

# PROSECUTING SECURITIES FRAUD FROM A NEW YORK PERSPECTIVE<sup>†</sup>

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One of the themes that has been raised consistently throughout this symposium is that Internet stock fraud is not all that different from fraud perpetuated through the telephone—the technology is all that differs. When the telephone first came into widespread use, a lot of prosecutors and investigators were certainly very concerned because it would permit forms of fraud that had never been previously anticipated. Many expected the same to be true with respect to the Internet—that it would allow new forms of fraud.

In my personal experience, and in that of my colleagues at the attorney general's office, Internet stock fraud is not difficult to detect. As the media and other sources suggest, “footprints”—the Internet term for the equivalent of fingerprints that allow us to track users—do exist.<sup>1</sup> As my California counterpart, Mark Crandall, explained, it is fairly certain that a prosecutor will eventually trace the fraud back to the computer on which it was perpetuated.<sup>2</sup> An excellent *New York Times* article by Leslie Eaton called *Stock Fraud is Easier, and Easier to Spot*, discusses a case involving a fifteen-year-old's “pump-and-

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1. See, e.g., Leslie Eaton, *Stock Fraud Is Easier, and Easier to Spot*, N.Y. TIMES, Sept. 22, 2000, at B5 (reporting that Stephen M. Cutler, deputy director for enforcement of the SEC, noted that “you have footprints, evidence right there in front of you” with Internet stock fraud); Terzah Ewing et al., *E-Mail Trail Leads to Emulex Hoax Suspect*, WALL ST. J., Sept. 1, 2000, at C1 (discussing how stock fraud related to shares of Emulex Corp. was traced through e-mail and other Internet methods).

2. See Marc S. Crandall, *State Securities Regulation and the Internet*, 5 N.Y.U. J. LEGIS. & PUB. POL'Y 23, 28-30 (2001) (discussing ease with which stock fraud over Internet can be traced to perpetrator).

dump” scheme.<sup>3</sup> The article summarizes both the ease with which it is possible to commit stock fraud over the Internet, and the ease in getting caught committing stock fraud over the Internet. Identity, on the other hand, is usually a more complicated issue: While it is typically easy to prove which computer was used to make a fraudulent posting, it is often difficult to prove which human being actually used the computer. This difference is, in fact, the very difference between proving a person’s guilt beyond a reasonable doubt and acquittal.

A tremendous amount of foreign exchange fraud, private placement fraud, and commodities fraud takes place over the Internet, involving investors being defrauded of hundreds of thousands of dollars. Although for many that would be a tidy sum, it is actually a small amount when compared to the large “bucket shop” and “boiler room” frauds that occurred in several prominent cases during the 1990s without the benefit of the Internet.<sup>4</sup> Those cases involved investors being defrauded of approximately seventy-five million dollars or more.<sup>5</sup> In my experience, individuals still will not part with large sums of money in the absence of some sort of personal, human contact. People may give up large amounts of money over the Internet, but the really big investors, the ones that can sometimes get caught up in a stock swindle of a larger magnitude, will usually be the victim of the telephone call, the in-person meeting, or the brick and mortar setup. Certainly, though, it is just as tragic when someone who could ill afford it loses \$30,000, \$40,000, or \$50,000. That person could be devastated. I believe, however, that we will not see these huge cases except in a broker-dealer context because the Internet eliminates that important personal contact.

In the recent prosecution of World Interactive Gaming Corporation for operating and offering gambling over the Internet, former assistant attorney generals from our office prosecuted an important case that involved many issues that have been discussed at this sympo-

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3. Eaton, *supra* note 1; see also *SEC Accuses 44 in Fraud Case*, N.Y. TIMES, Oct. 12, 2001, at C14 (“A pump and dump scheme involves accumulating a stake in a company at a low price and then urging others to buy shares, driving up the price. The original investor then sells shares at artificially high prices to unsuspecting investors.”).

4. See John M. Bellwoar, Note, *Bar Baron at the Gate: An Argument for Expanding the Liability of Securities Clearing Brokers for the Fraud of Introducing Brokers*, 74 N.Y.U. L. REV. 1014, 1014–16 (1999) (discussing major securities frauds that took place during this time period).

5. See *id.* at 1014 (“Before Baron went bankrupt, it perpetrated a \$75 million stock fraud against scores of investors . . .”).

sium.<sup>6</sup> This case involved an Internet gambling Web site in which the creators of the site also sold securities in the business, and enabled visitors to engage in Internet gambling, thereby breaking several different laws—securities laws, penal laws, and federal interstate gambling laws. The server was located in Antigua, so the case presented a number of unique jurisdictional issues. The New York State Supreme Court in our civil action issued an opinion that awarded millions of dollars to the investors, closed down the Web site, and developed a lot of excellent law on jurisdiction regarding the problem of server location.<sup>7</sup> The defendants asserted a variety of extremely intricate arguments concerning how they were not subject to New York State jurisdiction and how the actual gambling occurred in Antigua, and yet they lost on all counts.<sup>8</sup>

In contrast with how California deals with the problem of Internet fraud, under New York law we may consider the mere posting of a tout that is proven to be untrue to be a violation of securities law.<sup>9</sup> The New York State securities laws are collected under the Martin Act.<sup>10</sup> In my opinion, the Martin Act is one of the broadest anti-fraud statutes ever devised, at least in a democratic society.<sup>11</sup> The Martin Act has been tested many times in the high courts,<sup>12</sup> and contains a subsection that courts have interpreted to make it a misdemeanor to engage in either ill-founded or negligent statements about the sale of securities without actually taking any money, even in the absence of

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6. *People v. World Interactive Gaming Corp.*, 714 N.Y.S.2d 844 (N.Y. Sup. Ct. 1999).

7. *Id.*

8. *Id.* at 848–52.

9. *See Crandall*, *supra* note 2, at 26–28 (discussing California’s stance on prosecutions based upon untrue touts).

10. N.Y. GEN. BUS. §§ 352 to 359-h (Consol. 1999)

11. *See New York v. 7040 Colonial Rd. Assocs. Co.*, 671 N.Y.S.2d 938, 941–42 (N.Y. Sup. Ct. 1998) (“The Martin Act provides the Attorney General with what one commentator has characterized as ‘the broadest and most easily triggered investigative and prosecutorial powers of any securities regulator, state or federal.’”) (quoting David J. Kaufmann, *Introduction and Commentary Overview*, in 19 MCKINNEY’S CONSOLIDATED LAWS OF NEW YORK ANNOTATED 8, 9 (1996)); *In re Cenvill Cmty., Inc.*, 372 N.Y.S.2d 281, 284 (N.Y. Sup. Ct. 1975) (“[T]he Martin Act (General Business Law, §§ 352 to 359-h) is the most extensive of the nation . . .”).

12. *See, e.g., People v. First Meridian Planning Corp.*, 658 N.E.2d 1017 (N.Y. 1995) (finding use of term “security” in the Martin Act not unconstitutionally vague); *Dunham v. Ottinger*, 154 N.E. 298 (N.Y. 1926) (upholding use of Martin Act against constitutional challenge of its subpoena provisions); *People v. Florentino*, 456 N.Y.S.2d 638 (N.Y. Crim. Ct. 1982) (denying challenge alleging that language of Martin Act was unconstitutionally vague).

any *mens rea*.<sup>13</sup> Courts have held that a felony may be charged when the individual has the requisite *mens rea* and takes money.<sup>14</sup> But the mere touting with a certain very minimum *mens rea*, or no *mens rea* at all, is a misdemeanor under the Martin Act and can be prosecuted civilly.

Our office has also worked on cases where people used an Internet user name, or “handle,” that was intended to be very misleading. For example, in one case someone pretended to be an impartial investment advisor, but was, in fact, a major officer of the company for which he was touting stock. He wrote about how great a major officer of the company was, even though he was writing about himself. This is almost the inverse of the situation Marc Crandall mentioned before, in which someone was an investor claiming to be the officer.<sup>15</sup> Those types of cases would certainly be prosecuted under the Martin Act as well.

Much has been made of the potential of “Web crawling robots,” or computer programs that search the Internet in search of particular types of information, as a tool for securities enforcement. However, our experience has been that they are not as effective as one might imagine. When a program is asked to search the Web for a certain piece of information, they bring back random, often useless, material. One of the classic examples occurred when the computer program was asked to search for information regarding securities that had “YARD” in the title, and the program retrieved material on garage sales. The point is that such devices are basically mindless and net almost too much information because of the vast scope of information available on the Internet. In our experience, the best cases are still generated by citizens’ complaints, whether through the Internet itself, via e-mail or our Web site, or written by people who walk into the office.

We have seen a lot of private placement fraud over the Internet—frauds that involve tremendous amounts of unregistered securities offered on the Internet, which should in fact be registered under federal

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13. See *People v. Concord Fabrics*, 371 N.Y.S.2d 550, 554 (N.Y. Sup. Ct. 1975) (“The fraudulent practices, which are the target of the Martin Act, need not be fraud in the classic sense since, pursuant to the Act, the absence of scienter or intent to defraud does not relieve a defendant from liability.”) (citations omitted), *aff’d*, 377 N.Y.S.2d 84 (N.Y. App. Div. 1975).

14. See *In re Gaming Lottery Securities Litigation*, [2000-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,339, at 95,937 (Feb. 27, 2001) (“Defendants pled guilty to violation of New York General Business Law § 352-c(5) under the Martin Act, which provides that: ‘Any person, partnership, corporation, company, trust or association . . . who intentionally engages in any scheme constituting a systematic ongoing course of conduct with intent to defraud . . . shall be guilty of a class E felony.’”).

15. Crandall, *supra* note 2, at 27.

or state law.<sup>16</sup> Guaranteed-returns promises are proliferating like crazy on the Internet: “[I]nvest in this and get a guaranteed 25% return.” Of course, all of that is illegal. As I mentioned, a great deal of fraud involving securities allegedly offered on foreign stock exchanges has taken place as well. Why there is presently so much foreign exchange fraud is a mystery. Perhaps perpetrators think that they are exempt because of the differences in transnational laws, or perhaps it is touted as some type of “hedge” that lessens their potential liability.<sup>17</sup> We recently litigated a big case against a foreign exchange entity.<sup>18</sup> They claimed to be entirely exempt from the court’s jurisdiction on the grounds that they fell under neither our laws nor those of the Commodity Futures Trading Commission. We received a very favorable decision recently from the New York Supreme Court, finding that we did have jurisdiction and denying the defendant’s motions on all points.<sup>19</sup>

In terms of getting into securities fraud prosecution, there is a clear difference between registration and enforcement. One can run afoul of the laws by failing to register, but a lot of enforcement laws are not registration driven. As a result, if someone had fraudulent intent or committed an act with *mens rea*, it does not matter whether that person was covered by Regulation D<sup>20</sup> or failed to register with the SEC. When representing people, one must think about the difference between registering the security and having the improper state of mind. There’s all the difference. The laws are there for disclosure; if one has a bad state of mind, disclosure is probably lacking. Whether or not the security is technically registered will not make that much difference to the prosecutor or the victims.

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16. For an excellent general review of the sorts of stock fraud most commonly seen on the Internet, see Richard H. Walker & David M. Levine, “You’ve Got Jail”: *Current Trends in Civil and Criminal Enforcement of Internet Securities Fraud*, 38 AM. CRIM. L. REV. 405 (2001).

17. See generally Ronald E. Bornstein & N. Elaine Dugger, *International Regulation of Insider Trading*, 1987 COLUM. BUS. L. REV. 375 (discussing difficulties in enforcing laws relating to insider trading in international context).

18. *In re Withrope Grant, Inc.*, No. 403163/99 (N.Y. Sup. Ct. Apr. 25, 2000) (on file with the *New York University Journal of Legislation and Public Policy*); see also Orestes J. Mihaly & David J. Kaufmann, *Supplementary Practice Commentaries*, in 19 MCKINNEY’S CONSOLIDATED LAWS OF NEW YORK ANNOTATED 1, 4–5 (Supp. 2001); Marcia Vickers, *Currency Trading or Currency Scam?*, BUS. WK., Aug. 16, 1999, at 78 (both discussing general holding of *Winthrope Grant*).

19. *Winthrope Grant*, slip op. at 6–13 (discussing questions relating to jurisdiction and preemption of local securities law by federal statutes).

20. 17 C.F.R. §§ 230.501–.508 (2001) (requiring registration of most securities traded in United States).

The tools we have for enforcement are pretty good, and the laws are sufficiently flexible. I think that in most new forms of fraud, the federal and state securities laws have proven to be up to the task. I believe the cases turn on the issue of resources. I have not seen any case so complex and dense that it could not be cracked. I just see so many cases whose result depends on the availability (or lack thereof) of resources. This is not a new problem for government lawyers. It always boils down to how many attorneys, how many investigators, and how many staff members are available to deal with a particular case. If there are enough resources available to the prosecutor, it is going to be very difficult for anyone to commit a fraud and not get caught.