SEC Completes Fifth Nationwide Internet Fraud Sweep

2001-06-28

As the Internet gains ever increasing popularity as a medium for communication and conducting business, government agencies are seeking to expand their enforcement authority to reach Internet activities, and are re-focusing some of their investigatory resources on this area. Illustrative of this trend is the recent Internet fraud "sweep" conducted by the Securities and Exchange Commission ("SEC"), which resulted in 11 separate SEC enforcement actions against 23 companies and individuals that allegedly used the Internet to defraud investors. As this most recent sweep is the fifth such nationwide investigation by the SEC – previous Internet sweeps took place in October 1998, February 1999, May 1999, and September 2000 – it is apparent that the SEC is committed to identifying and prosecuting frauds perpetrated over the Internet, and is prepare to devote significant resources to this end.

While the alleged frauds discovered by the SEC during its most recent sweep involve a variety of online means and techniques, the common thread is that the defendants used the Internet as a means of disseminating false or misleading information to "pump" their market capitalization and/or raise new funds from investors. In total, the SEC claims that the alleged perpetrators increased their market capitalization by over $300 million, and raised approximately $2.5 million in proceeds from U.S. and foreign investors. The enforcement actions concern both publicly-traded and privately-held companies, and assert claims against the companies, certain company officers or controlling shareholders, and in one case the consulting firm that created a website where misleading information was published.

A wide range of Internet communications were used to disseminate the allegedly false or misleading information, including company and industry websites, "spam" emails, electronic newsletters, hyperlinks and message boards. While each case presents distinct facts, the cases generally can be broken down into the following patterns of fraudulent conduct:

- False Promises of Imminent IPO

  : for example, one private company allegedly used "spam" email and a website announcement to raise funds based on the promise of an upcoming, SEC-approved IPO, where the SEC had not approved an IPO, and where the company in fact had no offices, no inventory, and no products or services to sell.
- Baseless Projections

  : these cases involve a wide range of misleading online statements about financial prospects, including baseless projections of revenue and market share. In one case, it appears that the SEC first became aware of the misleading projections after noting a high volume of discussion about a certain press release on an Internet stock discussion board.

False Track Records and Inflated Performance Claims

: these cases concern Internet sites that use fake testimonials and inflated success rates to sell subscriptions to their market analysis, stock tips, and stock trading strategy services.

"Purchased" Favorable Analyst Coverage

: in these cases, the defendants posted links on their websites to what they claimed to be "independent" analyst reports (positive reports which led to an increase in the defendants' stock price), when in fact the defendants paid to have the favorable reports published.

Given the success of the SEC's recent Internet fraud sweeps – the SEC has now brought over 200 Internet-related enforcement actions, almost half of which have been filed since January 1, 2000 – it is likely that the SEC and other government agencies will continue to commit substantial resources to investigate Internet-related activity. Enforcement agencies also are expected to develop further their uses of the Internet as an investigatory tool and a mine for information about suspected frauds.

For these reasons, while companies must continue to carefully review their formal SEC filings, it is becoming increasingly important that they afford the same level of attention to press releases and announcements posted on their websites or disseminated through other electronic media, as such informal statements may be subject to more frequent scrutiny. A company also may be well served by setting up a mechanism to monitor the information posted about it on Internet message boards or in online "chat rooms" – especially if a company suspects that its employees are making unauthorized statements about company operations or prospects on such online sites – since it is possible that government officials are reviewing these sources as well.