts. Further, reports also show that these statistics will undoubtedly increase.<sup>9</sup> Regardless of what the statistics show (as they tend to change like the weather), on-line trading is forever entrenched into the landscape of U.S. and global securities markets.

The Internet also has changed the way investment research is conducted, making a wide array of information available to even relatively unsophisticated investors. Investors today have unprecedented access to all manner of investment-related publications, from real-time stock quotes, SEC filings,<sup>10</sup> and corporate news releases to the kind of spirited and provocative investment opinions found in Internet message boards, Web sites, and chat rooms.<sup>11</sup> It is not uncommon today to see entire communities of Internet users develop to trade information, insight, and invective about CEOs, companies, and particular industry segments or trading markets. Today's retail investor is much more likely to feel overloaded than overlooked.

Not only are investors accessing the securities markets through the Internet more frequently than they did before the advent of on-line trading, but the technological advances of the digital age are also changing the breadth of the markets themselves. Established securities markets are moving toward extended trading hours, and alternative trading systems are creating new points of entry to those markets.<sup>12</sup> This increase in the scope of the trading markets means that the Commission's capacities for regulation and enforcement will likely be tested as never before in coming years.<sup>13</sup>

9. Press Release, J.D. Power and Assoc., *Online Brokerage Firms Continue to Have a Strong Hold on Current Investment Pool; Study Shows Many Online Investors Plan to Maintain, or Increase Trading Volume* (Mar. 27, 2001), available at <http://www.jdpa.com/presspass/pr/pressrelease.asp?ID=106>.

10. A wide range of Commission filings by publicly-traded issuers are available to investors free of charge through the SEC's Electronic Data Gathering, Analysis, and Retrieval System (EDGAR), available at <http://www.sec.gov/edgar.shtml>.

11. See Jonathan Lansner, *A New Brand of Spam: Stock Touting on Reputable Bulletin Boards Can Inflate the Value of Obscure Companies*, ORANGE COUNTY REG., Feb. 12, 2000, at K01 ("Stock message boards on Internet financial sites have long been breeding grounds for rumors and stock hype. These sites are almost universally derided as bad places to get investment advice. Still, they draw plenty of online eyeballs.")

12. See SEC, SPECIAL STUDY: ELECTRONIC COMMUNICATION NETWORKS AND AFTER-HOURS TRADING (June 2000), available at <http://www.sec.gov/news/studies/ecnafter.htm>.

13. See, e.g., SEC Chairman Laura S. Unger, *Raising Capital on the Internet*, Remarks at the 2001 Corporate Law Symposium, University of Cincinnati School of Law (Mar. 9, 2001), available at <http://www.sec.gov/news/speech/spch471.htm>; see also, Press Release 2001-119, SEC Historical Society to Hold Major Issues Conference on Securities Regulation in the Global Internet Economy (Oct. 25, 2001), available at <http://www.sec.gov/news/press/2001-191.txt> ("The theme of Securities Regulation in the Global Internet Economy was chosen because the rapid development of global marketplace requires a careful reexamination of the fundamental principles of securities regulation.")

## SECURITIES FRAUD AND THE INTERNET

*I am not in the business. I am the business.*

Unfortunately, “[w]hile the Internet has brought significant benefits to investors, it also has created significant dangers for the unwary. [During the late 1990s, t]he Internet, coupled with the greatest bull market in history, . . . brought millions of relative novices to the markets, while also providing simple, effective, and anonymous ways for unscrupulous people to defraud them.”<sup>14</sup> Various forms of internet media, including a single mass e-mail, “spam,” a message board posting, an on-line investment newsletter, or any other form of electronic message can reach millions with the click of a computer mouse. Con artists today can exploit the benefits of cyberspace and easily and cheaply reach a more customized audience of investors far better than they could making thousands of cold calls from an old-fashioned boiler room, and the use of digital media can lend fraudulent material an air of credibility simply unachievable by a boiler room cold call. Still from their own living room, anyone with a home PC and some knowledge of the latest software (which is often available for free) can create an interactive, sleek Web site rivaling that of a Fortune 500 company—only now he or she can do so at even lesser cost and with even less training in the use of computers than four years ago.<sup>15</sup>

### INITIAL EXPERIENCES: NEW MEDIUM, FAMILIAR SCAMS

In the earliest days of the Commission’s Internet fraud program, the securities frauds that prevailed on-line were simply electronic versions of scams that had long been conducted through more traditional media such as paper newsletters, mass organizational meetings, and orchestrated telephone solicitations.<sup>16</sup> Principal among these were:

- *Stock manipulations*: These are typically so-called “pump and dump” frauds in which false and misleading information concerning an issuer is disseminated on-line to generate interest in a stock, allowing insiders to sell their stock at artificially inflated prices.<sup>17</sup>

14. Levitt, *supra* note 3.

15. See Cella & Stark, *supra* note 2, at 816 (“The entrepreneur, the inventor, and the small business owner now have a cheap and efficient alternative means to reach millions of potential interested parties without the expense of a road show, without hiring the usual cadre of lawyers and financial advisers, without hiring a printing service, and, most of all, without leaving the house.”).

16. See Levitt, *supra* note 3; see also Cella & Stark, *supra* note 2, at 835 (“The swindles of the Internet are no different from the confidence games of the past; the only difference is the medium.”).

17. See SEC v. Huttoo, Litig. Release No. 16,632A, 72 SEC Docket (CCH) 2194 (D.D.C. July 21, 2000) (discussing a large-scale pump and dump scheme resulting in Commission actions against more than forty defendants over a four-year period, and criminal charges against five defendants).

- *Offering frauds*: These include fraudulent on-line offerings of exotic investments,<sup>18</sup> interests in pyramid schemes,<sup>19</sup> and so-called "prime bank" programs.<sup>20</sup>
- *Illegal touts*: These are on-line securities recommendations that fail to disclose that the persons making such recommendations were paid for their positive opinions.<sup>21</sup>

18. See *SEC v. Frye*, Litig. Release No. 14,702, 60 SEC Docket 1882 (S.D.N.Y. Oct. 30, 1995). In the spring of 1995, Scott Frye posted a notice over the Internet soliciting investors by promising "riskless profits and above-average returns" from investments in two Costa Rican enterprises that produced coconut chips: ICP and the Jupiter Agro Development Project. According to the SEC complaint, Frye misled potential investors by telling them a bank would guarantee their principal and a fifteen percent return in one year and that one of the companies was a major distributor for A&P Supermarkets. See also *SEC v. Odulo*, Litig. Release No. 14,616, 60 SEC Docket 0122 (D.R.I. Aug. 24, 1995). In August 1995, the SEC filed a complaint against Daniel Odulo who solicited investors over several newsgroups of the Internet. Odulo offered for sale bonds meant to raise money for a company called Golden Waters which he claimed would yield a "whopping 20% rate of return" for a "very low risk." Odulo also assured potential investors that they would be insured against potential losses, even though there was no such insurance and made up the names of investment advisers who vouched for the bonds. According to the SEC complaint, Odulo failed to disclose that Golden Waters was a proposed new venture involving the acquisition and raising of eels and that he had no expertise in the culturing of eels. Moreover, the solicitation included several glowing endorsements from fabricated persons and entities. Odulo consented to an injunction from further violations of the securities laws but a monetary penalty was waived because of Odulo's financial condition. *Id.*

19. See *SEC v. Pleasure Time, Inc.*, Litig. Release No. 14,825, 61 SEC Docket 1189 (S.D. Ohio Feb. 26, 1996). A complaint filed by the SEC on March 15, 1995, alleged that John C. Hicks and a partner raised more than \$3 million by selling securities to approximately 20,000 investors, contacted both on the Internet and over the telephone. Investors were told that they would reap astronomical profits from a worldwide telephone lottery and were encouraged to recruit other investors through the Internet. The complaint alleged that the sales pitch failed to disclose the legal and regulatory obstacles to starting a lottery. The Commission requested a temporary restraining order (TRO), injunctions, and civil penalties against various participants in the scam. On the day the complaint was filed, the court entered the TRO, which included a freezing of assets. *Id.* at 1190.

20. See *SEC v. Block*, Litig. Release No. 14,828, 61 SEC Docket 1192 (D. Mass. Feb. 27, 1996). Starting in 1994, Renate Haag, of Langen, Germany, and Malibu, California, offered investors what seemed like a good deal, through a business she called Haag and Partner. Soon, Gene Block of Durham, North Carolina, operating through Block Consulting Services, and Robert T. Riley, Jr., of St. Louis, Missouri, operating through the Roberts Group, were pitching Haag and Partner investments on the Web as well. They raised over one million dollars by promising returns in some cases of 200% to 420% annually, and the promoters told investors their initial investments would be guaranteed against loss because they would be backed by "Prime Bank Guarantees." According to the Commission, however, Prime Bank Guarantees does not, in fact, exist. *Id.* at 1193. The court granted a TRO against Block and froze his assets; similar penalties were issued against the other defendants. *Id.*; see also *SEC v. Octagon Tech. Group*, Litig. Release No. 14,942, 62 SEC Docket 0377 (D.D.C. June 11, 1996). In *Octagon Technology Group*, a computer software company and two of its officers were sued for their roles in creating an elaborate sham offering of offshore debt securities on the Web. The Web site, established for the Agency for Interamerican Finance (AIF), a Panamanian shell subsidiary of Octagon, advertised AIF "Interamerican hard currency bonds" for sale to investors. The Commission alleged that this offering was essentially a fraud because no bonds ever existed, and AIF had no business operations or assets. AIF's web pages, however, promised prospective investors a risk-free investment with guaranteed returns of 11.75% annually and portrayed AIF as a successful provider of investment capital to Latin American businesses. See also *SEC v. Capital Acquisitions, Inc.*, Litig. Release No. 15,601, 66 SEC Docket (CCH) 433 (D. Utah Dec. 23, 1997); *SEC v. Interactive Prods. & Servs., Inc.*, Litig. Release No. 15,700, 66 SEC Docket (CCH) 2187 (N.D. Cal. Apr. 8, 1998); *SEC v. Internet Casino Sports Gaming, L.L.C.*, Litig. Release No. 16,025, 68 SEC Docket 3283 (C.D. Cal. Jan. 13, 1999).

21. See *SEC v. Chelekis*, Litig. Release No. 15,264, 63 SEC Docket 2900 (D.D.C. Feb. 25, 1997). In this case, the Commission's complaint alleged that Chelekis, a publisher who distributed various

## RECENT EXPERIENCE: ON-LINE FRAUDS BEGIN TO EVOLVE

As the Internet has evolved, so has Internet fraud. Virulent new variations on the familiar frauds have begun to emerge. Among these are:

- *Recommendation "scalping"*: an on-line version of a fraudulent practice in which the promoter of a Web site secretly acquires blocks of a security he intends to recommend and then clandestinely sells into the run-up triggered by his recommendation. This scalping can be carried out through a "momentum trading" site, an investment Web site through which a promoter attempts to create a short-term price spike in a thinly-traded stock by inducing groups of "momentum" traders to invest on a particular date at a particular time.<sup>22</sup> Alternatively, promoters may use a variant on the standard momentum site, a daytrading recommendation site; the daytrading site can provide investors with multiple picks per day. Frauds conducted through these Web sites are often advanced by fraudulent descriptions of the promoter's qualifications or track record.<sup>23</sup>
- *"Imposter" message board frauds*: an updated version of the pump and dump scheme, in which a manipulator (in a guise designed to lend the information credibility) posts false and misleading information on Internet message boards in order to influence the price of a stock.<sup>24</sup>

investment newsletters, known as the "Hot Stocks" publications, over the Internet and in print format, knowingly or recklessly made materially false and misleading statements concerning six publicly-traded companies and failed to disclose in the Hot Stocks publications that he and entities that he controlled (defendants KGC, Incorporated and Hot Stocks Review, Incorporated) received at least \$1.1 million from more than 150 issuers and 275,000 shares of stock from ten issuers, as payment for recommending the issuers' securities in the Hot Stocks publications. Without admitting or denying the allegations in the complaint, Chelekis, KGC, and Hot Stocks Review consented to the entry of a final judgment permanently enjoining them from violating the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. *Id.* The final judgment ordered the defendants to pay a total of \$162,727, representing \$75,050 in disgorgement, \$12,627 in prejudgment interest, and a \$75,050 civil penalty. *Id.*; see also SEC v. Samblis, Litig. Release No. 15,609, 66 SEC Docket (CCH) 576 (M.D. Fla. Jan. 6, 1998); SEC v. Savage, Litig. Release No. 15,954, 68 SEC Docket 1122 (Oct. 27, 1998).

22. See SEC v. Colt, Litig. Release No. 16,461, 71 SEC Docket 2387 (D.D.C. Mar. 2, 2000). This was a civil action and administrative proceeding alleging that Georgetown University law student Douglas Colt and a group of friends and relatives defrauded investors of nearly \$350,000 in illicit profits by recruiting large numbers of investors to purchase small-cap stocks recommended by the Fast-Trades.com Web site at particular times and failing to disclose that they were engaged in scalping.

23. See SEC v. Park, Litig. Release No. 16,925, 74 SEC Docket (CCH) 1183 (N.D. Ill. Mar. 8, 2001). This action involved a self-proclaimed stock-picking expert, "Tokyo Joe," who, without admitting or denying the Commission's allegations, consented to a permanent injunction against future federal securities law violations and agreed to pay \$754,650 to settle the matter. In its complaint, the Commission alleged that Park not only engaged in unlawful stock touting and scalping, but also published on his Web site more than 200 misleading statements, including false statements about his track record as a stock-picker.

24. In these frauds, stock manipulators may disguise their touts as press releases from established news organizations or the advice of an issuer's corporate officer or a brokerage firm analyst. See SEC v. Hoke, Litig. Release No. 16,117, 69 SEC Docket 1970 (C.D. Cal. Apr. 21, 1999) (involving a Webpage posting which provided a bogus link to Bloomberg News Service announcement); SEC v. Zbierajewski, Litig. Release No. 16,363, 71 SEC Docket 0285 (N.D. Ill. Nov. 18, 1999) (concerning

- "Misdirected" spam manipulations: attempts to manipulate a microcap stock's price through mass e-mails purporting to be accidentally delivered communications between investors unaffiliated with the recipient.<sup>25</sup>

## THE SEC'S EFFORTS TO COMBAT INTERNET FRAUD

*More human than human is our motto.*

### A TEAM APPROACH

The Commission's ongoing program to combat Internet securities law violations remains a team effort, in which every Division and Office plays a significant part.<sup>26</sup> The Division of Corporation Finance has analyzed numerous Internet securities offerings to determine their compliance with the Commission's registration and disclosure requirements. The Division of Market Regulation has monitored the impact of the Internet on the types of services offered to investors by broker-dealers, such as on-line brokerage and day-trading, and is developing an appropriate regulatory regime as more of the functions of traditional exchanges and other market mechanisms move on-line. The Office of Compliance Inspections and Examinations (OCIE) has been working to respond, through the examination process, to the rising tide of concerns about the operations of on-line brokerages, ECNs, and daytrading firms.<sup>27</sup> The Office of the General Counsel has helped to develop the legal analysis applicable to new types of on-line fraud and to provide guidance on the application of federal privacy law to on-line investigations. The agency's Office of International Affairs (OIA) works with the SEC's Enforcement staff and foreign authorities to obtain information needed to investigate and prosecute SEC enforcement actions and also assists foreign authorities in obtaining information needed from persons or entities based in the United States.<sup>28</sup> The Office of Investor Education and Assistance (OIEA) helps to build

a counterfeit PR Newswire release posted on Yahoo! Finance); *United States v. Jakob*, Litig. Release No. 16,857, 74 SEC Docket (CCH) 214 (C.D. Cal. Jan. 8, 2001) (pertaining to a false press release disseminated to news organizations via Internet newswire).

25. See *SEC v. Sheret*, Litig. Release No. 16,451, 71 SEC Docket (CCH) 1787 (S.D.N.Y. Feb. 24, 2000) (involving numerous e-mail stock recommendations addressed to appear to have been transmitted to recipients by mistake); see also *SEC v. Globus Group, Inc.*, Litig. Release No. 16,212, 70 SEC Docket 0506 (S.D. Fla. July 16, 1999). In the *Globus Group* case, the SEC alleged that certain defendants sent paper fax transmissions which purported to be mistakenly-sent messages from employees of banks or brokerage firms. This technique has been adopted by electronic junk-mailers, who routinely draft their stock recommendations in such a way that they appear to be misdirected communications—sometimes containing inside information—between friends or acquaintances.

26. Levitt, *supra* note 3.

27. For example, SEC examiners review: (i) the execution quality of orders entered on-line; (ii) systems capacity and reliability; (iii) the on-line public offering process; (iv) the use of and disclosure concerning margin; (v) customer complaints; and (vi) the security of on-line trading systems. See OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, SEC, EXAMINATIONS OF BROKER-DEALERS OFFERING ONLINE TRADING: SUMMARY OF FINDINGS AND RECOMMENDATIONS (Jan. 25, 2001), available at <http://www.sec.gov/news/studies/online.htm>.

28. See Press Release 2000-64, SEC, SEC and Regulators from Around the World Conduct an International Surf Day to Help Combat Internet Fraud (May 15, 2000), available at <http://www.sec.gov/news/press/2000-64.txt>.



an educated, informed investor community and advise the public on remedial strategies when investors are victims of fraud.<sup>29</sup>

## THE DIVISION OF ENFORCEMENT

The lead role in combating on-line fraud is played by the Enforcement Division, because it is charged with uncovering, investigating, and litigating civil actions alleging federal securities law violations. The SEC brought its first Internet enforcement action in 1995,<sup>30</sup> and at the same time, named its first "Special Counsel for Internet Projects" and tasked him with beginning to build an Internet enforcement program. The Division's Internet program has steadily expanded since that time<sup>31</sup> and, through a mixture of traditional and novel enforcement strategies, has achieved significant results.

### The Office of Internet Enforcement

In July 1998, as a result of the Internet's growing importance and the rising incidence of Internet fraud, a formal Office of Internet Enforcement (OIE) was created within the Enforcement Division.<sup>32</sup> Initially, OIE acted as a coordinator of the Commission's Internet program and as a liaison with other regulatory and criminal law enforcement agencies at the federal, state, and local levels.

Between the spring of 1999 and the present, OIE staff has grown from three to twenty, including sixteen lawyers—all professionals who together possess experience and expertise in a wide variety of areas pertinent to Internet law enforcement. OIE's current functions include: conducting surveillance and identifying

29. See, e.g., SEC, INTERNET FRAUD: HOW TO AVOID INTERNET INVESTMENT SCAMS, available at <http://www.sec.gov/investor/pubs/cyberfraud.htm> (last modified Mar. 16, 2001).

30. SEC v. Frye, Litig. Release No. 14,702, 60 SEC Docket 1882 (S.D.N.Y. Oct. 30, 1995).

31. The Internet program received no formal budget allocation at its inception; rather the program generally draws from the Commission's overall appropriation from Congress. The Commission, however, reprogrammed \$5.5 million to combat Internet fraud during fiscal 1999, and in November 1999, Congress appropriated an additional \$7 million over the Commission's fiscal 2000 request to augment the Commission's Internet fraud program. See Levitt, *supra* note 3. With these new funds, the Commission created ninety-two new slots for our Internet fraud program. Seventy-five of the slots have been assigned to the Division of Enforcement. The remaining seventeen slots have been assigned to other specialized divisions and offices within the Commission to aid their Internet-related efforts. Two slots have been allocated to the Office of International Affairs, three to the Division of Market Regulation, three to the Division of Corporation Finance; four to the Office of Compliance, Inspections and Examinations, and five to the Office of Internet Enforcement. These new staff members focus on Internet enforcement and regulatory issues. Among other things, they (i) provide technical expertise to the Enforcement Division; (ii) develop policies for the securities industry's use of the Internet; (iii) inspect and examine regulated entities operating on-line; and (iv) consider the need for and, when appropriate, develop rulemaking alternatives or legislative changes necessary to prevent and address market abuses involving the Internet. The Commission has also used the funds (i) to develop its own customized search engine that surfs publicly accessible areas of the Internet for potential securities law violations; and (ii) to renovate the Commission's on-line Enforcement Complaint Center. Both technology projects are discussed herein.

32. See Press Release 98-69, SEC, SEC Creates Office of Internet Enforcement to Battle Online Securities Fraud (July 28, 1998), available at <http://www.sec.gov/news/pressarchive/1998/98-69.txt>. John Reed Stark, formally the Division's "Special Counsel for Internet Projects" was promoted to Chief of OIE.

new areas for future monitoring, analyzing the complaints received in the on-line Enforcement Complaint Center (ECC), formulating investigative procedures, conducting law enforcement training for SEC staff and outside agencies, engaging in special technology-related projects, ensuring staff compliance with federal privacy statutes and other applicable laws, conducting certain important Internet-related investigations, and serving as a resource on Internet matters for the entire Commission.<sup>33</sup>

OIE has also constructed a state-of-the-art computer lab, warehousing a separately secure and fire-walled local area network facility that includes the latest software, hardware, and operating systems. The computer lab utilizes its own T-1 line,<sup>34</sup> and has the capability to warehouse Web sites, Internet protocol trails and other important electronic evidence.

OIE also maintains its own internal SEC intranet Web site, that centralizes thousands of pages of useful Internet-related information, as well as an Internet Web site that catalogs all public Internet-related SEC Enforcement (and other) information.

### **Special Internet Investigative Branches**

Within the Enforcement Division, this past year the SEC created ten new investigative branches—two in Washington, D.C., and one each in San Francisco, Los Angeles, Chicago, Miami, New York, Boston, Fort Worth, and another divided among the three offices comprising the SEC's Central Region (Denver, Fort Worth, and Salt Lake City). These branches consist of lawyers and, in some cases, non-lawyer Internet specialists. Unlike the rest of the Enforcement Division's staff, lawyers in the Internet branches are wholly devoted to conducting Internet-related investigations. This specialization—a new and different direction for the Division—has allowed the SEC to develop a cadre of Internet experts throughout the country who can respond quickly and effectively to on-line fraud when and where it happens.

### **The CyberForce**

Alongside OIE remains the CyberForce—more than 200 Commission lawyers, accountants, and investigators nationwide—whose purpose is to conduct regular Internet surveillance as well as certain special projects such as internal “surf days.”<sup>35</sup> CyberForce members dedicate a portion of their workweek to surfing the Internet, developing leads for potential enforcement cases. Formed in 1996, the CyberForce began as an Enforcement Division “corps of [SEC staff] volunteers who ‘surf’ the Web for a few hours each week in search of securities law viola-

33. See SEC, INTERNET ENFORCEMENT PROGRAM: ABOUT THE OFFICE OF INTERNET ENFORCEMENT, available at <http://www.sec.gov/divisions/enforce/internetenforce.htm> (last modified July 16, 2001) [hereinafter INTERNET ENFORCEMENT PROGRAM].

34. T-1 lines grant access at 1500 bits per second (significantly faster than the average high speed modem which only transfers 56.6 bits per second).

35. See *infra* notes 36-39 and accompanying text.

tions.<sup>36</sup> The CyberForce also originally provided many of the leads for the first two Commission sweeps (the touting sweep in October 1998 and the offering sweep in May 1999). Additionally, the CyberForce participates in coordinated surveillance projects with other federal agencies, such as the joint law enforcement initiative Internet fraud “surf days” orchestrated over the past three years by the Federal Trade Commission and the International Organization of Securities Commission’s (IOSCO’s) “surf days.”<sup>37</sup>

## SURVEILLANCE

*If only you could see what I've seen with your eyes.*

Despite the apparent anonymity offered by the Internet, the Commission has had no lack of success in finding suspect conduct on-line; by the very nature of their businesses, securities fraudsters need to be easily found. Perpetrators of on-line fraud want to disseminate their message to as many users as possible. Further, the Internet offers an investigator a clear set of electronic footprints (including easily captured Internet protocol) with which to trace scammers. Even more importantly, thanks to the Internet, law enforcement officials and regulators now have the opportunity to watch a fraud as it develops in front of their own eyes. The Internet offers a “window” and “plain view” into the schemes through any desktop computer, allowing for “real time” observation of fraudulent activities. Fraudsters may not realize that by sending their schemes via spam, Web site, newsgroup or otherwise, they do indeed reach a vast audience—including the Enforcement Division of the SEC. With this fact in mind, the Commission maintains an active fraud surveillance program with several important prongs.

## ENFORCEMENT COMPLAINT CENTER

In June 1996, the SEC opened the Enforcement Complaint Center (ECC), an on-line mailbox through which investors can inform the agency electronically of potential securities law violations. The ECC generally receives between 300 and 400 investor complaints per day—with fluctuations resulting from heightened media activity involving the Commission—relating to virtually every type of potential securities violation occurring on-line. ECC review and analysis is resource-intensive, but very worthwhile. ECC complaints have thus far provided (and continue to provide) the Enforcement Division with many of its most promising investigative leads.

Recognizing that the ECC has evolved into probably the most critical part of the Division’s Internet program, the Commission has almost completed a \$2 million renovation of the ECC. The new system that will replace the simple ECC

36. Cella & Stark, *supra* note 2, at 836-37; see also Levitt, *supra* note 3.

37. See Press Release, Fed. Trade Comm’n, Surf Day Monitors Investment Opportunities (Dec. 21, 1998), available at <http://www.ftc.gov/opa/1998/9812/iosd.htm>; see also Press Release 2000-64, SEC, SEC and Regulators from Around the World Conduct an International Surf Day to Help Combat Internet Fraud (May 15, 2000), available at <http://www.sec.gov/news/press/2000-64.txt>.

mailbox is internally referred to as C.H.A.R.T. (Complaint, Handling, Assignment, Response and Tracking). C.H.A.R.T. will greatly modernize the Commission's electronic complaint process, making the system far more robust and enabling lawyers throughout the SEC to process, track, and assign complaints, while assembling a comprehensive, searchable complaint database.

## SURF DAYS

In order to leverage staff and resources and to focus the Commission's efforts on key investigative areas, the Office of Internet Enforcement coordinates quarterly internal "surf days." The goal of each surf day is to locate potential frauds in key program areas including market manipulation, fictitious investment schemes, momentum trading, suspicious stock offerings, false statements, and unregistered entities.

On the designated surf day, the CyberForce members from the SEC's home, regional and district offices surf the web in a precisely-targeted manner, homing in on a particular "territory" (such as a message board, Web site or web ring) or a violation type (such as so-called prime bank schemes<sup>38</sup> or pyramid/ponzi activities). CyberForce members send the results of their search efforts to OIE, where the material is reviewed and potential investigative leads referred to offices within the SEC or to other appropriate federal or state agencies. OIE maintains extensive records of all surf day leads and constantly convenes to improve surveillance techniques and discuss future surf day subjects.

## SEC INTERNET SEARCH ENGINE

The SEC's Internet Search Engine is a customized automated search engine—the most recent of its surveillance initiatives. On August 18, 2000, the Commission awarded the contract for the Internet Search Engine to Science Applications International Corporation (SAIC). SAIC designed and developed the system from August to October 2000. In November and December 2000, the Internet Search Engine became operational, and OIE received its first trial downloads of data; these were analyzed to determine the Internet Search Engine's operational capabilities and baseline site relevance.

Using search words and phrases, the Internet Search Engine identifies relevant sites and newsgroup posts in the public areas of the Internet. In order to protect the privacy of Internet users, the Internet Search Engine surfs only public areas of the Internet, much as any other publicly-available Internet search engine might.

38. Prime bank schemes involve the sale of fraudulent investment opportunity in so-called prime bank notes, debentures, and other types of interest. The instruments, entirely fictional, purport to represent a secondary market for stand-by letters of credit. Such a market does not exist and is simply a means to defraud investors. See SEC, WARNING TO ALL INVESTORS ABOUT BOGUS "PRIME BANK" AND OTHER BANKING-RELATED INVESTMENT SCHEMES (Sept. 15, 2000), available at <http://www.sec.gov/divisions/enforce/primebank.shtml>. Given that many prime bank frauds now take place over the Internet, the Office of Internet Enforcement now administers the SEC's prime bank program (in addition to the Internet program).

The Internet Search Engine's battery of search terms and algorithms are constantly being updated and modified to reflect current patterns of suspect on-line conduct identified by OIE.

After searching the Internet, the Internet Search Engine filters out irrelevant material and ranks the remaining information by relevance. For each Web site the Internet Search Engine delivers (vis-à-vis a user-friendly browser enabled graphical user interface): (i) an archived version of the site; (ii) a link to the live version of site; (iii) the site's domain registration information; and (iv) Web site link information. The Internet Search Engine also captures and warehouses other sites and posts that have met the search criteria, but that may not have received a highly relevant score. As a result, the SEC has access to an even larger searchable database of potentially fraudulent sites and posts.<sup>39</sup>

OIE staff can access the Internet Search Engine's database through the T-1 connection in OIE's computer lab, or through a secure Web site viewable on selected desktop computers. The Internet Search Engine delivers an average of 100 or so Web sites and newsgroup postings per month. Overall, the sites delivered to date appear to be highly relevant, and the Internet Search Engine is already providing strong leads for investigations. Future refinement of the process should yield even better leads. Though the search engine will never replace other important surveillance efforts, it is an effective complement to the Division's other monitoring efforts.

## TECHNIQUES FOR ADDRESSING ON-LINE FRAUD

*It's not an easy thing to meet your maker.*

### ENFORCEMENT SWEEPS AND COORDINATED FILINGS

One investigative technique that has helped the agency achieve its twin goals of deterrence and education is the "sweep," the simultaneous filing of multiple enforcement actions targeting similar misconduct and presented as a cohesive package. The sweep allows the Commission to deliver its message more forcefully and effectively than the filing of individual cases might. Sweeps have served as an efficient tool of the Internet enforcement program, particularly during the programs infancy.<sup>40</sup>

The first enforcement sweeps targeted "touters" who recommended stocks without disclosing adequately to investors that they received compensation from the issuers. The October 1998 sweep involved the filing of twenty-three separate enforcement actions against forty-four individuals and entities.<sup>41</sup> A follow-up tout-

39. See Press Release 2000-44, SEC, Chairman Levitt Issues Statement on Internet Search Engine (Apr. 5, 2000), available at <http://www.sec.gov/news/press/2000-44.txt>.

40. To review more information about all five SEC Internet fraud sweeps, see INTERNET ENFORCEMENT PROGRAM, *supra* note 33.

41. See Press Release 98-117, SEC, SEC Charges 44 Stock Promoters in First Internet Securities Fraud Sweep (Oct. 28, 1998), available at <http://www.sec.gov/news/headlines/netfraud.htm>.

ing sweep in February 1999 included actions against an additional thirteen individuals and entities.<sup>42</sup>

In an effort to stem the tide of fraudulent on-line securities offerings, a May 1999 enforcement sweep combined actions against eighteen individuals and eight entities who used the Internet to engage in securities offerings in violation of federal law. These actions generally involved alleged offerings of non-existent securities, or offerings in which exaggerated claims were made concerning expected investor returns. This sweep demonstrated that the Internet gives investigators a "window" into fraudulent activity and permits the offerings to be halted, in many cases, before any investors are harmed. Of the fourteen offerings that formed the basis of the May 1999 sweep, five were stopped before investors lost any money.<sup>43</sup>

Though not a full-fledged sweep, the Commission's coordinated filing of four actions in July 1999 against the purveyors of so-called "free stock" proved an important blow to a potentially dangerous and unlawful on-line practice.<sup>44</sup> The designation "free stock" was really a "misnomer" in these offerings.<sup>45</sup> While cash did not typically change hands in free stock offerings, the companies that issued the stock usually received valuable benefits.<sup>46</sup> In an on-line environment where merchants and retailers struggle for market share, information about, and access to, potential customers are valuable commodities. Free stock giveaways were typically employed to help generate these valuable customer databases, or to stimulate other forms of commercial activity.

By offering an investment opportunity that on its face appeared to involve no risk with seemingly no payment of money for the stock itself, issuers promoted an expectation of financial gain for the holders of the "free stock" that was dangerous for the investor and could be easily exploited by an issuer or promoter at a later date, for example, in a manipulation scheme.

Further, despite several regulatory pronouncements pertaining to the illegality of free stock offerings,<sup>47</sup> during 1999, such offerings continued to proliferate on-

42. See Press Release 99-24, SEC, SEC Continues Internet Fraud Crackdown (Feb. 25, 1999), available at <http://www.sec.gov/news/headlines/spamcase.htm>.

43. See Press Release 99-49, SEC, SEC Steps Up Nationwide Crackdown Against Internet Fraud, Charging 26 Companies and Individuals for Bogus Securities Offerings (May 12, 1999), available at <http://www.sec.gov/news/headlines/nets0599.htm>.

44. See Press Release 99-83, SEC, SEC Brings First Actions To Halt Unregistered Online Offerings of So-Called "Free Stock" (July 22, 1999), available at <http://www.sec.gov/news/press/pressarchive/1999/99-83.txt>.

45. *Id.* (quoting SEC Enforcement Director Richard H. Walker).

46. *Id.* Issuers of these offerings offer so-called "free" shares to individuals under a variety of circumstances such as: (i) requiring an Internet user to register with or visit the issuer's Web site, typically offering more "free" shares if identified as a "reference" by future visitors to the issuer's Web site who similarly register for "free" shares; (ii) requiring cash payments for the "free" shares (as much as \$10 per share) to "defray the printing costs of the stock certificates"; and (iii) requiring the purchase of a product, such as a phone card, or a service, such as an Internet service provider account, in order to receive one or more "free" shares.

47. The Division of Corporation Finance has issued several no-action letters advising that the distribution of "free stock" to individuals who visit or register on an Internet Web site constitutes an event of sale within the meaning of section 2(a)(3) of the Securities Act of 1933. *Simplystocks.com*, SEC No-Action Letter, 1999 WL 51836 (Feb. 4, 1999); see also Vanderkam & Sanders, SEC No-Action

line. Thus, given the potential danger to investors, the Commission brought four matters at the same time in an effort to crackdown on the unlawful practice.<sup>48</sup>

Turning to another type of on-line fraud, in September 2000, the Commission brought a sweep consisting of fifteen enforcement actions against thirty-three companies and individuals who preyed upon investors in the volatile "microcap" market to perpetrate so-called "pump-and-dump" schemes over the Internet. The alleged perpetrators of these market manipulations "pumped" up the total market capitalization of the seventy microcap stocks involved by more than \$1.7 billion and reaped illegal profits of more than \$10 million.<sup>49</sup> This sweep reemphasized the fact that, in the digital age, frauds that used to require large amounts of time and resources could now be done in minutes by a single person using a home computer. Indeed, some of the individuals involved in these sweep cases had no securities industry experience at all—one was a bus mechanic, and another was a college student who drove for a car service.

Recently in a March 2001 sweep, the SEC's fifth, the SEC simultaneously filed a group of Internet fraud actions covering many aspects of on-line securities fraud already mentioned. This sweep highlighted various on-line methods used by fraudsters to lure investors to their scams: "spam" e-mails, electronic newsletters, Web sites, hyperlinks, message boards and other Internet media. This sweep included eleven enforcement actions against twenty-three companies and individuals and involved both publicly-traded and privately-held companies. In these matters, the alleged perpetrators used the Internet to "pump" the market capitalization of the stocks by more than \$300 million and to raise \$2.5 million in ill-gotten gains from investors in the United States and abroad.<sup>50</sup>

Letter, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,520, at 78,585 (Jan. 27, 1999); *see also In re Capital Gen. Corp.*, Securities Act Release No. 7008, 54 SEC Docket (CCH) 1322, 1330 (July 23, 1993) ("Capital General's distributions of securities [which were purportedly for free] constituted a 'sale' within the meaning of the Securities Act since the distributions were dispositions for value . . . [which] accrued to Capital General and Yeaman by virtue of the creation of a public market for the issuer's securities . . .").

48. In each of the four actions, investors were required to sign up with the issuers' web sites and disclose valuable personal information in order to obtain their "free" shares. Free stock recipients were also offered extra shares, in some cases, for soliciting additional investors or, in other cases, for linking their own Web sites to those of an issuer or purchasing services offered through an issuer. Through these techniques, issuers received value by spawning a fledgling public market for their shares, increasing their business, creating publicity, increasing traffic to their Web sites, and, in two cases, generating possible interest in projected public offerings. For a discussion of all four SEC actions, see Press Release 99-83, *supra* note 44. Two of these free stock issuers offered stock through Web sites that featured false claims. In one action, investors were told that the free shares they received would give them interests in an aerospace company that would revive lunar exploration. In fact, the company was never incorporated and its promoter had no space exploration or aerospace engineering experience. *See In re Looftbourrow*, Securities Act Release No. 7700, 70 SEC Docket 0391 (July 21, 1999). In another action involving an Internet telecommunications marketing firm, the Web site informed free stock recipients that their shares could eventually exceed \$200 each in value, even though the firm had realized less than \$30 in gross operating revenues. *See In re Web Works Marketing.Com, Inc.*, Securities Act Release No. 7703, 70 SEC Docket 402 (July 21, 1999).

49. See Press Release 2000-124, SEC, SEC Continues Nationwide Crackdown Against Internet Fraud, Charging 33 Companies and Individuals With Fraud For Manipulating Microcap Stocks (Sept. 6, 2000), available at <http://www.sec.gov/news/press/2000-124.txt>.

50. See Press Release 2001-24, SEC, SEC Charges 23 Companies and Individuals in Cases Involving

These sweep efforts seem to have had a positive impact in the on-line investment community. Current surveillance suggests that touters have become more sensitive to the law's disclosure requirements, and the SEC is seeing fewer blatantly suspect on-line offerings. Further, the offering of so-called "free stock" has almost ceased entirely. And investors—now more keenly aware of the need to question what they see on-line—have been increasingly eager to notify the ECC of conduct similar to that charged in the SEC's enforcement sweeps.

## SWAT TEAMS

Another innovation utilized by the Division of Enforcement during the past few years has been the "SWAT" team approach. The technique describes a method for accelerating an investigation by increasing assigned staff and having these staff members work full-time solely on a single matter.

Application of this technique in the Internet context led to the successful criminal and civil prosecutions of Gary Dale Hoke, who published on the Internet a phony Bloomberg press release designed to drive up the price of the common stock of Pair Gain Technologies, Incorporated ("Pair Gain") by falsely reporting that Pair Gain was a takeover target.<sup>51</sup> Within just three days of the false Bloomberg release's posting, SEC staff and criminal investigators were able to identify Hoke as the creator of the release. Within a week, Hoke was arrested and charged with securities fraud by federal prosecutors and the Commission.<sup>52</sup>

A second SWAT team investigation led, in four weeks, to the arrest of two individuals alleged to have generated over \$300,000 in illicit profits by posting false rumors about a company to several Internet message boards over a weekend in November 1999.<sup>53</sup> The rumors drove the price of the company's stock from \$0.13 per share to over \$15 per share the following Monday, before returning to \$0.50 the same day.<sup>54</sup>

Broad Spectrum of Internet Securities Fraud (Mar. 1, 2001), available at <http://www.sec.gov/news/press/2001-24.txt>.

51. See SEC v. Hoke, Litig. Release No. 16,266, 70 SEC Docket 1604 (C.D. Cal. Aug. 30, 1999). In settling the Commission's civil action, Hoke consented to an antifraud injunction. In the criminal case, Hoke was sentenced to five months of home detention and ordered to pay over \$93,000 in restitution. See also United States v. Jakob, Litig. Release No. 16,857, 74 SEC Docket (CCH) 214 (C.D. Cal. Jan. 8, 2001) (SEC and criminal action brought within a week of Jakob's publication of false news release).

52. *Id.*

53. The Commission has obtained emergency relief against the three civil defendants, including a TRO and a freeze on the defendants' assets. See SEC v. Aziz-Golshani, Litig. Release No. 16,391, 71 SEC Docket (CCH) 721, 722 (C.D. Cal. Dec. 15, 1999).

54. *Id.* The U.S. Attorney for the Central District of California prosecuted criminally two of the SEC defendants, Arash Aziz-Golshani and Hootan Melamed, for their manipulation of NEI Webworld.

Aziz-Golshani pled guilty to one count of securities fraud and one count of conspiracy to commit securities fraud. Melamed pled guilty to one count of conspiracy to commit securities fraud. Aziz-Golshani was sentenced on January 22, 2001 to 15 months incarceration, and ordered to pay restitution in an amount to be determined. Melamed was sentenced on January 12, 2001 to 10 months incarceration and ordered to pay restitution in an amount to be determined.

SEC v. Aziz-Golshani, Litig. Release No. 16,867, 74 SEC Docket (CCH) 519 (C.D. Cal. Jan. 23, 2001).



Most recently, within just six days after the publication of a false press release stating that the Commission was investigating Emulex Corporation, that its CEO had resigned and that it would be restating its earnings to show a loss, and the resulting sixty-one dollar plunge in Emulex's share price, the Commission and criminal authorities had brought actions against the fraud's architect, Mark Simon Jakob. Jakob's fraud caused an estimated \$110 million in investor losses. In January of this year, Jakob pleaded guilty to two counts of federal securities fraud and one count of wire fraud,<sup>55</sup> and on August 8, 2001, the SEC announced that a district court judge sentenced Jakob to forty-four months in prison for his role in the fraud.<sup>56</sup>

Each of these actions demonstrates the utility of the "SWAT" concept when addressing major, high-impact securities frauds occurring over the Internet. Early experiences employing this approach have been highly successful (allowing for "real time" enforcement actions) and will likely remain an integral part of the agency's remedial arsenal in months and years to come.

### TRADING SUSPENSIONS

Although the number of trading suspensions sought has declined recently, suspensions have proven to be useful during the early stages of the Internet program as a means of minimizing the damage to investors who might put funds into suspect issuers' securities. These actions alert investors to the fact that information in the marketplace about the suspended stock is materially inaccurate or incomplete.

One example of how the trading suspension can be beneficially used is the case of *Uniprime Capital Acceptance Inc. (Acceptance Inc.)*.<sup>57</sup> As alleged in that action, the common stock of Uniprime, a purported owner of automobile dealerships, had risen in price from \$0.06 to nearly \$8 per share, along with similar increases in the stock's trading volume, on the strength of dubious claims concerning a new AIDS treatment being developed by Uniprime's principal subsidiary. Unable to find any basis for Uniprime's claims, the Commission imposed a trading suspension against the issuer on July 22, 1999. By mid-August, the Commission had filed a securities fraud complaint seeking a temporary restraining order and asset freeze against Uniprime and the president of its subsidiary. The trading halt may have saved thousands of investors from being defrauded.

### EARLY INTERVENTION TECHNIQUES

Not every potential securities law violation warrants a full-scale enforcement proceeding or investigation. Particularly in the case of more technical violations, a simple "warning" letter may suffice.

55. *Jakob*, 74 SEC Docket (CCH) at 214.

56. See SEC v. *Jakob*, Litig. Release No. 17,094, 75 SEC Docket (CCH) 1317 (C.D. Cal. Aug. 8, 2001).

57. See SEC v. *Uniprime Capital Acceptance, Inc.*, Litig. Release No. 16,252, 70 SEC Docket 1181 (S.D.N.Y. Aug. 13, 1999). For a complete listing of SEC trading suspensions, see <http://www.sec.gov/litigation/suspension.shtml>.

To date, the Commission's Division of Corporation Finance has sent more than 340 such warning letters concerning unregistered on-line securities offerings identified by the Division of Enforcement. The purpose of these letters is to induce compliance with the law without the necessity of a lengthy, resource-intensive enforcement investigation and in situations where simple ignorance or inadvertence may be the cause of a technical violation. As a result, the warning letter helps the agency's staff to address and remedy a wider range of potential misconduct than it could using only conventional investigative techniques.

Results thus far indicate this program is successful. In about seventy percent of cases, persons or entities receiving a warning letter either removed their securities offerings from the Internet, altered the terms of the offering, or opened discussions with the Division of Corporation Finance regarding the terms of their compliance with federal law. The Commission recently began a similar warning letter program within the Commission's Division of Market Regulation targeting unregistered broker-dealers. This program shows early signs of similar success, having sent out more than twenty warning letters to date, with sixteen recipients taking satisfactory steps to "cure" their violations.

## EDUCATIONAL PROGRAMS

The SEC strongly believes that an educated investor provides the best defense against securities fraud, including Internet 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.

To educate investors about the risks presented by the Internet, the SEC uses the following educational resources:

- Free Publications. The SEC publishes and distributes more than a dozen free brochures, including *Internet Fraud: How to Avoid Online Investment Scams*.<sup>58</sup>
- Web site. In March 2001, the SEC significantly redesigned its Web site to make it more user-friendly, and launched a revised series of investor education webpages on the site.<sup>59</sup> The new Office of Investor Education pages feature information about on-line investing and Internet fraud.<sup>60</sup> The Commission has successfully encouraged on-line broker-dealers and others to link to the SEC's Web site.
- Investors' Town Meetings. The SEC has participated in more than forty investors' town meetings throughout the country. The last town meeting (like many others before) even included a dedicated segment on Internet fraud.

58. See SEC, INTERNET FRAUD: HOW TO AVOID INTERNET INVESTMENT SCAMS, available at <http://www.sec.gov/investor/pubs/cyberfraud.htm> (last modified Mar. 16, 2001).

59. See SEC, INVESTOR INFORMATION, at <http://www.sec.gov/investor.shtml> (last modified July 31, 2001).

60. See *id.*

## LIAISON ACTIVITIES

*I was quit when I came in here, I'm twice as quit now.*

### JOINT CRIMINAL/CIVIL PROSECUTIONS

The Commission is firmly committed to working with other law enforcement agencies to aggressively pursue Internet fraud. Criminal prosecutions are perhaps the most effective form of deterrence. Accordingly, joint efforts with prosecutors are another way for the Commission to leverage its resources.

The SEC's longstanding commitment to joint prosecutions in the Internet area has produced a string of important cases addressing on-line fraud.<sup>61</sup> The Commission is committed to building upon cases like these to forge even stronger working relationships with criminal prosecutors in the future.

The Commission is also partnering with the FBI in an ongoing nationwide investigatory initiative called "Operation InvestNet," conducted through the Financial Crimes Section of the Bureau's Economic Crimes Unit. The Commission shares leads and information with FBI investigators, and provides training and legal guidance to investigators and prosecutors on securities matters the FBI is pursuing.<sup>62</sup>

As the Internet program has evolved, criminal prosecutors at the state and federal levels have demonstrated a strong willingness to prosecute securities fraud over the Internet. Criminal prosecution involves four major categories of cases: (i) market manipulation; (ii) offering fraud; (iii) insider trading; and (iv) money management. Market manipulations cases comprise the bulk of on-line prosecutions, numbering nine to date.<sup>63</sup> In all of these types of actions, prompt, efficient and meaningful cooperative efforts clearly achieve results.

### CONTINUING TRAINING PARTNERSHIPS

Commission staff have always maintained an active schedule of training sessions for outside criminal and civil enforcement agencies. OIE staff have been regular lecturers at the FBI training facility at Quantico, Virginia. For the past two years, the Commission has sponsored yearly Internet Securities Fraud Training Programs, which are attended, in person and via videoconference link, by more

61. See generally *United States v. Jakob*, Litig. Release No. 16,857, 74 SEC Docket (CCH) 214 (C.D. Cal. Jan. 8, 2001); *SEC v. Moldofsky*, Litig. Release No. 16,493, 2000 SEC LEXIS 593 (S.D.N.Y. Mar. 30, 2000); *SEC v. Aziz-Golshani*, Litig. Release No. 16,391, 71 SEC Docket 846 (C.D. Cal. Dec. 15, 1999); *SEC v. Hoke*, Litig. Release No. 16,266, 70 SEC Docket 1604 (C.D. Cal. Aug. 30, 1999); *SEC v. Uniprime Capital Acceptance, Inc.*, Litig. Release No. 16,252, 70 SEC Docket 1181 (S.D.N.Y. Aug. 13, 1999); *SEC v. Interactive Prods. and Servs., Inc.*, Litig. Release No. 15,700, 1998 SEC LEXIS 630 (N.D. Cal. Apr. 8, 1998); *SEC v. Huttoe*, Litig. Release No. 15,237, 63 SEC Docket 2383 (E.D. Va. Jan. 31, 1997).

62. See FED. BUREAU OF INVESTIGATIONS, SECURITIES AND COMMODITIES FRAUD: A PRIMER, available at <http://www.fbi.gov/majcases/uptick/secprim.htm>.

63. See 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, 410-415 (2001).

than 600 representatives from a wide range of criminal and civil enforcement agencies and self-regulatory organizations (SROs). These training efforts will certainly continue, as will formal and informal liaison programs to insure that all law enforcement remains up-to-date on the latest trends or development in the securities-related Internet fraud arena.

### ONGOING WORK WITH DOMESTIC CIVIL AGENCIES, SROS, AND FOREIGN SECURITIES REGULATORS

In addition to its work with criminal authorities, the Commission intends to continue its cooperation with civil enforcement agencies, such as the Federal Trade Commission, and SROs, including the National Association of Securities Dealers, Inc. and the New York Stock Exchange. The Commission is also active in a number of interagency working groups designed to fight Internet fraud.<sup>64</sup>

The Commission also understands that cooperation cannot stop at our shores. The Internet is inherently international and the SEC's Internet cases evidence a growing incidence of overseas conduct. The Commission is undertaking initiatives to help alleviate the problem of foreign-based Internet fraud, both by establishing relationships with foreign regulators and systematically bringing suspicious foreign-based conduct to their attention, and by participating in training programs designed to help international regulators identify and target securities frauds emanating from their countries. For example, the Commission's Office of International Affairs offers a wide range of training and liaison programs with foreign nations, including an annual Fall International Securities Institute with delegates attending from more than fifty countries.

### CONCLUSION

#### *Too bad she won't live, but then again who does?*

The Commission is dedicated to ensuring that the Internet remains a valuable and safe medium for investors. The Commission has now brought more than 275 Internet-related securities fraud actions, charging close to 930 individuals and entities and there is no sign of a slowdown.

Of course, some of the same questions of four years ago still linger: Do we need to rewrite the securities laws in light of the Internet's onslaught? Can the SEC's Internet program reconcile its mission to root out fraud with the cherished free-

64. The SEC participated with the FTC and several other civil and criminal law enforcement agencies and cabinet departments, in the President's Working Group on Unlawful Conduct on the Internet, a body that wrote a comprehensive report on Internet fraud pursuant to executive order. In addition, the Commission is part of the National Securities and Commodities Fraud Working Group. Its Internet Securities Fraud subcommittee, co-chaired by the Commission and the FBI, is designed to focus on issues relating to on-line fraud affecting the securities markets. The SEC also is a member of the Telemarketing and Internet Fraud Working Group, a joint effort by various state and federal law enforcement, tax, and banking agencies to target unlawful financial, commercial, and securities activity on the Internet. The Commission also works closely with the states and the North American State Securities Administrators, Incorporated on an ongoing basis to address fraudulent Internet activity.

dom endemic to an evolving and revolutionary medium like the Internet? Only now, based on the Commission's track record in combating Internet fraud, there may indeed be some answers to these critical questions.

First, it remains as true today as it was four years ago, that the SEC's anti-fraud provisions serve the public quite well whether the violation occur in a boiler room or a chatroom.<sup>65</sup> After more than 275 enforcement actions charging more than 920 persons and entities, no SEC defendant or respondent has ever prevailed by arguing that the anti-fraud provisions of the securities laws (or any other provision of the securities laws) do not apply to conduct in cyberspace.<sup>66</sup>

Second, the cherished freedoms of the Internet remain firmly intact despite a vigorous SEC Enforcement program. By focusing its on-line enforcement efforts on fraud, the Commission has reaffirmed the adage that neither the First Amendment, nor any other law on the books, confers the right to lie, cheat, or steal from investors.<sup>67</sup> In fact, by rooting out the small number of users who attempt to pollute the Internet with fraudulent schemes, the Commission insures that precious civil liberties remain firmly intact.

Finally, e-commerce has clearly flourished because of, not in spite of, the SEC's Internet Enforcement program. By launching an Internet program that makes bringing the perpetrators of on-line fraud to justice a top priority, the Commission has made the virtual streets safer (and thereby, more profitable) for lawful on-line enterprises. From its inception, the point of the SEC's Internet program was to act swiftly and forcefully and send the message to those contemplating on-line scams that they had better think twice before doing so.

In fact, even if the perpetrated fraud has not involved major investor losses (which many have not),<sup>68</sup> the Commission has still remained poised to act with unequivocal resolution. The approach remains somewhat akin to New York City Mayor Rudolph Giuliani's successful implementation of the "broken window theory" during the early 1990s. Just like the New York City cops on the beat who would not ignore petty, quality-of-life crimes, the Enforcement staff would similarly not neglect petty, quality-of-cyber-life, securities frauds. In both instances,

65. The same holds true for the investigation and civil prosecution of securities violations committed over the Internet; the laws need not change, only their application will need to evolve. The Division's traditional firearms, embodied in the current Securities Act and Exchange Act, will likely provide adequate legal bases for prosecuting Internet securities fraud. For instance, the antifraud provisions of the section 10(b) of the Exchange Act and Rule 10b-5 thereunder obviously would apply to any fraudulent communication over the Internet, just as they apply to any information communicated on paper, or over the radio or television.

Cella & Stark, *supra* note 2, at 835. Of course, improving the securities laws is always a goal of any Commission, and to the extent that any change in the securities laws will benefit investors and other market participants such changes will also likely result in similar benefits for the Internet program.

66. Nor has any defendant prevailed by arguing that the First Amendment protects those who perpetrate fraud in cyberspace. See e.g., SEC v. Park, 99 F. Supp. 2d 889 (N.D. Ill. 2000).

67. *Id.*

68. For example, the Commission has brought a slew of Internet-related actions in which investor losses were not only minimal but even non-existent, such as five of the actions in the May 1999 Internet fraud offering sweep. In those sweep actions, the Commission initiated a pre-emptive strike, stopping a range of sophisticated and potentially dangerous securities frauds *before* investors lost a penny. See Press Release 99-49, *supra* note 43.

such inaction only leaves ordinary citizens, or Internet users, concerned that nobody is in charge and leads the bigger crimes, or on-line securities frauds, to thrive.

More than four years after the original EnforceNet pronouncement described in this publication (which is probably more akin to four decades ago in "Internet years") the Commission's hefty track record in the area of Internet-related securities fraud prosecution not only evinces that vigorous, robust and aggressive Internet enforcement efforts can work, but also and more importantly, that when it comes to securities frauds, policing the Internet is not just possible, it is proven.