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Stock market scams, shell companies, penny shares, boiler rooms and cold calling: The UK experience

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ABSTRACT

This paper examines the fraudulent sale of stocks and shares in shell companies by boiler rooms in order to defraud UK investors. It examines the law, the way boiler rooms are organised, the types of companies and scams used, and the markets involved including penny shares, US Regulation S stocks and the Over-the-Counter markets. It also examines the record of the UK regulators, primarily the Financial Conduct Authority (previously the Financial Services Authority) in acting against firms and individuals they had 'authorised', and other prosecutors in criminal actions against the perpetrators (usually unauthorised brokers running boiler rooms). The paper makes the point that whilst the public purse bears the costs of prosecution and compensation, the quasi-regulators (the professionals adding credence to a scheme) have rarely been pursued either as parties to a fraud or sued for negligence.

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1. Introduction

For many years now, stock market scams in the form boiler room operations have posed a major problem not only in terms of their cost to the economy (regulatory costs and losses to victims) but also frustration because the scams are so easily avoidable. It has been estimated that £200 m on average is lost in the UK each year by individuals from this kind of telemarketing fraud; the average amount being lost is £20,000 by 10,000 individuals each year and the largest individual loss reported £6 m.¹ The latest statistics of cases reported to Action Fraud show that between October 2013 and September 2014 more than £1.73bn was lost to fraudsters by 5252 investors across the UK, the average amount lost rising to over £300,000. Action Fraud has also calculated that each City of London-based boiler room is making, on average, almost £1.25 m.²

Using publicly available information such as telephone directories, lists of shareholders, names of company directors, together with marketing lists sold to businesses, these scams tend to start with a telephone call out of the blue. Telemarketing fraud is a type of what is known as 'mass marketing fraud' involving an uninvited contact and false promises designed to con the victim out of money (OFT, 2006). The victims are subjected to high pressure sales tactics (hence the term 'boiler room') often designed to force the victim into making a rushed decision and no time to consider the nature of the investment. Mass-

E-mail address: Paul.a.barnes@btinternet.com.URL: <http://www.paulbarnes.org.uk>¹ See <https://www.fca.org.uk/consumers/share-fraud-boiler-room-scams>.² See <http://www.actionfraud.police.uk/operation-broadway>. It should not necessarily be inferred from a comparison of these statistics that, whilst the number of victims per year may have fallen, the size of the losses has increased. The more likely reason is changes in the means of reporting.<http://dx.doi.org/10.1016/j.ijlcrj.2016.11.001>

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marketing fraud has gradually moved from being a predominantly North American problem into a pervasive global criminal threat (IMMFTA, 2010). In the UK approximately 2.6 million adults have fallen to these scams, with approximately 500,000 adults having fallen victim to dating/romance scams, 900,000 boiler room investment scams, 700,000 charity scams, 900,000 'need funds for an emergency' scams, 700,000 inheritance scams and 800,000 lottery scams. In 2012 alone, 800,000 UK adults became victims of mass-marketing fraud (Whitty, 2015). Of further concern is the number of repeat victims and under-reporting. Almost a quarter of victims had been scammed on at least one other occasion (Whitty, 2015). Action Fraud has also been estimated that less than 10% of the population report this type of crime: reasons include: the shame and embarrassment; lack of knowledge of where/how to report it and the futility of reporting it.

Button et al. in their survey of the mass-marketing fraud literature (NFA, 2009) identify the following strategies to avoid detection: 1. 'Rip and tear' a term referring to the fact that fraudsters, boiler room based fraudsters in particular, will move the physical location and move on before the local law enforcement is moved to act, 2. operating from regimes with limited police interest or if caught the sentencing regime is light (e.g. boiler rooms in Spain do not attack Spanish citizens) or 3. It is unlikely that they report the fraud, e.g. because it is unclear where a victim should report or who has responsibility for investigating it. Brochures often have warnings in small print of the risks involved contradicting the main message.

The purpose of this paper is to explain and discuss this type of stock and share scam.³ I have acted as an expert witness in most of the criminal cases and provided expert evidence in submissions to the Financial Services Compensation Scheme (FSCS) and, since the mid-1980s, studied their occurrence (Barnes, 1987). The paper is arranged as follows: the workings of a boiler room, the operation of the 'Over-the-Counter' (OTC) market and the nature of penny stocks are first explained and discussed. The law relating to the scam is then outlined and discussed followed by a review of the criminal cases and the civil actions of the Financial Services Authority (FSA) later to become the Financial Conduct Authority (FCA) in 2013 ('FSA/FCA' if referred to together). Finally, I discuss the preventative efforts by the FSA/FCA and the City of London police and the recovery and restitution of money lost, and make some recommendations.

2. Boiler room operations

2.1. How the scam operates

See Fig. 1. Essentially, there are two aspects to the fraud. There is (A) the boiler room operation run by fraudsters purporting to be brokers and there is (B) the shell company (or companies) the owners of which are fraudsters purporting to be businessmen. Fraudsters A and B may effectively be the same individuals, i.e. they run a boiler room, set up and own the fake companies whose shares they sell. Instead of setting up a fake company they may decide to buy a defunct or moribund one from its previous owners at a nominal price. If its shares are already listed on an exchange, this would enable the fraudsters to effectively acquire a share listing cheaply and bypass a lengthy and complex process. Also, if they are known fraudsters or have a dubious reputation, they may find listing on a reputable stock exchange difficult.

Alternatively, fraudsters who have set up the companies or acquired existing ones (B) may decide to employ an existing boiler room operation run by other fraudsters (A) and share the proceeds from the issue of the shares, say 50:50. Another scenario is that the companies run by (B) were legitimate businesses but found it difficult to raise equity or even innocently decided to employ a firm of brokers to raise capital not realising it was a boiler room operation run by fraudsters (A). In other words, in this scenario the members of Group B are not fraudsters but Group (A) are.

In most cases, the selling operation (i.e. the boiler room) will probably be from a separate location (e.g. Spain) to that of its official or purported base (e.g. a firm of stock brokers in London) and the companies' places of business (if they exist) and their registered offices (e.g. Nevada). The money sent by the victims, the buyers of the stock, will go directly to one of the two fraudster groups (A or B above) or their agents, who may be escrow agents or lawyers, and then transferred to another/other locations (e.g. in Hong Kong) i.e. laundered, quickly out of reach of investigators, asset tracers and recovery agents.

The shares will be part of a 'pump and dump scheme': that is aggressively sold over a certain period of time when the price and investor expectations are 'pumped'. At which point, whether the boiler room finds it too difficult to keep up the pretence, there are other companies' shares to sell or, for other reasons, decides to push another stock, the pretence ends, the share price ceases to be supported, i.e. 'dumped', and falls to zero or thereabouts, as it has no significant assets, no prospects of earnings and no real value.

The fraudulent brokers may have various strategies in order to maximise their profits. They may just decide to sell as many stocks as possible, simply choosing a new company name when they think the previous one is exhausted or another becomes available. Some of the cases that have come to court suggest that this is a common practice. Another one is to initially recommend shares in genuine companies from which they would build up their trust with victim investors who would then be offered shares in one of the shell companies.

How do they find victims? From my experience as an expert witness, they were found by a variety of methods including the purchase so called 'sucker' lists which contain the details of those previously fallen for a scam (Barnes, 2013; Shover et al., 2004; also refer to this), the purchase and/or commissioning of research to identify them and, of course, shareholder lists, although they are now not so easily available.

³ The terms 'stock' and 'share' are used in the paper. Their meaning is precisely the same and used interchangeably.

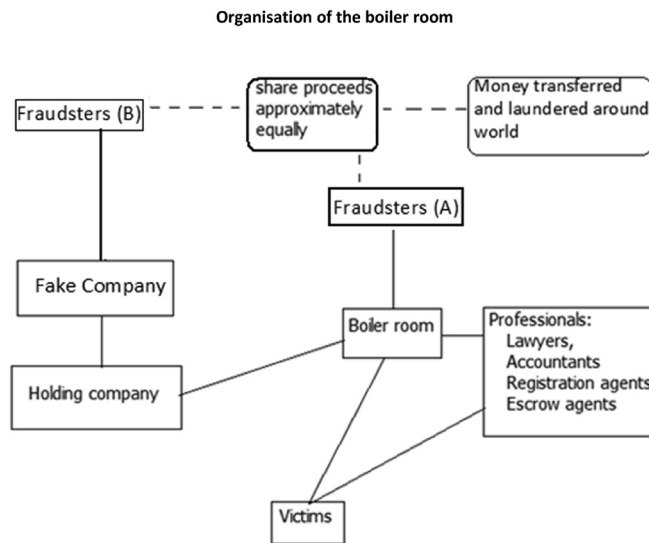


Fig. 1. Organisation of the boiler room.

2.2. The organisation of a typical boiler room

The typical size of a boiler room is 20 staff comprising sales staff ('brokers') and managers. Those targeting investors in Europe will usually be located in Spain,⁴ whilst those targeting the Australasian market will usually be located in Thailand, the Philippines, Cambodia or Laos where staff will have more diverse backgrounds. The boiler room will probably use technology and creativity to obscure its real location. Its salesmen may route calls through London dialling codes and direct investors to send payments to another location, probably in a reputable financial centre.

There is a fairly strict division of labour within the boiler room. At the bottom of the hierarchy are the 'qualifiers' who try to interest customers into making an investment. They may make unsolicited telephone calls and send out newsletters. Next are the 'verifiers' or 'openers' who call customers to make them more interested in the investment and their firm, win the confidence of the victim and sell them, perhaps initially, a small amount of shares. This may be followed up with hints of inside and other information suggesting how the price will rise. They will usually use false names. If the money is not forthcoming, a 'driver' will contact the victim saying that he/she has missed an opportunity as the price has risen in the meantime. The driver may then offer the shares at the original price. Once the victim has paid for the shares he/she will hear no more. When the share price stops rising and falls he may then contact the firm in a panic. He/she will be put in contact with a 'cooler' who has the task of calming down victims. Victims are then transferred to a 'loader' whose job it is to persuade them to buy more while the price is low. Dissatisfied customers are often told that the original opener has left the organisation. Coolers are instructed to return no more than 25% and if the pressure gets too great the boiler room may decide to close down and reopen under a new name.⁵ About 90% of victims soon accept the situation and write off the investment. Very few have recovered any of their money.

The salesmen who make the calls are typically well-spoken: In the case of targeting US or European investors they are typically male, English speaking, not highly educated but confident with good verbal skills with a background in telesales or at least have sales experience. Police say recruitment is being stepped up on university campuses in England to attract students hungry for jobs.⁶ Applicants are offered high earnings potential and full training is provided. Usually they are new to the business but aim to get rich quickly and to be able to demonstrate their wealth. Although turnover of staff is high, they are

⁴ According to the FSA in 2009, about one-third of all known boiler rooms were located in Spain, most of which are in the 1000 mile stretch of Mediterranean coastline between Barcelona and Marbella and known as the 'Costa del Crime'. An article in a Costa del Sol newspaper explained 'Spain's beach communities gained notoriety as a safe haven for British criminals in the early 1980s, when convicted robber Ronnie Knight spent a decade there on the run. A century-old extradition agreement between the U.K. and Spain lapsed in 1978 amid tensions over the status of Gibraltar, the self-governing British territory that Spain claims as its own. While the agreement was re-established in 1985 just before Spain joined the European Community, the predecessor to the European Union, the country didn't shake off its image as a gangster refuge. See <http://costadelsol.jigsy.com/entries/general/300-million-pounds-that-police-estimate-boiler-rooms-will-steal-from-u-k-investors-this-year>.

⁵ Shover et al. (2003) in their study of criminal telemarketers find a similar approach and division of labour involving: sales agents who make the first calls with a scripted pitch and identify potential victims; closers, who are more experienced, and then take on the role and 'reloaders', who are the most experienced and maintain contact with those already defrauded to secure more monies from them.

⁶ The OFT (2006) found that a important factor affecting the success of mass-marketing scams was the professional and legitimate appearance of what enticed victims, such as advertisement, e-mail, letter, brochure, telephone call, presentation etc. Shichor et al. (2001) found the credibility of names to be important in investment schemes, accents of salesmen/women in telemarketing, quality of documentation/brochures etc.

provided with incentives to remain working. Many have a record for dishonesty or violence. According to 'Operation Archway' in the UK,⁷ a quarter have criminal records of which half have a previous charge or impending prosecution for fraud. They are attracted to the lifestyle at the location - sun, sea, alcohol, soft drugs and access to prostitution - and they usually live in rented accommodation. Recruitment takes place through the internet, adverts and recruitment fairs.⁸ If the latter, it is through third parties. Boiler rooms operating in Asia and Spain normally recruit from backpackers passing through.

This description is consistent with findings regarding telemarketing criminals more generally who have similarities to other professional thieves: they are markedly individualistic in their dealings with others; they pursue a hedonistic lifestyle featuring illicit drugs and conspicuous consumption and attempt to justify their actions protecting them from moral rejection. However, telemarketing criminals and boiler room sales staff are more often from middle class, entrepreneurial backgrounds (Shover et al., 2003).

2.3. *Victims*

Targeted victims are typically older people with money to invest such as inheritance, pension or redundancy payments. They are often affluent, well educated with previous experience of investment (FCA, 2014). Many describe themselves as experienced investors having gained false confidence from their experiences during the Reagan-Thatcher era when they were actively encouraged to purchase stocks. Some have been the victims of other financial frauds and scams such as Ponzi schemes and lottery scams. 'Operation Archway' in the UK has estimated that 50% are aged over 65 and as mentioned in the Introduction, the average amount lost is £20,000. Although most victims are male, recently, there has been an increase in female victims and younger males indicating that the brokers will approach just about anyone. According to Operation Archway, boiler room scripts suggest that the criminals find men are easier to deal with as 'women ask too many questions' and men are more likely to feel shame and not report crimes than women. UK investors are particularly vulnerable to cold calls because names of shareholders in publicly traded companies are required to be listed on registers which are publicly available.

2.4. *Others knowingly involved in the scams*

There are many professional groups involved effectively adding the reputation of their firm or profession to the credibility of the investment. Firstly, the accounting firms who act as auditors to the companies or reporting accountants in prospectuses and offers for sale/subscription. In those cases where the companies concerned have filed audited accounts, it is likely that the accounting firm will know and understand the scheme, the financial arrangements, and the difference between it and what is understood by investors. In other words, it is reasonable to assume that the accountants/auditors know that the company they are putting their name to is part of a scam.

In a similar way the lawyers used by the boiler room and companies in the preparation of documents are likely to recognise the scheme as a scam and that they are allowing their name and reputation be used to mislead investors into thinking it is valid. The use of escrow agents to act as intermediaries in the receipt of money also has the effect of adding apparent legitimacy to something they should know is not.

2.5. *Secondary scams - fake regulators and fraudulent recovery agents*

After having been the subject of a scam, the investor may attempt to recover his/her money by contacting recovery agents and/or regulators. This may be seen by fraudsters as an opportunity to steal more from the victim and is common (FCA, 2014). There are regular reports of 'phantom regulators' who confirm the reputational status of the fraudulent brokers or direct victims to firms – fraudulent of course – who claim to provide assistance in recovering the lost money. Usually, these fraudulent recovery agents require victims to submit personal identity and confidential information online on 'claim forms' for which they request a fee. Victims are also contacted by fraudulent recovery agents or someone claiming to be from the police or a government agency stating that they know the investor has been a victim of a scam and offer advice. Recent examples of fake regulators include State Securities Commission, International Exchange Regulatory Commission, International Securities Department, Regulatory Compliance Commission, Securities Protection Agency and International Registry Corp (Singer, 2011) and fraudulent recovery agents include Securities Financial Commission and Crest Trust Management.⁹

There are other scams. The fraudsters may offer to exchange the stock for another one they are pushing provided the victim pays the transfer fee involved. The investor might also be told that the brokers have sold the stock and a large profit has been made but the victim needs to pay the capital gains tax bill to them before the proceeds can be released. Of course, this is not true.

⁷ 'Operation Archway' is a reporting system set up in the UK by the City of London Police to co-ordinate intelligence-gathering around boiler room scams. See www.fsac.org.uk/library/communication/pr/2010/019.html.

⁸ This advert in a UK newspaper is typical 'TELEMARKETERS WANTED FOR JOB OVERSEAS 18–30 years, with previous experience but not necessary. Training, flights and accommodation provided for successful applicants. Excellent communication skills and good phone manner are essential. Please phone

⁹ Various names appear on the forum at www.theinternetpatrol.com/new-online-investment-scam-mimics-regulatory-agencies.

3. Fake companies and the markets in which they are sold

Most of the stocks sold to UK victims are in small US or UK companies ('microcaps') and known as 'penny stocks'. These are usually sold 'Over-the-Counter' (OTC) on a US, UK or European OTC market. If US stocks, they are likely to be what is known as Regulation S or 'Reg S' stocks. In other cases, they may not yet be traded on an OTC market but sold as 'pre-IPO' stocks which, when listed, their value will increase considerably.

3.1. Penny stocks and shares

The term 'penny stock' or 'penny share' generally refers to low-priced, highly speculative stocks generally sold on an OTC market and generally not listed on an exchange. In the UK, there is no official definition of penny stocks and different observers may use different criteria. Most will suggest an upper limit for the market price to be anything from 50p to £3. Others may specify a ceiling on the market capitalisation of the company. The website, www.pennystocksshare.co.uk suggests that a penny share must be one with a share price of less than £1 or a market capitalisation of less than £100 million. The FSA Handbook offered a complicated definition: 'A readily realisable security in relation to which the bid-offer spread is 10 per cent or more of the offer price, but not (a) a government and public security; or (b) a share in a company quoted on The Financial Times Stock Exchange 100 Index; or (c) a security issued by a company which, at the time that the firm deals or recommends to the client to deal in the investment, has a market capitalisation of £100 million or more (or its equivalent in any other currency at the relevant time).¹⁰ The SEC states 'Penny stocks may also be traded on securities exchanges, including foreign securities exchanges' (<https://www.sec.gov/answers/penny.htm>). Penny stocks may trade infrequently, which means that it may be difficult to sell them. Also, if it is difficult to find quotations for a certain penny stock, it may be difficult, or even impossible, to accurately price.

For these reasons, penny stocks are considered speculative investments. In the US, broker-dealers are required under Section 15(h) of the Securities Exchange Act of 1934 to:

1. Approve the customer for the specific penny stock transaction and receive from the customer a written agreement to the transaction.
2. Provide the customer with a disclosure document called a Schedule 16G which describes the risks of investing in penny stocks. Customers must sign the Schedule 16G to show they have received it before the broker executes the trade in the stock.
3. Disclose to the customer the current market quotation, if any, for the penny stock; and
4. Inform the customer the amount of compensation the firm and its broker will receive for the trade. In addition, after executing the sale, a broker-dealer must send to its customer monthly account statements showing the market value of each penny stock held in the customer's account.
5. Wait at least two working days after sending the disclosure statement before executing the trade to give the customer time to consider the purchase.
6. Provide the customer a statement of his/her financial situation and investment goals explaining why penny stocks are a suitable investment for them.
7. Obtain from the customer written agreement to the transaction.
8. Send to the customer a monthly account showing the estimated value of each penny stock if there is sufficient information to make the estimate.

(The penny stock rules (Exchange Act Section 15(h) and Exchange Act Rules 3a51-1 and 15g: 1 - 100).

As an illustration of the speculative nature of penny stocks, a few years ago, I took a sample of 100 US OTC stocks and studied their subsequent performance over a period of three years. Their adjusted prices (i.e. after stock splits, reverse stock splits and rights issues) at the end of each quarter year were obtained and the capital gain/loss computed. In respect of 33 stocks their prices had fallen by 90% or more over the three year period, i.e. effectively the investor had lost all its money and the stock price was negligible. A further 12 stocks' prices had fallen by between 80% and 90%. In other words, the investment in 45% of the stocks had effectively been lost. On the other hand, 20 stocks had risen in price, although two stocks' prices had more than doubled over the three year analysis period.

3.2. Over-the-counter market

Instead of being listed and traded on the main highly regulated stock exchanges, shares may be traded on what is usually referred to as the 'OTC market'. An OTC market is not a stock exchange in the way that the New York Stock Exchange (NYSE) and LSE are. It simply provides a means by which securities may be bought and sold. There is no central 'exchange'. Trading occurs via a network of middlemen, called dealers or broker-dealers, who hold stocks of shares to facilitate the buying and

¹⁰ This was repeated in the FCA's handbook, glossary of terms. See <https://www.handbook.fca.org.uk/handbook/glossary>.

selling orders of investors, rather than providing an order matchmaking service as occurs on the large exchanges. Broker-dealers communicate and trade directly with each other and, in order to notify others they are willing to trade a security at a particular price, offer 'quotes' which are also displayed on financial websites. The important point is that the reported prices on a stock exchange are 'transaction based', i.e. derived from actual purchases and sales, whereas the prices shown on a financial website for OTC stocks are 'quotation driven', i.e. based on quotations from dealers as to the prices they state they would be prepared to buy or sell. As a result, OTC prices are more susceptible to manipulation as the broker-dealers are not bound by their quotes. Also, as there are no checks on the companies concerned and dealers and brokers, these stocks involve greater risks for investors.¹¹

The principal inter-dealer quotation system is NASDAQ ('National Association of Securities Dealers Automated Quotations System') in which brokers and securities firms provide competing bids to buy and sell NASDAQ listed stocks. These are aggregated and ranked and represent the reported 'market' for a security. The result is an orderly market and regulated by FINRA (The Financial Industry Regulatory Authority). FINRA sold its interest in NASDAQ and now provides it with regulatory services. NASDAQ consists of two separate markets: the NASDAQ Global Select Market and the NASDAQ Capital Market. The former is for larger and more actively traded stocks; the latter for smaller capitalised stocks. Each has its own set of financial requirements with which the listed companies must comply. Companies in the Global Select Market must satisfy stringent financial, capitalisation and corporate governance standards. The NASDAQ Capital Market has less stringent standards, although the corporate governance requirements are the same. As they become more established, companies in the Capital Market may transfer to the Global Select Market. NASDAQ is separate from and should not be confused with the US OTC market and the OTCBB ('Over the Counter Bulletin Board') quotation system. Although FINRA regulates both the NASDAQ and OTCBB, the latter are not listed on NASDAQ or any of the US national exchanges. On occasions, the OTCBB is referred to the NASDAQ Bulletin Board but this is misleading.

OTCBB stocks are traded by a group of market makers that enter quotes and trade reports through a closed computer network run by OTC Markets Group Inc. (www.otcmarkets.com) a private company, which provides electronic quotations, trading, messaging, and information platforms for about 10,000 stocks. Just like the NASDAQ, OTCBB broker-dealers communicate and trade directly with each other by means of an inter-dealer quotation system in which the quotes are reported on financial websites in the same way, the highest 'bid' (purchase price) and lowest 'ask or offer' (sale price) becoming the 'inside market' or NBBO.

OTC Markets classifies its stocks using three 'tiers' based on the quality and quantity of information the companies make available (www.otcmarkets.com/learn/otc-market-tiers). These are:

OTCQX – for established investor-focused U.S. and global companies. They must meet high financial standards, demonstrate compliance with U.S. securities laws, up to date in their financial reporting and be sponsored by a professional third-party advisor.

OTCQB - for entrepreneurial and development stage U.S. and international companies that are unable to qualify for OTCQX. They must be up to date in their financial reporting and undergo an annual verification and management certification process. They must also meet a minimum \$0.01 bid price test and may not be in bankruptcy.

OTC Pink¹² - for a wide spectrum of equity securities and brokers comprising companies for reasons of default, distress or design. They are sub-categorized by the level of information they provide. These are:

Current Information by following the International Reporting Standard, which requires the company to be listed on a Qualifying Foreign Exchange that requires periodic disclosure filings, or by following the Alternative Reporting Standard by making filings publicly available through the OTC Disclosure & News Service pursuant to the OTC Pink Basic Disclosure Guidelines. The Current Information category is based on the level and timely availability of disclosure and is not a designation of quality or investment risk.

Limited Information - for companies with financial reporting problems or in economic distress or bankruptcy. This category also includes companies that may not be troubled, but are unwilling to comply with OTC Pink Basic Disclosure Guidelines.

No Information - for companies that are not able or willing to provide disclosure to the public markets, either to a regulator, an exchange or OTC Markets Group. Companies in this category do not make Current Information available via OTC Markets Group's News Service, or if they do, the available information is older than six months. This category includes defunct companies that have ceased operations as well as 'dark' companies with questionable management and market disclosure practices. Companies that are not willing to provide information to investors should be treated with suspicion and their securities should be considered highly risky.

Additionally there is a 'distressed tier' comprising companies with limited information, a dark/defunct tier and a toxic tier. OTC Markets uses the following designations:

Caveat Emptor (Buyer Beware). Here, there is a public interest concern associated with the company, stock or person. This includes, but is not limited to, a spam campaign, questionable stock promotion, under investigation for fraudulent or other criminal activity, regulatory suspensions, or disruptive corporate actions and comprises about 500 companies.

¹¹ In the case of most OTC markets, but not NASDAQ listed stocks.

¹² 'Pink' refers to the original pink sheets which began in 1904 reported market data on pink coloured paper. The service was run by the National Quotation Bureau. It changed its name in 2000 to Pink Sheets LLC and to OTC Markets in 2010.

'OTC', Other OTC' or 'Grey Market'. These are stocks that are not currently traded on the OTCQX, OTCQB or OTC Pink marketplaces as broker-dealers are not willing or able to provide public quotes because of a lack of investor interest, company information availability or regulatory compliance.

3.3. Reg S stocks

These are shares in US companies which, because they have recently been issued, cannot be held by US citizens until a period has elapsed (one or two years) at which point they need their restrictive transfer legend to be removed by a registered transfer agent before they can be traded. Until that time, if they do have a price, this will have been artificially created as there is no proper market in the stock. In the case of fraudulent Reg S stocks with no assets and no real business prospects, as soon as they can be openly traded, their price will collapse as they are worthless.

Regulation S is a regulation relating to US stock sold outside the US. Section 5 of the Securities Act, 1933 states that, unless they qualify for an exemption, securities offered or sold to the public in the US must be registered by filing a registration statement with the SEC. However, under Reg S, companies do not have to register stock they sell outside the US to foreign or off-shore investors. It frees companies from registering their stock sold outside the U.S., and makes it easier for foreign investors to purchase the stock of U.S. companies. The regulation was created in 1990. Regulation S contains two safe harbour provisions: an 'issuer safe harbour' and a 'resale safe harbour'. In both, Reg S requires that offers and sales of the securities be made outside the US and that an offering participant (which includes the issuer, the banks assisting with the offer and their respective affiliates) does not engage in 'directed selling efforts'. In the case of issuers for whose securities there is substantial US market interest, the regulation also requires that no offers and sales be made to US persons, including those physically located outside the US.

Securities acquired in unregistered private sales from the issuer, or an affiliate, are known as 'restricted securities'. When issued, they are stamped with a restrictive legend stating that they may not be resold in the market unless they are registered with the SEC or are exempt from the registration requirements. SEC Rule 144 allows public resale if certain conditions are met.

If the company that issued the securities is subject to the reporting requirements of the Securities Exchange Act of 1934, the securities must be held for at least six months but, if not, they must be held for at least one year. The relevant holding period begins when the securities were bought and fully paid. However, even if the conditions of Rule 144 have been met, restricted securities cannot be sold to the public until the legend has been removed from the certificate by a transfer agent. It will only agree to do so if the stock holder has obtained the consent of the issuer for the restricted legend to be removed, usually in the form of an opinion letter from the issuer's counsel. Unless this happens, the transfer agent does not have the authority to remove the legend and execute the trade. Therefore, to begin the process, an investor needs to ask the issuing company about the procedures for removing a legend (www.sec.gov/investor/pubs/rule144.htm).

Most Reg S companies that are part of boiler room stings are incorporated in US states such as Nevada, Delaware, Wyoming, Alaska and Florida, particularly the first two which encourage companies to incorporate there by offering various advantages including tax benefits and a relatively liberal regulatory environment.¹³ At the forefront of this has been Delaware but in recent years Nevada has tried to 'out Delaware' Delaware (http://en.wikipedia.org/wiki/Nevada_corporation).¹⁴

3.4. Other markets popular for boiler room stocks

Boiler room shares have also been listed in the UK on the Alternative Investment Market (AIM), OFEX and PLUS. AIM is a sub-market of the LSE with a more flexible regulatory system allowing smaller companies to float. It has less stringent listing requirements, primarily concerning the provision of financial information. OFEX and PLUS are now part of the ISDX exchange (full name ICAP Securities and Derivatives Exchange) which offers small companies a springboard for listing on the Main Market or AIM.

Elsewhere in Europe, boiler room shares have been listed on Xetra and the Frankfurt and Berlin exchanges. Xetra (**Ex**-change **Electronic Trading**) is a worldwide electronic securities trading system based in Frankfurt, Germany. It was originally created for the Frankfurt stock exchange but now also operates on a number of other exchanges including the Vienna, Irish, Bulgarian, Budapest and Shanghai stock exchanges. The Frankfurt Stock Exchange (FSE) is the world's third largest stock market. Although it has some traditional broker-supported floor trading, most of the trading is done via Xetra. The FSE has both a regulated and an 'open' market (also referred to as the 'regulated unofficial market') which is not subjected to the transparency standards and the strict investor protection provisions for EU-regulated markets. The Berlin Stock Exchange is a relatively new exchange but it lists many US, international and other European companies.

OTCBB companies can obtain a dual listing on these exchanges at a relatively small cost. This may give the impression of the company's shares being traded on international markets and when victims complain that they are unable to sell their shares on one market, this may help a boiler room sales person to say that there is a good market elsewhere.

¹³ For a discussion see [Bishop \(2008\)](#).

¹⁴ In Nevada, there is no personal tax, corporate income tax on income from the company. It does not report data to the IRS and allows 'nominees' to be appointed in place of real directors and officers, making it difficult, if not impossible, to find who is really behind a company.

3.5. *The manipulation of prices and information influencing them*

Most schemes involve not only simple theft by selling shares in effectively worthless companies but also the ‘pumping’ of a company’s stock price, the creation of the appearance of an active and liquid market, or public perception of the company. There are various ways in which this may be done. The publication of incorrect and misleading press releases to raise expectations is common. Financial statements are also manipulated – if they are reported. Many fake companies whose shares are available OTC may not comply with reporting requirements, e.g. those of the SEC.

A share price may be altered at a stroke by means of a ‘stock split’ or a ‘reverse stock split’. These are perfectly legal procedures, the former often used by listed companies in the belief that it would make trading in their shares easier as their unit price is smaller. A stock split is simply the division of a share into smaller units. For example, if you held one share, a two for one split would cause you to own twice as many shares, in this case two. As nothing else has changed to affect the company’s value other than the number of shares in issue has doubled, the value of each one (and therefore the new price) will be half of that which it was before. A reverse stock split is precisely the opposite. For example, if you held two shares, a one for two reverse split would cause you to hold half as many shares, in this case one, but it would now be valued at twice what it was previously. The effect on the price of a share is to cause it to rise by the relevant proportion; here by 100 per cent. Theoretically, a share’s market price would adjust precisely in line with the proportional effect described. However, this may not always be the case as a sophisticated market may see a split or reverse split as having ‘information content’ and adjust to that as well. In a less sophisticated market in which scams occur, these changes may not be seen as artificial devices designed to change the price of a share but to be believed and/or presented as real changes; in the case of a stock split, a windfall increase in the number of shares the investor holds and a reverse stock split as a windfall increase in the share price.

Finally, in the case of OTC stocks it is possible that the ‘market makers’ themselves may manipulate reported prices and volume of trade. As the prices are ‘quotation-based’ rather than ‘transaction-based’ effectively they may return price quotations of whatever figure they may choose. It would be another matter if they actually agreed to buy or sell stocks at that price. False volume data may be achieved by means of artificial sales, say from one market maker’s hand to its other or from one market maker to another.

4. The law

4.1. *Historical background*

The regulation of stockbrokers and dealers has traditionally been done by licensing. Under the Prevention of Fraud (Investments) Act, 1939 and later the Prevention of Fraud (Investments) Act, 1958, stockbrokers and dealers were required to be licensed by the Department of Trade and Industry (DTI). However, members of a recognised stock exchange, such as the London Stock Exchange (LSE), were exempted. In fact, there was an air of snobbery by those not having a licence and being exempted. Having a licence was seen as an indication of inferiority. Investment ‘advisers’ as opposed to ‘dealers’ and certain investments outside the scope of the Licensed Dealers (Conduct of Business) Rules 1960 which banned door-to-door and telephone selling, were also excluded from regulation. There were also a number of unlicensed dealers who were not regulated in any way. In sum, the licensing system was arbitrary.

The various scandals and collapses which occurred in the 1980s demonstrated the deficiencies of the regulations and that once a company was given a licence, its customers had little protection (Pimlott, 1985). The Barlow Clowes collapse in 1988 dramatically highlighted the inadequacies of licensing of dealers by the DTI. It incorrectly informed Barlow Clowes that it did not require a licence. When it recognised it had made an incorrect decision in 1985, the DTI hastily issued one knowing that Barlow Clowes’ books of account were inadequate. Barlow Clowes collapsed soon after, and given the circumstances of the issue of its licence the Parliamentary Ombudsman decided that investors should be compensated (Baker, 1990).

Under the Financial Services Act 1986, licensing was tightened up. A self-regulatory authority, the Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBRA) was charged with the task of licensing all involved in financial services and imposing on them effectively a system of rule books. Under the Financial Services and Markets Act, 2000 (FSMA) FIMBRA was replaced by a regulatory authority, the FSA/FCA. Both are/were operationally independent from Government and responsible for the investigation of possible misconduct and subsequent enforcement proceedings.

4.2. *The law today*

Firms offering financial services in the UK must be authorised by the FSA/FCA. Under Section 21 of the Financial Services and Markets Act 2000 (FSMA) a person must not, in the course of business, communicate an invitation or inducement to engage in investment activity unless that person is an authorised person or the content of the communication is approved by an authorised person. Under Section 19 of FSMA, any person who carries on a regulated activity in the UK must be authorised by the FSA/FCA. Under Section 20, if an authorised person carries on a regulated activity in the UK, or purports to do so unless granted permission he/she is to be taken to have contravened the Act.

If an authorised person has contravened the Act, under Section 205, the FSA/FCA may publish a statement to that effect, a ‘Decision Notice’ or ‘Public Censure’ and, if he/she has contravened the Act, the FSA/FCA may impose a penalty (Section 206). The criteria used by the FSA/FCA when deciding if an authorised business’ or individual’s conduct has been proper and

Table 1
FSA/FCA principles of business.

1. Integrity: A firm must conduct its business with integrity.
2. Skill, care and diligence: A firm must conduct its business with due skill, care and diligence.
3. Management and control: A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4. Financial prudence: A firm must maintain adequate financial resources.
5. Market conduct: A firm must observe proper standards of market conduct.
6. Customers' interests: A firm must pay due regard to the interests of its customers and treat them fairly.
7. Communications with clients: A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
8. Conflicts of interest: A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9. Customers: relationships of trust: A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.
10. Clients' assets: A firm must arrange adequate protection for clients' assets when it is responsible for them.
11. Relations with regulators: A firm must deal with its regulators in an open and cooperative way, and must disclose to the appropriate regulator appropriately anything relating to the firm of which that regulator would reasonably expect.

satisfactory are contained in their 'principles of business'. These are listed in Table 1.¹⁵ Under the, more recent, Financial Services Act 2012 (FS) the FCA also has the power to ban financial products, publish details of misleading financial promotions, and when they are proposing to take disciplinary action against a firm.

Under UK law, there are both civil and criminal market abuse offences. In respect of a criminal offence, FSMA section 397, which replaced section 47(2) of the Financial Services Act, 1986, it is unlawful for a person to:

- (i) make a statement, promise or forecast which he knows to be misleading, false or deceptive or
- (ii) dishonestly conceal any material facts whether in connection with a statement, promise or
- (iii) recklessly make (dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive.

Section 397 was repealed by section 95 of the FS and the single offence replaced by three separate offences: misleading statements (section 89) misleading impressions (section 90) and misleading statements in relation to benchmarks (section 91, a new offence in respect of the manipulation of LIBOR and outside the scope of this paper). They largely cover the same ground as the single offence under 397 but the misleading impressions offence is now broader in that it includes misleading impressions made recklessly in addition to those made intentionally.

In respect of market abuse as a civil offence, Section 118 of the FSMA specifies seven types.¹⁶ These are listed in Table 2. It is unnecessary to show dishonest intention to commit market abuse; negligent action or inaction may be sufficient and it is irrelevant where the behaviour occurred, in the UK or abroad. Section 118 was amended in 2005 to implement the current Market Abuse Directive (2003/6/EC) although the main provisions were unchanged. On 3 July 2016, under the Financial Services and Markets Act 2000 (Market Abuse) Regulations 2016, this regime was superseded by a new EU Market Abuse Regulation (EU/596/2014)(MAR).¹⁷ Although the main provisions were unchanged, the Regulations extended the civil market abuse regime to new markets and instruments and a new offence of attempted market abuse was introduced.

These types of fraud are also covered by the general criminal offence of fraud under the Fraud Act 2006.¹⁸ It can be committed in three ways: by false representation, failing to disclose information, and abuse of position. The latter has particular relevance to market abuse as it states that a person is in breach of this section if he/she occupies a position in which he/she is expected to safeguard, or not to act against, the financial interests of another person, dishonestly abuses that position, and intends, by means of the abuse of that position to (i) make a gain for his/herself or another, or (ii) cause loss to another or to expose another to a risk of loss. There are two basic requirements which must be met for the general offence to apply. The behaviour of the defendant must be dishonest and it must be his intention to make a gain, or cause a loss to another. However, it is no longer necessary to prove that a gain or loss has been made, or that a victim was deceived by the defendant's behaviour.

Most of the large market abuse criminal cases have been prosecuted under the Criminal Justice Act 1993 Part V insider dealing provisions in conjunction with the Criminal Law Act 1977 section 1 which makes it an offence to conspire to commit an act which would be a substantive offence in criminal law. In addition to all the above, a person may also be charged for laundering the proceeds under the Proceeds of Crime Act, 2002 ('POCA').

An important component of these scams is cold calling. However, it is not an offence for a boiler room to phone potential customers in this way. As in most countries, cold calling is not illegal but there are regulations in place to limit them. In the UK,

¹⁵ The legal requirements for persons selling investments are similar elsewhere. In the US, a stockbroker license from the Financial Industry Regulatory Authority is required and in Australia an Australian financial services (AFS) licence is required.

¹⁶ This was supplemented by guidance and examples in the FCA's code of market conduct.

¹⁷ MAR was accompanied by a Directive on Criminal Sanctions and Market Abuse but the UK chose not to implement it.

¹⁸ In a recent case, *R. v Still and Van Sante*, the two defendants were charged with making or supplying articles for fraud contrary to Section 7(1) of the Fraud Act 2006.

Table 2

The seven types of market abuse (FSMA, 2000).

-
1. Insider dealing.
 2. Improper disclosure - of inside information to another.
 3. Misuse of information - behaviour based on information that is not generally available that would affect an investor's decision about the terms on which to deal.
 4. Manipulating transactions - trading, or placing orders, to give a false or misleading impression of the supply or demand for an investments, raising its price to an abnormal level.
 5. Manipulating devices - trading, or placing orders, which employ fictitious devices or any other form of deception or contrivance.
 6. Dissemination - knowingly providing information that gives a misleading impression about an investment.
 7. Distortion and misleading behaviour - to gives a misleading impression or distorts the market in an investment.
-

the Privacy and Electronic Communications (EC Directive) Regulations 2003¹⁹ prohibits the use of public electronic communication services for the purpose of making unsolicited calls for direct marketing purposes where the recipient has previously notified the caller that such calls should not be made on that line or where the recipient's telephone number line is listed in the Telephone Preference Service register or the Corporate Telephone Preference Service register. Anyone may register. Callers from overseas on behalf of UK organisations are required to comply with these regulations. However, they do not prevent recorded/automated messages, silent calls, market research, overseas companies, debt collection and scam calls.

Finally, it should be pointed out that brokers can act in the capacity as either the 'agent' or 'principal'. An agent is simply acting as a third party in the purchase or sale of a stock for a client. Agents are typically paid a commission of about 1 percent. A principal stockbroker is selling shares it has already acquired either directly from the company as a part of a placement or in bulk from a market maker. In both instances the principal may be able to obtain the shares at a considerable discount to the market price or the price it charges the client. Principal trading therefore creates a significant conflict of interest for stock-brokers who are advising clients to buy shares especially if they stand to make a considerable profit from the transaction.

5. The frauds

5.1. Cases

The criminal cases brought in the UK against boiler rooms since 2009 are listed in [Table 3](#). There have been nine. There were earlier cases but these were mainly in the US whose victims were UK citizens but the fraud perpetrated there, notably Bruckman and Trafalgar Capital (UK) in 1985.²⁰ Cases in which the FSA or the FCA has acted against boiler room operators are listed in [Table 4](#).

It appears that if the fraudulent brokers are authorised then the FSA/FCA may act against them by issuing fines and/or closing them down. The victims would be able to claim compensation from the FSCS. If the brokers are unauthorised, the FSA/FCA is unable to penalise them and has limited powers. In which case, the only course of action is a criminal action. But that, of course depends upon the whereabouts of the fraudsters and the stolen money (e.g. if they can be identified and traced) the likelihood of success (e.g. the strength of evidence) the cost of the action, given the regulatory austerity and other pressures on the SFO and other prosecuting authorities. It also appears that the two approaches (FSA/FCA penalty or a criminal action) are largely mutually exclusive, i.e. there have been few cases of criminal action against an authorised broker; equally, there have been few instances of victims' losses being paid out of the FSCS where there has been a criminal action, although there have been instances when part of their losses have been paid out of the funds recovered. There are also cases where neither has happened. That is of boiler room operations that have been operated by unauthorised persons (in which case, victims are unable to claim on the FSCS) that have not been criminally prosecuted. Also, of course, there are cases of authorised persons against whom the FSA/FCA has not acted.

5.2. Prevention, recovery and restitution

There have been various preventative efforts. The FSA/FCA published/s lists of both authorised and unauthorised firms and individuals known to be offering services unlawfully together with clones of registered firms.²¹ However, if a firm appears on the unauthorised list, it may simply decide to change its name making, almost by definition, the list out of date and incomplete.

There have been many warnings on regulators' websites, such as the FSA/FCA, the City of London Police in the UK, the FBI, SEC and OTC Markets in the US. Unfortunately, internet notices were found to be ineffective and in 2011 the FSA decided to

¹⁹ These regulations have been amended recently under the Privacy and Electronic Communications (EC Directive) (Amendment) Regulations 2015 to permit a caller to call in an emergency.

²⁰ Bruckman's Chartwell Securities AG, in Zurich, Dusseldorf and Munich sold OTC stocks traded in the UK and US. His strategy was to first obtain stocks in a good company that would yield investors high returns then, based on this success, sell investors their worthless shares. Bruckman was eventually charged by the US authorities, found guilty and jailed. For the full story see [Bosworth-Davies \(1987\)](#) p.107–122.

²¹ See www.fsa.gov.uk/doing/regulated/law/alerts/unauthorised-firms.

Table 3

UK criminal cases relating to boiler room operations.

Date	Individuals	Details
9/4/09	Inaam Ul Haq, Niven Gunaratnam, Frazer Beatie, Nicholas Ailey	Sentenced to 42, 66, 54 and 48 months, respectively. The boiler-room was based in Barcelona and marketed shares in a UK company, Netjet Ltd, which was to be floated on AIM. Investors lost around £4 m. https://www.herts.police.uk/pdf/make_criminals_pay_op_wizard.pdf .
27/4/09	Henrik Botcher Fraser Jenkins Claude Greaves Roozbeh Yazdaniyan	Sentenced to 45 and 21 months, 5.5 years, 33 months respectively. The boiler-room was in Barcelona, 500 investors lost a total of £2.4 m mainly by investing in Artemis Energy, in which it was falsely claimed would soon publicly trade shares on the AIM market.
14/6/11	David Mason David Sinclair	Sentenced to 2 yrs and fined £68,000 by FSA respectively. 32 people invested £270,000 in the belief that EduVest would soon be listed on the PLUS stock exchange. Share certificates were never issued, EduVest was never listed and investors' funds were never used for EduVest business http://www.fsa.gov.uk/library/communication/pr/2011/051.shtml
22/8/11	Tomas Wilmot ^a Kevin Wilmot Christopher Wilmot Michael McInerney	Sentences 9–4.5 yrs. 16 different boiler rooms in Barcelona, Alicante and Palma Spain. Their back office, accounts and the companies used were from Malta, Italy, Slovakia, Lithuania, Anguilla, Austria, Andorra, Brazil, Belize, Dubai and the Caribbean. The operation involved the sale of shares to 1700 UK victims between 2003 and 2008 who incurred losses of £27.5 m. Start-up companies needing IPO funding were approached with a promise of funding from venture capitalists. This was a ruse used to persuade them to agree to issue penny stocks. http://www.fsa.gov.uk/library/communication/pr/2011/073.shtml .
13/10/11	Dennis Potter Redmond Johnson Steven Murphy Greg Pearson Paul Murphy Lee Homan Peter Bibby	Sentences 7 - 3 yrs. Investors incurred losses of £8 m. Boiler-rooms in Marbella and Barcelona claimed to be calling from offices Frankfurt, Stockholm or Amsterdam. They targeted thousands of UK investors selling Reg S stocks. http://www.sfo.gov.uk/press-room/latest-press-releases/press-releases-2011/seven-guilty-in-bio-diesel-investment-fraud.aspx
24/4/12	Brian O'Brien Lynne D'Albertson James Pye Damien Smith	Sentences 8 - 4 yrs. Various boiler-rooms in Spain and Ireland targeting UK investors netting £4 m. Initially, used two small companies that wanted to raise capital quickly. Unknown to them, their shares were being sold to investors at far higher prices than had been agreed. Rooms also sold shares in companies they said were about to be listed on a recognised stock market, such as Ofex (now PLUS Markets) and AIM claiming that this would give the share value a significant boost. http://www.sfo.gov.uk/press-room/latest-press-releases/press-releases-2012/offshore-share-sharks-who-duped-british-investors-jailed.aspx
4/6/14	J. Revell-Read A. May D. Gooding S.D. Rumsey Philip Morris J.S.F. Emery I. Hughes E. Farmer M. Coleman	Sentences 7yrs 4months–21 months suspended. Between 2003 and 2007, about 1000 UK investors lost around £70 m, the largest case to date. The gang operated boiler rooms in Madrid. The case involved 52 stocks, most of which were US Reg-S stocks but also AIM and Ofex (now Plus Markets) stocks. They claimed to be traded over the US OTC market and also listed on the on European exchanges such as the Frankfurt, XETRA and Berlin exchanges. Techniques such as stock splits, reverse stock splits takeovers, reorganisations, reconstructions and fraudulent press releases were used to inflate the apparent worth of the stocks. http://www.sfo.gov.uk/press-room/latest-press-releases/press-releases-2014/nine-convictions-linked-to-70m-boiler-room-fraud.aspx
29/5/15	A. Khan R. Karim N. Amin A. Baugh W. Karim	Sentences 6yrs 9months – 4yrs. 100 investors lost £3 m in 10 IPO stocks. The boiler room in Palma, Majorca, used VOIP (Voice over Internet Protocol) to cold call potential investors in the UK. They were all found guilty of conspiracy to defraud and money laundering and jailed. http://www.cityoflondon.police.uk/advice-and-support/fraud-and-economic-crime/fraudsquads/fraudsquad-News/Pages/Multi-million-pound-boiler-room-share-scam-gang-jailed.aspx
15/3/16	S.J. Still M. Van Sante	Both received sentences of 40 months for printing and assisting in the production and distribution of brochures for the brokers under section 7(1) of the Fraud Act, 2006 relating to the making or supplying articles for use in fraud, estimated to be worth £1.5 m. The operators of the boiler room probably located in the Caribbean are unknown. Most of the fraudulent stocks were unlisted OTC stocks registered in the US. https://www.cityoflondon.police.uk/advice-and-support/fraud-and-economic-crime/fraudsquads/fraudsquad-News/Pages/Business-partners-convicted-of-producing-brochures-used-to-con-investors.aspx

^a The author of a book on the Over-the-Counter market (Wilmot, 1985)!

write to over 75,000 people whom it considered potential victims.²² Various other firms and organisations have also decided to issue warnings²³ and newspapers, radio and TV have campaigned about share scams by exposing cases, particularly those in which the FSA/FCA or the Serious Fraud Office (SFO) decided not to pursue.

There have been other initiatives. In 2007 the City of London Police launched 'Operation Archway' which was a reporting system for boiler room fraud through which they could gather intelligence and co-ordinate their efforts. In 2015 Operation Broadway was set up comprising a multi-agency taskforce was set up specifically to tackle the organised criminality.²⁴ In order to demonstrate to virtual and serviced office providers that they may be unknowingly providing criminals with prestige

²² This is known as 'Operation Bexley' and is the result of the FSA having recovered a number of lists containing the names of 76,732 people from companies involved in boiler room operations. See www.fsa.gov.uk/library/communication/pr/2012/039.shtml.²³ For example, HSBC in the UK on its internet banking website.²⁴ See endnote 2 above.

addresses from where to work and promote their scams, a number of offices in London's financial districts, including the Square Mile, Canary Wharf and Westminster were raided by City of London Police, City of London Trading Standards and Metropolitan Police. They have also leaflet office workers warning them of the consequences of being found to be part of a criminal operation.

There have also been efforts to close down boiler rooms. When I started researching them in the 1980s, the most popular location was Amsterdam. As a result of public pressure, the Dutch police were successful in driving them out.²⁵ Unfortunately, they simply went elsewhere.

Despite the prevalence of fraudsters purporting to act as recovery agents, there are genuine organisations that do attempt to recover lost money.²⁶ It is also possible that a victim may obtain compensation under the FSCS in the event of a 'default'²⁷ by an authorised firm. The Financial Ombudsman Service may also settle individual complaints about firms providing financial services. However, many boiler room operations are perpetrated by unauthorised firms and, unless it can be shown that the firm is an authorised representative of an authorised firm, compensation is not available.

In the UK, if a fraudster is found guilty in a criminal case, under the Proceeds of Crime Act he/she is required to repay the funds obtained illegally. All funds in the fraudster's possession are assumed to have been obtained illegally unless the fraudster(s) is able to prove otherwise. In which case, if the action is quick enough, it is possible that a confiscation order obtained from the court, their bank accounts frozen, and the fraudsters ordered to return the stolen money before the money is transferred abroad.²⁸ How successful this is in practice is not known as in most cases the amount distributed to the victims is not made public.²⁹ Also, unfortunately, for the victims, there have been relatively few cases brought to court, the fraudsters' money could not be traced, or were outside the reach of the court. What has happened, particularly in the US, is a plea bargain in which restitution of some of the lost money is bargained in return for a lighter jail sentence. It has also been possible for the FSA to obtain a freezing order against a US fraudster for it to return money to UK victims of a boiler room operation.³⁰

Finally, in rare instances the victims have been able to recover the lost money from the fraudsters. One investor who was the victim of boiler room scams on various occasions was able to largely recover the lost money by means of aggressive calls, letters, visits to company offices and the employment of a private detective able to pressurise the fraudsters into agreeing to repay the amount invested.³¹

6. Final remarks

The public attitude towards victims of online fraud, is that they are greedy, gullible and their losses their own fault (Cross, 2015). This is not surprising. Why should the taxpayer foot the bill? Why shouldn't investors pay for themselves to be insured for these types of loss, particularly if these scams are so obvious? At the moment, the FSCS provides this for free. The red flags are clear: if a broker is unauthorised, an investor should simply not purchase the stock. If the broker is authorised, an investor should be cautious about OTC and penny stocks and avoid Reg S stocks. My research shows that the likelihood of a large capital gain is very low for US OTC stocks and unjustified relative to the risks involved. Also, because the reported prices are 'quotation-based' rather than 'transaction-based', an investor should be sceptical about the published price and volume data. If the shares offered are part of an IPO, the share of the funds raised and paid as fees to the promoters is stated in the share offer document. (It should be around say 5% and not 30% as in the Wills & Co and Ascension Securities' IPOs.) If an investor is unable to obtain this, he/she should seek advice.

In a study of victims of a US boiler room operation, Shichor et al. (2001) found that the perpetrators were not seriously punished for the fraud and their victims were not able to recover their losses. This raised hostility and negative attitudes from the victims toward the regulators and the criminal justice system - stronger than the animosity toward the perpetrators themselves. These feelings were exacerbated by the belief that whilst many street criminals go to prison for relatively minor crimes, white-collar offenders often steal large sums of money and are softly treated. Despite this, the morality of boiler room scams is obvious: they are simply theft. It is also clearly in the public interest (and, therefore, public policy) that capital markets are, and are seen to be, efficient (in the sense of effective pricing leading to the efficient allocation of capital), fair (in the sense of 'investor egalitarianism') and savers are able to invest without expecting to be defrauded (i.e. takes on the business risk)(Barnes, 2009).

From the outset, the FSA/FCA has embraced the policy of 'credible deterrence'.³² Although it remains formally undefined, IOSCO (2015) has listed seven factors contributing to credible deterrence: legal certainty, good detection, co-operation and

²⁵ For an account of how this was done in 1986, see Francis (1988) p.8–31.

²⁶ For example, Hallbrook Partners, for whom I have acted in submissions to the FSCS.

²⁷ This means that the brokerage is unable or likely to be unable, to pay claims against it.

²⁸ For example, in February 2012 the FSA obtained a court order against Monobank plc enabling £64,000 of redress to be paid to victims of a boiler room scam. See www.fsa.gov.uk/library/communication/pr/2012/016.shtml.

²⁹ See for example the UI Haq and others case listed in Table 3. Details of the award were given in www.watfordobserver.co.uk/news/8303580. Also, re Michael McInerney in Table 3 see www.fsa.gov.uk/library/communication/pr/2012/109.shtml.

³⁰ The FSA obtained a court order against Sinaloa Gold Plc and one of its directors, G.L. Hoover, a US resident to return 127,000 to 79 UK victims. At one stage, Sinaloa was quoted on the Frankfurt Stock Exchange's First Quotation Board. See www.fsa.gov.uk/library/communication/pr/2012/074.shtml.

³¹ Private correspondence with the victim.

³² See for example, Tracey McDermott speech of 18 June 2013 available at <https://www.fca.org.uk/.../news/enforcement-credible-deterrence-speech.pdf>.

Table 4

UK non-criminal cases involving actions taken by the FSA/FCA relating to boiler room operations.

Date	Individuals	Action
3/3/05	Highbury Financial Services Ltd	Fined £35,000 for breaching Principles 2, 3 and 7 of the FSA Principles of Business in relation misleading publications relating to penny shares. http://www.fsa.gov.uk/pubs/final/highbury_3mar05.pdf
4/8/06	Astor Securities Ltd	An appointed representative that is no longer an agent of an authorised firm https://register.fca.org.uk/
10/1/08	Square Mile Securities Ltd, formerly Halewood International Futures Ltd	Fined £250,000 for breaching Principles 1,3, 6 and 9 of the FSA Principles of Business in relation to the sale of shares for emerging or small capital companies that had been, or were intended to be, traded on the AIM or PLUS markets. www.fsa.gov.uk/library/communication/pr/2008/060.shtml
26/6/08	Chesteroak Ltd, Bingen Investments Ltd, and S. Kahn	In 2007, the FSA obtained interim injunctions against both companies and Mr Kahn for dealing in shares or arranging deals in shares without authorisation. Their assets and other assets under their control were frozen. The companies were wound up and bankruptcy order made against Kahn. Kahn fined £1,094,000. As Chesteroak and Bingen were not authorised by the FSA investors were unable to make a complaint to the Financial Ombudsman Service or claim compensation from the FSCS. http://www.fsa.gov.uk/library/communication/pr/2008/060.shtml
27/1/09	Pacific Continental Securities Ltd, Steven Griggs and Charles Weston	FSA issued a 'public censure' for breaching Principles 1, 3, 6 and 11 of the FSA Principles of Business. It would have fined PCS £2 m if it had not been in liquidation. Griggs and Weston were fined £80,000 and £95,000 respectively. PCS sold AIM and Reg S stocks. The FSA estimated that between January and June 2006 PCS sold AIM stocks of £7.3 m from which it earned commission of £1.8 m. The FSA also estimated it sold AIM stock of £14.m p.a. and earned commission over £3.6 m p.a. www.fsa.gov.uk/library/communication/pr/2008/060.shtml
29/1/09	Falcon Securities Montague Pitman Stockbrokers (MPS)	Censured for breaches of Principles 3, 6, 7 and 9 of the FSA Principles for Businesses between 17 September 2007 and 30 January 2009 relating to advising on and arranging the sale of higher risk small stocks traded on AIM and contracts for difference for MPS's retail clients. A penalty of £240,000 would have been imposed but was waived as Falcon agreed to cease selling investments to clients and was in administration. http://www.fsa.gov.uk/pubs/final/falcon.pdf
3/9/09	White Square Investments Ltd	Cancellation of permission to carry on regulated activities because of a capital resources deficit. www.fsa.gov.uk/library/communication/pr/2008/060.shtml
31/10/07 16/2/10	Wills & Co Darren Lansdown, Katharine Prichard	Censured and fined £49,000 for breaching Principles 3 and 7 of the FSA Principles of Business relating to advising, arranging and selling high risk stocks to its private customers involving a number of IPOs promising that they would be listed on the AIM market. However, this was not normally achieved and the companies failed. Wills acted as the Nomad for most of the companies and, usually acting as principal and based on misleading financial information, sold their stocks at inflated and unrealistic prices. www.fca.org.uk/.../fsa-final-notice-2010-wills-co-stockbrokers-limited
17/2/10 25/6/09	Direct Sharedeal Ltd First Trade UK (representative for DS)	Fined £101,500 for between 29 October 2007 and 31 March 2009 breaching Principles 3, 6 and 10 of the Principles for Businesses and Rule 12.6.5R in the Supervision manual of the FSA Handbook which states that a 'firm must not permit an appointed representative to hold client money ...' and it 'must take reasonable steps to ensure that if client money is received by the appointed representative, it is paid into a client bank account of the firm, or forwarded to the firm'. http://www.fca.org.uk/static/pubs/final/direct_sharedeal.pdf Cancellation of permission to carry on regulated activities. www.fsa.gov.uk/library/communication/pr/2008/060.shtml
15/4/10	Hythe Securities Ltd and its CEO Meenaz Mehta	Fined £200,000 for breaching Principle 3 of the FSA Principles of Business in relation to the sale of penny shares on AIM, PLUS markets and contracts for difference between 1 June 2006 and 21 May 2008. http://www.fsa.gov.uk/pubs/final/hythe.pdf Mehta fined 35,000 and prohibited from doing FSA related business http://www.fca.org.uk/static/pubs/final/mehta.pdf
22/4/10	Winterflood Securities Ltd, Stephen Sotiriou and Jason Robins	Fined £4 m, £200,000 and £50,000 respectively plus costs £52,500. Winterflood was an FSA authorised firm and the largest market maker on the AIM market. In June 2008, the FSA found that Winterflood and its traders had played a pivotal role in an illegal share ramping scheme. In particular, the market maker had misused rollovers and delayed rollovers thereby creating a distortion in the market for a particular stock for about six months in 2004. Winterflood made about £900,000 in the stock at the time. http://www.fsa.gov.uk/library/communication/pr/2010/071.shtml
25/11/10	Ascension Securities Limited	ASL had raised money for a number of IPO's mainly in gas and oil exploration, many of which were in Australia. They were all new companies set up to exploit mining opportunities and the like. None realised the claimed potential, none became listed and the money raised from shareholders was spent on overheads and directors' salaries. Many shared the same directors, some of whom were connected to directors of ASL. On 31 August 2010 it was found to be failing to satisfy the threshold conditions relating to the adequacy of its resources and was insolvent. Its permission to conduct regulated activities was cancelled on 25 November 2010. http://www.fsa.gov.uk/static/pubs/final/ascension.pdf

(continued on next page)

Table 4 (continued)

Date	Individuals	Action
24/6/11	Partners in solicitors Fox Hayes, Leeds.	Fined £454,770 for breaches of FSA Codes of Business. Involving at least 20 financial promotions to 670 customers between February 2003 and June 2004 involving \$20 m. The FSA code of business at that time stated 'A firm must be able to show that it has taken reasonable steps to ensure that a non-real time financial promotion is clear, fair and not misleading' and 'A firm must not communicate or approve a specific non-real time financial promotion which relates to an investment or service of an overseas person, unless ... (b) the firm has no reason to doubt that the overseas person will deal with customers in the United Kingdom in an honest and reliable way.' http://www.fca.org.uk/static/pubs/final/fox_hayes.pdf
10/2/12	Bishopsgate Capital Stockbrokers Ltd Bishopsgate Financial Management Ltd	No longer authorised No longer appointed as authorised representatives https://register.fca.org.uk/
31/7/12	Bridge Hall Stockbrokers Ltd Arc Fund Management Ltd, Arc Equities Ltd	Declared in Default March 2012. https://register.fca.org.uk/ShPo_FirmDetailsPage?id=001b000000MfZOyAAN
8/1/13	Gracechurch Investments Ltd, Sam Thomas Kenny and Carl Peter Davey	No longer appointed as authorised representatives Publicly censured for misconduct, including using pressure-selling tactics with customers to invest in the shares of small companies, resulting in client losses of at least £2 m. The FSA would have fined Gracechurch £1.5 m had the firm not been in liquidation. http://www.fsa.gov.uk/static/pubs/final/gracechurch-investments.pdf

Additionally, there were various 'clone firms', i.e. unregulated firms, using the name of genuine regulated firms. As these clone firms were not authorised by the FSA/FCA, the victim investors are unable to claim on the FSCS and, as they were unregulated, the FSA/FCA was unable to act against the clone firms other than issue a notice that they are clones and unauthorised firms.

collaboration, bold and resolute enforcement, strong punishments, public understanding, good governance. These are useful criteria in assessing whether the UK authorities have been vigorous in their deterrence of boiler room operations. Whilst the FSMA (now strengthened by the FA) and the FSA/FCA rules and principles provide legal certainty both in terms of the offence and the punishment, prosecution has been difficult because of jurisdictional and other legal problems.

Tomasic (2011) has argued that prior to the global financial crisis in 2007, a culture of minimal regulation of financial markets existed in which many undesirable practices such as insider trading, foreign corrupt practices, tax avoidance, money laundering were able to avoid detection until public outrage prompted the regulators and prosecutors agencies into action. It is difficult to know from publicly available data whether criminal enforcement in the case of share scams has been a 'haphazard pursuit' as Tomasic suggests. It has been shown here that there have been a number of large criminal prosecutions in the UK since 2009 whilst the number of civil actions by the FSA/FCA appears to have slowed. It is not possible to deduce from publicly available data how proactive the FSA/FCA are/were in their investigations (e.g. greater stringency may account for a reduction in civil cases) but, taken together, these pieces of evidence support Wilson and Wilson's view (2014) that, in this area, the FSA/FCA's pursuit of financial crime has been 'determined and extensive'.

This paper has listed the cases in which criminal actions have been taken against those running boiler rooms and those instances in which the FSA/FCA imposed penalties on authorised firms and individuals (victims' losses being paid out of the FSCS). There have been no cases in which both have occurred. The two approaches appear to be mutually exclusive. There have also been cases where there has been no action, no doubt in some cases for good reason, e.g. the fraudsters have fled and could not be located. Nevertheless, after all the efforts to raise public awareness, the problem still exists. Clearly, prevention is preferable to prosecution. Deterrence in the form of a criminal action is costly and efforts to raise awareness amongst investors are to be encouraged and, as has been shown, there have been various preventative initiatives.

But what about the quasi-regulators, the professionals adding credibility to the offer of shares, the reporting accountants, auditors, lawyers, escrow agents and share registrars? If the red flags of a scam should be obvious to investors, the professionals would surely recognise a fraudulent scheme. Even if the fraudsters were not charged, they could still be. These professionals will also have stringent money laundering reporting obligations. How the money raised in a share issue was spent and where was it sent to are important matters. In only two cases has action been taken against them (Fox Hayes and R v Still and Van Sante). So why have the professionals involved in other cases not been pursued (say, as a party actively aiding a fraud under the Fraud Act, 2006) or by the victims, FSA/FCA et al. or even their professional bodies as a civil action for negligence?

This raises another issue. Whilst the regulators may have been able to recover as much money as possible from the convicted fraudsters under POCA, they would not have powers to recover it from others party to the fraud (i.e. should have recognised the scam) such as auditors, reporting accountants, lawyers, share transfer agents, if they had not been charged and found guilty of a criminal offence. Also, where the alternative approach is used by the FSA/FCA and investors offered compensation under the FSCS, it would similarly not be possible to recover money from any of those party to the scam. Not only is it unlikely in both of these cases that victims would not be fully recompensed but, in some instances where the FSCS is accepting claims, the fake companies used have continued (even to this day) are solvent and continue to remunerate their directors and professional advisers such as auditors and lawyers while their funds last. Not only is this an unnecessary loss to the victims but also to the public purse funding the FSCS.

Also, why haven't the Spanish authorities chased out the boiler rooms in the same way the Dutch authorities did in Amsterdam in 1986? But of course, as the latter indicates, the fraudsters are likely simply to relocate (the most recent criminal case relates to a boiler room thought to be operating out of the Caribbean). Also, as the regulators become more effective or the likelihood of prosecution increases, fraudsters may turn away from shares to other financial instruments and investments that are not so closely regulated. Recent cases of boiler rooms selling bonds, foreign exchange, futures, carbon credits, even fine wines as investments suggest this to be so. Also, effectively simple betting in share price movements using contracts for difference or binary options are becoming popular, the latter typically being marketed from offshore unregulated and using boiler room selling methods.

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