WCC Issue
Securities/Investment Fraud

(Last updated June 2003)

Definition

Securities fraud is any manipulation or deception that affects the purchase or sale of a security and usually includes the misrepresentation or omission of material (significant) information. The definition of a security, in general, is an investment instrument from which an investor expects to derive financial benefit through the efforts of others. The two primary laws that govern the securities industry and serve to protect investors are the Securities Act of 1933 and the Securities Exchange Act of 1934.

The Securities Act of 1933 (known as the “truth in securities” law) was established to “require that investors receive financial and other significant information concerning securities being offered for public sale” (disclosure) and “prohibit deceit, misrepresentation, and other fraud in the sale of securities.” The Securities Exchange Act of 1934 was established to empower the U.S. Securities and Exchange Commission (SEC) with broad authority over the securities industry. Specifically, this act “identifies and prohibits certain types of conduct in the markets” and requires “periodic reporting by companies with publicly traded securities.”

In addition to these federal laws, each state has related statutes and rules that govern securities transactions, and the securities industry itself has regulatory requirements imposed by membership organizations such as the National Association of Securities Dealers (NASD), the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX).

How it Happens

Typically, a small collection of techniques and investment products are used to defraud investors. Common techniques include Ponzi or pyramid schemes, pump and dump schemes, Internet fraud, and affinity fraud. Investments that are commonly used in fraudulent schemes include payphone or ATM machine investments, callable certificates of deposit, promissory notes, prime bank notes, and viatical settlements. In addition, these investments are often sold by individuals who are not licensed to sell securities, particularly life insurance agents.

Pyramid or Ponzi Schemes

A pyramid scheme involves the collection of money from new investors to pay earlier investors. Despite the appearance of a legitimate multi-level marketing program with legitimate products or services to sell, along with the promise of high returns on a short-term investment, these schemes eventually collapse. At some point, it becomes impossible to collect enough money from new investors, and many investors lose all of their money. A Ponzi scheme is a type of pyramid scheme named after Charles Ponzi, who scammed New England residents in the 1920s with the promise of a 40% return in just 90 days. In a Ponzi scheme, a legitimate investment product may exist to some extent. However, the product is used only to make the
scheme appear more legitimate and is never sufficient to support the promised returns. Like all pyramid schemes, the Ponzi scheme eventually collapses and results in the loss of virtually all of investors’ money.4

**Pump and Dump Schemes**

A pump and dump, or stock price manipulation, involves a small group of investors who buy a stock, promote the investment with false or misleading information (the “hype”) and convince a mass of investors to buy it. Often these promoters “claim to have ‘inside’ information about an impending development or to use an ‘infallible’ combination of economic and stock market data to pick stocks.” 5 After generating sufficient demand to increase the stock price (the “pump”), the promoters sell their stock at inflated prices (the “dump”) and discontinue the hype. In the end, the price of the stock usually drops dramatically, and investors lose most or all of their money.

Traditionally, the most common method for carrying out this scheme was telemarketing, or a “boiler room” operation. Since 1996, however, the Internet has become the most common venue for the pump and dump (see Internet Fraud). While the stock used in the scheme may be entirely fraudulent, with no company existing to support the stock, it may also be a legitimate stock of a legitimate company (usually a micro-cap stock and a relatively small company). In either case, the information used to hype the stock and (artificially) increase the stock’s price is false information that misrepresents the potential value of the investment.

**Internet Fraud**

The Internet is particularly appealing to fraudsters as a tool for investment fraud because of the huge number of potential victims online and the minimal expense required to develop and maintain a fraudulent scheme on the World Wide Web (the Web). The SEC warns that “it’s easy for fraudsters to make their messages look real and credible. But it’s nearly impossible for investors to tell the difference between fact and fiction.” 6

One of the most common forms of Internet fraud is the pump and dump (see Pump and Dump Schemes). In addition, the Internet is used to execute pyramid schemes (see Pyramid or Ponzi Schemes), off-shore frauds, and so-called “risk-free” opportunities. Off-shore frauds may involve fraudulent opportunities in currency exchange or inheritance investments. "Risk-free” investment scams often involve fraudulent opportunities in high-tech or exotic-sounding ventures, such as wireless cable projects or eel farms. Three of the most frequently used methods of communicating fraudulent information on the Web are (1) online investment newsletters, (2) online bulletin boards, and (3) “spams," or mass e-mails. For this reason, the SEC warns investors: "Never, ever, make an investment based solely on what you read in an online newsletter or bulletin board posting, especially if the investment involves a small, thinly-traded company that isn’t well known.” 7

Currently, roughly half the states have Internet surveillance programs to monitor fraudulent activity or investigate investor complaints. 8 In addition, the SEC’s “CyberForce,” or the Office of Internet Enforcement (OIE), conducts and coordinates significant Internet surveillance efforts. However, since the potential volume of Internet schemes is so large, it is important for investors to take steps to protect themselves – by reading information on the Web sites of the SEC, NASD, and state securities regulators; by contacting regulatory agencies for information about investment products and investment professionals; and by researching any investment thoroughly before purchasing it.

**Affinity Fraud**

Affinity fraud is an attempt to defraud members of a particular religious, ethnic, professional, age, or social group by members of these groups or persons claiming to provide assistance to these groups. A high level of trust among group members is used by fraudsters to encourage investors in these groups to purchase
worthless investments. Affinity fraud may take many different forms, including gifting programs at churches to foreign exchange scams targeting Asian Americans.

**Pay Phones/ATM Machine Investments**

This type of investment involves coin-operated, customer-owned telephones (COCOTs) or ATM machines. Investors "purchase" payphones or machines, lease them back, and are promised annual returns of as much as 15 percent in the form of "lease" payments. Typically these investments are offered by life insurance agents or other individuals not licensed to sell securities. They are also often fraudulent pyramid schemes that result in total losses to investors.

**Callable Certificates of Deposit (CDs)**

Some certificates of deposit (CDs) have "call" features, "meaning that the issuing bank may choose to terminate – or call – the CD before the stated maturity date." For example, a one-year callable CD may be a CD with a maturity of 15 or 20 years – not one year – that the issuing bank – not the investor – can call after one year. While this type of investment may be legitimate and appropriate for some investors, sellers of callable CDs often do not adequately disclose the risks and restrictions, which are significantly different from a traditional fixed-rate bank CD. Characteristics of a callable CD may include (1) a 20-year maturity; (2) a fractional ownership for each investor in a larger (often $100,000) CD; (3) a requirement that a buyer be found for an investor's fractional ownership in the event the investor wishes to sell (withdraw) the investment before maturity; and (4) the risk of losing the initial principal investment, much like an investment in shares of stock. In addition, some callable CDs are entirely fraudulent, with no CD actually issued or held by a bank.

**Promissory Notes**

A promissory note is a debt instrument that a company may issue to raise money. Unlike shares of stock (which represent equity or ownership in a company), the promissory note represents a debt that a company promises to pay the investor, usually at a fixed rate of interest. Although this type of investment can be legitimate, the SEC warns that promissory notes “that are marketed broadly to individual investors often turn out to be scams.” Some of the distinguishing characteristics of a promissory note scam identified by the SEC include

- the sale of the note by an insurance agent or other individual who is not licensed to sell securities (and usually not required to disclose the high commissions);
- the promise of an unusually high fixed rate of return;
- the promise that the notes are guaranteed or insured and have a very low level of risk; and
- pressure for the investor to "roll over" the investment after maturity rather than cashing it out (suggesting that the investment is part of a pyramid scheme and the principle portion of the investment is used to pay interest to other investors).

**Prime Bank Notes**

Prime bank notes are "fictitious and fraudulent instruments -- not backed or endorsed by any legitimate financial institution." In other words, "prime bank notes" do not exist. These "investments" are often marketed using an assortment of vague terms such as debentures, letters of credit, commercial paper, prime notes, bills of exchange, bank secured trading programs or loan roll programs. The sales pitch typically includes promises of unrealistic rates of return (e.g., 150 percent) and discussions of Federal
Reserve, European Bank or World Bank involvement. In addition, the seller typically refers to the investment as “secret,” or available only to select investors, as well as guaranteed, secured by collateral, or insured. In the end, despite supporting documents that may appear to be legitimate financial instruments, “prime bank” notes are simply a form of pyramid scheme.

Viatical Settlements

Originally designed to help gravely ill patients pay medical bills, viatical settlements are investments in another individual’s life insurance policy that can be purchased for a price that is less than the death benefit of the policy. The insured receives a portion of the death benefit in cash, and the investor receives a portion of the death benefit when the insured dies. Legitimate viatical settlements can be extremely risky, and many viatical settlement investments are entirely fraudulent.

Costs and Statistics

A study conducted by the NYSE in 1998 revealed that 84 million individuals (43 percent of the country’s adult population) held investments in stocks, either directly through shares in individual companies or through equity mutual funds and retirement accounts. This figure represents a 21 percent increase in investors since 1995 and a 61 percent increase since 1989. While these increases in market activity indicate likely increases in opportunities for economic growth and individual wealth, they also suggest possible increases in opportunities for criminal activity. In 2000, for example, the North American Securities Administrators Association (NASAA) estimated that losses from securities and commodities fraud exceeded $40 billion per year and losses from Internet-related stock fraud exceeded $10 billion per year (or $1 million per hour).

Table 1

<table>
<thead>
<tr>
<th>Program Area</th>
<th>Civil Actions</th>
<th>Administrative Proceedings</th>
<th>Total</th>
<th>% of Total Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities Offerings</td>
<td>79</td>
<td>40</td>
<td>119</td>
<td>20%</td>
</tr>
<tr>
<td>Broker-dealer Actions</td>
<td>17</td>
<td>65</td>
<td>82</td>
<td>14%</td>
</tr>
<tr>
<td>Issuer Actions</td>
<td>69</td>
<td>94</td>
<td>163</td>
<td>27%</td>
</tr>
<tr>
<td>Investment Advisor Actions</td>
<td>13</td>
<td>35</td>
<td>48</td>
<td>8%</td>
</tr>
<tr>
<td>Insider Trading</td>
<td>53</td>
<td>6</td>
<td>59</td>
<td>10%</td>
</tr>
<tr>
<td>Market Manipulation</td>
<td>27</td>
<td>15</td>
<td>42</td>
<td>7%</td>
</tr>
<tr>
<td>Touting</td>
<td>5</td>
<td>8</td>
<td>13</td>
<td>2%</td>
</tr>
<tr>
<td>All Other Cases</td>
<td>54</td>
<td>18</td>
<td>72</td>
<td>12%</td>
</tr>
<tr>
<td>Total</td>
<td>317</td>
<td>281</td>
<td>598</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: [http://www.sec.gov/about/annrep02.shtml](http://www.sec.gov/about/annrep02.shtml)

In 2002, the SEC initiated 598 civil and administrative actions (Table 1) and referred to criminal agencies cases that resulted in 259 criminal indictments, informations and contempts. In addition, the SEC obtained orders requiring securities law violators to repay approximately $1.29 billion in illegal profits (an increase of 170% from the previous year) and $101 million in civil penalties (an increase of 130%). The SEC’s enforcement division also initiated temporary restraining orders to halt ongoing fraudulent activities in 48 actions and to freeze assets in 63 actions.
High Profile Examples/Case Studies

In recent years, violations of disclosure rules and fraudulent accounting practices by public corporations have been the most widely publicized of SEC actions. Included among these are actions against Enron Corp.; Tyco International, Ltd.; WorldCom, Inc.; Dynegy, Inc.; Adelphia Communications Corporation; Rite Aid Corporation; Kimberly-Clark Corporation; and Waste Management, Inc., as well as actions against some individual officers of these companies. Other SEC actions included insider trading violations associated with ImClone Systems, Inc. and Nalco Chemical Company.19

Recent Internet fraud actions included the following:

**SEC v. K.C. Smith**

Between May 2002 and February 2003, K.C. Smith, a 20-year old Kentucky resident, allegedly raised $102,554 by falsely guaranteeing double-digit monthly returns for fictitious investments using two websites and approximately nine million spam e-mail messages. In addition, Smith created a website for a (fictitious) company that "fully insured" the investments against loss and included on the site the SEC's official seal. According to the SEC, Smith "took careful steps to conceal his identity, including calling potential investors on disposable cellular telephones, using stolen service provider accounts to access the Internet, and collecting investor funds through online payment services that maintain payee confidentiality." Smith was required to pay $107,510 in disgorgement and pre-judgment interest.20

**SEC v. eConnect, Thomas S. Hughes, Richard Epstein & Alliance Equities, Inc.**

In July 2002, eConnect and its former president, Thomas S. Hughes, age 53, of California, “issued false and misleading press releases and posted false statements on eConnect’s websites.” According to the SEC, “these statements concerned a purported $20 million investment of ‘AA’ rated bonds that in fact were not rated, a nonexistent stock repurchase program and a purported $964,000 purchase order for eConnect’s principal product.” “During the period when the false statements were issued, both the price and trading volume of eConnect’s stock increased by over 500 percent.” In August 2002, Hughes was indicted by a grand jury on seven criminal charges, including three counts of securities fraud, three counts of wire fraud and one count of criminal contempt.21

**SEC v. Douglas Norman**

Beginning in 2000, Douglas Norman, the alleged founder and chief executive officer of World Transport Authority, Inc. (WTA), “knew of and approved false or misleading press releases issued by WTA, made or knowingly permitted the posting of materially false or misleading statements on the Internet,” and permitted WTA to file false reports with the SEC. In these statements, WTA claimed to have designed a revolutionary car and a unique system for manufacturing the car that could be set up in 90 days and produce a single car per day. During this period, Norman sold at least 5.5 million shares of WTA stock, making a profit of at least $1.8 million from the sales.22

The Response/Current Efforts

Very often, a securities or investment scam targets investors who have little or no experience in the markets and involves a product that is unregulated or ambiguously regulated. That is, inexperienced investors are often victims of fraudulent investment scams in hedge funds, foreign currency exchange,
business ventures, or some other investment that may not be directly regulated by the SEC or state securities regulators. In some cases, these investments are not clearly regulated by any government agency. For this reason, state and federal regulators have developed initiatives to educate investors and to caution investors not to invest in anything that they do not understand. Fraudsters target inexperienced investors and use non-traditional investment products because inexperienced investors are often too embarrassed to admit that they do not understand the details of the investment and fail to ask questions about things that seem unclear.

Investment advisors and securities brokers must be registered with state regulators, the SEC and/or some internal regulatory organization, such as the NASD. This registration process allows for regular monitoring of conduct and violations. Although verification of registration and review of previous professional conduct alone cannot assure an investor that investments offered by an advisor or broker are not fraudulent, research of this kind, including research of specific investments, can significantly reduce an investor’s chances of losing money from a fraudulent scheme.

In addition to disclosure and conduct rules of the SEC, the NASD, and other regulatory organizations, additional rules pertaining to conflicts of interest among corporations, brokerage firms and accounting firms have been recently developed and expanded in response to the disclosed fraudulent practices of public corporations such as Enron. For example, in January 2003, the SEC adopted rules associated with the Sarbanes-Oxley Act of 2002 that “mandated heightened standards of auditor independence,” required disclosure of “codes of ethics for executive officers,” and “required securities lawyers to report evidence of fraudulent corporate conduct ‘up the ladder’” to the chief legal officer, chief executive officer, or board of directors of a corporation.23

Rules specifically criminalizing securities fraud were also included in the Sarbanes-Oxley Act of 2002. Although securities fraud has long been prosecuted under mail and wire fraud statutes, sec. 807 of the Act is significant in that it removes the need to demonstrate that a particular activity, involving the purchase or sale of a security, constitutes a fraud and was “willfully” committed. Instead, violation requires only the knowing execution of a fraud “in connection with any security.” Although these differences seem subtle, the application of the new language could have significant effects on the processes of investigation and prosecution in securities fraud cases.

Any number of rules or enforcement actions, however, is insufficient to protect investors from fraud without a concerted effort on the part of investors to gather information on any investment product, and any individual offering that product, before making a decision to invest.

“For More Information” Links

- National Association of Securities Dealers (NASD) - http://www.nasd.com
- Commodity Futures Trading Corporation (CFTC) - http://www.cftc.gov
- Internet Fraud Complaint Center (IFCC) - http://www.ifccfbi.gov
Endnotes


