Day Two—Securities Fraud

Group Breakout Session Five

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GROUP FIVE: SECURITIES FRAUD

MR. STARK: My name is John Stark. I'm chief of the Office of Internet Enforcement at the U.S. Securities and Exchange Commission here in Washington. I've been in charge of the Internet Program there since '94, been at the SEC for the last ten years or so, just doing enforcement actions.

There are a lot of exciting things that are going on on the Internet, a lot in the area of securities fraud. So we put this panel together to sort of give you an idea of what's been going on, to tell you a lot of the realities. I noticed in the last panel that they were trying to dispel some of the myths that are out there. We are going to really take the same approach.

I want to introduce my colleagues. This is a great panel. We've got two very important people sitting up here with me. To the far left is Rob Khuzami, who is chief of the Securities Fraud Group in the Southern District of New York at the U.S. Attorney's Office.

Rob, how many years have you been chief now? Two years. I work very closely with Rob on a lot of different investigations. Rob and his group have—if it's possible for the Southern District to be at a higher level than it was before he got there—really taken it to an even higher level, and he's one of the few prosecutors that I know who has real expertise in securities fraud, in law enforcement overall, and in technology.

And really understanding those three areas is key for a lot of the prosecutions that we do. And I think that more importantly for an agency like the SEC—and we really owe a lot to Rob—is that his office is willing to take on some of the tougher, more complicated cases that a lot of the U.S. Attorneys' offices in the country, the district attorneys' offices, or a lot of criminal prosecutors just won't do because they don't have the resources or they don't understand the complexity and the importance of a lot of these cases.

So we at the SEC really owe a great debt of gratitude to Rob and his group of attorneys in New York.

Next to him is Cam Funkhouser, and we owe a similar debt to Cam. Cam is vice president in charge of Market Regulation at NASD, the National Association of Securities Dealers regulation arm. And Cam is really probably one of the foremost experts in the country on market manipulations, any type, anywhere, any kind, and he's become an expert in the area of Internet fraud.

And we probably find with most of the leads that we get—anything that you read about in the paper, any famous securities fraud case that's brought by any agency, be it the SEC or any other prosecutorial agency—Cam's group is going to be involved, providing a lot of the background and analyses of the types of violations that go on and digging through a lot of the records and a lot of the very technical information you can get during the context of a securities transaction.

So actually what happens from the time that you put your trade in until the time that you actually get your shares, there are all sorts of players in there who are regulated in all sorts of different ways. And Cam is a real expert in that area and has testified quite often in a lot of the criminal proceedings across the country, again as an expert, to put in plain English what a market manipulation is.

And we also owe a lot to Cam because we get these things called "Cam calls" in my office—about five to ten a week—where he calls up and says, "I got a really, really good one for you." And you sort of count the number of "reallys."

If he says "really, really, really," that probably means three people should be assigned right away, each person assigned to the number of the level of hyperbole that he uses, because most of the cases that we're going to talk about today usually came from Cam's office or a member of the public, and we work side by side. And that's why this panel is pretty interesting, because all three of us really do work side by side.

We have to trust each other. We have to feel comfortable working with the other, and particularly with someone like Rob. When you have grand jury proceedings going on on the civil side, you're not going to know what's going on on his end. He's not always going to know everything that's going on on your end, and so the trust and the relationship building that you've done can really pay off.

Okay. Let's get to the presentation. I think a lot has gone on in the area of securities fraud over the last four or five years in particular. I teach a course called "Securities Law and the Internet" at Georgetown. When I started teaching, we had brought two Internet fraud cases. Since that time, we've brought 200. There were maybe 12 or 13 online brokerage firms. There are now more than 160.

There were maybe four regulatory pronouncements that were relevant for Internet-related securities conduct. There are now probably closer to 15 or 20, or maybe 30 if you count all the no-action letters. Quite a lot has gone on in the area of Internet fraud. The media just love to write about it, love to talk about it, and love to say everything that's wrong about it, meaning not morally wrong, meaning just getting their facts wrong.

So part of what we're here to talk about is to try to get the facts straight so that you have a better understanding and so that when you're thinking about things like sentencing and the other important discussion areas of this symposium, you can really understand.

Internet fraud is a lot different than hackers trying to tamper with the energy grid or these denial of service attacks. It's a lot different than anything else in the computer crime area. It's really not even a computer crime. I probably wouldn't even characterize it that way. So that's what we're going to talk about today.

As I said, I want to welcome everyone to our seminar and get people really excited. I think we're going to teach you a lot in the next hour. I think by the end of the hour, you'll feel like you've really learned something and you didn't waste your time. So welcome, everyone, on behalf of the NASD, on behalf of the U.S. Attorney's Office of the Southern District of New York, and on behalf of the SEC.

I think just a few background numbers. If you are curious about the types of things and the types of growth on the Internet—I mentioned a few before—but you can see that for trading volume, online accounts, online assets, retail trades, these numbers just keep getting larger and larger.

All you have to do is pick up any article ever written about the Internet and you'll see the growth and you'll feel it. A good example is the number of households online. You can see the numbers growing very rapidly, and it's certainly going to become something as common as the fax machine or the telephone.

When I first started training at the SEC, nobody really even knew what the Internet was. Nobody really used it. It wasn't on anyone's desk top. I set up a bunch of computers at the SEC on different floors for people, got us an America Online account, and it's just so amazing how far we've come. Now everybody uses it; everybody depends on it, in just a few years.

Another good example is the assets in online accounts. You can see the number of people who are putting their money on the Internet and using the Internet to manage their own money. Again, these projections usually end up doubling within any time frame. It's always important to talk about the Internet's benefits before you talk about fraud because you're really only talking about a small group of people trying to spoil the Internet for the rest of us.

Don't believe that it's so terrible on the Internet that you should never make your investment decision based on anything you read on the Internet. But you need to do your homework when you make your investment decision, not necessarily because of all the hype and the fraud.

What the Internet really allows you is direct communications with market participants, the short sellers, the shareholders, the competitors. Everybody comes together in one place and you get instant access to market information from the more technical stochastic data to the more simple price and volume data. It's all available.

Internet fraud, unfortunately, is really the dark side of it all, and the number of cases really has grown. Just about every case we've ever brought is a fraud case, meaning a lying, cheating, and stealing type of case that doesn't pass the straight-faced test in the sense that when you listen to it, you know these people are guilty of fraud and are trying to rip people off.

Most of the cases have been brought in the last two years or so. The numbers of cases have grown pretty rapidly, and I think that has a lot to do with the growth of the Internet. I think Internet fraud has grown concomitantly with the growth of the Internet. But we've also stepped up our enforcement activities in the area, assigning more people to Internet-related cases.

Okay. Here's where I want to get into the idea that there is quite a lot of hype out there, quite a lot of myths out there, quite a lot of written things that just aren't true in the area of Internet fraud.

First of all, people say that the Internet—and this might be a theme of the symposium that securities fraud just doesn't fit into—has a new type of fraud never seen before. That's 100 percent wrong. We're dealing with pretty much the same scams in a new medium, and that means pyramid and Ponzi schemes, prime bank schemes, these bogus instruments purporting to represent a secondary market for stand-by letters of credit, high-yield investment programs—there's no such thing—unlawful touting, market manipulations, "pump and dump" schemes, and bogus offerings of every kind. Every type of offering is available on the Internet.

Internet schemes can be exotic, of course. The first few cases that we brought involved eel farms and coconut plantations and some of the more nutty offerings that you'll see, and people do actually invest in this stuff. Even investment in an underwater island. We've got a quick video of it. Of course, you can't see it because it's underwater, but there is a video.

The Internet schemes can be complicated, and, as I said, we have the prime bank schemes, foreign currency trading schemes, and the third party market manipulations, which are really probably one of the biggest differences that the Internet has brought.

The Internet has made it easier, faster, cheaper. Anybody can commit a securities fraud from their own living room with no money down, with no sophistication, bucket shops, or boiler rooms, or fancy offshore offerings. It's all very simple.

Let me explain one of them that Cam and I worked together on. It involved a company called NEI Webworld. NEI Webworld was a stock that was trading at about eight to 12 cents a share. The SEC alleges that some former UCLA students, a group of young guys on the west coast, decided that they were going to buy up a lot of this stock at about 12 cents. So allegedly they were responsible for about 97 percent of the purchasing that went on.

This stock, NEI Webworld, was a shell company both physically and metaphysically. Metaphysically, it's a shell company because it doesn't have any assets. There's nothing to it. It just was actually liquidated in Chapter 7.

Physically, it's a shell company because there's a building with the words NEI Webworld on it that's gutted so there's nothing inside it. So I think it really represented that there was nothing that you were buying when you bought these shares, but they traded publicly. So the SEC alleges that these guys bought up about 97 percent of the stock at about 12 cents or so. Cam, you want to talk about what they did next?

MR. FUNKHOUSER: Yes. The company—it's kind of got a neat name, NEI Webworld—went out on the Internet and started placing messages on these message boards that people look at up on Yahoo and Raging Bull. They sent to just hundreds of message boards, saying "high flyer Monday."

So if you're looking on this message board, you would see this header saying "high flyer Monday," and you'd click it on, and it would have this message saying, this is a great stock. NEI Webworld, it's a shell company, it's trading for pennies, but they're going to merge with a private company, and it's then going to have the assets of this private company called LGC Wireless, which has its own website. And once this is announced, it's going to be five or ten dollars at least. And they hyperlink you down here to the LGC Wireless website, which is a legitimate company—private, great website—and they continually put this message out. We couldn't tell you how many people, but millions and millions of people probably see these messages, and a very small percentage of those people say, "You know what, I'll check it out."

And so what they did is they created a message thread on some financial websites and had some interactive chat with themselves saying, "Oh, yes, this is great, I called the company, it's going to do this reverse merger. When it's announced, it's going to be a great company."

And you look at the psychology of this. You've got a pretty low priced stock trading somewhere between eight and 25 cents, and for the average person, it's got a neat name, NEI Webworld. It's kind of interesting that you get hyperlinked. You go to a message board. There's a lot of talk on it. You're saying, "Hey, 25 cents, you know I'll throw a thousand dollars at it, and if this thing turns out—do the math, 25 cents to five or $10—I'll make, you know, a bazillion dollars if I just invest a thousand dollars."

So you have a lot of potential victims out there who have money, just sort of gambling money. And this is how these guys attack in this type of fraud. They count on people saying, "I've got a little bit of money to throw at this deal," and the audience that they're broadcasting this message to is huge.

MR. STARK: So the SEC alleges that happens on a Friday. They buy up—I don't remember how many—tens of thousands of shares of this NEI Webworld. This group allegedly buys about 97 percent of the stock. Well, this is what Cam wakes up to in his market surveillance report on the next day.

MR. FUNKHOUSER: This stock closed somewhere around 25 cents on Friday. I believe it was the 13th or the 12th.

MR. STARK: The 12th.

MR. FUNKHOUSER: The 12th. They closed at 25 cents. These guys perpetrated this scam over the weekend. So over the weekend, they start broadcasting these messages. And when you think about it, it's kind of a cool scam because the people that would be reading this message would be probably your online investors because they're on the Internet already.

So what do you do after you do your research and say, "You know what, I'll throw a thousand bucks at it." You do the math and say, "Okay, I'll buy 1,000 shares or 4,000 shares," whatever you want to throw at it. You go to your online account, and you punch in an order on Sunday or Saturday, and you say, "I'll take $1,000 worth," which you think is going to be 4,000 shares. So the way you place your order is you don't place your orders typically by dollar amount, you place it by share amount.

So they click—people click in 1,000 share orders, 4,000 share orders—to buy it on Monday thinking, "Hey, it's going to be 25 cents on Monday. But the way the market works with these online accounts is that all these orders can't get executed till Monday when the market opens. So there is all this buying pressure that's built up online all weekend. So when the market opens, it's a supply and demand analysis.

There's a ton more buying pressure on the stock than there are sellers. There are some very willing sellers, which we're going to talk about, but the buying pressure takes this stock which closed at 25 cents on Friday; it had basically a dormant market activity for months and months and months, and the stock opens up at eight dollars. Within 20 minutes, it's at $15.

So my guys are on the phone. The unique position we have at NASD Regulations is that we have all the trading data. We're going into our market data server, and we're finding out not who's buying the stock, but who's selling the stock. We're going back down the pipe, and we're trying to find out who's selling the stock, and we learn very quickly that there were Israeli bank trusts or something.

MR. STARK: Well, there was one foreign account and then there were a bunch of online brokerage accounts that were local in California.

MR. FUNKHOUSER: Right.

MR. STARK: And we found out that those accounts had just been opened.

MR. FUNKHOUSER: Right.

MR. STARK: There were maybe five different accounts, including one that was offshore. So we're in a panic mode at this point because if there's money offshore, with the amount of time it takes for a trade to clear, you've only got about two to three days to freeze that money offshore or it could go. So we've got to work.

MR. FUNKHOUSER: To tell you how powerful this is, this thing goes to $15. My staff is calling the brokerage firms as we're pulling the trades out. The market opens at 9:30. At 9:50, it's at $15. By 10:20, because we were calling around asking a lot of questions, the stock went back down to I think about 50 cents or something like that. So they didn't get to pull their entire scam off, but it was—

MR. STARK: And between Cam and I, we quickly find out who these sellers are. We get some of their names because it turned out to be just a few people. We find out how much profit they made, and we quickly find out where their brokerage accounts are. We quickly contact those brokerage firms, and tell them that we're investigating. We don't have unilateral freezing authority, but at this point, we know who the people who traded are.

We have this stuff on the Internet. It's time to trace the Internet protocol footprints that they've left, and it's time to get the criminal authorities involved because, at this point, you've got a conspiracy potentially of three or four people. We realize these are some bad people doing some bad things.

So we contacted the Central District of California because they were located in California and the accounts were located in California. We immediately started working with them, and we discovered that those postings, it turns out, were made from the UCLA Bio-Med Library, once we send out series of subpoenas and track the information.

So at that point, the FBI got involved and wired up one of the guys who ended up cooperating, and we quickly gathered enough evidence against everybody within just about less than a month, suing three of them. We sued three of them for manipulating the NEI stock. We froze all of their money. The criminal prosecutors in California arrested the two guys, and then we also found that they had done this with about 13 other stocks, but just not as good a job, meaning they'd only made maybe a thousand dollars and managed to pump it up a little bit.

One of the interesting things that happened was that the ex-girlfriend of one of the defendants had used her account either through her ex-boyfriend or herself, bought those NEI shares, put her market order in at 4:01 and 30 seconds on Friday, missing the close of the market.

So her order was one of the first executed. She only wanted to buy I think 20,000 shares at 12 cents. Her order was in for that. She thought it was going to be about 12 cents, somewhere in there, and on Monday she woke up with a debt of 20,000 shares at eight dollars. So she woke up with a $160,000 debt, and so she was very upset about her trade, and obviously contacted the brokerage firm.

That was a third party manipulation. If you notice, NEI wasn't involved. They had nothing to do with it, but one scheme that Rob's office handled actually involved an issuer conducting the actual fraud, and the case is called *Uniprime*. Want to talk about it, Rob?

MR. KHUZAMI: Yes, sure. This case was simpler simply because it didn't involve tracing the individuals who were involved in the fraudulent conduct. This is often the challenge you're faced with in Internet fraud cases through the use of nominees. Just tracing back through the computer network to find out who's responsible is difficult.

Uniprime Capital was a small company that was in the business of purchasing or intended to be in the business of purchasing retail automobile dealerships, thereby allowing you to purchase cars over the Internet. But it quickly became apparent through a referral by Cam that the company was touting itself as having acquired a subsidiary that had discovered the cure for AIDS.

I've heard of diversification in corporate America, but that was one that raised your eyebrows. And what happened is they issued a series of press releases that talked about European trials of patients where they had successfully gotten great results for curing AIDS. It talked about how they conducted certain trials and that the treatments had been successful.

And why don't I actually let Cam tell you how it was that he actually discovered this.

MR. FUNKHOUSER: I'd love for you to tell that story.

MR. KHUZAMI: Well, you tell it much better.

MR. FUNKHOUSER: I know, but it makes me feel better when you tell it.

MR. KHUZAMI: Why don't you go ahead.

MR. FUNKHOUSER: Okay. I was up one night in the middle of the night with this newborn baby that I have, goofing around on the Internet, and saw one of these messages. These guys always sort of attack the public by putting messages out on the message board, and—I was looking at a New York Stock Exchange stock—and they put out a message that said "the greatest opportunity ever" or something.

A once in a lifetime opportunity. So I clicked on it, and it went through this little OTC company, over-the-counter company. You could buy the stock anywhere near two dollars. It was like buying Microsoft for a nickel. So on the Internet, the great thing is you can go and research these things and very quickly read all these press releases that you just saw.

Pretty interesting story because it's going to be in *Time* and "20/20," and all this. On the press release, if you get a chance to see this, it's so silly. It's almost like people sat in a room and were so uncreative because it said they received documentation from the government of Spain for this breakthrough in AIDS, but it was done at General Hospital. Okay. General Hospital, which is like, "Wait a minute, you've got to be more creative than that."

There is some other stuff in here. Oh, the name of the subsidiary is New Technologies. Something a little more creative. The other thing is this guy, Alfred Flores, was located and this big lab in which he was working on AIDS was located in Lisbon, Portugal. I had just been to Lisbon, and I don't know if you've ever been to Lisbon. Has anybody been there? I don't think there's a lot of scientific stuff going on over there.

MR. FUNKHOUSER: When I went there, there were piles of rocks, and they were pounding them in to create sidewalks. So I don't know. That was my perception. So I said—if you went through any of the public press releases of this company—the company was basically diversifying itself. It was a car dealership. Then they had acquired an insurance company, then New Technologies. And there are some other press releases out there that were pretty crazy.

MR. STARK: Rob, you want to talk about some of the actual postings that were on after the press release was disseminated.

MR. KHUZAMI: Right, right. In charging the case, I don't know at the end of the day if we spent a lot of time with the postings because we quickly discovered certain aspects of the fraud that made it so apparent that we didn't need to spend time with a lot of the details.

For example, Mr. Flores had been in jail in Colorado for murder during the period of time that he was allegedly conducting this patient research in Portugal.

MR. STARK: The postings can show, though, that there are actually people out there buying.

MR. KHUZAMI: Buying the stocks, absolutely.

MR. STARK: If you were thinking that, "I'm waiting for this news to hit CNBC, the stock is worth the risk." So quickly—

MR. KHUZAMI: And the stock spiked to, I believe, five dollars a share. It went from a dollar to five dollars a share. And, you know, the volume went up, the price went up, and hit five dollars a share. And I guess a lot of these cases present similar and difficult loss, gain, and causation issues in calculating them, and I think maybe we'll reserve that discussion until we've gone through a couple of these other cases.

MR. STARK: Along the way you discovered that he was working as a floor buffer in a nursing home and that patients hadn't heard of this plasma plus system. Most of the releases were so blatantly false I don't think either of you really spent too much time. Neither did the SEC. We quickly suspended trading, announced the trading suspension on the Internet, which we do with most of our trading suspensions, which allows for commentary by the public, like this one: This investigation is not by the SEC, and this is the government trying to suppress information to the public with pressure from the major drug companies. Here's what Rob and the SEC did. You want to talk about the type of action that you brought?

MR. KHUZAMI: Yes, we conducted a search in Las Vegas and arrested Mr. Flores. He's been charged. He's actually involved in competency hearings at this point because there's a question about his ability to stand trial and assist in his defense.

QUESTIONER: Have you gotten to the point of determining loss?

MR. KHUZAMI: We have not in this case. He's not pled, and he's not gone to trial yet. His competency is being evaluated as we speak.

QUESTIONER: You would, I assume, treat this the same way you treat other stock cases in terms of measuring loss? There's nothing different about the Internet from other—

MR. KHUZAMI: No, not really. They present a question of the ability to calculate under some circumstances. If a stock spikes from a dollar to five dollars, you might say, "Yeah, there's a four-dollar-per-share loss," or you might look at where the stock peaked and then what it fell to once the fraud was revealed and multiply that times the float. It depends, first of all, on sort of whether or not you can actually identify all the purchasers and sellers. There's some bulletin board stocks that have relatively small numbers of purchasers. You can actually go out and pull the information and do the audit trails and analyze them on a person by person basis. But there are also manipulations where it's not easy. And so you move more into the realm of trying to make reasonable estimates of the loss, recognizing that often, there is a lot of trading that's going on in-between the period of time that the first person bought and the time the fraud is revealed.

QUESTIONER: I just wondered if he is in custody or on bail?

MR. KHUZAMI: He is in custody.

QUESTIONER: Good.

QUESTIONER: But he has a laptop in his cell.

QUESTIONER: Does he have CJA federal defender or a private counsel?

MR. KHUZAMI: He has CJA counsel, I believe.

MR. FUNKHOUSER: One of the problems, to answer your question, is that these kinds of frauds are unlike a lot of manipulations where you have boiler rooms, and there's like one brokerage firm that controls the stock and you can see all the money flowing to one place. In the online environment, when something like this starts, it takes off. You've heard this term before, "daytraders."

So there are software programs out there that start to identify stocks that are moving. So when a guy like this perpetrates a fraud and he gets victims who are sucked into this fraud to buy the stock, it creates volume that also brings in the daytraders.

QUESTIONER: Some of whom make money on the way up.

MR. FUNKHOUSER: Exactly.

QUESTIONER: Many of whom do.

MR. STARK: We never sued any of those people.

MR. FUNKHOUSER: Right.

MR. STARK: Because they lack the requisite scienter, I think.

MR. FUNKHOUSER: No.

MR. STARK: But some of them are equally as bad because they know what's going on.

QUESTIONER: I'm not talking about culpability.

MR. KHUZAMI: No, you're talking about loss.

QUESTIONER: I'm talking about measuring loss. You and I can debate culpability.

MR. FUNKHOUSER: But it poses a problem when guys like Rob say, "Well, how much did they make?" because you can always show that Albert Flores bought or sold "x" amount of shares. But that's not necessarily the real loss to the marketplace and the real damage to the marketplace because one of the things we're concerned about in our organization is the integrity of the marketplace.

And when people can come in here and cause blips in the market, you don't know what the public confidence in the marketplace will be after this type of event.

MR. KHUZAMI: That's right. The gain is obviously much easier to identify under these circumstances and the guidelines allow you to use it as an alternative measure. But it's something as a general matter that we would resist and do resist if there is any way to reasonably estimate what the loss to the investing public is.

Emulex, I guess, is the best example of that. Temporarily, $2 billion was shaved off of the market cap of the company when the false posting was posted. Now, that stock climbed back up and it went from 110 to 50 back up to 100 within half a day. Two billion dollars seems like an inaccurate figure because that's not just a gross figure, that's just a gross and temporary figure, because a lot of those people if they held on to the stock—it climbed back up and it's not an actual loss figure.

MR. FUNKHOUSER: But you face a monumental task in that situation because you have people holding the stock like that on margin, and when that thing tanks, like it did, you've got massive margin calls and people may not know what's up. They may sell their stock into the margin call and can't hold on even for the day through that scenario. It creates a whole host of market moving problems beyond the fraud.

MR. STARK: At the SEC, we focus primarily on the ill-gotten gains, particularly in the market manipulation context, and sometimes also in the offering context. For instance, we did a market manipulation sweep where we found 16 cases in which the SEC alleges almost two billion of market cap movement, but we only sought ten million in disgorgement because that was the amount of profits that they had made.

We can also seek penalties depending on the nature of the conduct. All penalties also leave us with the alternative of pecuniary gain versus just finding someone for each act. Is each act of spamming or each message board posting an act in furtherance of the securities violation? Is each one of those an unlawful act? And sometimes it's a little tougher to get into those calculations, too.

But sometimes the bad guy hasn't made anything, hasn't profited. The good thing about the Internet is that it's an incredible opportunity for law enforcement. We've been showing you some of the evidence.

I have evidence from just about every single Internet case we've ever brought that's just as resplendent as the evidence that I showed you a few minutes ago in the sense that you're looking at this as it's happening. And that's the amazing thing, particularly in the offering context. You can often get an offering before anybody has bought anything because somebody reports it to you and you've got enough evidence to make it clear that it's a fraud.

They're guaranteeing 1000 percent return in a week. You know you don't have to do a lot of investigation to realize that that is false. And sometimes in the context of the fake press releases like Emulex, it's a fake press release. It's absolutely false. It's obviously material. It doesn't take a lot of investigation. So you can quickly figure out what exactly has happened.

MR. KHUZAMI: There are two questions. Go ahead.

QUESTIONER: A comment and a question. We notice that there are number of these chat rooms up, and we've had a couple of incidents where little messages have come across that appear to be written by people who know what's going on, possibly insiders, talking about some product or some potential earning announcement, and then we see a dip in our stock that we can tie back to the timing of that comment or that chit-chat back and forth.

But it's had some significant effect. The question is what do you, in your capacity, look at in deciding whether to investigate these kinds of things?

MR. STARK: Well, that happens quite often. An issuer will call us directly and say, "Somebody is on the Internet spreading bad information about us." Our first responsibility is to be skeptical of that information. It might very well be true. So we need to look at the information and decide whether it's true or false, and that usually means working with the company, particularly if it's a smaller company with some type of technology, drug approval.

It depends what the nature of the discussions are. If it's a blatant fake press release like is alleged in Lucent, which Rob is going to talk about, where someone just says your quarterly earnings are going to be bad and here's the actual press release a few days early for you to look at, again, that's pretty cut and dry. It's a matter of the intent is clear; the false nature of the information is clear.

I think sometimes when a company calls and you look at it, you're asking is it opinion; how much of it is fact; what's going on? It's sort of the totality of the circumstances.

QUESTIONER: So you do take those calls and investigate them?

MR. STARK: We bring those cases when we can. We call them cyber-smears—when, in an effort to drive the price of company stock down, you're spreading false information. Those have always been the toughest cases at the SEC because there are a lot of short sellers out there. It's part of the marketplace to spread bad information about companies, for instance, information that they believe the company is overvalued. So they start explaining why.

One time we got a call that said an analyst was coming to visit a company, and the analyst had told the company, "Look, I'm going to spread bad information about you unless you pay me $40,000."

Now that's a securities violation, yes, but we immediately contacted the criminal authorities on that because that's just extortion to me. You know, as I said, we encourage companies to call us. Companies should have their own policies in place. Most of the time, it's an employee, believe it or not.

Three times out of four, when we start investigating in these cyber-smear cases, it turns out to be an employee, a disgruntled spouse, somebody who is angry at the company for one reason or another. So you should have good policies for your employees for their use of the Internet, each specific medium: message boards, spam, websites, everything, covering all the different types of mediums.

And what I also think companies should do is have sort of a strike force, an informal strike force, in place. It doesn't have to be anything elaborate, but your tech person, your CEO, your CFO, your PR person, your investor relations person, all of those people are going to be involved.

So oftentimes when the company calls me, I'll have those five or six people on the line, outside counsel, SEC counsel, and it's clear that they're all meeting each other for the first time and aren't exactly sure what to do. It's nice to have a few people in place. You might want to monitor the message boards a little bit. You might want to put a policy on your website that says, "We don't comment on them ever. We don't think they're accurate. We don't think you should base your investment decisions on what you read on a message board. We think you should do your homework before you purchase our stock." That kind of more innocuous advice would probably be a smart thing to do.

MR. KHUZAMI: There was a question up there.

MR. STARK: Yes.

QUESTIONER: How do you decide whether to take the case criminal and are the issues in measuring loss the same for the criminal matters as in civil matters since I do know that a lot of the securities fraud matters do stay on the civil side?

MR. STARK: I think that for us, we want almost every case to be criminal in the Internet fraud area. I think Rob would probably agree with that.

MR. KHUZAMI: We want the appropriate cases to be criminal.

MR. STARK: Right. All of our fraud cases we think are pretty bad. We are always looking for any criminal prosecution agency to pick them up because—and our chairman has said—a lot of this conduct is pretty bad. But criminal prosecutors don't have the resources to do every case.

MR. KHUZAMI: And not every case is appropriate for criminal prosecution. The Internet cases present that issue particularly well. I have found in a lot of these Internet cases that you may not really have intent to commit fraud, but what you've got is, for lack of a better term, just a prankster. For example, somebody posts a phony press release about a strategic alliance between one company and AOL. It was just duped from a real strategic alliance that AOL had engaged in with *drkoop.com*. And the stock, as I recall, took a real spike.

And so we ran around like we do in these cases. I had the postal inspectors parked outside the guy's work site in Chicago, and I had them parked outside of his house. And we decided, "Well, let's interview this guy first before we conduct an arrest and before we search his cubicle at work and get him fired, and do something that perhaps isn't prudent." And we talked to the guy.

And after ten minutes, it became readily apparent that the guy was a prankster, in the sense that he had a buddy with whom he would debate this stock. And he wanted to give his buddy a hoax to make him think that there was a merger and the guy was going to make a lot of money.

He didn't trade himself, and there were other factors which led me to make the conclusion that this is a matter that's more appropriate for the civil authorities, but not for criminal prosecution. You get some of those cases.

On the other hand, you get sophisticated traders who know exactly what the consequences of their conduct is going to be. They engage in deception in the sense that they use nominee accounts or offshore accounts, or they make misrepresentations and "pump and dump" schemes about "I'm really recommending the stock because I think it's good" rather than "I'm recommending the stock because I've got an undisclosed position and then I'm going to sell into the demand that I've created."

In one sense, it's not different than the call you make in any criminal case, but I have found that because of the Internet, you have to pay particular attention to make sure that you're not doing something improper in the zeal to make Internet cases.

MR. STARK: In our case, what our job is to do under those circumstances—particularly because of the one-way street of a criminal/civil prosecutorial relationship—is just to provide all the evidence for you—just to provide everything—to do whatever auditing we can do, internal analysis we can do, and present that all to the criminal prosecutor. We let them engage in the calculus that Rob just described—which I think is one of the tougher tasks for these Internet cases, in particular, because you get a lot of people who are outraged and want to know why these people aren't locked up. There's a culture of vigilance on the Internet and people don't like it when others try to spoil it. And it is in the public eye.

QUESTIONER: Is it more common for these folks to be detained or to be released on bond, and if they're released on bond, are there special bond conditions?

MR. KHUZAMI: Yes.

QUESTIONER: To the extent you can generalize?

MR. KHUZAMI: White collar criminals in general are rarely detained, and these Internet cases are really no different. Unless there is an aggravating circumstance, like they're here illegally. Actually, the guy who perpetrated the Lucent scam was, in fact, detained because he was here illegally; he had no residence; he had no family, so he was detained.

But as a general matter, they're placed on bond, and I don't think that the factors that go into establishing the conditions of release are really any different from any other case. It's a bond with a cash deposit, perhaps property, cosigners who hopefully have some moral suasion over the defendant, travel restrictions, that kind of thing.

MR. STARK: I think we've been talking about how these cases are in a lot of ways the same, but there are some iterations that have developed over the last year or two, particularly over the last year. They have made, I think, Rob's decisions even tougher because they are little more technical and the fraud in and of itself—although blatant on its face, when you do a closer analysis, it isn't always as clear cut.

And these are momentum sites, stock recommendation sites, imposter hoaxes and insider trading. Those are the four types that I want to go over. They're all sort of related to each other; the analysis is actually very different for each type. If you just read *The Wall Street Journal*, by the way, most of this stuff is always on the front pages, and you can see something like momentum trading sites.

Before we even brought our first case, there was an article written about these sites and what they were doing. Rob, did you want to explain what a momentum trading site is?

MR. KHUZAMI: Yes. You know, it's really just a website, perhaps a website that bills itself as being able to pick stocks that they think are susceptible to a short-term increase in price. They will send out e-mails or information to their subscribers, indicating when a certain stock pick is going to be made, and then the stock pick is made, and it's no surprise that buying results and the price is driven up.

Usually they have some information about the company. It's not necessarily fraudulent information about the company. Somebody may go out and just cobble together information from legitimate company-issued press releases that talk about contracts they may have gotten or other good news. They just package that up and say, "We think for this reason this company is well positioned," or they might commit actual fraud and just make misrepresentations.

But generally, they're just collecting information, and through the subscribers that they've created, through making the recommendation, they think they can create a spike. Of course, what happens is they usually secretly buy in advance of the recommendation, sometimes with limit orders, so that they'll automatically profit as the retail demand is generated from the recommendation.

In a couple of the cases John will talk about, that's exactly what happened.

QUESTIONER: Is it your experience that with Internet momentum sites, as you call them, that most of the trading is done by Internet daytraders as opposed to people who call their broker at Merrill Lynch to buy 100 shares?

MR. KHUZAMI: Yes, I think that's—

QUESTIONER: And the reason I ask is that it creates some interesting problems. The people who are daytrading, a lot of them are momentum traders. That's the whole point. So they are playing the same game as your supposed malfeaser. Everything is in there for the up and they're betting. You know they're going to do a hundred of these every two weeks and they'll win 60 times and lose 40. And, you know, if you're going to allow daytrading, you're not going to regulate the actual practice. If you're going to allow people to buy and sell like that, to some degree isn't it inevitable?

MR. KHUZAMI: But there's deception in one case and not in the other.

QUESTIONER: One person's deception is another person's gain. I mean, they're all working; they all want the stock to move.

MR. KHUZAMI: Well, if you're deciding who to prosecute and who not to prosecute—

QUESTIONER: If anybody.

MR. KHUZAMI: Then you've got the people who put together the momentum site and don't disclose to people out there that they're going to be buying ahead of the recommendation and selling into the demand, and who are perhaps engaged in other deceptions like sending out e-mails under various names saying that the site is a good site and that people should listen to it or falsely posting the returns from previous selections.

If you have devices like that that are deceptive, that is fundamental garden variety criminal fraud. The fact that you have daytraders who are out there, who, once that information is disclosed, decide, "Hey, maybe I can jump on this early and get out in half an hour and make a tic or two, fine." That's what they do. But I don't see any deception in what the daytraders do, and I do see deception in what the perpetrators do.

MR. FUNKHOUSER: I think you hit on a good issue here because one of the things that has to be done in these kinds of situations is simple investor education. People shouldn't be jumping in to these situations. That's one issue.

QUESTIONER: They find it easier than going to Atlantic City.

MR. FUNKHOUSER: Right. We spend a lot of money and time on precisely that issue—that there are a lot of people who are caught up in the idea of daytrading. Go take a course for $5,000, and we're going to show you how to get rich. I've gotten stuff. One of the great ones is: you can become a millionaire at home, just sitting at home, and it's eight pages long of Hazel the housekeeper. She doesn't work anymore because she took $500 and daytraded. Just come to my seminar.

And I think the studies have shown that a pretty high percentage of the people who take the course and start to daytrade end up losing every nickel.

MR. STARK: And you have to look at daytrading. It's really several different areas. There are the daytrading firms that actually give you ways and training, and that's actually a very small industry of people who are professionally just running in and out of stocks trying to take advantage of small disparities between a bid and an offer, and those are the people who sign up for these companies and take the seminars and have their own level two screens right in front of them giving them instant access to whatever the present quotes are.

And then you've got your people in the online brokerages who just have an online brokerage account and trade a lot, and they think they might grab the momentum of some price and get it up and maybe make some money.

And then you've got the stock recommendation services that we're going to talk about a little bit. And the momentum trading sites that are just giving you advice, and you're subscribing to their advice, and if you have a pure momentum trader who is not spreading any false information, not saying anything false about his track record, their disclosure says, "I am here to rip you off and steal from you, and I am here to create momentum. Let's all buy at one time. Let me jump in there. If you jump in at the right time, you're going to win; if you don't, you're going to lose. I hope you lose because I want to win." I've seen disclaimers like that.

Those people obviously are less culpable because of the disclosure they have, but there is still a manipulation taking place; you're just not using the false statement prong of Rule 10(b)(5) to actually prosecute them. In that case, you might be saying, "This is just a pure manipulation; let's look at it."

A case that actually happened that raises a lot of the concerns that you're talking about involved some local students right here, law students right here, not at George Mason, at Georgetown where I teach. And it turned out that these law students allegedly were engaged in a momentum trading site, and their site was called Fast Trades. *Time* magazine did a feature and explained exactly what these guys did, and how we caught them, and exactly what their MO was in perpetrating this scheme.

MR. KHUZAMI: Yes. This was a website that recommended stocks, and in general, I think the website suggested that the stocks were being picked because the people behind the website thought that they were well positioned for a short-term increase in price.

You would expect that the recommendations would be based on factors that would be relevant to that, including what kind of market they were in and what their product was, et cetera, et cetera. In fact, the reality of it is that the stocks were being picked because they could be easily manipulated in such a website, which means that there is thin-trading volume and a low price because, obviously, the less volume, the easier it is to pump the price up with just a little bit of buying. And low volume means you don't have to buy very much in order to do that.

So if you want to talk about what's deceptive and what's not, the first thing that you might argue is deceptive about this thing is that they're recommending stocks because they say they're positioned for a short-term increase and suggesting—maybe explicitly—that these are good, substantial value companies. In fact, they're being picked because they have price and volume characteristics that make them easy to manipulate.

MR. STARK: Here's an example of one. This is what we allege happened: This guy, Doug Colt, was a law student at Georgetown and was the ringleader of this crew. They pick a stock like American Education Corp. It's trading at about a buck a share. They decide to start buying, again, a thinly traded stock. March 5 they start buying the stock at 10:47 a.m. It continues until 2:19 p.m. They buy up about 19,000 shares and drive up the share price. Colt starts hyping the stock on various message boards. Also, what they really did was hype their track record, saying, "Come to Fast Trades. We're going to make a lot of money for you; just follow the momentum and you'll make it." So he says this is going to be his favorite pick on *Fasttrades.com*. The price skyrockets. By 2:45, when Colt posts the stock on Fast Trades—they call it posting the stock—100,000 shares had been traded, and now the stock is at ten dollars. Quickly, he dumps because, as Rob explained, he's got the limit order. What does the limit order tell you when you're looking at it?

MR. KHUZAMI: The limit order just says that he buys the stock at $1.25 and then puts a limit order saying sell it when the stock hits four or whatever his best guess happens to be as to what the price will rise to after the announcement. And, therefore, he doesn't have to do anything else, and if the price rises, he automatically bails out at his position and the price is increased because of the artificial retail demand he created.

MR. STARK: Does that factor into your looking at the scienter of the guy?

MR. KHUZAMI: Well, it could be evidence of intent. It certainly suggests that—certainly confirms that he's not in it for the long haul and suggests that he expects a rise. Now those two things aren't necessarily indicative of criminal intent, but with all the other factors, it certainly could be.

MR. STARK: So allegedly, quickly he makes about $41,000 in addition to money made by some friends and family members. His mother was a Colorado city councilwoman. By the day's end, the stock drops back down, and Colt, as he decides to post on the Internet, laughs all the way to the bank.

Fast Trades was an interesting case because it had this selling into your own buy recommendation; you've got misleading disclaimers; you've got postings that are false; track records that are false; you've got this many subscribers; you're making that kind of profit on companies that as far as you could tell they're just picking out of thin air. That's good evidence.

But I think the blueprint that the SEC alleges that he decided to post on a message board that explained how he operates his momentum trading site provided probably the most significant evidence. And he says this is how he conducts his momentum trading: run a stock, screen for stocks in the one-to-two-dollar range, find the stock that gets to that, pull text press releases from the company—as Rob says, which are overly optimistic—throw in something about the company being an Internet wonder and what it's like with the Internet expanding, Who knows where this company can go? Buy a bunch of this garbage stock. Tell your idiot subscribers about how great the stock is, and like sheep, they will run out and buy it. Dump the shares you bought a few hours ago to all these suckers and laugh all the way to the bank.

So that's what he decided to say to the world, to the audience, of which the SEC was a part of. So I think getting to his scienter, getting to figure out what he was thinking, was not as tough.

There's another iteration, the stock recommendation sites, which employ a different concept than do the momentum sites. These are stock gurus who give instantaneous advice on when to buy a stock and when to sell a stock.

This is like an investment newsletter on steroids. They're just giving you advice, and you're paying for the advice. Fast Trade subscribers didn't pay anything to become a subscriber. The more people Colt had to buy the stock, the more likely the momentum would be brought. These people make their money by giving custom-tailored investment advice to people.

They promise quick riches. They promise to improve your golf game. High performance figures. The violations here are more regulatory in nature—that, and false and misleading advertising. Some of these cases have been brought by the FTC for some of that. Yes.

QUESTIONER: I don't mean to derail you at all, but—

MR. STARK: That's okay.

QUESTIONER: But we are talking about loss and sentencing. Before we get off the momentum sites and those type of criminal cases—that's really what this is about. I understand that the SEC is very busy and I appreciate that, but I—

MR. STARK: Well, I think the point is—

QUESTIONER: I'd like to talk more about the definitions of loss and how you would calculate loss from the guidelines in a situation of a momentum site, for instance?

MR. KHUZAMI: For some securities fraud cases, obviously calculating loss is not really a problem. Private placements, unregistered securities—there's not a publicly traded market. Somebody bought it at five. It had no value. They lose five dollars. There was no market for it. They were lied to.

In an Internet case where you sort of gauge, or any momentum case, or any case involving publicly traded securities, where it's a situation where you can't identify all the actual purchasers, or it's just too complicated to do so, or there's too many of them, you do the best approximation you can as the guidelines permit you to.

And that may involve figuring out what the drop was and what the price was in the stock during the time of a fraudulent scheme, for example, and then what the price crashed to after a scheme was—

QUESTIONER: So is fraud on the market measured from a civil fraud perspective?

MR. KHUZAMI: Sure. And it's done in the accounting fraud cases on the criminal side as well, where somebody doesn't disclose liabilities in their 10(k) for a year and then it comes out and the stock crashes to four. You might take that drop in price times the public float and calculate a loss figure.

Now it's not going to be perfect because, as I said before, there's trading that goes on. People are in and out of the stock during that whole period, but as a general matter, the gain figure, the alternative under those circumstances, is not particularly satisfying to me because that's just generally going to dwarf the harm that was caused.

Now, in a momentum case like this, gain and loss may more approximate each other just because the market action is more limited. You have fewer buyers, fewer sellers, and so maybe you might want to consider it under those circumstances.

QUESTIONER: John mentioned in one case before where the profit was $41,000, plus family and friends. I assume the family and friends are people who supposedly knew that they were running this type of site and got in at the right time. I don't know whether you treat those people with a broader fraud number or whether they might be more appropriately treated by their gains or like an insider trading notion? That their particular gain would be—

MR. KHUZAMI: You mean they were just—

QUESTIONER: They didn't set up the site. They didn't set up—

MR. KHUZAMI: Did they know about it?

QUESTIONER: They knew that it was good to jump in because—

MR. STARK: Those people actually bought before. He had a small circle of people that he told to buy before his posting.

QUESTIONER: Right. But did they know that he was posting a fairly manipulative—

MR. KHUZAMI: Look, if they didn't know and all they were told was that you should get in early because I think you'll make some money, we would probably include those numbers in his, but not include in theirs the entire scope of the conspiracy.

MR. STARK: The reason I talk about these investment advisories is because these cases receive similar types of attention. The case that we brought recently against Tokyo Joe was pretty much front-page everywhere.

The SEC alleges that this guy, an online stock guru, used to run a chain of burrito restaurants. What he did there, his subscribers paid $100 to $200 a month. The allegations there were the same things: scalping, selling the same stock you recommended. At least one issuer had provided stocks to Tokyo Joe, and he hadn't disclosed that adequately—the nature and source and amount of that compensation.

We alleged that he had lied about his track record and we also found what we allege to be 200 false or misleading statements on that website. So I think in that situation, with us again on the SEC side, it is much simpler because you're thinking how much did he gain, and you're going to use that in the traditional civil context to figure out exactly how much was experience. I don't know how that would be done.

MR. KHUZAMI: One other thing that is worth mentioning is another kind of case that we do a fair amount of: market manipulations where the whole point of the scams are to box the stock and prevent investors from selling.

The point of it is that the issuer or the promoters will get control over a large percentage of the float, either through reverse merger or otherwise. And then they, through perhaps bribes to brokers or alliances with Internet promoters or newsletter writers, start to pump up the stock. And the whole point is to bring the stock up and then maintain the price there, allowing the insiders to bail out.

Now, under those circumstances, you might simply say, "Well, we're just going to try and figure out what the actual loss was and give a credit for those people who are able to get out." But in some respects, that scenario is closer to the Ponzi scheme kind of case. Second Circuit rulings say that you should not, in fact, credit funds that the investors got when they sold the position or payments made to the investors because the whole point of the scheme is to prevent people from selling.

And that's done through a variety of sales practice abuses. Boiler rooms have actual no-net sale policies where, if you want to sell your stock, they're not going to let you, or your ticket goes in the drawer or you can't sell unless you agree to buy a similar number of shares of another house stock. Or you can't sell unless I get another customer to buy or a whole host of other devices. And under those circumstances, we've taken the position that—and some district court opinions have upheld it—the perpetrator is not going to get credit for investors who were both defrauded and then were able to get out.

They're going to pay a gross loss calculation because it's so integral to the scheme in the same way that making lulling payments or interest payments is to somebody in a Ponzi scheme.

QUESTIONER: The other side is, though—because sometimes it's hard to measure or because the role of different participants is different—that either gain to the overall scheme or gain to the individual participant may be the more accurate measure.

MR. KHUZAMI: You're talking about the low-level cold caller, for example?

QUESTIONER: Low-level cold caller, a broker, or in the case of the company that's manipulating its own price up, with a no-net sales rule, even though some people may have gotten profit. It's their profit when they start dumping their stock that really provides measures of the fraud. I mean it's a discrete number.

MR. KHUZAMI: Well, let's take those one at a time. If you take the cold-calling low-level broker—the rule that we generally try and follow is again set out in Second Circuit law, which is that you're responsible obviously for the loss that you created. I think loss is better than gain under those circumstances because a low-level cold caller is probably getting 20 percent or 30 percent of kickback or commission of the stock that he's selling.

And I guess we can debate, as we have for the last day and a half, as to whether or not you should charge them with the dollar or the 20 cents; which is the better measure of intent and harm? But as a general matter, if he's pitching worthless stocks, it's hard for you to argue that he shouldn't be responsible for that dollar when he knows he's lying to people about what they're buying, and it's worthless, and there is no market for it.

So we would generally hold him responsible for his own customers, the ones he was cold calling, the ones that he sold to. And then beyond that, we would generally hold him responsible under reasonable foreseeability tests and relevant conduct for the losses created by the people that he worked with where there was something other than just knowledge.

I mean if all you've got is that there's a cold caller, and he's in a boiler room with 30 other people, and he knows that other people are doing it, Second Circuit law says there's got to be more than just knowledge. You've got to have some supervisory or other role for that person before you can hold him responsible for the entire loss.

Maybe there's an override which would typically be for a team leader or a guy who is running a crew of cold callers, where maybe that supervisor is getting ten percent of everybody else's sales, and so under those circumstances, it would be appropriate.

Does the person exercise managerial or supervisory responsibility? For the individual cold caller, is he paired up with one guy, which you see a lot, where they work each other's customers. One guy wants to sell, and these boiler rooms have these go-to guys. Now the guys that you bring in when the first cold caller just isn't getting the job done or somebody really wants to sell. It's like in the movie "Boiler Room."

MR. FUNKHOUSER: Like buying a car.

MR. KHUZAMI: Like buying a car, yes, exactly. You know, you might hold the cold caller responsible for loss generated by him and the partner he worked closely with. But as a general matter, I'm not unsympathetic to the rather draconian results that can occur from holding a low-level cold caller responsible for a whole boiler room full of losses or, in fact, the losses generated by different offices. You might have five offices of the same broker dealer doing this kind of thing.

MR. FUNKHOUSER: It is interesting to hear you talk because, when you actually go out on the front lines and talk to these guys, it just never ceases to amaze me—and I've done this for 17 years—how much damage a 24-year-old cold caller can do. Sometimes I have some of these guys pitch me. I say, "Just do it for me; show me how you do it." It's really interesting.

They're very persuasive and I think what happens is—and you probably have to go through this analysis—that you bring in these guys and they throw themselves down and say, "I'm 24 years old, I didn't know what I was doing; I was sucked into all the money." But then if you really get them off the record, they know exactly what's going on. And so it's very frustrating to make that analysis. And then, as you get the more experienced scamsters who are managing the group, you see that these guys are very good closers and they really get these young guys into a frenzy.

And it's really fascinating to see how much damage is done by the same guy who tells you, "I'm just 24, and I'm not college educated, but I'm pitching a hundred customers." And they're very persuasive. It's hard to make that call on who to charge and how to charge them.

MR. STARK: In the technology arena, though, you do hit that area more because in the Internet hoaxes, for instance, in the 200 or so cases that we've done, there's no standard composite. You're not dealing with boiler rooms or bucket shops.

You've usually got a small number of people. Sometimes they're young. You know we recently charged a 15 year old. Sometimes they're old. We've charged people in their 70s. Sometimes they're very experienced. Sometimes they're not experienced. Sometimes they know what they're doing. Sometimes they don't seem to know what they're doing. Or they claim they don't know what they're doing. You don't get as many recidivists, although sometimes they are recidivists and sometimes they're not. So it's a little tougher.

I think the Internet hoaxes, the impersonation hoaxes, bring that issue to light, and that is what we're going to talk about next. PairGain is probably a good example and, Rob, maybe you can explain. I'll just say what happened. Gary Hoke posted anonymously on a message board. He set up a phony anonymous web page stating that this company, PairGain, was going to be bought by an Israeli company.

Here's the actual posting that happened. It was front-page news everywhere because the guy forged a Bloomburg website. Bloomburg obviously picked it up and then quickly said that it was false. And if you looked closely at the announcement, you'd realize it was false also.

He had posted it on an anonymous website called "Angel Fire" and used an anonymous account on Yahoo, and it netted an arrest pretty quickly. And very quickly he was charged. He was sentenced to five years probation and ordered to pay more than $93,000 in restitution.

I don't know what you would do with a case like that, Rob, because he didn't profit from the trading himself.

MR. KHUZAMI: I believe he had PairGain stock in an IRA, but he didn't sell. But I think what happened is the prosecutors in the Central District in California in that case, in the initial complaint, picked five investors and charged each, using the purchases of each of those five investors as a separate count as you can do under 10(b)(5), rather than charging the overall scheme in one count.

And I think they bought a total of maybe 60,000 shares of the stock and that just carried through to the end. He was sentenced only on the basis of the stock purchases of those five investors that he was originally charged with. The guidelines wouldn't limit you to that amount of loss.

And I don't know what factors the prosecutors in California took into account. It may be that they decided that the losses were too difficult to calculate, but in any event, there's a guy who caused much more loss than simply five investors' worth; he ended up getting probation. I don't know if there was a downward departure in the case or not.

QUESTIONER: Looks like he got five months of house detention. He was a 12.

MR. KHUZAMI: His was a 12, yes. He was a Zone C. So, that is kind of the exercise of discretion frankly that is both encouraging for those who like to see justice meted out on an individual basis and very scary for those who worry that it's unbridled and the next guy who comes along is going to get sentenced for $2 billion worth of fraud in one of these cases and go away for a long period of time.

MR. STARK: There's a strong effort on the part of the SEC to make everything consistent. It's obviously easier when you're dealing with unlawful gain, but we have a hard time figuring out with some of the different types of frauds, exactly who's worse and who's better each time, and who deserves a harsher penalty. Yes?

QUESTIONER: What happened to the kids from Georgetown?

MR. STARK: They were not prosecuted criminally. The three of them saw civil charges.

QUESTIONER: Why not?

MR. STARK: I'll speak just from my experience on these cases and not directly to that one, but I think that given that it was a momentum trading site, that these kids were lawyers and they were relying on their lawyers, I think the level of intent is tougher to prove in momentum trading cases for the criminal prosecutors.

QUESTIONER: Were they allowed to finish law school?

MR. STARK: Well, you know it's interesting. They did.

QUESTIONER: You know, the hell with prosecuting them—

MR. STARK: I polled my students. I polled my students and I asked them, "What do you think?" Half of them said they couldn't believe that these people were not in jail, and the other half said they should be allowed to graduate, what they did wasn't so bad.

QUESTIONER: Did you present that to a prosecutor? I mean was it declined or was it just never—

MR. STARK: Well, I don't think anything is ever formally declined or prosecuted. Everything that we do we generally will give to some criminal prosecutor and generally talk to him or her. We use so many different prosecutors; they've got their own resource determinations. Different circuits have different law. Some of them have securities squads. Some of them don't.

QUESTIONER: Go to the Manhattan DA's office. They'll prosecute anything.

MR. STARK: Well, I don't know if that's true. But, yes?

QUESTIONER: If those students had been prosecuted, and they had finished law school, would they ever be allowed to work in—

MR. STARK: In the securities industry. They've got an injunction. The collateral ramifications are pretty extensive. There are certain types of offerings you can't do. There is certain disclosure that you have to do if you're associated with any type of offering.

It seems to me that if I was going to hire them, that I would want to know. Certainly the government asks you all kinds of questions about yourself, and that's going to pop up. An injunction to us is very, very serious.

The students ask me, "Well, what about the bar authorities? Can they even be licensed to practice law?" And I think that the answer should be, "No." I obviously had my own opinions. I thought they should have been thrown out of law school. I thought what they did was something terrible and I agreed with the students who felt that way.

A lot of the students said, "Look, we're in law school; we keep our records clean because we fill out these surveys when we come to law school, saying that we're honest people." But I had recused myself from the case once we were working on it, and we figured out that they were from Georgetown.

So I wasn't really involved until after it was filed and then on the Georgetown side, I recused because I had been somewhat involved at the SEC. And I'm also an adjunct professor, which means not a real professor, so it's not as if my opinion would really matter.

I think the worst thing that criminal authorities do to these guys—like they did to Gary Hoke—was that they dig up that high school photo of you and circulate it. I think that can be harder. This is the case that Rob was talking about before, *bid.com*, where they had a false posting, but the criminal authorities opted not to prosecute.

MR. KHUZAMI: Yes. The other thing in that case is that the stock really didn't move.

MR. STARK: Right.

MR. KHUZAMI: I mean there was inner-day movement but very little. It just wasn't effective. And a couple of other things with respect to the decision to prosecute. The other thing you want to look at in these cases is the disclosure.

If you have a situation where they're not really making any false representations about the stock that they are promoting—in the sense that they're not saying that they've just discovered the cure for AIDS—what they're doing is they're just taking press releases legitimately issued by the company and packaging them up and extracting phrases from them and putting them on the website. If there is a disclosure, maybe it's not perfect.

A perfect disclosure on one of these momentum websites would say, "We're going to be buying before the recommendation, and we're going to be selling into the demand that I've created and that you're creating through your buying." That would be the perfect disclosure.

If the disclosure says, "You should know that we may be buying in advance and we may take positions in some of the stocks we recommend," what should a criminal authority do?

You know there is some effort to make the disclosure. Maybe it's not perfect, but you would want to look at that. There are also situations where there are advice of counsel defenses. And people have, in fact—perhaps not seeking out a securities lawyer as they should, getting the best advice—consulted some form of legal advice to decide whether or not what they're doing is proper.

So you combine all those kinds of factors, and at the end of the day, you decide not to criminally prosecute. One good thing about the securities area is that, because it's a regulated industry, we can decline criminal prosecution. But it does not mean that these people are not going to be sanctioned in some way, and that's why the Commission and the NASD serve very effective roles because offenders can be fined and get their profits disgorged and suffer various other sanctions. So in that sense, it's a good thing.

MR. STARK: They're not likely to be in the industry. I mean that stuff is obvious. I think when you're subjected to an injunction and you pay penalties, I don't know where you're going to work in the industry because the legitimate industry is going to stay away from you, I would hope for maybe 20 or 30 years, if you've decided that what you did was wrong.

But a lot of times that is a problem when the SEC brings a case. Sometimes the people still think they didn't do anything wrong, which is the case of the 15 year old and his father who are running around after we sued him saying, "We're proud of him; we don't think he did anything wrong."

Obviously, we feel dramatically different. There are so many cases that we decline, I think that we tend to bring the more serious ones. Here's one that is actually in progress.

MR. KHUZAMI: Before we go on, are there any more issues that are really focused on loss that people want to bring up or talk about or have questions about? Yes.

QUESTIONER: I'm involved with a case of free riding. The person had an account with Fidelity or whatever, and he's obviously a gambler, and he was running out of money. Because he had the account and he had been trading a lot, he was able to buy some stocks. He then sent a check to cover the stock, and the check was no good, but the stock went up, and so when they found out that the check was no good, they kept the profits.

So my question is, what would be the loss? If he hasn't been prosecuted yet, what would be the loss in a case like that where normally, if you write a bad check, the intention is that the full check would be used as the loss because the intention is to get the money. But there was no intention to lose anything here. The intention was to gain. In fact, he did gain, but he didn't get—

MR. KHUZAMI: Well, you might use intended gain under those circumstances. What was the amount of the check?

QUESTIONER: I think he ended up losing 100—well, he gained $140,000.

MR. FUNKHOUSER: The problem with that, and we run into this a lot, but in the securities industry, not unsurprisingly, you can't do that trade. He set out to commit a fraud, and your question, I know, is, "How do you calculate it?"

QUESTIONER: Yes.

MR. FUNKHOUSER: But I would assume that if I walked into any store around here and wrote a check for $140,000 or whatever the number is, you would say I basically—

QUESTIONER: I would say that you were cheating me out of $140,000.

MR. FUNKHOUSER: Right. I mean, that would be pretty safe bet.

QUESTIONER: But in his case, he wasn't cheating. He was trying to gain that—

MR. FUNKHOUSER: Well, but you can't do the trade. If that stock goes down, you know who's on the hook for that? The brokerage firm because they've extended that credit to you.

MR. KHUZAMI: Under those circumstances, I would use the gain figure.

QUESTIONER: The gain figure. What about the figure from the check, the bad check?

MR. KHUZAMI: The check is not a particularly good proxy for what he was intending to do under those circumstances, so I don't know. I guess it would depend. What was the amount of the check, and what was the amount of the gain?

QUESTIONER: 80,000.

MR. KHUZAMI: 80?

QUESTIONER: 80,000 and the stock went up to 140,000. It was worth 140,000.

MR. KHUZAMI: All right. Well, under the guidelines, it's all the same, because it goes from 70 to 120.

QUESTIONER: From 70 to 120.

MR. KHUZAMI: And it would make a one-level difference.

QUESTIONER: The gain is only 60 so you would probably use the $80,000 intended loss.

MR. KHUZAMI: Right. And the guidelines allow you to do that, you know. They say gain is an alternative.

QUESTIONER: Yes.

MR. KHUZAMI: Yes?

QUESTIONER: There was one example where you said you took five victims and that limited the loss. How do you avoid giving the probation officer the entire loss so that it would be relevant conduct?

MR. KHUZAMI: Well, first of all, I didn't do the five ones and you're absolutely—

QUESTIONER: "You" being the collective "you."

MR. KHUZAMI: And the Central District of California may have had perfectly good reasons, and I don't want to speak for them. They're fine prosecutors. The probation officers would get all the information on what happened. We have a very active and independent probation office in our district, and it properly acts as a check on what we do.

Under those circumstances, we would probably sit down and explain to them, "Here is the market for this stock," and we would struggle together to figure out what is the best way to estimate this.

We've done it in boiler room cases, and we've done approximations in other situations where there is market trading. We haven't reached a point yet where we've done them in sort of the Internet fraud cases, but we either struggle as best we can, or if it can't be done, we usually fall back on a gain analysis. And that's kind of what we do.

And if probation has a different view, they will certainly let it be known.

MR. STARK: Yes?

QUESTIONER: There may not be a good answer, but just in case there is, I just wanted to once again pose the question of whether you use a different method for calculating loss when you proceed on the civil side as opposed to what you do under the guidelines?

MR. KHUZAMI: Well, when you say the civil side, what are you talking about?

MR. STARK: Your civil side at the Southern District.

MR. KHUZAMI: Are you talking about the SEC or are you talking about private class action?

QUESTIONER: No, I'm assuming that all of you do have cases that end up being prosecuted criminally.

MR. KHUZAMI: I'm the only one who does the criminal stuff.

QUESTIONER: You only do criminal?

MR. KHUZAMI: Yes.

MR. STARK: But you have a civil side to the U.S. Attorney's office.

MR. KHUZAMI: We have a civil side at the U.S. Attorney. But they don't—

QUESTIONER: So we may not be able to get that comparison here. I just wondered if any of you could shed any light on whether there's a difference between the way loss is calculated?

MR. STARK: Well, as I said, on the SEC side, we don't really ever calculate it. I mean, we calculate it more for purposes of explaining to people, "Here's what happened to the market cap," but we focus on the gain. There's so much more money that you want from people, and most of the time they don't have the assets to pay.

But generally in these cases, you figure out how much profit they made and go by that, and there are also penalty statutes.

MR. KHUZAMI: The SEC is a quasi-law enforcement agency so they're looking to penalize the perpetrator, and therefore, they're looking to the perpetrator's ill-gotten gains.

If you carry it over to the private class action context, purely civil conduct, that typically occurs when people send in claim forms, and they say, "I bought it at two dollars and I sold it at one dollar and I'm out a dollar, and they send it in, and that's what the potential settlement is, and then it's negotiated.

On the criminal side, we do that in cases where it can be done where you have a limited market, a private placement stock where you can actually identify who bought the stock and what the price started at and what it ended up at. But where you've got a fast-moving market and a lot of buyers and sellers, you end up estimating.

Just a quick side note. I will say that in one case conviction recently involving a company called Ferrofluidics—whose CEO was convicted of a whole variety of frauds in connection with buying off analysts for favorable recommendations and phony private placements to sell his own stock—the judge ultimately used the amount of a class action settlement on the civil side as the loss figure.

There were competing theories about how you could value loss, and because the fraud had so many tentacles, it was difficult to do. And in the end, he said, "Look, there was arm's length negotiation between plaintiff's class and the defendant issuer and the various other people, and this is the number they ended up with, and I'm going to go with it.

QUESTIONER: Did the government take a different position on it?

MR. KHUZAMI: In the end, we said, "Your Honor, here are three different ways to calculate this loss," and we said, "Since there's the footnote that says when you can't do it with certainty, you can reasonably estimate, they were all reasonable estimates in their own way." And the judge ended up choosing one of them. I don't think we advocated a particular one.

MR. STARK: We also segregate them. On the civil side, we have the penalties and also the disgorgement. The disgorgement is just the ill-gotten gains. A lot of the time, the disgorgement just doesn't make sense.

It's put in a fund, and a receiver is appointed, and we'll put ads in *The Wall Street Journal* and so forth to say, "Did anyone buy at this time?" We'll contact some of the major market makers, for instance, and find out who the purchasers were in the context of the manipulation and try to figure out a way to carve that money up and give it back to investors.

But there comes a point where that disgorgement is just not big enough to warrant the hiring of the receiver and all the analyses that you need to do. So as a result, it just goes over to the U.S. Treasury.

The penalties go directly into the U.S. Treasury. So your first efforts are always toward disgorgement, but the reality is even in an offering context, as Rob said, like a private placement context, that's the easiest because you try to get the money back. You've got a list of investors. You hire a receiver, and they can carve it up and put it in a plant or in a thinly traded security.

The one case that we probably just won't get to, this Lucent case, would be a tough case, where somebody is spreading false information about Lucent. Do you want to explain this case, as a final note, because this is a case that's in progress right now?

MR. KHUZAMI: This a case where basically the individual posted a phony earnings warning on Lucent. He was short that day, took short positions in the stock, but had closed out those positions until he was flat at the end of the day, and then sent out the phony press release, which is a little different than the normal situation. You would expect them to go short, send out the phony release, let the price drop, and then cover and profit.

He didn't do that, and you know the posting said that they were going to miss their numbers. There are going to be some difficult loss issues there because, first of all, Lucent trades 15 million shares a day; second of all, tech stocks took a hit that day, and so on causation analysis, a lot of the loss—I think the company maybe lost billions in market cap that day, or at least on an inter-day basis.

But tech stocks in general took a hit that day. So how are you going to calculate loss under those circumstances? And those are issues that we're going to have to deal with.

QUESTIONER: He had no gain? He had no personal gain?

MR. KHUZAMI: He had no personal gain. He may have had nominee accounts that we haven't found yet, but he had no gain.

MR. STARK: I think what you're going to do first is call Cam if you're either Rob or me.

MR. KHUZAMI: And I would say, "Would you please do an audit trail for Lucent."

MR. STARK: Yes.

MR. FUNKHOUSER: Which is now trading at $20 a share, so everything he said turned out to be true, which poses a real problem.

QUESTIONER: What was his motive?

MR. KHUZAMI: This was another case where the decision as to whether or not to take it criminal is one you look at closely. But I think as is publicly alleged—first of all, this guy was a very active daytrader. He was not someone who would be able to claim he didn't realize what the market impact of the conduct was. This was as opposed to somebody who, perhaps, dabbles a little in this, but doesn't quite realize the consequences of their action.

Two—he put together the phony press release obviously. There was also a fair amount of deception; he posted on various bulletin boards and websites attracting people's attention to this phony posting, and he did it under different screen names, and he even adopted a screen name of someone who he knew to be very well respected with respect to Lucent stock. And he changed the name just a little, changed the spelling of the screen name to make it look like it was the well-respected guy, but, in fact, it wasn't.

So ultimately to answer your question what his motive was—I'm not sure I know exactly what his motive was. Thank God it's not an element of the offense, although a jury often wants to hear what the motive is, and it's hard to understand any other intent here except to drive down the price of the stock.

QUESTIONER: Has he been indicted?

MR. KHUZAMI: Yes.

QUESTIONER: So it is criminal?

MR. KHUZAMI: Yes, it is criminal.

MR. STARK: Any other questions? I think the theme of today, the one thing that I wanted to present, is that these cases really aren't that different than your traditional securities cases.

They're easier to commit, they're easier for us to track down, but the bottom line is that most of these issues of loss—which you in the criminal sector have to really deal with—sound pretty tough. But I don't think that the technology has really changed the game as opposed to some of the other technologies that have been discussed today. So thanks for your time and we'll see you in the plenary session.