An Uphill Battle: The Difficulty of Deterring and Detecting Perpetrators of Internet Stock Fraud

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I. INTRODUCTION

When fifteen-year-old Jonathon Lebed of New Jersey was convicted of securities fraud through the Internet by the Securities and Exchange Commission (“SEC”) in September of 2000, it brought national attention to an already existing question in the investment world. That is, “Where is the boundary line between legal promotion of stock and illegal misrepresentation of stock?” Unfortunately, there is no clear answer, and as investing online through the Internet allows for increased communication among all potential and actual investors, perpetrators of Internet stock fraud will continue to take advantage of the blurry distinction.

Undoubtedly, advancements in technology and increased access to the Internet have allowed the securities industry to go “online.” Not only has the Internet increased the number of traders and investors in securities, it has dramatically increased the amount of information available to investors. Because the securities market is essentially driven by information about securities, it is no surprise that the securities market has embraced and exploited the information capabilities of the Internet. But increased information and trading online has also given criminals new means of perpetrating stock fraud to unsuspecting investors. “The Internet has opened new avenues for securities fraudsters to swindle the investing public.”

3. Id.
4. Id.
5. Judith Burns, SEC’s Walker Vows Continued Fight Vs. Internet Stock Fraud, DOW
Responsible for regulating the securities market, the SEC is aware of the current and future threats posed by Internet fraudsters. Richard Walker, director of the Enforcement Division of the SEC, recognized that “[w]hile insider trading was top priority for the agency in the past decade . . . policing the Internet ‘is unquestionably our greatest enforcement challenge today.’”

In addition to the efforts of the SEC, other sources of protection from, and enforcement against, securities violations exist. Federal statutes give defrauded investors private causes of action for illegal misrepresentation, and state enforcement agencies that monitor the securities markets offer some protection against Internet fraud. But due to the vastness of both the securities markets and cyberspace, these protections fall woefully short of successfully curbing Internet fraud. Despite the seemingly successful and much publicized SEC sanctioning of the teenage fraudster, Lebed, the SEC and other enforcement agencies face an uphill battle as they attempt to deter and detect perpetrators of Internet stock fraud in their attempt to secure the integrity and legitimacy of securities traded online.

This Note argues that because of the limited resources of the SEC, the demanding requirements to prove misrepresentation, the current lack of cooperation between federal and state securities regulators, and a perverse admiration for fraud masterminds, illegal stock price manipulators like Lebed will continue to profit from unsuspecting investors. Various measures to curb Internet fraud, however, are currently being pondered by industry experts. Among the most effective and realistic are, in order: increasing investor education and awareness, increasing the SEC’s “firepower,” increasing penalties and jail time for offenders, furthering coordination of federal and state efforts, and creating a “seal of approval” for traders and brokers. Absent an increased effort in a combination of some or all of the proposed solutions, Internet stock fraudsters will continue to exploit the “easy pickings” created by Internet investors.

II. TYPES OF INTERNET FRAUD

Unfortunately for both investors and the SEC, it is not easy to discern

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6. Id.
9. Id.
10. Id.
if online advisors and promoters are acting within the law.\textsuperscript{11} "Telling the difference between what’s legal and what’s not has always been tricky, and it’s getting more complicated in the Internet age, where opinion and fact and hype are combined in a volatile mixture."\textsuperscript{12} Individuals may legally tout or promote a stock if they actually believe in the value of it, and much of this sort of communication is harmless because no one believes it.\textsuperscript{13} But problems arise when information posted on Internet message boards, chat rooms, and e-mail possesses enough information and apparent authenticity so that a reasonable investor cannot distinguish it from traditional “puffing” of stock.\textsuperscript{14} Alan Bromberg, a securities expert, explains that “[t]he Internet ‘amplifies the fuzziness because there is so much chitchat . . . . You’ve got anonymity and glibness and mixed motives, and all the uncertainty that goes with it.’”\textsuperscript{15} Even if an investor unknowingly relies on misleading information about a stock, whether the author or creator of the information intended for others to be deceived by his action is not always clear.\textsuperscript{16}

Regardless of whether a stock manipulation scheme in action is easily detectable or not, there are three general ways in which manipulators defraud investors: sham offerings, “pump and dump” schemes, and illegal touting.\textsuperscript{17} Securities experts and SEC officials agree that these methods are not new to the industry, but the medium in which they are now performed, the Internet, is both a novel and powerful tool.\textsuperscript{18}

As far as securities fraud is concerned, the Internet is just another medium through which people communicate with each other. Bad

\textsuperscript{12} Id.
\textsuperscript{13} Id.
\textsuperscript{14} Id. Puffing is a term traditionally used to describe the persuasive, hyperbole-like technique used by salesmen to promote their product. An example of typical, yet legal, puffing would be a car salesman’s claim such as: “This car will run forever.” It is such an exaggeration since no reasonable person would rely on its literal truth when buying the car. See id.
\textsuperscript{15} Id. (Professor Bromberg is a professor of securities law at Southern Methodist University in Dallas, Texas).
\textsuperscript{16} See id.
\textsuperscript{18} Remarks of Richard Walker, supra note 17; see generally Securities Fraud on the Internet: Hearings Before the Permanent Subcomm. on Investigations of the Comm. on Governmental Affairs, 106th Cong. (1999) (testimony of Tom Gardner, Headfool, The Motley Fool) [hereinafter Testimony of Tom Gardner]. Richard Walker of the SEC, and Thomas M. Gardner of The Motley Fool, Inc., an investment advice newsletter, both commented that the only change in securities fraud is the medium in which it is conducted.
people have used all advances in communications, dating from the printing press, telegraph, telephone, and the radio, so it would be surprising if securities fraud was not taking place on the Net.\footnote{19} The first of the three traditional types of fraud is the sham offering. This involves perpetrators creating sophisticated Web sites and/or mass-mails that offer securities that either do not exist or are misleading. The subject matter of these offerings tends to be exotic, offering interests in, for example, eel farms, coconut plantations, and projects to explore near earth asteroids.\footnote{20} With the availability of advanced, yet inexpensive, software through retail outlets and increasingly through the Internet, fraudsters can create sophisticated Web sites that present the facade of a legitimate investment opportunity. An army of telemarketers or an actual “boiler room” full of fraudsters is no longer necessary to create sophisticated scams. For example, in October of 1998, a solo California scam artist was convicted on fifty-four felony counts by offering stock entirely over the Internet.\footnote{21} The promoter raised over $190,000 from 150 investors, using the money to purchase groceries, clothing, and stereo equipment.\footnote{22}

The second category of fraud perpetrated on the Internet is market manipulation, usually in the form of “pump and dump” schemes. In this case, fraudsters use the Internet to circulate widely false and misleading information on message boards, chat rooms, and through mass e-mails to drive up a stock’s price. Internet bulletin boards and chat rooms devoted to investing often foster a false sense of community and trust among their readers, causing unwary investors to react and invest.\footnote{23} Because messages may be posted anonymously, an individual, through multiple pseudonyms, can create the impression that such information is being relied upon by many different investors.\footnote{24} The perpetrator then unloads his holdings at the artificially high price. Once the scheme is complete, the price of the stock usually collapses, with the legitimate investors suffering the loss.\footnote{25}

Perhaps the most widely known “pump and dump” schemes were those perpetrated by Jonathon Lebed. He targeted penny stocks and companies with low price and trading activity because it was easier to manipulate the price of smaller, lesser-traded companies. Once he identified his target company, he would buy upwards of 20,000 shares of

\footnote{19} Testimony of Tom Gardner, supra note 18, at 84.\footnote{20} Remarks of Richard Walker, supra note 17, at 6.\footnote{21} See Electronic Commerce: Internet Stock Scam Results In Criminal Conviction of Promoter, 30 SEC. REG. & L. REP. (BNA) 1543 (1998).\footnote{22} Id.\footnote{23} Testimony of Howard M. Friedman, supra note 2, at 22-23.\footnote{24} Id. at 23.\footnote{25} Remarks of Richard Walker, supra note 17, at 6.
its stock. Using various message board names on Silicon Investor and Yahoo!, Lebed posted messages such as “next stock to gain 1,000%,” and “This stock will explode this week.” By unloading his shares after the price rose, Lebed netted around $800,000.  

Short sellers of stock can also inversely manipulate the market by a practice called “cybersmear.” Internet communication is used to drive a stock price down by using negative, false information. Short sellers then profit by covering their short sales at artificially deflated prices.  

Ironically, anonymous messages on the Internet are not always false. A study presented at the 1998 Summer Symposium on Accounting Research suggested that anonymous forecasts appearing on the Internet were better predictors of the performance of technology companies than were the traditional analysts’ forecasts appearing in the electronic First Call Network. The existence of legitimate information on chat rooms and message boards favors Internet fraudsters because investors will not necessarily dismiss all Internet opportunities as fraudulent. Hoping to find the legitimate “hot tip,” investors can easily fall prey to savvy Internet fraudsters.  

The third category of fraud on the Internet is illegal touting. This occurs when seemingly independent newsletter Web sites or e-mail publications are paid to report favorably upon a stock, but the online promoter does not disclose the fact that it is being paid to do so. Often, the company or its promoters pay the online promoters with stock. With the increased amount of information available on the Internet, the reliability of information has become increasingly important. Richard Walker of the SEC has stated that investors have a right to know if the promotional information they see on their computer screens is really just a paid advertisement, like the sort of notice commonly found in magazines and newspapers. In October of 1998, an SEC-conducted Internet fraud sweep that focused on illegal touting revealed that nearly $7 million in cash and

29. Testimony of Howard M. Friedman, supra note 2, at 6 (the study was conducted by Professor Susan Watts of Purdue University, Professor Mark Bagnoli of the University of Michigan, and Professor Meddod Beneish of Indiana University).  
30. Testimony of Tom M. Gardner, supra note 18, at 84.  
over two million shares were garnered by just forty-four illegal touters.\(^\text{32}\)

The stock fraud schemes may be old news, but the increase in frequency and damage caused by Internet fraud schemes indicates that more protection against Internet fraud is necessary.

III. CURRENT PROTECTION FROM INTERNET STOCK FRAUD

Because securities fraud was present long before the existence of the Internet, current sources of protection from securities fraud already exist, including the federal SEC and state regulation efforts. There is debate, however, among industry experts as to whether the current safeguards are enough to deter the new online fraudsters. Professor Howard Friedman believes that the current statutes and rules prohibiting securities fraud are adequate to allow for prosecution of most of the current Internet securities violations.\(^\text{33}\) In contrast, Tom Gardner, an investment advisor and expert, argues that enforcement efforts and monitoring of the Internet and the securities markets must not only continue but should expand as well.\(^\text{34}\) Legislators, like Senator Susan Collins of Maine, are hoping to beef up Internet stock fraud enforcement through new legislation.\(^\text{35}\) But before contemplating any new measures, it is important to identify and analyze the existing regulatory forces.

A. The Securities and Exchange Commission

Promulgated by the Securities and Exchange Act of 1934 (the ‘34 Act), the SEC is the primary regulator of the securities market. Within the Act, the SEC is empowered to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies, as well as the various self-regulatory organizations (‘SROs”) like the New York Stock Exchange (“NYSE”) and the National Association of Securities Dealers (“NASDA”).\(^\text{36}\) With the SEC’s mandate to protect investors, the Commission has broad powers to regulate the securities market and enforce the provisions of the 1933 Securities Act (the ‘33 Act) and the ‘34 Act.

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\(^{32}\) Id. at 7.

\(^{33}\) Testimony of Howard M. Friedman, supra note 2, at 23 (Friedman is the director of the Cybersecurities Law Institute at the University of Toledo and is the author of SECURITIES REGULATION IN CYBERSPACE (2d ed. 1998)).

\(^{34}\) Testimony of Tom Gardner, supra note 18, at 21.

\(^{35}\) Burns, supra note 8, para. 3.

\(^{36}\) U.S. Sec. & Exch. Comm’n, The Investor’s Advocate: How the SEC Protects Investors and Maintains Market Integrity, at http://www.sec.gov/asec/wwwsec.htm (Dec. 1999) [hereinafter The Investor’s Advocate]. The NASDA is the actual association of over-the-counter stocks, and the more familiar NASDAQ is the quotation system that allows these over-the-counter stocks to be priced and presented to the trading public.
Within the SEC, the Division of Enforcement is responsible for investigating possible violations of the securities laws, recommending Commission action, prosecuting the Commission’s civil suits, and negotiating settlements on behalf of the Commission. When an investigation reveals a possible violation, the Division has the option to file suit in a federal court, or bring an internal, administrative action before an independent administrative law judge. Which option the Division chooses depends on the severity of the violation, the technical nature of the matter, tactical considerations, and the type of sanction sought. Perhaps the most relevant distinction between the two proceedings is the severity of sanctions. A federal court, in a civil suit, may issue an injunction against a violator that prohibits the acts or practices committed by the individual, call for audits and accountings for frauds, and assess civil monetary penalties such as the return of illegal profits. In addition, the courts may bar or suspend an individual from serving as a corporate director or officer.

The sanctions available through administrative actions are less severe, and include: cease and desist orders, suspension or revocation of broker-dealer and investment advisor registrations, censures, bars from association with the securities industry, and payment of civil monetary penalties. Although the Division may choose to pursue both types of proceedings, neither allows for imprisonment for violators. In order for offenders to serve jail time, the SEC must work in conjunction with criminal law enforcement agencies throughout the country.

With the explosion of the Internet in the early 1990s and its immediate impact on the securities industry, the SEC began to survey the Internet for possible abuse in 1995. As the Director of the Enforcement Division admitted, at that point, the Commission’s equipment and technological support barely allowed it to access the Internet. In response, three years later, the Commission formed the Office of Internet Enforcement (“OIE”) in July of 1998 to combat online fraud. The OIE coordinates the entire Enforcement Division’s Internet Program. Made up of Internet specialists, the OIE “identifies areas of surveillance, formulates investigative procedures, provides strategic and legal guidance to Enforcement staff nationwide, conducts Internet investigations and prosecutions, . . . performs training for Commission staff and outside

38. Id. para. 11.
39. Id. para. 12.
agencies, and serves as a resource on Internet matters for the entire Commission.\textsuperscript{42} In sum, the OIE, using all 850 of the Enforcement Division’s personnel, orchestrates the SEC’s entire Internet effort.

In addition to its other duties, the OIE oversees arguably the two most promising Internet enforcement weapons: Cyberforce and the online Enforcement Complaint Center. The Complaint Center handles reports of stock fraud from individual investors, normally receiving hundreds of complaints daily.\textsuperscript{43} Cyberforce, with more than 200 personnel nationwide, consists of attorneys, accountants, and investigators that surf the Internet looking for securities fraud.\textsuperscript{44} Richard Walker expects both Cyberforce and the OIE to expand rapidly, undoubtedly due to their early successes.\textsuperscript{45} Since its inception, the OIE has filed 180 cases of Internet fraud. Most recently in its fourth sweep, the OIE netted 33 companies and individuals suspected of artificially pumping up the market capitalization of the stocks involved by $1.7 billion, and profiting by more than $10 million from fraudulent actions.\textsuperscript{46}

When the SEC discovers stock manipulators, it normally prosecutes them under the ‘33 Act and the ‘34 Act, both federal statutes. The ‘33 Act applies when fraudsters attempt to sell nonexistent or misleading securities because they are essentially selling securities without registering with the SEC, as the ‘33 Act prohibits. More often, the ‘34 Act applies, which prohibits the use of “any manipulative or deceptive device or contrivance,” “in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, . . .”\textsuperscript{47} Although it is rarely used, the federal Wire Fraud Statute may also be applicable.\textsuperscript{48} Because the Internet relies on communication, or “wire” lines, the Act may be used because it imposes fines and imprisonment on those “having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, transmits or causes to be transmitted by means of wire, radio, or television communication in interstate or foreign

\textsuperscript{42} Id.
\textsuperscript{43} Id.
\textsuperscript{44} Id.
\textsuperscript{45} Remarks of Richard Walker, \textit{supra} note 17, at 5.
commerce . . .” The Wire Fraud Statute is less used by the SEC, most likely because the SEC cannot conduct administrative actions with it, and instead must work in conjunction with the federal courts or other criminal enforcement agencies.

With the broad powers given by the ‘33 and ‘34 Acts, the SEC has considerable tools with which to monitor and prosecute stock manipulators. The SEC is not alone, however, in its attempt to catch Internet stock fraudsters.

B. Private Civil Actions

Defrauded investors, as private citizens, may also use the ‘33 and ‘34 Acts to uncover wrongdoers and seek recovery for financial losses by bringing civil suits against perpetrators. Unfortunately, private individuals face an uphill battle toward success in these cases because of the demanding elements required to prove the occurrence of fraud in addition to the recently enacted heightened pleading requirements. 50

The primary cause of action available to private individuals to pursue perpetrators of securities fraud is provided by Rule 10b-5 of the ‘34 Act. 51 Promulgated by the SEC, Rule 10b-5 requires a plaintiff to allege that:

in connection with the sale or purchase of securities, the defendant (1) made a false or misleading statement of material fact, or failed to state a material fact, (2) that the defendant acted with scienter, (3) that plaintiff relied on the misrepresentations, and (4) sustained damages as a proximate result of the inaccurate statement. 52

At first glance, these elements are quite broad, but the massive amounts of securities litigation since the rule’s inception has given them more definition, at times making it more difficult for a plaintiff to recover damages. 53 For example, much ambiguity exists over what sort of misstatement is “material,” and what level of “scienter” on the part of the defendant is sufficient for liability to attach.

Despite the refinements to the requirements of bringing a private

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49. Id.
53. It is not the intention of this Note to discuss the refinements of Rule 10b-5, but it is important to note the multiple complexities of meeting the rule’s requirements. For further discussion, see JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS (2d. ed. 1997).
action for securities fraud, Congress made it even more difficult for a plaintiff to merely plead securities fraud in 1995 by amending the ‘34 Act with the Private Securities Litigation Reform Act (PSLRA).\footnote{15 U.S.C. § 78u-4 (Supp. V 1999).} This Act sought to curb the abuse by private securities litigants and their lawyers who allegedly looked to extort settlements based on the size of the defendant’s resources rather than the actual merits of their complaint.\footnote{Sheldon, 31 F. Supp. 2d at 1291.} As a result, a plaintiff must meet stringent pleading requirements regarding the alleged misrepresentations and the perpetrator’s intent. In short, a plaintiff must allege “\textit{what} misrepresentations were made by the defendant, \textit{to whom} these representations were made, \textit{when} these representations were made, [and] \textit{how} these representations furthered the alleged fraudulent scheme.”\footnote{Id. (quoting Farlow v. Peat, Marwick, Mitchell, & Co., 956 F.2d 982, 986 (10th Cir. 1992)).}

With the broad applicability of Rule 10b-5 to Internet securities fraud, it is clear that defrauded investors have a means to pursue Internet fraudsters, especially in the form of a class action suit. But considering the stringent pleading requirements, in addition to the demanding elements, it is debatable whether the current federal securities regulations in fact protect online investors from Internet fraud.

\textbf{C. State Enforcement of Securities Regulation}

Almost all states have their own enforcement divisions or agencies that regulate the securities market activities within their borders.\footnote{See, e.g., Indiana State Securities Regulations Division at http://www.state.in.us./securities.} Although the state capabilities and resources devoted to securities regulation vary from state to state, state regulators have been actively cracking down on Internet fraud.\footnote{Remarks of Richard Walker, supra note 17, at 11.} For example, California convicted nine fraudsters in June of 1999, one of whom allegedly sold interests in a floating condominium and a time machine.\footnote{Id.} In Florida, the Comptroller’s Division of Securities has also attempted to increase its Internet enforcement presence. With eight regional offices in the state, Florida securities regulators have linked up their own computers and developed other programs for sharing information with securities regulators in twenty states and four countries.\footnote{Jim Freer, A Computer Web to Catch Crooks, S. FLA. BUS. J., June 30, 2000, at 35.} Through its efforts, Florida helped catch a Washington, D.C.-based fraudster who conducted his fraudulent communications through the UCLA computer.
Gilford Robinson, the director of the Orlando Division of Securities, hopes that additional states will develop similar laws to those that allow Florida to cooperate with other states, so the state governments may prosecute Internet fraud crimes that occur in multiple jurisdictions.

When it comes to protecting online investors, state enforcement agencies have advantages over the SEC capabilities, but are also limited in other regards. Due to the virtual nature of the Internet, fraudsters act in multiple jurisdictions, but state regulators’ remedies are solely limited to their borders. In addition, state regulators do not have the financial resources to fund Internet enforcement programs like the federally-funded SEC.

Despite the state securities regulators’ limitations, they hold one valuable enforcement tool coveted by the SEC: the ability to conduct undercover operations. State enforcement agencies are not bound by federal privacy laws, and thus may covertly investigate Internet fraudsters. In contrast, SEC officials must identify themselves as federal regulators, and cannot assume a false identity to conduct undercover work. For this reason, both the SEC and state regulators hope they may collaborate in the future and allow the SEC to apply federal sanctions and penalties against Internet fraudsters based on state investigations. In fact, Senator Collins’ Internet antifraud bill would seem to allow this sort of collaboration.

Because securities fraud is nothing new to the market, several sources of protection against securities fraud already exist. The SEC seems to be the primary source because of its enforcement capabilities, while the state enforcement agencies and private causes of action serve as supplementary sources of protection. But as the Internet and its communications capabilities exponentially increase the tools available to fraudsters, it is unclear whether the existing laws can be tweaked enough to deter them, or instead whether new Internet fraud legislation is required. Perhaps the most telling sign that increased efforts to prevent Internet stock fraud are necessary is Richard Walker’s affirmative answer to his figurative question of whether there is a bull market in securities fraud.

IV. PROBLEMS WITH THE CURRENT INTERNET SECURITIES FRAUD PROTECTIONS

Whether one believes the existing protections against Internet stock fraud are sufficient or not, it seems universally conceded that fraudsters

61. Id.
62. Id.
63. Remarks of Richard Walker, supra note 17, at 11-12.
64. Id. at 1.
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will continue to dupe unsuspecting investors. This is compounded by the numerous problems, listed below, that exist within the current enforcement scheme. First, the sheer vastness of the Internet realm may be too large for any entity to realistically police. Second, current enforcement procedures are too often selectively enforced and often lead to enforcement against the wrong party. Third, the private causes of action that allow defrauded investors to seek retribution are far too cumbersome and demanding for the average investor. Fourth, the duplication of efforts between state and federal enforcement wastes precious resources. Fifth, advocates for privacy along with the federal privacy laws hinder the SEC’s ability to monitor and infiltrate fraudulent schemes. Sixth, the penalties for committing fraud are not sufficient to seriously deter perpetrators. Fines are merely a cost of doing business for fraudsters, and jail time for offenders is rarely distributed as punishment. Finally, and perhaps most disturbing, is the perverse, yet pervasive, admiration for Internet fraudsters like Jonathon Lebed. Rather than being labeled as convicted felons, fraud masterminds are admired, and even inspiring to some. These factors are discussed in detail below.

A. The Internet Is Too Vast and SEC Resources Are Too Small

The realm of the Internet, which is already massive, continues to grow at a phenomenal rate. In addition to the sheer volume of users, the fact that no individual entity, private or public, owns any significant portion of the Internet infrastructure, makes the regulation of the medium a virtual impossibility. The vast wilderness of the Internet has created regulatory quandaries in numerous areas besides securities, including pornography and obscenity, trademark and copyright infringement, and protection of privacy. Therefore, it is not realistic to believe that the SEC and state authorities can successfully monitor and punish all Internet securities fraudsters. Perhaps the more practical question is whether regulators can muster enough resources to raise serious deterrents against Internet fraud. As of 1999, over three million people had online trading accounts, and this figure was expected to rise to fourteen million by 2001. Richard Walker recognizes the resource strain on his organization which was created by the growth of the Internet, but claims that the SEC is willing to go to exhaustive lengths to fight fraud in this new medium. This effort may not

be enough, however, to seriously deter fraudsters.

According to some, the SEC’s resources are both limited and primitive, and the SEC has had a difficult time getting the necessary funds from Congress.\(^68\) Although Senator Collins’ bill, the Microcap Fraud Prevention Act of 1999, attempted to answer the requests for help, the SEC has been left to make do with the tools they have, some of which are embarrassingly primitive. For example, SEC lawyers spend hours using Yahoo!’s free Internet search engine to run searches using phrases such as “risk-free returns” and “ground-floor opportunities,” hoping to bump into fraudulent activity.\(^69\) The enforcement staff then must comb through each search result to ensure the validity of the offer. Although relatively inexpensive software that could perform weeks of SEC monitoring in a few hours is available, the funding is not there.\(^70\)

Another resource constraint on the SEC is the difficulty of procuring and retaining skilled staff members. SEC attorneys’ salaries range from $75,000 to $115,000, which are similar to other government attorneys’ salaries. The SEC lawyers, however, can double and triple their salaries in the private sector. In the New York office of the SEC, from September 1996 through September 1998, the SEC had to replace 54% of its 137-member staff, including fifty-seven of eighty-eight attorneys.\(^71\) As a result, while the volume of trading, public offerings, and, presumably, fraud on the Internet soars, the number of enforcement cases against violators remains the same.\(^72\) Fully aware of the situation, Richard Walker conceded that the growing fight on the Internet has caused some cases and investigations to suffer.\(^73\) The General Accounting Office, commissioned by the Senate, also recognizes the shortcomings of the SEC, forecasting that regulators will struggle to coordinate their Internet policing activities because of insufficient human and technical resources.\(^74\)

Another problem with respect to the SEC’s resources is that some key Republican legislators strongly oppose increased resources for and regulation by the SEC, despite the alarming reports of increased Internet fraud. Philosophically, they believe the government should not interfere with the markets by creating heightened regulations. According to Texas

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69. Id.

70. Id.

71. Id.

72. Id.

73. Id.

74. Schroeder, supra note 66.
Senator Phil Gramm, “[w]hat the SEC needs is the economic equivalent to the Hippocratic Oath: First, do no harm . . . [l]et technology lead, and regulation will follow.”\textsuperscript{75} Such legislators point to the lower trading fees and increased access to securities information as direct, positive results of the Internet medium. They contend that any sort of government regulation would offset the advantages investors gain by trading online.

In light of the limited resources of the SEC, a hands-off philosophy makes some sense. The abundance of information made accessible to individuals via the Internet allows previously uninformed investors to sophisticate themselves. The lower costs, the added convenience to the securities markets, and the increased access, all created by the Internet, seem to encourage a less regulated industry. Giving individuals who would not participate without the Internet access to the investment world may be better than denying them access completely, even though they would enter with less protection. Some argue that the original purpose behind the creation of the SEC and the ‘34 Act is no longer relevant.\textsuperscript{76} Now that the typical investor is either sophisticated and informed, or easily may become so, protection for the common investor through aggressive enforcement and burdensome regulations may be outdated.\textsuperscript{77} Therefore, regulators calling for less securities regulation, rather than more, may not be as callous as they appear. Armed with such arguments, passive regulators claim the SEC should try to fix problems only after deficiencies become apparent.\textsuperscript{78}

Apparently, these passive regulators are oblivious to the endless stories of defrauded investors over the past several years. As Theodore A. Levine, a former SEC enforcement official, countered, “If you allow regulation to run two years behind innovation, there’s a lot of harm left along the way . . . .”\textsuperscript{79} By adopting Senator Gramm’s philosophy of allowing regulation to follow technology, regulators are essentially creating fertile fields for technologically savvy fraudsters. While the philosophical debate festers on, Internet stock fraudsters will continue to reap the benefits of wrongdoing due to the increase in online investors, the limited resources of the SEC, and the political opposition to increased enforcement efforts.

\textsuperscript{75} Paltrow et al., supra note 68.

\textsuperscript{76} See generally Michael Lewis, He Wanted to Get Rich. He Wanted to Tune Out His School-Kid Life. And Neither His Parents Nor the S.E.C. Was in a Position to Stop Him: Jonathon Lebed’s Extracurricular Activities, N.Y. TIMES MAG., Feb. 25, 2001, at 32-33.

\textsuperscript{77} Id.

\textsuperscript{78} Paltrow et al., supra note 68.

\textsuperscript{79} Id.
B. Selective Enforcement and the Difficulty of Identifying Fraud

As discussed earlier, the difficulty of separating illegal misrepresentations of securities from mere puffing of stock, exacerbates the problem of enforcing antifraud measures. Rule 10b-5 allows the use of a manipulative or deceptive device in the commission of fraud, but defining these terms is not easy. Arguments as to how much false information mixed with accurate information is necessary in a statement before a reasonable investor would rely on it, are endless and not particularly helpful. Proving that the disseminator of information intended to mislead others is also difficult. After all, people are free to state their own beliefs and people may be wrong. Therefore, identifying fraudulent schemes on their face is a nebulous proposition.

In addition to the murkiness of the standard, many investors complain of inconsistent enforcement. The same sort of advice passed among investors on Wall Street for years is now problematic on Internet message boards and in chat rooms. Perhaps the most obvious reason for this inconsistency is that face-to-face, or at least phone-to-phone, communication that actually took place on Wall Street ensured an element of reliability, especially where the conveyor of information was identifiable by appearance or voice. With the anonymity of the Internet, the same sort of information may come from a scheming teenage fraudster, and yet, appear even more reliable on the screens of unsuspecting investors’ computers. The more telling answer to the inconsistency, however, is due to limited resources. Howard Friedman believes that in many instances a case could have been brought, but was not, because regulators, aware of budgetary constraints, must be selective. As a perpetrator of fraud, knowing the SEC’s selective enforcement policy does not provide much of a deterrent. Indeed, it seems to provide an incentive to try and dupe unsuspecting investors.

C. Private 10b-5 Action Requirements Are Too Demanding

Various experts claim that the current set of securities laws adequately protect the individual investor, but the lack of successful suits brought by individuals against fraudsters questions the truth of these claims. Undoubtedly, antifraud laws like Rule 10b-5 are applicable when

81. See Simon & Schroeder, supra note 11.
82. See id.
83. See id.
84. Testimony of Howard M. Friedman, supra note 2.
an online investor is defrauded, but the demanding elements and the heightened pleading requirement for plaintiffs appears to bar most online investors. As discussed earlier, it is also difficult for both traditional and online investors to show that the perpetrator’s statements were false and made with the intent to deceive. But for online investors, operating where anonymity is easily maintained, it is difficult for plaintiffs to identify who made the misleading statements. Some experts claim that securities fraud is easier to detect because e-mail and message board postings leave “trails,” but the typical online investor may not have the technical capabilities to identify the perpetrator.

One problem is that most Internet chat rooms and message boards allow individuals to use usernames and aliases when posting messages. Defrauded individuals must rely on Web site operators and Internet service providers (“ISPs”) to disclose the actual names of the fraudsters. Reliance on ISPs and Web site operators; however, is yet another obstacle for defrauded investors. Absent a court-issued subpoena, ISPs and Web site operators are not required to disclose the identity of their users and subscribers. While some sites such as Yahoo! are relatively willing to disclose the names of their users, others like America Online (“AOL”) vigorously defend their users’ anonymity.

This problem of anonymity on the Internet is magnified by the heightened pleading requirements enacted by the PSLRA. As discussed earlier, the PSLRA requires the plaintiff to plead with particularity each statement alleged to have been misleading, to show the reason or reasons why the statement is misleading, and to show a strong inference that the defendant acted with a particular state of mind. A defrauded online investor may have trouble both showing intent and identifying the perpetrator. Although there are few cases involving private online investors pursuing a 10b-5 action, Sheldon v. Vermonty is illustrative of a plaintiff’s challenge.

In Sheldon, the plaintiff brought a Rule 10b-5 action after purchasing stock in Power Phone, Inc. and losing $75,000. The plaintiff learned of the company in an Internet chat room, where the defendants, some of whom identified themselves as “investor relations” representatives of

86. Testimony of Howard M. Friedman, supra note 2, at 23.
87. Fred Cate, Professor at Indiana University School of Law—Bloomington, Electronic Communication, B646, Fall 2000.
89. Id.
91. Id.
Power Phone, Inc., disseminated false information relating to the financial fitness of the company.\textsuperscript{92} In their subsequent e-mail correspondence with the plaintiff, the defendants allegedly gave false information regarding the company’s economic growth potential by stressing the “sound financials” and characterizing certain future contracts as “done deals.”\textsuperscript{93}

The court dismissed the complaint because the plaintiff could not identify the “exact time, place, content, and speaker of each of the alleged misrepresentations.”\textsuperscript{94} The plaintiff was only able to give references to verbal and written communications and could not identify which defendant made each misrepresentation.\textsuperscript{95} Although the plaintiff attached copies of transmitted e-mails, press releases, and other communications, the court refused to recognize them as sufficient.\textsuperscript{96} It is unclear whether the plaintiff in \textit{Sheldon} had access to technological assistance to obtain the information necessary to create a sufficient pleading, but without the benefit of discovery, it is doubtful that most online plaintiffs could meet the particularity requirements of the PSLRA.

When the PSLRA was passed in 1995, legislators most likely did not anticipate the development of stock fraud committed via the Internet. Rather, the purpose behind the PSLRA was to eliminate frivolous and unmerited strike suits filed by plaintiff lawyers, but the Act’s effectiveness is questionable. According to SEC statistics, the number of class action strike suits filed since the implementation of the PSLRA has remained the same.\textsuperscript{97} It is unknown how many strike suits have been denied or even never filed because of the heightened pleading standards, so a repeal of the PSLRA could help the plight of the Internet investor. For example, the plaintiff in \textit{Sheldon}, had his complaint passed the pleading muster, may have been able to obtain the necessary information to sustain a successful suit using the discovery process backed by the power of the courts. In light of the significant lobby of issuers, broker-dealers, investment advisors, and other proponents of the PSLRA, however, defrauded investors like the plaintiff in \textit{Sheldon} should not hold their breath because the heightened pleading requirements are likely to remain in effect for quite some time.

Of course, defrauded investors cannot claim they are entirely left

\textsuperscript{92} Id. at 1289.
\textsuperscript{93} Id. at 1290.
\textsuperscript{94} Id. at 1291.
\textsuperscript{95} Id.
\textsuperscript{96} \textit{Sheldon}, 31 F. Supp. 2d at 1291.
\textsuperscript{97} Practicing Law Institute, \textit{Ten Things We Know and Ten Things We Don’t Know About the Private Securities Act of 1995}, 1015 PLUCorp 1015, 1020 (1997) (joint Written Testimony of Joseph A. Grundfest and Michael A. Perino); see generally COX ET AL., supra note 53.
without recourse because of the SEC’s relatively new Online Complaint Center ("OCC"). Created by the Division of Enforcement and the Office of Investor Education and Assistance, the OCC will review and evaluate each submitted complaint, and if the complaint implicates any violations of federal securities law, the SEC will conduct a confidential investigation. As discussed earlier, the OCC is a powerful tool that can alert the SEC to illegal activity, but it does not necessarily mean that the defrauded investor receives compensation for his losses. The OCC can assist a defrauded investor in analyzing and establishing his or her claim, or it may conduct its own investigation based on the complaint. A defrauded investor, however, must meet certain eligibility requirements in order to receive any proceeds collected by the SEC in the event it orders the disgorgement of profits reaped by the fraudster. Therefore, the OCC may not be a satisfactory substitute for the defrauded investor who seeks monetary damages where the individual is unable to meet heightened pleading requirements in a private action. Despite the existence of the OCC, the heightened pleading requirement effectively serves as a layer of insulation for Internet stock fraudsters, making the private cause of action offered under Rule 10b-5 of little value to the online investor.

D. Overlapping Federal and State Enforcement

With enforcement resources scarce both at the state and federal levels, the overlapping of monitoring and investigating should be kept to a minimum in order to conserve resources, but the duplication of enforcement efforts occurs frequently. As the current laws stand, the SEC cannot rely on state investigations into stock fraud and must instead conduct its own investigations. This is primarily due to the federal privacy laws which prohibit the SEC from using aliases, and the state enforcement agencies have found that undercover operations are effective in nabbing fraudsters. Both sides appear eager to coordinate their efforts, as state regulators testified before Congress in March of 1999, arguing that "it makes no sense for federal regulators to duplicate stock-fraud investigations."
investigations already done at the state level."\textsuperscript{104} The SEC also voiced its approval of such coordination because it would allow it "to bring cases much faster," which is often crucial to effective enforcement.\textsuperscript{105} Despite the mutual agreement between state and federal regulators, no legislation allowing for it has been passed, and Internet stock fraudsters continue to elude both sides.

\subsection*{E. Privacy and Free Speech Concerns Hinder Enforcement Efforts}

Yet another obstacle to Internet securities fraud enforcement for the SEC and other regulators, is the concern for privacy and free speech. In an effort to increase the efficiency of the SEC resources, the agency is entertaining bids from private contractors to develop software that will automatically search public Internet Web sites for fraudulent activity.\textsuperscript{106} The SEC hopes a "web crawler" or "spider" will help detect online fraud, so that SEC attorneys spend less time surfing the web and more time bringing cases.\textsuperscript{107}

Unfortunately for Internet investors, the SEC is receiving significant opposition from lawmakers who worry that automated searching will infringe on an individual’s right to privacy.\textsuperscript{108} In particular, Representatives Michael Oxley (R-Ohio), Edolphus Towns (D-N.Y.), and Billy Tauzin (R-La.) all submitted letters to former SEC Chairman Arthur Levitt expressing their concerns about privacy protections. They argue that the SEC’s proposal for automated Internet searches would, in addition to raising privacy concerns, violate Americans’ right to free speech.\textsuperscript{109} The legislators are likely concerned that Internet users’ speech will be chilled if they are aware that they are being monitored. Ironically, chilling fraudulent communications on the Internet is exactly the SEC’s intent. But because

\begin{itemize}
\item \textsuperscript{104} Burns, \textit{supra} note 8, para. 6.
\item \textsuperscript{105} \textit{Id.} (noting remarks by the SEC Enforcement Division Chief, Richard Walker).
\item \textsuperscript{106} Judith Burns, \textit{Levitt Says SEC Won’t Engage in Online Snooping}, \textit{DOW JONES NEWS SERV.}, Apr. 5, 2000, para. 5.
\item \textsuperscript{107} SEC Chairman Levin feels that forcing lawyers to conduct manual searches on the Internet is wasteful. \textit{Id.} A spider, also known as a web crawler, is a software program run by a Web server that fetches Web sites based on criteria given in the program. The spider programs get their name because they navigate by linking from a Web site that links to other Web sites, and thus “crawl” within the Internet. Spiders are most often used to feed Web pages to search engines, but in the SEC’s case, it would use the spider to fetch suspicious Web sites for investigation by SEC officials. It is unclear what sort of criteria the SEC would use to identify suspicious and nonsuspicious Web sites. \textit{See generally} Lycos Internet Tech Glossary, \textit{at} http://webopedia.lycos.com/TERM/s/spider.html (last visited Oct. 12, 2001).
\item \textsuperscript{108} \textit{Id.}
\item \textsuperscript{109} \textit{Id.}
\end{itemize}
the freedom of speech is one of the most fiercely defended rights in America, it is a serious roadblock for SEC automated searches. Between the free speech principles and the “almost libertarian strain of antigovernmental sentiment that accompanies many of the major writings on the Internet, it is not hard to imagine that assertions of regulatory authority by the SEC and other agencies may face vigorous public opposition . . . .”

In defense of its proposal, the SEC has promised that the automated searching would be limited to public Internet bulletin boards, such as those found on Yahoo!, AOL, the Microsoft Network, and Prodigy sites. Former Chairman Levitt claims that the SEC has never had any intention of intercepting or monitoring private communications, including those taking place in chat rooms or in e-mail. Enforcement Division Chair Walker seconded Levitt’s claim that the SEC is not seeking to intercept private communications, nor is it seeking to enter chat rooms unannounced. But as noted earlier, much of the current Internet securities fraud occurs in private chat rooms and mass e-mail distributions. This is an example of how fraudsters, by embracing the Internet as their medium to perpetrate fraud, have exhibited their ability to stay one step ahead of regulators. If they know regulators cannot monitor their private communications, the fraudsters are given a realm of immunity in which to continue their deceit. Although automated searches limited to public Internet sites will help combat Internet fraud, it still leaves resourceful fraudsters with room to operate.

F. Overly Rapid Response by SEC May Lead to Wrongly Prosecuted Users

Rapid enforcement against Internet security fraudsters is generally considered a positive, in that “[s]peed helps reinforce a strong deterrent message.” It can backfire, however, when overly rapid enforcement ensnares innocent parties. Such was the case in the SEC’s action against eConnect, a small Internet company which was merely the subject of an apparent pump and dump scheme perpetrated by an independent firm, resulting in multiple law suits against eConnect, and a drop in its stock to

110. John Reed Stark, Securities Regulation and the Internet, 520 PLI/Pat 793, 830 (1998).
111. Id. at 799.
112. Burns, supra note 106.
fifty-five cents per share. On February 28, 1999, with its stock hovering around $1.25 per share, eConnect announced a strategic alliance agreement with a Florida brokerage firm. The following week, a wholly unrelated group, Independent Financial Reports (“IFR”), distributed four “strong buy” recommendations, touting eConnect’s potential, resulting in a stock value increase up to $20 per share, before dropping to $16.50. When the SEC learned of the dramatic increase, it ordered a halt in the stock’s trading on March 23, and brought suit against eConnect’s president for issuing false press releases, without even talking to anyone from eConnect. Although his allegedly false press release was essentially accurate, the president quickly settled to avoid litigation costs, while denying any wrongdoing. Further investigation by the SEC revealed that a 44-year-old man named Stephen Sayre was the sole owner and employee of IFR, whose skeletal corporation cleared over $1.4 million by purchasing and selling eConnect stock. Although Sayre’s lawyer denies any wrongdoing, Sayre remains out of the country, holding $19 million in a Canadian bank account. Meanwhile, eConnect remains burdened by more than twenty shareholder lawsuits with its stock trading under a dollar.

Although the SEC should be applauded for its quick notice of the fraudulent activity, its overly aggressive enforcement caused an innocent company to suffer the losses caused by an independent Internet stock fraudster, who remains at large. Undoubtedly, the SEC must respond quickly to prevent further manipulation of securities through the Internet, but the eConnect case illustrates the complexity and difficulty of finding and prosecuting the responsible fraudulent actor(s).

G. Fraudsters Are Not Significantly Deterred Without the Threat of Jail Time

Legislators like Senator Collins and enforcement officials like Levitt and Walker of the SEC have expressed their intent to crack down on Internet securities fraud, but what this means to investors remains unclear. Under the current provisions of the ‘34 Act, the SEC is essentially limited to imposing fines and possibly barring a rogue broker when securities violators are prosecuted. But as Walker has discussed, criminal

114. Id.
115. Id.
116. Id.
117. For more details on the eConnect case, see generally id.
118. See, e.g., Burns, supra note 8.
119. The Investor’s Advocate, supra note 36.
prosecution of fraudsters is “necessary because the prospect of a prison sentence is apt to deter more fraud than anything the SEC can do . . . .”120 Although a bar from participating in the securities market may deter investment advisors and rogue brokers, it will have little, if any, impact on private, individual fraud artists because they normally operate under pseudonyms and false pretenses. Besides making them a recognized con artist by the SEC, any censure or civil reprimand will have little deterrent effect upon fraudsters. Unfortunately, due to the inherently civil nature of the SEC’s administrative proceedings, imposing criminal punishment is not a possibility without coordination with criminal prosecutors like the Federal Bureau of Investigation or state criminal enforcement agencies.

Walker’s figurative goal for SEC enforcement is to leave Internet fraud artists “naked, homeless and without modem.”121 A more literal interpretation of this threat, however, may be necessary considering the fact that most fraudsters get to keep some of their ill-gotten profits, even after being prosecuted and sanctioned by the SEC. Perhaps the most famous example is Jonathon Lebed. When the SEC announced Lebed’s conviction and his fines of $272,826 in September of 2000, the agency left out a few important facts. Lebed was only convicted on eleven of twenty-seven charges of fraud, allowing Lebed to keep over $500,000 in profit.122 Even Lebed’s lawyer, Kevin Marino, felt that the SEC’s settlement was “somewhat arbitrary,” and he did not “understand the SEC’s basis for selecting some trades and not others.”123 Lebed kept 65% of his total revenues, a return any businessman would admire. This kind of return on Internet securities fraud schemes sounds more like an incentive than a crack down on fraud.

H. Fraud Artists Are Seen as Heroes to Some

Notwithstanding the legal and technological obstacles of preventing Internet securities fraud, perhaps the most troubling and counterproductive aspect of Internet fraud is the way in which con artists are perceived by the public. Continuing with Jonathon Lebed as the prime example, breaking the rules is becoming increasingly acceptable as the con artists get younger.124 Lebed’s “achievement” of garnering over $800,000 by pumping and dumping stocks made him somewhat of a local hero in his hometown of Cedar Grove, NJ. His actions were described by classmates as “pretty

120. Burns, supra note 5, para. 15.
121. Id. para. 13.
122. Schroeder & Simon, supra note 25, para. 3.
123. Id. para. 7.
124. Kadlec, supra note 1, at 52.
cool,” and his father claims that he is proud of his son. With stories of Internet stock trading creating instant millionaires, the public seems to be taken with everyone’s “right to get rich,” and ignoring the means by which one achieves the status. Rather than suffering public fallout, in addition to fines and sanctions, clever Internet fraudsters garner the envy of some and obtain a somewhat elevated position in society. Aside from encouraging the public to come to its senses, there is little that regulators can do to change the situation. This irrational public response to fraudsters like Lebed is counterproductive in the fight against Internet securities fraud.

V. REALISTIC SOLUTIONS TO INTERNET STOCK FRAUD

Between the sheer size of the Internet and the increasing number of online perpetrators and the multitude of ways in which they can defraud investors, no one particular solution or method is capable of significantly reducing securities fraud on the Internet. But, in light of limited financial and technological resources and the feasibility of implementation, increased investor education and increased SEC resources are more realistic solutions than increased regulation, lessened pleading requirements for stock fraud, or implementation of “seal of approval” safeguards. Of course, a combination of solutions may ultimately be the best way to curb Internet securities fraud.

A. Increased Investor Education and Awareness

Perhaps the most common and logical reaction to reports of Internet stock fraud is one of scorn and condescension towards defrauded investors. One can understandably argue that if Internet investors took more time to investigate their investment possibilities and verified that their opportunities were legitimate, then fraudsters would have no one to defraud. Not surprisingly, experts agree with this reasoning. Richard Walker suggests that “[e]ffective investor education is the best line of defense against fraud . . . .” and claims that the SEC’s Office of Investor Education and Assistance continues to distribute and disseminate various educational materials. In addition, former Chairman Arthur Levitt “held 28 town meetings across the country where he has met with investors and helped them to understand and identify the warning signs of Internet and microcap fraud.”

125. Id.
126. Id.
128. Id.
Investment advisor Tom Gardner agrees that investor education would prevent many investors from falling for fraud schemes, but also recognizes the enormity of the task. He acknowledges the SEC’s latest efforts, but claims they face a great task due to the “massive financial illiteracy” of many Americans. Despite the apparent widespread investing ignorance, Gardner claims that the sort of information and advice needed to prevent fraud is unoriginal, and comes from common sense. Investors need only to do their own homework, learn about the nature of their investments, and not act on tips, regardless of the source.

Undoubtedly, the sort of investor information that can reduce Internet securities fraud is simple, but begs the question: if the advice is so simple, why are investors not following it? It is unclear whether typical investors are reasonably informed or whether they merely choose to ignore the warnings, but regardless, increased education should ultimately be effective. Just as the Internet’s communicative capabilities allow fraudsters to massively disseminate their fraudulent propositions, the Internet can be a medium for widespread, yet inexpensive investor education. As Gardner reasons, “if people would heed [the investment warnings], securities fraudsters could hype, tout, rumormonger and scam to their hearts’ content without being able to manipulate markets or hurt anyone.”

B. Coordination of Federal and State Enforcement

As discussed earlier, Internet securities fraud investigations by the SEC often overlap and duplicate those conducted by the states. The various state enforcement agencies often possess more effective tools in detecting and prosecuting fraudsters primarily because they do not have to work around federal privacy laws. Because state regulators can conduct undercover operations, they can detect and identify fraudsters more effectively. It is also easier for these regulators to coordinate with state criminal enforcement authorities so the state may enforce criminal punishment with less effort. Unfortunately, the states lack the deeper pockets and the broad jurisdictional authority enjoyed by the SEC. Coordinating the two levels, as Senator Collins’ bill proposes,” would certainly make more efficient use of the limited resources to reduce Internet

129. Testimony of Tom Gardner, supra note 18, at 21.
130. Id.
131. Id. Gardner further commented that “[i]f someone tells you that you must ‘ACT NOW’ or lose a massive investment opportunity, you should probably skip it. Finally, the only surefire way to get rich quick is through inheritance, although through simple, systematic investment over time, you can get rich slowly.” Id.
132. Freer, supra note 60.
133. Remarks of Richard Walker, supra note 17, at 11-12.
stock fraud, and both sides appear eager to do just that.

Unfortunately, the realistic chance of significant coordination between state and federal forces seems doubtful. Before coordination legislation can be passed, legislators must address issues of privacy, federalism, and jurisdiction. For example, if the SEC used evidence collected by a state agency in a manner in accordance with that state’s laws, but would violate federal privacy laws if collected by the SEC, a federally-convicted fraudster would easily be able to plead a deprivation of due process under the Sixth Amendment.\textsuperscript{134} Essentially, the SEC would be using federally inadmissible evidence to achieve convictions. The potential opposition such legislation would receive from various privacy groups renders the coordination solution a distant reality. Coordination of enforcement personnel training and awareness programs, however, would certainly help fight Internet securities fraud, as evidenced in Florida’s securities enforcement program.\textsuperscript{135} In the abstract, coordination of federal and state efforts sounds ideal, but the reality of it becoming a major solution seems remote.

\textit{C. Creating a “Seal of Approval” for Issuers and Brokers}

Another possible solution to curbing Internet securities fraud is to establish a sort of “Good Housekeeping Seal of Approval” for legitimate stocks offered online so that investors can ensure that they are investing in legitimate opportunities.\textsuperscript{136} Under such a plan, a third party, after verifying the legitimacy of Web sites that offer securities opportunities, would issue a special seal to be displayed on the Web site.\textsuperscript{137} The seal would indicate that the Web site meets the third party’s standards. In addition, a link to the verifying third party could exist on the Web site, so investors who encounter problems could easily contact the third party. Theoretically, legitimate Web sites would not object to participating because they have nothing to hide.\textsuperscript{138} Such a program was established in the accounting industry; the American Institute of Certified Public Accountants established a program called WebTrust, which audits the business practices, information, and transaction integrity of commercial Web sites.\textsuperscript{139} A similar program for Web sites offering securities opportunities would

\begin{footnotesize}
\begin{enumerate}
\item See U.S. Const. amend. VI.
\item See Burns, supra note 8, para. 18.
\item Testimony of Howard M. Friedman, supra note 2, at 24.
\item Burns, supra note 8, para. 17.
\item Testimony of Howard M. Friedman, supra note 2, at 24.
\end{enumerate}
\end{footnotesize}
help investors verify the security of their own investments, and possibly keep them from investing on Web sites that do not possess the "seal of approval."

If such a "seal of approval" system were implemented, however, it must come from the efforts of the private sector. According to Richard Walker, it is unlikely that government agencies could create such a system, but he encouraged any independent, third-party, private sector group that would want to establish the verification system.\(^{140}\)

Perhaps Walker’s reluctance to undertake the task of establishing a government-funded third-party verification system stems from the current requirements of the ‘33 and ‘34 Acts. The ‘33 Act requires certain issuers of stock to register with the SEC, and the ‘34 Act requires all brokers and dealers of securities to register with the SEC.\(^{141}\) In a sense, a third-party verification system already exists in the SEC, if investors would just take the time to check the SEC filing records.

A similarly related solution to Internet securities fraud is to hold brokers and dealers to a higher standard in screening out investors who are pursuing investment strategies that are too risky for their financial status.\(^{142}\) But not only is this proposition overly burdensome for brokers and dealers, it would also interfere with an investor’s right to contract. In sum, placing a higher burden on issuers and dealers to prove their legitimacy and protect their investors would certainly help curb Internet fraud, but such measures will have to come from the issuers and dealers. Yet, in light of most issuers’ and brokers’ intent to minimize expenses and maximize profits, a movement to increase investor protection, requiring additional expenditures, is unlikely to come from such groups.

D. Increasing SEC Resources

The most practical and likely solution to deter perpetrators from committing Internet securities fraud is to increase SEC enforcement resources. The SEC already has the expertise and knowledge of how fraudsters operate, and it knows how to pursue securities law violators. Although the SEC was initially slow to react to securities fraud online, it has made significant strides since 1995, as the Internet Enforcement Division continues to grow and expand its arsenal. Since beginning its Internet sweeps in 1998, the SEC has brought more than 180 Internet-related enforcement actions, and about one-third of these were brought in

\(^{140}\) Burns, supra note 8, para. 18.


\(^{142}\) Testimony of Howard M. Friedman, supra note 2, at 24.
the past year. With sufficient funding and cutting edge technology like T1 Internet access lines, automated surveillance, and the powerful hardware necessary for executing the Internet searches, SEC insiders claim that the Internet Enforcement Division will detect most fraud, wherever it may be. But they also recognize that the infinite territory of the Internet precludes a guarantee that every nook and cranny can or will be searched.

Increased funding for the SEC is easier to obtain than additional legislation and regulation. Rather than having to explore new policy and potential issues with new legislation, Congress need only grant the SEC additional funds to strengthen its Internet Enforcement Division.

E. Increased Penalties for Internet Stock Fraudsters

The most effective deterrent against Internet securities fraud is to increase the punishments for convicted violators, especially attaching jail time to the civil fines. Although the threat of disgorgement of profits and additional fines may deter some individuals, the prospect of jail time and the deprivation of one’s liberty will clearly deter a greater number of potential fraudsters. Supporting increased criminal sanctions for fraudsters, Richard Walker claimed:

[T]here is a certain breed of bottom feeders who are simply not deterred by the prospect of civil injunctions or even stiff monetary penalties . . . . [The civil remedies] are simply a cost of doing business. There is no other option to achieving deterrence for them than the threat of a life behind bars making license plates.

Of course, the SEC only has civil jurisdiction, so it must rely on federal and state criminal prosecutors to impose jail terms for violators, but the SEC strongly supports such action. While criminal prosecution is on the rise, the SEC continues to urge prosecutors to bring more securities cases.

Besides the obvious deterrent that jail time poses to fraudsters, criminal punishment may also help reshape the public’s opinion of successful fraud masterminds like Jonathon Lebed. As opposed to being viewed as savvy entrepreneurs who cut a few legal corners, fraud perpetrators thrown in jail may be seen as lowly criminals, like the typical burglar or thief. If Lebed were sitting in jail at the time the public read

143. SEC Continues Nationwide Crackdown, supra note 46.
144. Stark, supra note 110, at 830.
145. Id.
147. See id.
about his fraudulent schemes, fewer people may have been willing to trade places with him. In addition, perhaps fewer of his classmates would still categorize him as “cool.” While most people, especially teenagers, may not appreciate the implication of civil fines and injunctions, most people clearly recognize the implications of sitting in a jail cell.

In sum, increased penalties and jail time for perpetrators of Internet securities fraud will not only serve as a greater deterrent for fraudsters, but it will help the disillusioned public see the fraudsters as the criminals that they really are.

VI. CONCLUSION

Unquestionably, the Internet has revolutionized the securities market because of its ability to disseminate information and support communication between millions of people with the click of a mouse. The legitimate investment opportunities made available to millions by the Internet are unlimited. Unfortunately, the opportunities for unscrupulous individuals to defraud eager investors are also unlimited. Because of technological innovations, widespread, yet anonymous communication and an underinformed investing public, individuals are using the Internet to commit securities fraud in increasing numbers. Securities fraud on the Internet will continue to grow because the Internet is too vast for all fraudsters to be identified, and the legal consequences for convicted fraudsters is not a sufficient deterrent. In addition to being able to keep a significant amount of the proceeds from their fraudulent actions, clever perpetrators are somewhat admired by their peers. Therefore, skilled fraudsters have little reason to refrain from their deceptive behavior.

As the primary regulator of the securities market, the SEC is aware of the challenge it faces in curbing Internet fraud. Unfortunately, limited resources hinder its ability to detect fraud, and quite frankly, the Internet is too big for the SEC to solve the problem alone. “Given the size and growth of the Internet . . . it is like expecting one precinct house to patrol all of New York City.” 149 It simply cannot be done. Other preventative solutions exist, but they too suffer from limitations. State enforcement agencies are limited by resources and jurisdictional restraints, and private actions under Rule 10b-5 150 are too demanding for defrauded investors to effectively use. Although Senator Collins’ bill attempts to address several of these problems, the bill has yet to advance from the Senate Banking Committee. 151

149. Testimony of Peter C. Hildreth, supra note 103, at 49.
151. Senator Collins presented her bill to the Permanent Subcommittee on Investigations
Industry experts posed a variety of measures to deter fraud, and a combination of these is likely to be most effective. Among the most realistic are increased investor education, increased SEC resources, and increased penalties and jail terms for convicted perpetrators. Coordination of state and federal enforcement efforts, lessening stock fraud pleading requirements, and implementing third party verification of security issuers and dealers, are less feasible due to legislative and constitutional barriers. In order to avoid further tales about perpetrators like Jonathon Lebed, who illegally take advantage of the Internet enforcement gaps without suffering significant consequences, the securities industry regulators must increase investor education and beef up their ability to deter, detect, and punish Internet security fraudsters.