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INTERNET SECURITIES FRAUD: OLD TRICK, NEW MEDIUM

¶ 1 Billions of securities are traded every day in public and private markets around the world. This practice is hundreds of years old and as long as securities have been traded, someone has tried to defraud the system to make a quick buck. With the advent of the Internet, new securities fraud schemes have appeared.

Fraud on the Internet: Recent Examples

¶ 2 A number of recent Internet fraud cases dramatically demonstrate the extent to which this new medium creates potential for vast losses. The FBI's Internet Fraud Complaint Center (IFCC), a joint project with the Department of Justice (DOJ), reports that most Internet fraud complaints stem from online auctions. The amount at issue in these claims, however, pales in comparison to the multi-million dollar hoaxes perpetrated in the financial markets. Internet fraud involving stock information is the second most common form of investment fraud, amounting to losses of over \$10 billion a year.^{[1](#)}

¶ 3 One of the most common forms of securities fraud on the Internet involves an imposter who attempts to manipulate the price of a stock by disseminating phony press releases or information, or creating phony websites. A recent example of this scheme is the hoax perpetrated against PairGain Technologies. In the PairGain case, a former employee posted a fraudulent message on an Internet website designed to look like a legitimate Bloomberg news service page. The message falsely stated that a competitor was acquiring PairGain. In the resultant flurry of trading PairGain's stock rose 30%, and even after the message was debunked PairGain's stock remained high, eventually closing 10% up, a net gain of \$46.5 million. The false site convinced even money managers at the Wall Street news and thestreet.com.^{[2](#)}

¶ 4 Another recent example of the use of the Internet to disseminate phony information is the Emulex case. On August 25, 2000, the web-based news service Internet Wire posted a press release containing information about Emulex Corporation, a computer hardware manufacturer. The press release, posted just as the financial markets opened, stated that Emulex's CEO had resigned and that Emulex had been forced to restate 1998 and 1999 earnings as losses instead of initially reported gains. Other news services, including CBS Marketwatch, Bloomberg, and Dow

Jones, picked up the release's information about half an hour later. Emulex's stock, which opened at \$110.69/share, went into free-fall. By the time Nasdaq decided to step in and halt the slide until the information could be verified, the price-per-share stood at \$43, a loss of over 61%. In a matter of hours, Emulex stock suffered a net loss of over \$2 billion dollars.

¶ 5 According to the FBI, the press release was a fraud perpetrated by 23-year-old college student Mark Jakob, a former Internet Wire employee who recently lost money selling Emulex shares short. On August 17 and 18, Jakob "sold short" 3,000 Emulex shares at \$80/share. Selling shares short is a form of stock speculation; in effect, an individual borrows shares from a broker and sells them under the understanding that the individual must eventually buy them back to repay the broker. The buyer hopes that in the meantime the share price of the stock will drop below the price the buyer "borrowed" them at, so that he may later repurchase the shares to repay the broker and pocket the difference. Instead, Emulex stock rose to over \$113 a share and Jakob lost over \$97,000 when he was forced to repurchase the stock he sold for \$80/share at the new price. After submitting a press release to Internet Wire drafted in a manner that suggested it had already been reviewed for veracity, Jakob again began selling shares short, this time realizing a profit of more than \$54,000 as the stock plummeted. Jakob later sold another 3,500 shares short. His total profit from the hoax was more than \$241,000. On December 29, 2000, Jakob plead guilty to two counts of securities fraud and one count of wire fraud in connection with the hoax. His sentencing is scheduled for March 26, 2001; and he faces a maximum 46 months in prison, a \$220 million fine, and a possible \$110 million in restitution to Emulex shareholders. In addition, attorneys recently filed a class action lawsuit against Internet Wire and Bloomberg on behalf of Emulex shareholders.

¶ 6 A second form of Internet fraud comprises the category of "pump and dump" schemes. While the outcome of "pump and dump" schemes is identical to imposter schemes, namely the enrichment of the perpetrator at the expense of the majority of shareholders, the means employed to effectuate that result differ. Typically, the individual gives trading advice and tips to investors on the Internet, talking up stock that the individual already owns and then selling when the demand occasioned by the advice reaches a given level. A recent representative "pump and dump" case involved the website of Yun Soo Oh Park, who billed himself out as "Tokyo Joe" and specialized in stock tips and trading advice. On January 5, 2000, the Securities and Exchange Commission (SEC) filed fraud charges against Park, alleging that he used his website to maintain an ongoing "pump and dump" scam, talking up stocks he already owned to subscribers of his tips service and then surreptitiously selling them when demand increased. Between selling stocks he recommended and charging fees for subscription to his service, Park

made over \$ 1.1 million in a twelve-month period ending in June 1999. As a result of this activity, the SEC filed four counts against Park, the most relevant count being violations of the Investment Advisers Act of 1940, specifically 15 U.S.C. §88b-6(1) and 15 U.S.C. §80b-6(2).³

Legal Responses to Internet Fraud

The Investment Advisers Act

¶ 7 The Investment Advisers Act of 1940 was intended to regulate those individuals and companies providing investment advice by making it illegal for "investment advisors" to defraud their investors. In *Lowe v. Securities and Exchange Commission*, the Supreme Court set forth a definition of an investment adviser as a person who "for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling, or who for compensation and as part of a regular business, issue or promulgate analyses or reports concerning securities."⁴ The Court held that the intent for such a statute was clear—Congress was interested in "regulating the business of rendering investment advice, including publishing activities that a normal incident thereto."⁵ This broad definition is cut back by several exceptions, one of which is the First Amendment rights of the press to publish non-personalized information.

¶ 8 Park argued that his advice fell clearly within the First Amendment exception to this statute, in that his publications over the Internet website were both "bona fide" and had a "general and regular" circulation. The court wholly rejected this argument because Park's web-based advice was not a "bona fide" publication; it did not contain disinterested commentary and analysis, but rather published promotional material disseminated as a tout.⁶ In order to be considered a "general and regular" publication by the Court, the Defendant may not be one who "sends out bulletins from time to time on the advisability of buying and selling stocks."⁷ Moreover, when these bulletins are sent out, the court emphasized that a "regular" circulation "would not be timed to specific market activity, or to events affecting or having the ability to affect the securities industry."⁸ They ultimately decided that Park's activities violated the Investment Advisor's Act; that these activities fell within the category of activities that the Court deemed not to be "general and regular" circulation.⁹

The Communications Decency Act: The First Amendment, Fraud, and Internet Publishers

¶ 9 Nearly 50 years after the passage of the Investment Adviser's Act of 1940, technology forced Congress to address the subject again. In 1996, Congress passed the Communications

Decency Privacy Act, which provides in relevant part: "No provider . of an internet computer service shall be treated as the publisher or speaker of any information provided by another information content provider."¹⁰ Technology has recently introduced new forms of information providers, and this statute allows Congress to address the specific concerns of protecting freedom of speech on the new forum of the Internet. While immunity for bona fide newspapers and other paper forms of communication had clearly been established under the Investment Adviser's Act, the new wave of technology opened a door that needed to be explicitly protected as well.

¶ 10 Two recent cases involving this Act found that large Internet news services such as America Online (AOL), are in fact interactive computer service providers and are immune under both federal and state law from liability under §230 of the Communications Decency Privacy Act.¹¹ Under this Act, an "interactive computer service is an information service, system, or access software provider that provides or enables computer access by multiple users to a computer service, including specifically a service or system that provides access to the Internet." Furthermore, the statute also sets forth than an "information content provider," which is liable under this Act, is "any person or entity that is responsible, in whole or in part, for the creation or development of information provided through the Internet or any other interactive computer service."¹²

¶ 11 In *Kenneth Zeran v. American Online, Inc*¹³ an unknown individual posted defamatory statements about Mr. Zeran on AOL. Mr. Zeran then notified AOL of the postings and requested their removal. AOL removed the posting, but Zeran continued to receive threatening phone calls in connection with the published statements, and subsequently filed suit against AOL.¹⁴ Mr. Zeran argued that AOL was notified of the defamatory statements and took action to remove them, therefore AOL's immunity under §230 was negated by notice. Furthermore, Mr. Zeran contended that the affirmative actions taken by AOL in removing the statements constitutes an exercise of creation and development in the information itself. Since AOL had notice of their distribution of defamatory statements, Mr. Zeran argued that AOL is not a publisher, but rather a distributor, and is liable.¹⁵ The court, bearing in mind the intent of Congress to protect these Internet service providers and encourage freedom of speech on the Internet, held that for the purposes of §230 immunity, distributor liability is a subset of publisher liability, and therefore bars AOL from liability completely.¹⁶

¶ 12 Three years after the Zeran decision, the Supreme Court handed down a similar decision involving the same defendant, AOL, in *Ezra v. AOL*.¹⁷ In this case, the plaintiff wanted

to hold AOL liable for inaccurate stock information provided by Comstock on their website. Ezra founded its liability claim on the fact that defendant and Internet service provider, AOL, no longer was protected from §230 immunity because it took an active role in the creation and regulation of the false information released on its website.¹⁸ Relying on Zeran, the Court stated that imposing liability on AOL for such third party actions would treat Defendant as the publisher or speaker.¹⁹ Such liability is invalidated by §230 immunity for information service providers. The court recognized that it is possible for an interactive computer service to be found liable for information because it has created it, but mere regulation of any content on service's website did not qualify as a "creation."²⁰ Specifically in this case, the district court determined that while AOL did communicate with Comstock each time it found errors in stock information, this communication alone would not strip AOL of its immunity.²¹

¶ 13 Congress' desire to offer such immunity comports with its goal of maintaining and ensuring an unfettered atmosphere of speech and communication throughout the Internet. A high value is placed on freedom of speech on the Internet, and accordingly Congress has noted the importance of restraining government regulation in the medium. Tort liability imposed on service providers for the communications of third parties would prove to be an undue government regulation and ultimately would result in an unwelcome silence within a forum that service as a stage for a substantial amount of prolific speech. The Court recognized Congress' desire to encourage service providers to actively play a role in the regulation of obscene, fraudulent, and defamatory statements on their sites, when it declined to recognize such self-regulation as the creation of information which would exposes them to liability. The sheer amount of information posted on the Internet hampers government's ability to regulate all postings themselves, accordingly government must encourage self-regulation and thus strongly oppose any attempt to create liability on such regulation. In order to avoid being the subject of a lawsuit, service providers (including Internet news websites) would more than likely shun any attempts at self-regulation and allow fraudulent information to flourish throughout their websites.

¶ 14 It appears likely that the news services under suit in Emulex (Bloomberg and Internet News Wire) will prevail, as they will be immune from tort liability under §230 of the Communications Decency Privacy Act. Even if the news service providers were negligent, if not reckless, in posting and later disseminating fraudulent press releases, this potential harm is outweighed by Congress' explicit goals of preventing over-regulation and preserving free speech. The Court in Zeran acknowledged the importance of this goal when it noted that "if computer service providers were subject to distributor liability, they would face potential

liability each time they receive notice of a potentially defamatory statement-from any party, concerning any message."²² Consequently, in response to such notification a service provider would be forced to investigate; in effect chilling the very nature of the Internet Congress wishes to protect. In this respect both the Court and Congress have recognized the unique nature of the Internet. While researching all information published in a newspaper is possible and required, imposing such a requirement on interactive computer services, who receive an overwhelming amount of posting every day on their sites, would be an impossible burden with disastrous ramifications.²³

¶ 15 This being said, however, it is important to note that while computer services find themselves protected by immunity, the original culpable party who posts defamatory and fraudulent messages will not be protected by such measures. These individuals will find themselves subject to liability for such statements. As the court in *Zeran* was careful to point out, although Congress' focus is to keep government regulation of the Internet to a minimum, it is "also found to be the policy of the United States to ensure vigorous enforcement of Federal criminal laws to deter and punish trafficking in obscenity, stalking and harassment by means of computer."²⁴ Congress was forced to make an emphatic policy stance when faced with deterring harmful online speech. In balancing the competing interests of free speech on the Internet and punishment of Federal criminals, Congress and the courts make it clear that it would be a wrong decision to "deter harmful online speech through the separate route of imposing tort liability on companies that serve as intermediaries for the other parties' potential injurious messages."²⁵

Conclusion

¶ 16 While fraud is nothing new to securities trading, the Internet has allowed some unique and negative situations to recently arise. The government has addressed the issue; but it appears that as long as securities are traded, someone will try to defraud the system to make a quick buck; and the Internet only helps him or her out. The Internet has broadened our horizons and allowed instant communication across borders, but it also allows new securities fraud schemes to flourish.

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Footnotes

1. Internet Fraud Complaint Center (visited January 30, 2001) <http://www.fbi.gov/pressrm/pressrel/pressrel100/ifcc.pdf>
2. *Pairgain Worker Admits Fraud*, at <http://cnfn.cnn.com/1999/06/22/companies/pairgain/> (last visited Feb. 27, 2001).
3. S.E.C v. Yun Soo Oh Park, 99 F. Supp. 2d 889, 891 (N.D. Ill. 2000).
4. *Lowe v. Securities and Exchange Commission*, 47 U.S. 181, 203-204 (1985).
5. *Id.* at 204.
6. *See Park*, 99 F. Supp. 2d at 895.
7. *Id.* at 896.
8. *Id.*
9. *Id.* On February 7, 2001 Tokyo Joe reached a settlement with SEC investigators. Under the settlement he would pay a fine of \$750,000 without admitting any wrongdoing. This settlement remained subject to review by SEC commissioners and could be rejected or modified.
10. Communications Decency Privacy Act of 1996, Pub.L.No. 104-104, 110 Stat. 137-39 (codified at 47 U.S.C. §230 (c)(1) (1996)).
11. *See Ezra, Weinstein, and Co., Inc. v. American Online Inc.*, 206 F.3d 980 (10th Cir. 1997).
12. 47 U.S.C. §230(f)(2), (3).
13. 129 F.3d 327 (4th Cir. 1997).
14. *Id.* at 329.
15. *Id.* at 332.
16. *Id.* at 330-332.

[17.](#) 206 F.3d 980 (10th Cir. 2000).

[18.](#) *Id.* at 985

[19.](#) *Id.*

[20.](#) *Id.*

[21.](#) *Id.*

[22.](#) *Zeran*, 129 F.3d at 333.

[23.](#) *Id.*

[24.](#) *Zeran*, 47 U.S.C. §230(b)(5).

[25.](#) *Zeran*, 129 F.3d at 330-331.