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WCC Issue
Securities/Investment Fraud

Definition
Securities fraud can be described as deceptive practices in the commodity and stock markets. The Securities Act of 1933 and the Securities Exchange Act of 1934 prohibit the use of manipulative or deceptive devices, making false statements in order to increase market share, conspiracy and other acts of unfair market practices.[1]

How it Happens
Like many other types of financial fraud, the web of offenders in securities fraud can include stockbrokers, promoters, traders, accountants, and lawyers. Professionals like these working together can defraud stockholders out of billions of dollars. Although the idea of boiler room schemes pushing worthless penny stocks upon unsuspecting victims comprises part of the problem, the SEC and federal courts have imposed both civil and criminal sanctions upon such diverse groups ranging from organized crime rings[2] to high school students.[3]

The four most prevalent types of securities crime include "churning", insider trading fraud, outsider training, and "pump and dump" fraud. Churning refers to the buying and selling of stock in order to generate commissions for the stockbroker at the expense of client's profits.[4] Insider trading refers to the misappropriation of nonpublic information. While the original statutes made it illegal for employees to directly benefit from market-sensitive information, the definition of insider trading has been expanded to disallow sharing privileged information to a third party who might buy shares in the company.[5]

Outsider trading evolved from insider trading laws.[6] The United States Supreme Court first recognized a form of outsider trading in the 1997 case *United States v. O'Hagan*.[7] The court in that case applied what they called the "misappropriation theory." The misappropriation theory, "subjects individuals who trade on material, non-public information to prosecution, regardless of whether they worked for the company whose stock was being traded or otherwise owed the corporation's shareholders a fiduciary duty."[8] While originally involving a strict interpretation of the Securities Exchange Act, decisions from cases before O'Hagan in the early eighties limited the criminal liability of outside traders to only those instances in which the outsider should have known that the information resulted from a breach in the first place.[9]

One of the most common Internet scams is in fact, one of the oldest investment schemes of all time: the "pump-and dump" scam. Historically pump-and-dump schemes are run out of makeshift offices staffed with fast talking telemarketers that convince innocent investors to buy debatable stock. The high pressure sales tactics generate enough demand to push up the share price of stock. This phase of the scheme is known as, the "pump". The "dump" occurs when the price of the stock reaches a specific objective and the operation that was originally encouraging investors to buy, sells its shares for a significant profit. The sell-off will also lower demand and consequently the share price, leaving unsuspecting investors with a loss.

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1 Securities Act of 1933, 15 U.S.C. Sec 77a to 77aa, 1982. Securities Exchange Act of 1934, 15 U.S.C. Sec 78a to 78k, 1982.

2 Kit R. Roane, "The Mob goes Downtown (Stock Fraud)," *U.S. News and World Report*, June 26, 2000, p.16.

3 Kevin Peraino, "A Shark in Kid's Clothes: A 15-Year-Old is Accused of Online Stock Fraud," Newsweek, October 2, 2000, p. 50

4 James Armstrong et al., "Securities Fraud," *American Criminal Law Review*, Vol. 33, 1995, p. 973-1016.

5 John Boland "The SEC Trims the First Amendment," *Wall Street Journal*, December 4, 1986, p. 28.

6 Kimberly Kempf, N. Arshadi and J.H. Eyssell, "It is Insider Trading, but the Offenders are Really Outsiders," *Journal of Crime & Justice*, Vol. 15, 1992, p. 111-137.

7 *United States v. O'Hagan*, 117 S. Ct. 2199 (1997).

8 Michael D. Monico and Jacqueline S. Jacobson, "Supreme Court Turns Insider Trading Inside Out," *The Champion: The National Association of Criminal Defense Lawyers*, December 1997.

9 *Chiarella v. United States*, 445 U.S. 222 (1980).

Cost/Statistics

Securities regulators and other prominent groups have estimated that securities and commodities fraud totals approximately $40 billion per year.[10] A recent article by the Federal Bureau of Investigations economic crime unit stated that the securities market in the United States is responsible for amassing the nation's wealth and putting it to work in industry, commerce, and business.[11] In the same article the FBI looked at a study conducted by the New York Stock Exchange (NYSE) in the mid-1990's, that revealed approximately 51.4 million individuals owned some type of traded stock, and an additional 200 million individuals owned securities indirectly. In those same financial markets that afford the opportunity for wealth to be obtained, also exists the opportunity for criminal activity.[12]

High Profile Examples/Case Studies

In September of 2000, the SEC announced that it had brought action against 33 companies and individuals that engaged in “pump and dump” stock scams online. The parties named in the actions allegedly used the Net to inflate the prices of more than 70 micro-cap stocks, netting $10 million in illegal profits. They used electronic newsletters, Web sites and message boards to spread false information on the companies, inflating their market capitalization by over $1.7 billion.

Another high profile case involved Jonathan Lebed, a 15-year old high school student, who was accused of using online chat rooms to manipulate stock prices in a number of schemes that netted him almost a million dollars.[13] The case against Lebed also highlights some of the challenges in both enforcement and sentencing. Without admitting or denying SEC findings, Lebed agreed to return $285,000, far less than what he earned on all of his “pump and dump” schemes.

“For More Information” Links

United States Secret Service
http://www.ustreas.gov/usss/

United States Securities and Exchange Commision
http://www.sec.gov/

Duke Law and Technology Review
http://www.law.duke.edu/journals/dltr/ARTICLES/2001dltr0006.html

10 Federal Bureau of Investigation “Securities and Commodities Fraud” http://www.fbi.gov/hq/cid/fc/ec/about/about_scf.htm

11 Ibid

12 Ibid

13 Kevin Peraino “A Shark in Kid's Clothes: A 15-Year-Old Is Accused of Online Stock Fraud,” Newsweek, October 2, 2000, p.50.