

# **“Click Here to Buy the Next Microsoft”: The Penny Stock Rules, Online Microcap Fraud, and the Unwary Investor**

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## I. INTRODUCTION

Investment fraud is a time-honored tradition. As far back as the 1700s, con artists on London’s Exchange Alley were using a “pump and dump” scheme to defraud investors.<sup>1</sup> The “pump and dump” scheme used by con artists in eighteenth century London was simple but effective: the price of worthless shares of the “South Sea Bubble,” a South American trading company, was inflated by false rumors of profitability spread about the company by owners of the shares, who then sold the shares at a substantial profit after the price of the shares increased.<sup>2</sup> The “pump and dump” scheme has since continued through the present day and has enriched a very few unscrupulous sellers at the cost of tens of thousands of investors.<sup>3</sup> Recently, though, the age-old schemes used by swindlers to sell phony or vastly inflated shares of stock have moved fully into the digital age: investors are now being duped over the Internet.<sup>4</sup> In fact, the number of fraudulent offerings of securities is predicted to grow as the number of investors trading online grows.<sup>5</sup> Historically, the existence of securities fraud in the United States has led to attempts by Congress to stem its growth, but what can or will be done about securities fraud conducted over the new medium of the Internet remains a matter of some speculation.

Indeed, much of U.S. securities regulation has focused on the prevention and punishment of fraud, and it was the abuses that contributed to the Stock Market Crash of 1929 that prompted Congress to enact the Securities Exchange Act of 1934 (“Exchange Act”).<sup>6</sup> The Exchange Act attempted to curb securities fraud through the establishment of the Securities and Exchange Commission (“SEC”) and the creation of a comprehensive regulatory scheme designed to manage and oversee trading on the stock exchanges.<sup>7</sup> The Exchange Act, fueled by congressional dissatisfaction over perceived speculation and manipulation of stock prices, provided restrictions on practices such as short selling and options trading, and, in § 9(a), prohibited specific

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1. Katrina Brooker, *The Scary Rise of Internet Stock Scams*, FORTUNE, Oct. 26, 1998, at 187, 192.

2. *See id.* at 192.

3. For a sobering discussion of the various penny stock scams of the past two decades, how they are conducted, and how much money investors have lost, see GUY W. BEAVEN, HELLO SUCKERS!: INSIDE THE BRUTAL WORLD OF STOCK MARKET SCAMS AND HOW TO PREVENT FALLING VICTIM 40-55 (1995).

4. *See* Brooker, *supra* note 1, at 187.

5. *See id.*

6. Securities and Exchange Act of 1934, 15 U.S.C. § 78 (1994); *see* JAMES D. COX ET AL., SECURITIES REGULATION 654-55 (2d ed. 1997).

7. *See* COX ET AL., *supra* note 6, at 654.

manipulative practices in connection with stock exchange trading.<sup>8</sup> Additionally, the SEC was given its own enforcement tool to combat securities fraud in § 17(a), which prohibits fraud in “the offer or sale of securities.”<sup>9</sup> Later, § 10(b) was added to the Exchange Act and it has since become the workhorse of the securities fraud regulation under the Exchange Act, since it is not explicitly connected to exchange-based trading and because so much of the activity associated with speculation and manipulation of securities occurs outside stock exchange trading.<sup>10</sup> But in 1990, Congress sought to expand the remedies under the Exchange Act for fraudulent activities made in connection with a stock sale or purchase due to the spiraling abuse of “peuny” or “microcap” stocks.<sup>11</sup>

Traditionally, stock swindlers have preferred microcap or penny stocks for their offerings since microcap securities for little known, thinly traded companies are often difficult to research and their shares are frequently not quoted on a daily basis.<sup>12</sup> Congress, in 1990, attempted to deal with the problem of microcap securities fraud through the Securities Enforcement Remedies and Penny Stock Reform Act (“Penny Stock Act”).<sup>13</sup> Pursuant to the Penny Stock Act, the SEC enacted the Penny Stock Disclosure Rules (“Peuny Stock Rules”),<sup>14</sup> which require broker-dealers engaging in penny stock transactions to provide certain information about the nature and risks of penny stocks to their customers before completing any sale.<sup>15</sup> However, the Penny Stock Act has proven to be mostly a paper tiger since its provisions, as adopted by the SEC in the Penny Stock Rules, can be easily circumvented simply by evading the statutory definition of a penny stock as set forth in Rule 3a51-1.<sup>16</sup> Consequently, microcap securities fraud has continued more or less unabated through to the present day.

But the Internet presents an even more alarming scenario for investors: sites are springing up daily that are either completely fraudulent, as was the case with one site

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8. 15 U.S.C. § 78(l); see COX ET AL., *supra* note 6, at 654.

9. 15 U.S.C. §78(g); see COX ET AL., *supra* note 6, at 681.

10. 15 U.S.C. § 78(j)(b); see COX ET AL., *supra* note 6, at 654-55.

11. See Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990) (codified in scattered sections of 15 U.S.C.). “Penny” or “microcap” stocks are defined in the Exchange Act as “low-priced shares of small companies not traded on an exchange or quoted on NASDAQ.” General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.15g-100 (1998).

12. See generally 104 Stat. at 931; 17 C.F.R. § 240.15g-100. The reason that most fraud involves penny stock is that penny stocks—also known as microcap or small-cap stocks—are often not listed on any national stock exchange but are sold on the over-the-counter market, which is generally conducted broker to broker, or listed in the “pink sheets” or NASD OTC Bulletin Board. See *id.* Such stocks are sometimes not quoted and information about the issuer is often more difficult to obtain than it is for stocks listed on a national exchange. See *id.*

13. 104 Stat. at 931.

14. Penny Stock Disclosure Rules, Exchange Act Release No. 30,608, 57 Fed. Reg. 18,004 (1992); see also 17 C.F.R. §§ 240.15g-1 to -100.

15. See 17 C.F.R. § 240.15g-100.

16. 17 C.F.R. § 240.3a51-1; see also O. Douglas Hernandez, Jr., *Broker-Dealer Regulation Under the New Penny Stock Disclosure Rules: An Appraisal*, 1993 COLUM. BUS. L. REV. 27, 32.

that proclaimed itself to be “[t]he next Microsoft,”<sup>17</sup> or are materially misleading as to their expected profitability and stock value.<sup>18</sup> The prevalence of microcap, or penny stock, fraud on the Internet will likely assume greater significance in the future, as online trading is expected to grow substantially in the next few years,<sup>19</sup> which will make greater numbers of investors open to the types of online securities fraud that have previously ensnared relatively few investors. Accordingly, the Penny Stock Rules, as well as the antifraud portions of the Exchange Act, need to be rewritten specifically to include Internet offers and sales of securities in which issuers would be provided with firm guidelines and would be given substantial restraints on the method and manner of offering microcap securities, and to make those who commit fraud or make material misrepresentations of securities subject to stricter civil and criminal penalties.

This Note considers the growth of penny stock fraud conducted on the Internet, the response of the SEC as well as the response of individual investors in combating such fraud, and advances some possible solutions to the problem. Part I provides background on the explosive growth of online penny stock fraud, the response to the fraud by the SEC, and the reaction of groups of investors who, dissatisfied with the perceived ineffectiveness of the SEC, have taken the matter of policing the Internet for penny stock fraud into their own hands. Part II examines three possible solutions to the growth of online penny stock fraud and asserts that specific rules should be enacted by the SEC to govern online penny stock offers, sales, and trading, and that stricter civil and criminal penalties should be put in place to deter future instances of fraud. The Note then concludes that: (1) online penny stock fraud presents a serious threat to investor confidence in the medium of the Internet; (2) online penny stock fraud may ultimately undermine the stability of U.S. securities markets; and (3) online penny stock offerings must consequently be made under stricter regulatory control.

## II. PENNY STOCK FRAUD ON THE 'NET, SEC ENFORCEMENT, AND THE "CYBERVIGILANTE" RESPONSE

The Securities Act of 1933 (“’33 Act”)<sup>20</sup> and the Exchange Act were created to provide investors with enough information to make informed decisions when purchasing securities and to increase investor confidence in the securities markets.<sup>21</sup>

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17. Brooker, *supra* note 1, at 187.

18. *See id.* The Electro-Optical Systems scam discussed by Brooker is typical of many of the microcap stock frauds and illustrates the difficulty investors may encounter in trying to find out information about such companies. *See id.* at 192-93.

19. *See id.* at 188. The number of investors who use the Internet to research or invest in securities is estimated to be “nearly one-third” of the thirty million households online. *Id.* at 187-88. A recent survey indicates that three million of these households have online trading accounts and the number is expected to grow to fourteen million by the year 2001. *See id.* at 188.

20. 15 U.S.C. § 77 (1994).

21. *See* Arthur Levitt, The SEC Perspective on Investing Social Security in the Stock Market, Speech at the John F. Kennedy School of Government Forum (Oct. 19, 1998), available in 1998 WL 781104.

Unfortunately, the lack of adequate regulation over Internet offerings and trading defeats the very purpose of the '33 Act and the Exchange Act due to the burgeoning amount of online securities fraud. According to John Stark, chief of Internet enforcement at the SEC, con artists are practicing every variety of fraud through the Internet, including "Ponzi schemes, pyramid schemes, public offerings, [and] oil and gas fraud."<sup>22</sup> Much of the fraud, according to the SEC, involves "small-time stock promoters" working out of their homes and small companies who hope to boost the share price of their penny stocks.<sup>23</sup> But while the types of fraudulent securities schemes are as diverse as they are proliferate, the victims of such schemes do not fit any one category.<sup>24</sup> Victims range from so-called "sophisticated" investors, including attorneys, to those who have little or no background or knowledge of securities trading or of investing generally.<sup>25</sup>

*A. The Internet, Penny Stocks, and the Con Artist: A Growing Problem*

Given the apparent failure of governmental agencies to stem the tide of Internet securities fraud over the Internet, one might conclude that no law or regulation applies to offerings or sales of securities conducted online. But the antifraud provisions of the '33 Act and the Exchange Act,<sup>26</sup> as well as the Penny Stock Rules,<sup>27</sup> do apply to Internet offers and sales of securities aimed at U.S. residents.<sup>28</sup> Arguably, the enactment of the Penny Stock Act put investors on notice of the very risky nature of microcap stocks because broker-dealers are required, under the Penny Stock Rules, to obtain an investor's signature to the Schedule 15G disclosure statement before a sale of a small-cap stock may be completed.<sup>29</sup>

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22. David Barboza, *44 Stock Promoters Accused by S.E.C. of Internet Fraud*, N.Y. TIMES, Oct. 29, 1998, at A1. A Ponzi scheme is a phony investment plan in which monies paid by later investors are used to pay artificially high returns to the initial investors, with the goal of attracting more investors. See WEBSTER'S NEW WORLD DICTIONARY 1049 (3d ed. 1988). A pyramid scheme is a "property-distribution scheme" in which an investor pays for a chance to receive compensation based on introducing new persons to the scheme, as well as when the new persons themselves bring others into the scheme. BLACK'S LAW DICTIONARY 516 (Pocket ed. 1996).

23. Barboza, *supra* note 22, at A1.

24. See *id.* The fact that there is no typical profile of a victim of Internet securities fraud may have to do with the difficulty even relatively "sophisticated" investors have in verifying the legitimacy of an Internet offering or investment advice. See *id.*; see also Brooker, *supra* note 1, at 187.

25. For a good description of various kinds of securities victims, see Brooker, *supra* note 1, at 187. The victims include a California attorney, a bankruptcy clerk, and an unemployed engineer. *Id.*

26. See 15 U.S.C. §§ 77k-77l (1994); 17 C.F.R. § 240.10b-5 (1998).

27. Penny Stock Disclosure Rules, Exchange Act Release No. 30,608, 57 Fed. Reg. 18,004 (1992).

28. See Alexander C. Gavis, *The Offering and Distribution of Securities in Cyberspace: A Review of Regulatory and Industry Initiatives*, 52 BUS. LAW 317, 321 (1996).

29. 17 C.F.R. § 240.15g-100 (1998).

But the Penny Stock Act, as interpreted by the SEC in the Penny Stock Rules,<sup>30</sup> has proven to be mostly a paper tiger due to the substantial loopholes available to sellers of microcap securities.<sup>31</sup> When the SEC enacted the Penny Stock Rules, it was apparently torn between two regulatory goals: (1) the need to combat microcap securities fraud; and (2) the need to ensure that its disclosure requirements were not overly cumbersome to issuers, particularly those issuers who are small, marginally capitalized companies.<sup>32</sup> Moreover, the Penny Stock Rules do not include any provisions for outline trading of microcap securities nor do they impose any specific antifraud measures or penalties for the offering or selling of such securities. Accordingly, the application of the Penny Stock Rules, such as the requirement of the signing of the disclosure statement of Schedule 15G,<sup>33</sup> is problematic to enforce and virtually impossible to measure because Internet transactions may be conducted instantaneously and without the need for paper documents.<sup>34</sup>

The need for specific regulations for Internet solicitations and sales of microcap securities is underscored by the very nature of the Internet itself. The explosive growth of the Internet as a medium for commerce<sup>35</sup> is due, in part, to the ease with which products and services can be offered with relatively low cost to sellers.<sup>36</sup> Consequently, stock promoters find it easy and relatively inexpensive, or even wholly without cost, to tout stocks in "pump and dump" schemes<sup>37</sup> or to give out supposedly impartial investment advice for microcap stocks for which the promoters have actually been paid substantial sums of money by the sellers of the stocks.<sup>38</sup> But the lack of appropriate regulation over the Internet not only causes an increased amount of outright securities fraud, which ultimately undermines investor confidence in the integrity of the securities markets, but also produces an increased amount of market volatility due to the presence of "day traders."<sup>39</sup> Such market volatility adversely

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30. Penny Stock Disclosure Rules, 57 Fed. Reg. at 18,004.

31. See Hernandez, *supra* note 16, at 29; see also 17 C.F.R. § 240.3a51-1 (1998).

32. See Hernandez, *supra* note 16, at 33, 34 (discussing a narrowing of the penny stock definition).

33. 17 C.F.R. § 240.15g-100.

34. See, e.g., Kevin Mason, Comment, *Securities Fraud over the Internet: The Flies in the Ointment and a Hope of Fly Paper*, 30 CASE W. RES. J. INT'L L. 489, 495 (1998).

35. See *Fraud on the Internet: Scams Affecting Consumers: Hearing Before the Permanent Subcomm. on Investigations of the Comm. on Governmental Affairs*, 105th Cong. 3 (1998) [hereinafter *Scams Affecting Consumers*] (opening statement of Senator Glenn).

36. For instance, promoters of Internet stock scams can "spam" tens of thousands of people—that is, send them unsolicited e-mails—with almost no cost to themselves in time or money. See, e.g., Michael Schroeder & Rebecca Buckman, *U.S. Attacks Stock Fraud on Internet*, WALL ST. J., Oct. 29, 1998, at C1.

37. See Brooker, *supra* note 1, at 187, for the story of Michael Bowin, a petty con artist and alleged pimp, who set up a flashy Internet site at no cost to himself and made \$190,000 in profit in three months from a variety of would-be investors before the SEC caught him.

38. See Christine Dugas, *Stock Fraud Reached out on the Internet in 1998*, USA TODAY, Dec. 21, 1998, at 5B.

39. See Humberto Cruz, *We Have Met the Enemy and It Is Us*, CHI. TRIB., Dec. 11, 1998, § 6, at 3. "Day traders" are usually unsophisticated investors who hope to make a quick profit by darting in and out of stocks that are traded online. See *id.* However, such investors are rarely successful and are blamed for causing stock prices to fluctuate without any connection

affects the overall stability of the securities markets as well as investors who seek long-term investments in legitimate microcap securities.<sup>40</sup>

Currently, the SEC cannot keep pace with even a small percentage of the securities fraud taking place on the Internet.<sup>41</sup> In fact, since the SEC established its investor hotline on the Internet three years ago, the SEC has received about one hundred complaints per day, but only files, on average, one new charge per month against Internet securities promoters.<sup>42</sup> The perception among many investors is that the SEC is relatively ineffectual at combating fraud.<sup>43</sup> Clearly, the actions of the SEC in combating Internet securities fraud, while commendable, are not adequate to the task at hand. Consequently, the SEC needs to develop a more comprehensive approach that actually addresses how Internet securities offerings and sales of penny stocks should be conducted, along with increased penalties for committing fraud, as Internet securities trading grows.

### *B. The Response of the SEC to Fraud*

The SEC, the Federal Trade Commission ("FTC"), the Commodity Futures Trading Commission ("CFTC"), as well as other organizations such as the North American Securities Dealers Administrators Association ("NASAA"), and the National Securities Dealers Association ("NASD"), have all taken action to warn investors of the hazards of trading online.<sup>44</sup> The SEC has also established an online investor hotline<sup>45</sup> and has very recently conducted an extensive enforcement action against several companies and individuals suspected of illegally promoting penny

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to the profitability of the company offering the stock. *See id.*

40. *See id.* One may also question whether the Efficient Market Hypothesis—the theory that the capital markets reflect all the information available about any given security—truly applies to the capital markets given the presence of investors who engage in "day trading" despite the evidence that such trading is unprofitable for investors. *See COXET AL., supra* note 6, at 31-42. Indeed, the presence of "day traders," as well as the continuing amount of securities fraud despite all the warnings given by the SEC and other regulatory bodies, tends to support the "noise" hypothesis of stock market investing, which states that the securities markets are subject to "pricing influences not associated with rational expectations about asset values." *Id.* at 40. Or to state a variant of the "noise" hypothesis even more bluntly, one may quote financier Bernard Baruch, who declared, "[a]nyone taken as an individual, is tolerably sensible and reasonable—as a member of a crowd, he at once becomes a blockhead." *Id.* at 41 (quoting B.M. Baruch, *Foreword* to CHARLES MACKAY, *EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS* at xiii (2d ed. 1932)).

41. *See Brooker, supra* note 1, at 187.

42. *See id.*

43. *See id.*

44. *See* Robert MacMillan, *FTC Catches Bad Investment Wave*, NEWSBYTES NEWS NETWORK, Dec. 21, 1998, available in 1998 WL 20720604. Recently, NASAA, NASD, the FTC, and the CFTC joined together for "Surf Day," which entailed investigating and analyzing some 400 websites and usenet group messages that purported to give investment advice. *See id.*

45. *See Brooker, supra* note 1, at 187.

stocks over the Internet.<sup>46</sup> Additionally, the SEC has created a “cyberforce” of SEC investigators, whose task is to police the offering and trading of securities over the Internet.<sup>47</sup>

Finally, while the SEC has yet to promulgate a change to the Penny Stock Rules specifically dealing with online trading of microcap securities, it has provided some guidelines regarding the use of Internet websites to offer, solicit, or advertise investment advice offshore.<sup>48</sup> The SEC has also issued an interpretative release detailing how broker-dealers, investment advisers, and transfer agents may satisfy their delivery requirements under the Exchange Act and the Investment Advisers Act of 1940<sup>49</sup> (“Advisers Act”) using electronic media.<sup>50</sup> Additionally, the SEC has indicated some guidelines for issuers in a series of no-action letters that may prove instructive to small companies wishing to offer and sell securities online.<sup>51</sup> However, these measures are, at best, stopgap and do little to stem the rising tide of penny stock fraud and manipulation over the Internet due to the fact that no clear guidelines are present to require broker-dealers, and not just issuers, to disclose the risks of such investments and to specify in what manner such disclosures should be effected.

### 1. The SEC’s Attempt to Warn Investors

The SEC has not been lax in its attempts to warn investors of the hazards of purchasing penny stocks through online offerings or on the basis of recommendations and opinions found in online newsletters or websites.<sup>52</sup> For instance, the SEC has established a Web page that gives investors advice on the hazards of online investing and some practical tips on how to investigate a stock.<sup>53</sup>

46. See Schroeder & Buckman, *supra* note 36, at C1.

47. See Brooker, *supra* note 1, at 198. The SEC’s “cyberforce” conducted a sweep of 44 “stock promoters, Web-site operators and newsletter publishers” who were suspected of promoting penny stocks in violation of the antifraud provisions of the ’33 Act and of the Exchange Act. Schroeder & Buckman, *supra* note 36. The promoters typically gave out “enthusiastic ‘buy’ recommendations” either in e-mails or newsletters directed at investors without disclosing that the promoters had a financial interest in the trading of the stock. *Id.* One “public-relations company,” Sloane Fitzgerald Inc., sent out more than six million spams to potential investors touting the virtues of a penny stock. *See id.* Sloane Fitzgerald subsequently settled with the SEC and agreed to a permanent injunction and a civil penalty. *See id.*

48. See Statement of the Comm’n Regarding Use of Internet Web Sites to Offer Securities, Exchange Act Release No. 34-39779, 66 SEC Docket 1869 (Mar. 23, 1998).

49. 15 U.S.C. § 80b-1 (1994).

50. See Gavis, *supra* note 28, at 330-31.

51. See Spring Street Brewing Co., SEC No-Action Letter, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,201, at 77,001 (Apr. 17, 1996); Daniel Everett Giddings, Comment, *An Innovative Link Between the Internet, the Capital Markets, and the SEC: How the Internet Direct Public Offering Helps Small Companies Looking to Raise Capital*, 25 PEPP. L. REV. 785 (1998); Mason, *supra* note 34, at 493-94.

52. See *Internet Fraud: How to Avoid Internet Scams* (last modified Dec. 17, 1998) <<http://www.sec.gov/consumer/cyberfr.htm>> [hereinafter *Internet Fraud*].

53. *See id.*

Additionally, the SEC has conducted town meetings in which it attempted to educate investors on recognizing securities fraud.<sup>54</sup> Moreover, investors can obtain information on issuers, such as a copy of a prospectus, registered under federal securities laws through the Electronic Data Gathering and Analysis ("EDGAR") system, which is available to the public over the Internet.<sup>55</sup>

The SEC's website alert on Internet securities fraud is instructive of the SEC's approach to warning investors of online trading. The site basically encourages investors to use caution when considering whether to invest in an "opportunity" discovered on the Internet.<sup>56</sup> The tips on how to spot fraud include viewing investment advice given in online investment newsletters, bulletin boards, and in e-mail "spams" with a skeptical eye.<sup>57</sup> Other advice given on the SEC website alert to investors suggests that investors "get the facts" before investing by obtaining financial statements from the issuer, verifying the accuracy of the new product claims, calling all the suppliers and customers of the issuer to find out if they "really do business with the company," and finding out if the "people running the company . . . [have] ever made money for investors before."<sup>58</sup> Additionally, the SEC recommends that investors check EDGAR to see if the issuer is registered with the SEC.<sup>59</sup> The site also encourages investors to check with state securities agencies to see if they can provide more information about a "company and the people behind it."<sup>60</sup> Finally, the site concludes with a brief description of the various types of securities fraud and a list of some of the enforcement actions recently conducted by the SEC.<sup>61</sup>

However, while the advice offered by the SEC on its website is generally sound, investors may not heed it or give it appropriate weight in making investment decisions.<sup>62</sup> In fact, the evidence of past SEC enforcement actions,<sup>63</sup> or of the stories of investors who have been defrauded,<sup>64</sup> suggests that investors will probably not take the time-consuming steps necessary to determine whether a given piece of investment advice is legitimate. The lure of making an easy profit seems, for many

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54. See *Dep't of Commerce, Justice, State, and Judiciary, and Related Agencies Appropriations for Fiscal Year 1999: Hearing on H.R. 4276/S. 2260 Before the Subcomm. of the Senate Comm. on Appropriations*, 105th Cong. 498 (1998) (statement of Arthur Levitt, Chairman).

55. See *Internet Fraud*, *supra* note 52; see also Gavis, *supra* note 28, at 341.

56. *Internet Fraud*, *supra* note 52.

57. See *id.*

58. *Id.*

59. See *id.*

60. *Id.*

61. *Id.*

62. Indeed, "noise" theory proponents argue that investors do not make entirely "rational" decisions in choosing investments but instead are susceptible to fads, rumors, and the decisions of other investors, regardless of the actual profitability of investments made by others. COX ET AL., *supra* note 6, at 41. The question then becomes whether *any* warning, in and of itself, is ever sufficient enough to deter investors from a particular investment scheme.

63. See *Online Stock Fraud Brings 10 Years in Jail*, *ASIAN WALL ST. J.*, Nov. 9, 1998, at 12, available in 1998 WL-WSJA 22040545; Schroeder & Buckman, *supra* note 36, at C1.

64. See, e.g., Brooker, *supra* note 1, at 187, 192.



investors, to be the overriding concern in making investment decisions.<sup>65</sup> Additionally, as stated before, the ease with which con artists can set up detailed and seemingly legitimate websites tends to undercut any attempts to discern whether such sites are actually fraudulent simply by viewing them online.<sup>66</sup>

Accordingly, the only valid method for investors to determine whether a penny stock investment is legitimate is to follow the advice of the SEC website and verify new product claims by the issuer, review the issuer's financial statements, call the issuer's customers and suppliers to find out if they actually do business with the issuer, and check the EDGAR system for registration with the SEC.<sup>67</sup> Unfortunately for investors, however, the very steps recommended by the SEC are oftentimes extremely difficult or impossible to perform due to the very nature of penny stocks.<sup>68</sup> Additionally, as the SEC notes on its website, it may exempt some companies from registration requirements or require them to file only a "brief notice" that gives the names and addresses of stock promoters but "little other information."<sup>69</sup>

As stated earlier, the reason so much securities fraud involves penny stocks is because such stocks are very often difficult, or even nearly impossible, to research and investigate.<sup>70</sup> Stock promoters, whether operating out of a "boiler-room"<sup>71</sup> using a telephone and a scripted sales pitch or using a PC and a Web page, overwhelmingly prefer penny stocks for scams for the very reason that penny stocks oftentimes cannot be sufficiently researched by investors.<sup>72</sup> Consequently, investors are left to make an investment decision based only on the recommendation of the stock promoter's sales pitch or website. Finally, investors who place a phone call to a state securities office may discover little, as the resources of state securities divisions are often overtaxed in dealing with more conventional types of fraud and are generally unable to combat Internet fraud.<sup>73</sup>

## 2. The SEC's Enforcement Efforts

But the efforts of the SEC in combating online securities fraud are not limited to just investor education. Recently, the SEC completed an aggressive enforcement "sweep" against a variety of penny stock promoters which resulted in at least one criminal conviction and several large civil penalties.<sup>74</sup> The crackdown on Internet

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65. See Cruz, *supra* note 39, § 6, at 3.

66. See Brooker, *supra* note 1, at 187-92.

67. See *Internet Fraud*, *supra* note 52.

68. See 15 U.S.C. § 78o (1994); see also *supra* text accompanying note 12.

69. *Internet Fraud*, *supra* note 52.

70. See BEAVEN, *supra* note 3, at 39.

71. A "boiler-room" is a penny stock firm that uses high-pressure tactics, usually involving telephone solicitation, to sell its inventory and create a market for its stock. *Id.* at 182.

72. See *id.* at 104.

73. See Brooker, *supra* note 1, at 198. Additionally, state securities enforcement divisions often encounter jurisdictional problems in trying to prosecute alleged Internet securities con artists. See *id.*

74. See *Online Stock Fraud Brings 10 Years in Jail*, *supra* note 63, at 12; see also *SEC Internet Fraud Sweep Results in Actions Against Stock Promoters*, 30 Sec. Reg. & L. Rep. (BNA) 1565 (Oct. 30, 1998).

securities fraud, which consisted almost wholly of various penny stock promotion schemes,<sup>75</sup> stemmed from the SEC's "cyberforce" of investigators whose job is to police the Internet for potential violators of federal securities laws.<sup>76</sup> The Office of Internet Enforcement at the SEC ("OIE"), in addition to policing the Internet for potential cases of securities fraud, will also train law enforcement officials in other agencies to spot Internet fraud.<sup>77</sup> According to the OIE, the SEC receives about 120 complaints per day alleging securities fraud.<sup>78</sup>

Of course, the SEC is not able to act on all the complaints it receives even in a single day, even if each complaint proved to be factually accurate.<sup>79</sup> In the past year, the SEC was only able to bring thirty-eight actions against online stock promoters, which was a dramatic increase from the enforcement actions of previous years.<sup>80</sup> Given the increased amount of both online trading and online securities fraud, the SEC's Enforcement Division is likely to face considerable obstacles in attempting to respond to the numerous complaints from investors about suspected cases of illegal stock touting.

### 3. The SEC's Guidelines for Internet Offers and Sales of Securities

The SEC has also attempted to provide some guidance to issuers and broker-dealers who wish to offer and sell securities online. Initially, the SEC addressed the delivery of information by issuers, broker-dealers, and other "market participants" through a series of no-action letters.<sup>81</sup> An interpretative release from the SEC subsequently followed in October 1995, which detailed its views on the electronic delivery of prospectuses, proxy solicitation materials, and annual and semiannual financial reports.<sup>82</sup> In the release, the SEC acknowledged the '33 Act and the Exchange Act do not prohibit electronic delivery of information by market participants but that such delivery should include information equal to that found in paper-based mediums.<sup>83</sup> The SEC also indicated in the release that electronic delivery of information should provide "timely and adequate notice" to investors that such information is available, that access to such information should be as readily available in the electronic format as it is in the paper context, and that some evidence

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75. See Schroeder & Buckman, *supra* note 36.

76. See Merry Mayer, *SEC Sets Up Team to Battle Net Fraud*, NEWSBYTES NEWS NETWORK, Sept. 24, 1998, available in 1998 WL 11727254.

77. See *id.*

78. See *id.*

79. See Brooker, *supra* note 1, at 187.

80. See Schroeder & Buckman, *supra* note 36, at C1.

81. Gavis, *supra* note 28, at 325.

82. See Use of Electronic Media for Delivery Purposes, Securities Act Release No. 7233, 60 Fed. Reg. 53,458 (Oct. 13, 1995); Gavis, *supra* note 28, at 328.

83. See Use of Electronic Media for Delivery Purposes, 60 Fed. Reg. at 53,460; Gavis, *supra* note 28, at 329.

of the delivery of such information to investors through an electronic format should be provided.<sup>84</sup>

Additionally, the SEC issued another interpretative release in May 1996 that provided more guidance to broker-dealers, transfer agents, and investment advisers on how to use electronic media to comply with the delivery requirements of federal securities laws.<sup>85</sup> Essentially, the release emphasized the same requirements of the earlier release—notice of delivery to investors, comparable information available in a paper context, and some evidence of delivery to investors—but differed in a couple of important respects.<sup>86</sup> First, the May 1996 release specified that evidence of delivery could be established by obtaining the investor's "informed consent to electronic delivery . . . obtaining actual evidence of receipt through, for example, a return receipt electronic mail message . . . or . . . disseminating information through certain facsimile methods."<sup>87</sup> Moreover, the release stated that broker-dealers should take "reasonable precautions" to preserve the confidentiality of the personal financial information that they have collected on their customers.<sup>88</sup>

The SEC has also taken some tentative measures in a series of no-action letters to establish how securities may be distributed over the Internet as, for example, it did in the case of an initial public offering ("IPO") for a small, marginally capitalized issuer.<sup>89</sup> In the case of one small issuer, Spring Street Brewery ("Spring Street"), the SEC initially approved the issuance of its small-cap stock and also approved the creation of a bulletin board for Spring Street—Wit-Trade—which was to facilitate the trading of Spring Street stock.<sup>90</sup> The SEC, however, shut down Wit-Trade soon after it commenced operations but later allowed it to resume business after agreeing to disclose to investors that the trading of Spring Street stock by Wit-Trade was inherently risky due to the fact that the stock was speculative and relatively illiquid.<sup>91</sup>

The SEC granted another no-action letter to IPONet, a Texas company that placed public offerings of securities on the Internet, in July 1996.<sup>92</sup> In its no-action letter, the SEC specified that IPONet was liable for any misstatements or omissions on its

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84. See Use of Electronic Media for Delivery Purposes, 60 Fed. Reg. at 53,460; Gavis, *supra* note 28, at 330.

85. See Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information, Exchange Act Release No. 33-7288, 61 Fed. Reg. 24,644 (May 15, 1996); Gavis, *supra* note 28, at 334.

86. See Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information, 61 Fed. Reg. at 24,647; Gavis, *supra* note 28, at 335.

87. Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information, 61 Fed. Reg. at 24,647.

88. *Id.*

89. See Mason, *supra* note 34, at 491-96.

90. See *id.* at 491; see also Gavis, *supra* note 28, at 337.

91. See Mason, *supra* note 34, at 492; see also Gavis, *supra* note 28, at 338. While Spring Street and Wit-Trade voluntarily complied with the SEC and thus avoided the taint of illegitimacy, the Spring Street scenario illustrates the dangers of online trading of penny stocks. See *id.* The stocks are risky simply because the existence of an alternative online trading market such as that of Wit-Trade is not very different from the traditional over-the-counter market that is conducted broker to broker. See *supra* text accompanying note 12.

92. See Mason, *supra* note 34, at 493-94.

website.<sup>93</sup> IPONet responded to the SEC's restrictions by creating a system that permitted access through a password<sup>94</sup> to only those it deemed "sophisticated" investors.<sup>95</sup>

Finally, the SEC recently issued a release detailing the use of Internet websites to "disseminate offering and solicitation materials for offshore sales of securities and investment services."<sup>96</sup> The release provides the SEC's views on how U.S. federal securities laws apply to "broker-dealers, exchanges, and investment advisers" located outside of the United States who effect solicitation and sales of securities to U.S. residents.<sup>97</sup> The release states that the SEC interprets federal securities laws with regard to foreign offerings or investment advice directed at U.S. residents as not exempt from registration requirements,<sup>98</sup> and gives several suggested "precautionary" methods for foreign offerors to avoid targeting U.S. residents if the offerors do not wish to register with the SEC.<sup>99</sup> Additionally, as the SEC notes, although the release does not address the antifraud and antimanipulation provisions of federal securities laws, the antifraud provisions of federal securities laws will continue to apply to "all Internet activities that satisfy the relevant jurisdictional tests."<sup>100</sup>

While the guidance provided by the SEC has been somewhat helpful in establishing certain limitations for issuers wishing to offer and sell microcap securities online,<sup>101</sup> the no-action letters issued by the SEC as well as its interpretative releases are, at best, partial answers to the overall problem of how

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93. *See id.* at 494.

94. *See id.*

95. "Sophistication" is a relative term in securities law—it is typically used as a requirement for a certain type of purchaser in conjunction with private offerings of securities. *See COX ET AL.*, *supra* note 6, at 392. Essentially, the "sophistication" standard, as it relates to private offerings under the '33 Act, requires that prospective purchasers of a security have a certain level of income, have access to information from the issuer comparable to that found in a registration statement, and have "sufficient knowledge and experience in business affairs to enable the purchaser to evaluate the risks of the investment." *Mark v. FSC Sec. Corp.*, 870 F.2d 331, 336 (6th Cir. 1989).

96. Statement of the Comm'n Regarding Use of Internet Web Sites to Offer Securities, Exchange Act Release No. 34-39779, 66 SEC Docket 1869 (Mar. 23, 1998).

97. *Id.* at 1870.

98. *See id.* at 1871.

99. *See id.*

100. *Id.* at 1870. Of course, the "jurisdictional tests" spoken of by the SEC may prove very difficult to apply in practice, as the Internet is not actually located in any one place but is instead a word used to describe a worldwide network of interconnected computers. *See Gavis, supra* note 28, at 373. Hence, it is difficult to assert that solicitations or sales occur in any one locality.

101. Although, as Gavis notes, market participants will become increasingly involved in a variety of roles through the Internet, as was the case with Spring Street, which acted as both the issuer and market-maker for its stock. *See Gavis, supra* note 28, at 375. Such "blurring of distinctions," as Gavis terms it, has previously been the domain of "boiler-room" firms who sought to promote their own inventory of penny stock for worthless companies that the firms had themselves created. *Id.*; *see BEAVEN, supra* note 3, at 51; *see also id.* at 185 (defining "shell company").

small-cap issuers should conduct offerings online. The guidelines provided by the SEC for offers or solicitations of securities made online, as of this writing, do not affirmatively address the prevention of fraud on the Internet other than to state that material misstatements or omissions make the market participant subject to liability under federal securities laws.<sup>102</sup> In fact, the distinct impression that one gets from the SEC's approach to dealing with the problems raised by Internet securities offerings and trading is that no clear consensus exists on how such offerings and trading should take place. At present, no provisions provide either issuers or broker-dealers a clear picture of how to conduct their activities in cyberspace. Without such provisions, legitimate issuers will have to engage in the time-consuming process of seeking a no-action letter in order to make their offering a possibility.<sup>103</sup> More importantly, the lack of guidance from the SEC on the prevention of fraud and the corresponding lack of adequate regulation over penny stock offerings made online will ensure that the instances of microcap fraud will continue to be difficult to recognize, as investors will not be able to refer to any benchmark for determining whether a given website offering or touting a penny stock is compliant with federal securities laws.

### C. The "Cybervigilante" Response

Some investors are unwilling to wait for the SEC or other regulatory bodies to create a new set of rules and penalties for online securities fraud.<sup>104</sup> Instead, these investors have formed "cybervigilante" groups who alert other investors to instances of potential securities fraud.<sup>105</sup> These "vigilantes" warn other investors through establishing links at suspected sites or through e-mail sent to investors detailing the alleged fraud or shady nature of the offered securities.<sup>106</sup> Many of these self-styled "cybervigilantes" feel that the SEC oftentimes reacts too slowly to cases of alleged Internet securities fraud and thereby fails to recover the lost funds of investors in the majority of its enforcement actions.<sup>107</sup>

The lengths to which the cybervigilantes will go to expose potentially fraudulent online investments are impressive. For example, Silicon Investor features a link asking for submissions to the "Scammy Awards,"<sup>108</sup> which were billed as the awards for the Internet's most dubious investment opportunities.<sup>109</sup> On a more serious note, cybervigilantes have been targeting the purveyors of some of the Internet's more dubious investment offerings and advice and have established a "thread"—a series of posted messages—entitled "Stocks That Should Be Investigated by the SEC."<sup>110</sup>

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102. See Statement of the Comm'n Regarding Use of Internet Web Sites to Offer Securities, Exchange Act Release No. 34-39779, 66 SEC Docket 1869, 1870 (Mar. 23, 1998).

103. See, e.g., Mason, *supra* note 34, at 497.

104. See Brooker, *supra* note 1, at 187.

105. See *id.* at 198.

106. See *id.*

107. See *id.*

108. *Silicon Investor* (last modified Mar. 31, 1999) <<http://www.techstocks.com/~wsapi/investor/Subject-24628>>.

109. See *id.* The "Scammy Awards" were presented via the techstocks website on February 25, 1999, which, not coincidentally, was the same night as the Grammy Awards. See *id.*

110. Brooker, *supra* note 1, at 198.

One of the most visible of the cybervigilantes, Janice Shell, is especially notable for her devotion to exposing the various types of penny stock fraud conducted over the Internet.<sup>111</sup> After an Internet stock scam defrauded her a few years ago, Shell dedicated herself to pursuing Internet securities fraud and claims that she has exposed, over the past two years, “an investor relations director with a murder rap, a so-called biotech company that actually sold kitty litter, and a CEO who claimed to have run the largest corporation in Nevada but who was really the head of a two-man air-conditioning repair shop.”<sup>112</sup>

But Shell recently took part in a scheme previously reserved only for Internet penny stock purveyors: she staged her own fraudulent Internet IPO on April Fools’ Day 1997.<sup>113</sup> Shell’s site was for “FBN Associates,”<sup>114</sup> which purported to offer a product called “NeuralNet 2000” that would cure the Year 2000 (“Y2K”) bug in “one minute or less.”<sup>115</sup> While such a scheme may sound outrageous in retrospect, it successfully generated a number of sincere responses,<sup>116</sup> and Shell claims to have been flooded with requests for prospectuses and additional information about the company.<sup>117</sup> While ostensibly created for satirical effect, Shell’s FBN site aptly demonstrates the ease with which enterprising con artists can create sites that, even to a knowledgeable observer, appear perfectly legitimate. Moreover, the very existence of the “cybervigilante” groups points toward a need for more comprehensive regulation of Internet penny stock offerings by the SEC because these groups, who actively investigate and obtain detailed knowledge of various Internet penny stock scams, do not view the SEC’s enforcement efforts as having the needed deterrent effect.<sup>118</sup>

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111. *See id.* at 198, 200.

112. *Id.* at 200. Notably, Shell investigated a mining company entitled “Mountain Energy” that claimed to own a tract of land worth two hundred million dollars but which, following Shell’s investigation, proved to be worth a paltry one hundred thousand dollars. *See id.* Following a warning posted by Shell on Silicon Investor’s website, shares of Mountain Energy plummeted from one dollar and seventy cents to twenty-two cents. *See id.* Investors who had already purchased shares in Mountain Energy were subsequently outraged at Shell for depressing the value of their stock, and then at Mountain Energy when the SEC halted the trading of its stock and the company shut its doors, dismissed its employees, and disconnected its telephone. *See id.* The SEC has not presently filed an action against Mountain Energy but is monitoring it. *See id.*

113. *See id.* at 202; *FBN Associates* (visited Aug. 30, 1999) <<http://www.magnetdiary.com/fbn/>> (announcing the IPO of bogus company FBN Associates); *see also Silicon Investor*, *supra* note 108 (appearing to solicit investment in bogus company FBN Associates).

114. “FBN” stands for “Fly By Night.” *See Brooker, supra* note 1, at 202.

115. *FBN Associates, supra* note 113.

116. The site is, in fact, quite impressive and, as Brooker notes, is seemingly legitimate except for one small tip left by Shell—a link to a news release that proudly announces, “FBN Associates to receive Papal blessing. Company journeys to Vatican for ceremonies.” *Id.*; *see Brooker, supra* note 1, at 202.

117. *See Brooker, supra* note 1, at 202.

118. *See id.* at 198. While the cybervigilante groups may be an extreme example of the cynicism of investors concerning the SEC’s enforcement efforts against online penny stock fraud, they are not alone. Investors complain that by the time the SEC actually pursues an action against penny stock con artists, the company, the con artist, and the investors’ funds

## III. THE NEED FOR BETTER REGULATION: THREE SCHEMES

However, the question of what exactly should be done with regard to regulation of online penny stock offerings is not easily answered. Investors, such as Janice Shell, may wonder whether any measures taken by the SEC or any other regulatory body will ever prove effective enough to prevent or stop the "exploding" phenomenon of online penny stock fraud.<sup>119</sup> Additionally, the prevalence of microcap fraud over the Internet may create the impression among investors that all online penny stock offerings are illegitimate, thereby damaging an important source of capital for small companies. Finally, investors may begin to view the Internet as inherently risky for investing if sufficient safeguards against microcap fraud are not implemented, and such a perception may extend to other areas of business which could ultimately hinder the growth of the Internet as a vehicle for commerce.<sup>120</sup> But whatever the measures taken by regulatory agencies to combat Internet microcap securities fraud, the regulations must not be so cumbersome as to impede the development and emergence of small companies whose plans for growth, expansion, or simple survival hinge on the speculative capital investments that investors can provide.

Consequently, the SEC and other regulatory bodies have the task of determining what to do to stem the present tide of penny stock fraud being conducted over the Internet. One viable option that the SEC, the FTC, and the NASD have already implemented, in part,<sup>121</sup> is to conduct a national public relations campaign to educate investors about the risks of investing online and what to do to protect themselves from becoming victims. Another possibility for combating Internet fraud would be to halt, at least temporarily, all online trading in penny stocks as penny stocks are defined in the Penny Stock Rules.<sup>122</sup> While the halt in trading would not entirely prevent penny stock fraud, it would stop at least some of the fraud and alert investors of the risks of penny stock investing over the Internet. Finally, the SEC could amend the Penny Stock Rules to specifically address the issue of Internet penny stock fraud, to eliminate the loopholes in the rules that permit broker-dealers to easily circumvent their requirements,<sup>123</sup> and Congress could significantly expand the penalties for making materially false or misleading statements or omissions.

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have disappeared. *See id.* However, while the medium of the Internet may be new for penny stock scams, the complaints of investors regarding slowness of SEC enforcement actions is well established. *Cf.* BEAVEN, *supra* note 3, at 53-54 (discussing Hughes Capital, a penny stock).

119. Brooker, *supra* note 1, at 187.

120. *See Scams Affecting Consumers*, *supra* note 35, at 33 (statement of Hon. Robert Pitofsky, Chairman, FTC).

121. *See* MacMillan, *supra* note 44.

122. *See* 17 C.F.R. § 240.3a51-1 (1998).

123. *See* Hernandez, *supra* note 16, at 34.

*A. Public Information: Getting the Word out*

It would not be difficult to conclude from the multitude of penny stock scams present on the Internet<sup>124</sup> and the corresponding number of victims<sup>125</sup> of such scams that investors have had little or no warning about the dangers of investing in penny stocks offered online. However, the SEC, the FTC, the NASD, and NASAA have all taken steps to advise caution to investors and have provided investors with a variety of tips on how to research an online offering of a penny stock.<sup>126</sup> What is not certain is how widespread the warnings need to be in order to be effective.<sup>127</sup> Given the amount of penny stock fraud presently occurring on the Internet, investors are obviously not educated enough to avoid the risks of investing online.

Accordingly, as one possible solution to the burgeoning amount of penny stock fraud occurring online, the SEC could launch a national public relations campaign to educate investors about Internet penny stock fraud and to encourage them to take the affirmative steps necessary to prevent themselves from becoming victims. The program would have the advantage of being relatively simple to implement, provided that the SEC and other regulatory bodies could arrange for the funding to be allocated, and would constitute a proactive step that would alert all potential investors rather than the purely reactive stance that the SEC has taken thus far.<sup>128</sup> Additionally, a nationally conducted education campaign for investors, if conducted via print, television, radio, as well as the Internet, would have the desired effect of alerting the public at large to the risks of penny stock investing over the Internet. Finally, a national education campaign would not require any substantial rewriting of federal securities laws or regulations to accommodate the Internet as a new medium for offers, sales, and trading of penny stock.

But even if such a campaign succeeded, it might not wholly serve the purpose of federal securities laws, which were created to protect investors and to increase investor confidence in the U.S. capital markets.<sup>129</sup> In other words, the '33 Act was

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124. See, e.g., Brooker, *supra* note 1, at 187; see also *SEC Charges 44 Stock Promoters in First Internet Securities Fraud Sweep* (last modified Oct. 28, 1998) <<http://www.sec.gov/news/netfraud.htm>>.

125. See, e.g., Brooker, *supra* note 1, at 187; see also *SEC Charges 44 Stock Promoters in First Internet Securities Fraud Sweep*, *supra* note 124.

126. See MacMillan, *supra* note 44.

127. For instance, investors may not even be aware of the websites of the SEC or FTC. The testimony of Barry D. Wise, a certified public accountant, provides a disturbing but likely all too common example of the manner in which many investors approach Internet investment opportunities. According to Wise, he simply conducted his investigation of Fortuna Alliance, an investment "opportunity" that turned out to be a pyramid scheme, by "carefully studying" the site and making his determination to invest based on what he found out from Fortuna's own Web page. *Scams Affecting Consumers*, *supra* note 35, at 25. Although such evidence is anecdotal, it is nevertheless instructive in understanding the way many consumers and investors accept information posted on the Internet at its face value.

128. That is, in order to take advantage of the SEC's website, one must know it exists in the first place. The testimony of Barry D. Wise demonstrates that most investors do not even know enough to not accept information posted on the Internet at its face value. See *id.*

129. See Levitt, *supra* note 21, at \*1.



enacted with the "orientation [of] disclosure,"<sup>130</sup> while the Exchange Act was created as "a laundry list of problems for which Congress articulated neither the means nor the end objective" and instead "created the [SEC] and delegated to it the task of grappling with the problem areas."<sup>131</sup> Consequently, while a national investor education campaign on the part of the SEC and other regulatory bodies may increase overall investor awareness of the instances of penny stock fraud being conducted over the Internet, the campaign would not address disclosure by the small companies issuing penny stock nor would it address the issue of investor confidence in U.S. capital markets. As Chairman Levitt has stated, "[t]he SEC's mission is to protect investors,"<sup>132</sup> and that mission would not necessarily be served through alerting investors to the hazards of investing in small-cap stocks on the Internet.

At the very least, however, a public relations campaign could slow down, if not halt, the effectiveness of many of the fraudulent schemes present on the Internet. As Chairman Levitt stated, while speaking of the feasibility of allowing social security funds to be invested in the stock market,<sup>133</sup> investors need to understand "one word . . . and that is risk."<sup>134</sup> Additionally, as Chairman Levitt noted, "a great influx of new investors can sometimes test [the] integrity [of U.S. capital markets] by providing more opportunities for fraud."<sup>135</sup> Certainly the influx of investors onto the Internet has created a multitude of opportunities for fraud and the Internet's current popularity with investors accounts for at least some of the Internet's popularity with penny stock promoters.<sup>136</sup> Consequently, while an investor education campaign may not serve the ostensible goals of federal securities laws or completely halt the amount of securities fraud taking place on the Internet, it may constitute an important first step in educating investors to use considerable caution when investing online in penny stocks.

*B. A Temporary Halt in Trading: Drastic Measure  
or Proportional Response?*

The data on Internet penny stock fraud is not entirely reliable, as figures are subject to constant change, but the number of complaints made to the SEC each day,<sup>137</sup> as well as the numerous stories of investors who have been defrauded, suggest

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130. COX ET AL., *supra* note 6, at 7.

131. *Id.*

132. Levitt, *supra* note 21, at \*2. Although, to be fair, some critics might applaud a less paternalistic approach from the SEC in protecting investors. See COX ET AL., *supra* note 6, at 13.

133. Levitt, *supra* note 21, at \*1.

134. *Id.* at \*3.

135. *Id.* at \*2.

136. See Brooker, *supra* note 1, at 188. Probably just as compelling a reason for the popularity of Internet stock scams is the ease with which penny stock promoters can disseminate solicitations and obtain low-cost advertising. See *id.* at 187; see also Dugas, *supra* note 38, at 5B.

137. The complaints number over 100 per day. See Brooker, *supra* note 1, at 187. For more information about the exploding number of Internet stock scams and the SEC's difficulties in stemming the tide of scams affecting investors, see also Mayer, *supra* note 76, and Timothy

that the problem of Internet penny stock fraud is spiraling out of control.<sup>138</sup> If Chairman Levitt is correct in saying, while speaking of the proposed investment of social security funds in the stock market, that “novice investors are our society’s most vulnerable citizens,”<sup>139</sup> then perhaps the drastic measure of having the SEC temporarily halting online trading in penny stocks, as they are defined in the Penny Stock Rules,<sup>140</sup> is warranted.

While the prospect of halting online trading in small-cap stocks may seem excessive to those unacquainted with the growing problem of Internet securities fraud, the current regulatory actions by the SEC and the FTC, as well as by self-regulatory agencies such as the NASD, are not effective.<sup>141</sup> In fact, the goal of creating and maintaining investor confidence in U.S. capital markets has already fractured, as can be seen, for example, in the formation of “cybervigilante” groups who police the Internet themselves.<sup>142</sup> Additionally, in light of the disparity in investor complaints to the SEC and the number of enforcement actions against online stock promoters that the SEC pursues, it seems evident that the SEC cannot meet its obligation to protect investors.<sup>143</sup>

A temporary halt in online trading would draw attention to the problem of Internet securities fraud in a dramatic fashion, and would also allow regulatory agencies to address the backlog of cases that may have accumulated and to devote more resources to investigating and prosecuting investor complaints. Second, a temporary halt in online trading would deprive penny stock promoters of their most needed resource: capital from unwitting investors. Third, a move of this sort may very well send a message to investors that the SEC and other regulatory bodies are taking appropriate steps to restore investor confidence in online trading.

Of course, regulators will not likely implement such a draconian solution for a variety of reasons. Principally, regulators would most likely fear the damage that would be done to legitimate small issuers whose survival depends on the speculative capital provided by investors. Such small companies might have to suspend or downsize their operations if investors were suddenly prohibited from making online

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O’Brien, *Stock Hucksters Thrive on the Web*, N.Y. TIMES, Aug. 23, 1999, at A1.

138. The problem is reflected, as discussed in Parts II.A. and II.B.2. of this Note, by the variance in the number of investor complaints to the SEC and the number of actions that have been filed—that is, 30 SEC actions per year to over 100 complaints per day. See, e.g., Brooker, *supra* note 1, at 187. But see Joseph F. Cella III & John Reed Stark, *SEC Enforcement and the Internet: Meeting the Challenge of the Next Millennium*, 52 BUS. LAW. 815, 835 (1997), for a diametrically opposite view regarding the sufficiency of current SEC “antifraud weapons.” Despite the apparent attempts of “a lot of guys layin’ down a lot of rules and regulations,” *id.*—presumably referring here to the SEC—it is obvious from the burgeoning amount of securities fraud now conducted over the Internet that the present antifraud measures are inadequate to deter would-be stock hucksters or to sufficiently warn investors.

139. Levitt, *supra* note 21, at \*2.

140. See 17 C.F.R. § 240.3a51-1 (1998).

141. See generally Brooker, *supra* note 1.

142. See *supra* Part II.C.

143. See *supra* Part II.B.2.

trades. Moreover, as this Note discussed,<sup>144</sup> the many investors who trade over the Internet trade heavily in the stocks of small issuers,<sup>145</sup> although the overall benefit to capital markets of increased trading in penny stocks is somewhat questionable.<sup>146</sup>

Another factor that the SEC and other regulatory bodies must consider is competition from the capital markets of other countries.<sup>147</sup> A halt in online trading by the SEC could necessarily only apply to the territorial boundaries of the United States, which would mean that penny stock offerings from other countries would continue unabated. An additional concern is that U.S. regulatory agencies could garner a reputation—particularly outside of the United States—for enforcing even more stringent and paternalistic regulations than are presently in place,<sup>148</sup> and such a perception among foreign issuers could dampen their willingness to trade on U.S. exchanges.<sup>149</sup>

Furthermore, the SEC might very well find its backlog of complaints from investors actually increasing from a temporary halt in online trading because not all

144. See *supra* Part II.A.

145. See Cruz, *supra* note 39, at 3.

146. See *id.*

147. Competition from the capital markets of other countries has been a major factor in the SEC's promulgation of rules that make registration requirements less onerous for foreign issuers than for U.S.-based companies. See COX ET AL., *supra* note 6, at 322-23.

148. Securities regulation in the United States is "unrivaled anywhere else" and "most other industrialized countries do not maintain the level of enforcement staffs as regularly police American securities markets." *Id.* at 30.

149. See James D. Cox, *Rethinking U.S. Securities Regulation in the Shadow of International Regulatory Competition*, 55 LAW & CONTEMP. PROBS. 157, 161 (1992). According to Cox, foreign issuers are generally far less eager to expose themselves to U.S. securities regulation because of the perceived additional transaction costs in doing so. See *id.* at 183. In support of his argument, Cox cites the example of Japanese issuers who choose to list on the London Stock Exchange rather than on any U.S. exchange:

The far larger number of Japanese firms listing their shares on the London Stock Exchange . . . is consistent with the view that Japanese companies (and certainly other foreign issuers) do not find that the benefits of listing their shares in the United States provide sufficient reward for the additional disclosure duties and associated costs. . . .

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Both the reluctance of foreign issuers to list their shares for trading in the United States and the larger number of U.S. issuers who raise capital abroad point to a single financial truth: the overall rewards of investing and raising capital abroad are greater than the discounting that occurs due to less demanding foreign disclosure standards.

*Id.* at 183-84 (citations omitted).

Of course, one may very well question the validity of Cox's arguments, which were made prior to the explosion of Internet trading, in today's capital markets. While the spectre of U.S. securities regulation may continue to haunt some foreign issuers, it is difficult to imagine that a great many foreign issuers would not want to take advantage of the robustness and fluidity of current U.S. markets.

Additionally, as noted before, the problem of jurisdiction for SEC and state securities enforcement actions complicates matters greatly, since foreign issuers may argue that the SEC's heavy regulatory hand overstepped its boundaries. See *supra* note 100.

issuers or promoters would stop offering penny stocks to investors. Con artists such as Matthew Bowin<sup>150</sup> routinely operate outside the boundaries of federal securities laws and apparently are undeterred by the possibility of civil and criminal penalties.<sup>151</sup> Likewise, penny stock promoters may simply change their offerings enough to evade the definition of penny stock as found in the Penny Stock Rules<sup>152</sup> and so evade any outright violation of a mandatory halt in trading.

Ultimately, then, while a halt in Internet trading of penny stocks may be desirable from an enforcement standpoint, the logistical and practical difficulties of such an action by the SEC would likely render it impossible to carry out. Therefore, the question of what to do about the explosion of penny stock fraud on the Internet still remains unanswered.

### *C. New Regulations and Strict Liability*

If a campaign to educate investors is unlikely to stop them from purchasing penny stocks of questionable value, and a halt in online trading of penny stocks is impractical or impossible to execute, another solution must be contemplated. When the SEC enacted the Penny Stock Rules, the medium for trading such securities was the over-the-counter market.<sup>153</sup> At that time, very little securities trading took place online compared to the present, and the Internet had yet to assume its current commercial importance.<sup>154</sup>

The massive growth of the Internet as a commercial tool necessitates reevaluating how the SEC should regulate Internet stock trading in order to protect consumers. For offers, sales, and trading of securities, such a reevaluation means creating rules that are specifically tailored to the Internet and that address how investors should be protected in this new environment. Traditional, paper-based disclosure methods will be ineffective as will mandates that state that electronic submission of such forms will satisfy disclosure requirements because it is impossible to know if investors have actually received them since there is neither physical, tangible proof of their delivery nor is there any way to know if they will be delivered in time for investors to peruse them before making an investment decision.

What is needed is a set of specific rules that address how online buying and selling of securities should take place, which method for disclosure of information over the Internet should be used, what safeguards should be in place to protect investors, and how a stricter set of penalties for violations of federal securities laws should be implemented. Such a solution will not, of course, completely prevent fraud from occurring on the Internet, but the enactment of these types of provisions would at least provide mechanisms that would reduce the amount of fraud by making it harder

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150. See Brooker, *supra* note 1, at 187.

151. See *id.* at 202.

152. 17 C.F.R. § 240.3a51-1(1998).

153. See *supra* note 12.

154. Charting commercial use of the Internet is inherently problematic since it is not taxed or highly regulated but, according to Senator Glenn, the "Internet market exceeded \$1 billion in 1995 and . . . [will] grow by the year 2000 to more than \$23 billion." *Scams Affecting Consumers*, *supra* note 35, at 3.

to commit and by adding a deterrent effect that so far has been missing from federal securities laws.

### 1. Penny Stocks: Who Should Sell and Who Should Tell

One of the most problematic areas of the Penny Stock Rules is actually not found in the "Penny Stocks" section of the Exchange Act<sup>155</sup> but is instead located within the definition of penny stocks themselves along with a corresponding list of exemptions.<sup>156</sup> The difficulty with the list of applicable exemptions for penny stocks is that issuers and broker-dealers find it relatively easy to avoid their provisions, thereby divesting the Penny Stock Rules of much of their regulatory importance.<sup>157</sup> As O. Douglas Hernandez, Jr., points out, the definition of penny stocks leaves substantial gaps through which unscrupulous stock promoters may slip while defrauding investors:

Penny Stock Rule 3a51-1 modifies the definition of penny stock by exempting certain kinds of equity securities from the definition. The purpose of Rule 3a51-1 was to limit the heightened disclosure requirements under the [Penny Stock Act] to those low-priced, lightly-traded securities that have proven most susceptible to fraudulent sales practices.

. . . .  
The SEC's narrowing of the definition of "penny stock" is problematic for two reasons. First, broker-dealers can circumvent the protections enacted under the Penny Stock Rules by simply issuing securities that do not fall within the scope of the narrowed definition. . . . Second, securities priced at any level may be subject to market manipulation by broker-dealers. For these reasons, the SEC should have utilized a net capital standard . . . to define a penny stock, rather than the per-share price of an issuer's security.<sup>158</sup>

According to Hernandez, the solution that the SEC ought to have enacted would be to define a penny stock by the "net capital" of its issuer, which would presumably allow the SEC greater flexibility in identifying thinly capitalized issuers who are likely to be used in a market manipulation scheme.<sup>159</sup> With such a definition for penny stocks, issuers cannot as easily evade SEC disclosure requirements, which were principally the focus of the Penny Stock Act.<sup>160</sup>

155. See 17 C.F.R. §§ 240.15g-1 to -100 (1998).

156. See 17 C.F.R. § 240.3a51-1.

157. See Hernandez, *supra* note 16, at 34.

158. Hernandez, *supra* note 16, at 33-34 (footnotes omitted).

159. *Id.* at 34; see also BEAVEN, *supra* note 3, at 51-52 (describing a typical market manipulation scheme). Usually, the "issuer" is nothing more than a shell company created by the penny stock firm which artificially inflates the price per share of the issuer and then "dumps" the stock when the firm decides it has sold all the shares it has in its inventory and therefore cannot raise the price any further. The price is inflated by aggressive cold calling to unsophisticated investors. See *id.* The investors are then left with the worthless shares. See *id.* Using a net capital standard would, in theory, expose the thinly capitalized nature of the issuer as well as make it more difficult for stock promoters to evade the penny stock definition. See Hernandez, *supra* note 16, at 33-34.

160. See Hernandez, *supra* note 16, at 33-34.

But a change in the definition of a penny stock is only a beginning in making disclosure requirements for penny stock promoters less easy to evade. In the context of offerings made over the Internet, issuers, broker-dealers, and other market participants should not be permitted by the SEC to make any solicitation or accept "buy" offers from investors until the full disclosure intended behind Schedule 15G of the Penny Stock Rules<sup>161</sup> is delivered to prospective purchasers of a security. Such a disclosure could be accomplished by requiring "pop-up" screens<sup>162</sup> to appear before investors could make a purchase, as one possibility. Or, as another possibility, the SEC could require investors to click on a "link" that would take them to a website maintained by the SEC or one of the self-regulatory agencies, such as the NASD, before completing a purchase of penny stock. Yet another possibility would be for offerings to be conducted through a broker-dealer or issuer who has established a "password" system<sup>163</sup> that would certify that investors had been provided with the necessary disclosure documents and had still elected to purchase penny stocks. By enacting such steps, and taking advantage of the technology that the Internet offers, rather than attempting to make the antifraud provisions of the '33 Act and the Exchange Act fit, however awkwardly, into the present state of Internet offerings and trading of securities, the SEC could more effectively ensure that investors have all the necessary data to make an informed investment decision.

Effectively, then, the SEC would make penny stocks a "controlled" security, in the context of the Internet, insofar as investors would need to complete a series of steps in which disclosure documents were provided that would advise them of the potential risks involved before they could complete a purchase. Such provisions for Internet delivery of disclosure documents would follow the general mandate of Penny Stock Rule 15g-100,<sup>164</sup> but would provide some specific guidance for Internet penny stock offerings. The provisions also would specify the method of delivery over the Internet, which is important due to the problem of e-mailing disclosure statements, which could prove difficult for issuers to prove in retrospect and easy for investors to ignore given the amount of "spam" (junk e-mail) currently sent over the Internet.

The foregoing does not mean that investors would not still make purchases of penny stocks or that such purchases would result in financial losses to the investors. But, at the very least, investors would actually have received disclosure documents

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161. 17 C.F.R. § 240.15g-100 (1998). Of course, the counterargument is that broker-dealers, faced with heavier regulations and liabilities for Internet offerings of penny stocks, will either refuse to offer penny stocks altogether or will raise the price of conducting penny stock offerings so much so that small issuers will effectively be barred from raising capital through penny stocks. However, such arguments suffer from the weakness of relying on speculating about what broker-dealers might or might not do, and do not reflect the present reality that despite the SEC's numerous actions against brokers and broker-dealers for fraudulent offerings of penny stocks, the small-cap market continues to flourish. *See generally* BEAVEN, *supra* note 3; *see also* Brooker, *supra* note 1, at 188.

162. A "pop-up" screen is a screen of text or graphics, or both, that appears when a site is accessed.

163. A "password" system could resemble that of IPONet, *see supra* text accompanying note 92, except that anyone who wished to purchase penny stocks from an issuer or broker-dealer would be required to take this extra step. *See* Mason, *supra* note 34, at 494.

164. 17 C.F.R. § 240.15g-100.

such as Schedule 15G<sup>165</sup> before making the decision to purchase a penny stock online. The SEC could further protect investors by simply narrowing the types of broker-dealers or issuers who may offer securities over the Internet. A restriction specifying that only issuers who, say, agree to only solicit for a specific dollar amount within a given year<sup>166</sup> after they have been given an effective registration statement by the SEC<sup>167</sup> before they can solicit for penny stock online would help reduce the incentive that many "boiler-room" firms have to make a large profit at the hands of unsophisticated and inexperienced investors. Other issuers who wished to solicit more than the annual dollar cap would need to seek a no-action letter from the SEC before they could proceed with an offering. Broker-dealers who wished to solicit investors online for penny stock offerings could be required by the SEC to meet a higher than usual professional standard and to not have been the subject of any enforcement proceedings by the SEC under the SEC's broker-dealer standard setting authority in § 15(b)(7) of the Exchange Act.<sup>168</sup> The imposition of stricter requirements for the types of issuers and broker-dealers who are able to effect penny stock transactions online, as well as more specific methods for online disclosure, would enable the SEC to make the Internet safer for would-be investors in the small-cap market.

## 2. Strict Liability for All and Heavier Penalties

In addition to policing the types of issuers and broker-dealers who wish to offer penny stock online, and specifying the methods by which penny stock may be offered online, the penalties for committing fraud need to be more substantial in order to have the desired deterrent effect.<sup>169</sup> Also, the imposition of strict liability for anyone who stands to benefit financially, directly or indirectly, from the activities of penny stock promoters could potentially expand the class of defendants against whom an action may be pursued. Presently, the liability for material misstatements or omissions in a registration statement, for instance, subjects only the issuer to strict liability.<sup>170</sup> Expansion of strict liability to anyone connected with preparing the registration statement *when made via the Internet* would create a greater incentive on the part of those preparing the registration statement to avoid being involved in the creation of shell companies that are the preferred issuer of penny stock promoters.

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165. *Id.*

166. Perhaps something similar to the dollar limitations of Regulation D of the '33 Act. 17 C.F.R. § 230.501 (1998).

167. *See COX ET AL.*, *supra* note 6, at 4.

168. 15 U.S.C. § 78o (1994).

169. *See Brooker*, *supra* note 1, at 202. Brooker states that the "maximum penalty" for Matthew Bowin would be eight years in prison, but Bowin actually received a ten-year sentence from Santa Cruz County Superior Court. *Id.* at 202; *Online Stock Fraud Brings 10 Years in Jail*, *supra* note 63, at 12. However, Bowin will only serve four-and-a-half years before he is eligible for parole. *See Online Stock Fraud Brings 10 Years in Jail*, *supra* note 63, at 12.

170. *See* 15 U.S.C. § 77k (1994).

Moreover, the imposition of a “scienter” requirement for Exchange Act Rule 10b-5 by the Supreme Court in *Ernst & Ernst v. Hochfelder*<sup>171</sup> necessitates a rethinking of the language in § 10(b) of the Exchange Act<sup>172</sup> on which the *Hochfelder* Court premised its decision.<sup>173</sup> Obviously, the imposition of a scienter requirement by the *Hochfelder* Court makes an action against a penny stock promoter, for example, harder to pursue because satisfying that a promoter had “a mental state embracing intent to deceive, manipulate or defraud”<sup>174</sup> is clearly quite difficult to prove in retrospect because such a required mental state is necessarily a nebulous and subjective standard which cannot be established except through inference or confessions of guilt by the accused. This is particularly the case in the context of the Internet, where evidence of communications that might demonstrate such a mental state may prove impossible to obtain in any tangible, permanent form, given the transitory nature of e-mail and other Internet communications. A redrafting of the language in § 10(b) of the Exchange Act<sup>175</sup> that specifically did not use the term “employ” might allow the SEC to institute an action under Rule 10b-5 that did not require scienter.<sup>176</sup>

Criminal sanctions should likewise be easier for prosecutors to bring against Internet penny stock promoters. For instance, under the wire fraud statute,<sup>177</sup> “the government must establish that the defendant had *knowledge* of a scheme to defraud.”<sup>178</sup> As Cox points out, a scienter requirement for the wire fraud statute may allow salespersons who sell fraudulent investments to evade criminal sanctions if the government cannot prove that the salespersons *knew* that the investments were fraudulent.<sup>179</sup> In the context of Internet penny stock promoters, it may prove very difficult indeed to demonstrate that the salesperson was aware or should have been aware<sup>180</sup> that the scheme was fraudulent since the communication from salesperson to investor may consist of e-mail or other electronic communications that are not tangible and permanent in nature. Web pages, links, and online “newsletters” present even trickier questions, because they only give out information or advice that the creators of such pages may assert was provided to them by a third party and so escape criminal penalties under the wire fraud statute.

Overall, a redrafting of the securities laws establishing strict liability in the context of Internet offerings would offer a relatively streamlined system for pursuing enforcement actions as well as deterring future violations of securities laws by

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171. 425 U.S. 185 (1976).

172. 15 U.S.C. § 78j (1994).

173. See COX ET AL., *supra* note 6, at 697. *Hochfelder*'s scienter requirement was later extended to SEC injunctive actions in *SEC v. Aaron*, 446 U.S. 680 (1980). See COX ET AL., *supra* note 6, at 698.

174. *Hochfelder*, 425 U.S. at 193 n.12.

175. 15 U.S.C. § 78j (1994).

176. Of course, revision of the Exchange Act Rules or sections would necessitate congressional action. Given the prevalence of fraud, however, such action is certainly warranted.

177. 18 U.S.C. § 1343 (1994).

178. COX ET AL., *supra* note 6, at 959 (emphasis in original).

179. See *id.* (discussing *United States v. Parker*, 839 F.2d 1473 (11th Cir. 1988)).

180. See *id.* (discussing *United States v. Simon*, 839 F.2d 1461 (11th Cir. 1988)).



expanding the potential class of defendants in enforcement proceedings. While such harsh penalties may not be appropriate for paper-based penny stock promotions, the Internet facilitates such promotions and greatly expands the potential number of victims exposed to penny stock schemes. Given the fact that Internet use for securities trading is relatively still in its infancy but is expected to more than triple in use over the next few years,<sup>181</sup> Congress and the SEC need to enact a more readily applicable set of penalties to discourage Internet stock fraud.

Clearly, then, the Internet presents a unique challenge to enforcement of federal securities laws that is unlike any previously faced by the SEC and federal prosecutors. A fundamental rethinking of the sanctions, burdens of proof, and the liability for the commission of securities fraud is necessary if the enforcement actions against Internet penny stock promoters are to be successful enough to provide the needed deterrent effect on potential future violators.

#### IV. CONCLUSION

Penny stock fraud over the Internet potentially presents one of the most serious threats to the stability of U.S. securities markets that has yet been encountered, due to the ease with which penny stock promoters may reach substantial portions of the U.S. population. Currently, penny stock promoters freely operate in an environment that poses little real risk or cost—financial or otherwise—to themselves while the funds of thousands, potentially millions, of ordinary investors are continually drained away by the promoters' fraudulent schemes. While the SEC and other regulatory bodies have taken commendable steps to educate and protect investors, the sad fact is that by the time action is taken against a penny stock promoter, the funds of investors have disappeared without a trace. In order to ensure investor confidence in the Internet as a medium for investing, and to protect the funds of investors from fraudulent schemes that may leave such investors penniless, the securities laws must reflect a newfound intolerance for securities fraud conducted through the Internet.

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181. See Brooker, *supra* note 1, at 188.