

# Stock and Securities Fraud<sup>1</sup>

The term securities fraud covers a wide range of illegal activities but it boils down to three:

- Ponzi schemes,
- Insider trading ,
- Marketing scams involving high yield investment fraud, advanced fee fraud and broker embezzlement and late day trading.<sup>2</sup>

The first two are examined elsewhere and it is the purpose of this chapter to discuss the third.

The cold-calling of investors by bogus stockbrokers persuading them to invest in high yield securities when in fact they are shares in fake companies is a major problem. Although it is as old as shares themselves, modern communications are now making it not only easier to perpetrate but difficult to prevent, prosecute and recover the stolen funds. Although the technicalities may vary between countries, cold-calling usually comes from what are often referred to as 'boiler rooms', a term referring to the high pressure selling practices used. Invariably, the boiler room is not authorised to sell shares and its promoting and selling of stocks is illegal.

First it is necessary to clarify certain terms. Many of the companies whose shares are sold in this way are (or are claimed to be) 'microcaps' an American term used to describe small publicly traded companies with a market capitalization of below \$250m, although there is no official definition. (If the company is smaller, it is sometimes referred to as a 'nanocap'). Many of these companies are also 'penny' stocks or shares, a term simply referring to the fact that their market price is than a pound or dollar. A small price for a single stock helps them to be traded easily and a price change is likely to have a relatively large impact on returns. Penny shares are traditionally considered to be highly speculative and high risk, but have a large potential for high returns. They are often traded on second level markets around the world such as the over-the-counter ('OTC) operated by OTC Markets Group Inc in the US, the Alternative Investment Market ('AIM') in the UK.

The important point about both microcaps and penny stocks is that whilst they may be risky, they are not necessarily fraudulent and most are not. However, most fraudulent share scams do involve microcaps and penny stocks.

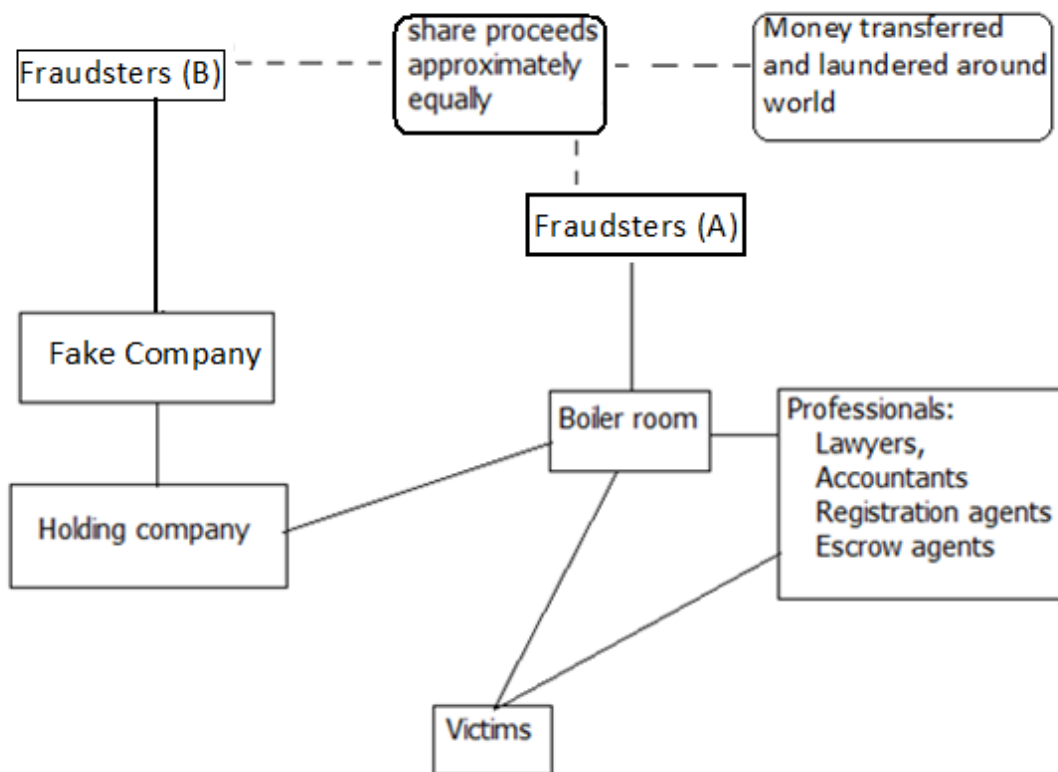
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<sup>1</sup> The words 'shares' and 'stocks' are used interchangeably and mean precisely the same thing. The word 'securities' is a more general term covering both common stocks or shares and bonds.

<sup>2</sup> See <http://www.fbi.gov/stats-services/publications/securities-fraud>

Most schemes involve 'pump and dump' in some way. This is a term to describe the fraudulent activity of artificially raising the price of a stock ('pump') before selling it ('dump') after which the price would fall to a more realistic one. Pumping will probably involve the boiler room salesmen attempting to convince potential investors that the shares are about to 'take off' in some way such as a still-secret takeover offer, a new listing, or some other unexpected change in the company's fortunes. It may also involve manipulating the price and the volume of trading in some way. A stock price chart would appear as an inverted 'V'. When they have exhausted their opportunities, they will cease to support and manipulate the share price and 'dump' it, allowing it fall to a more realistic one.

Figure 1  
**Organisation of the Scam**



## **2 The Scam**

### **2.1 How it operates.**

See Figure 1. Essentially, there are two aspects to the fraud. There is the boiler room operation which is run by fraudsters (A) and there are the owners of the sham company (or companies), fraudsters (B). Fraudsters A and B may effectively be the same individuals who generate new companies whose shares they sell. Another scenario is where fraudsters (B) decide to market shares and employ an existing boiler room operation run by fraudsters (A) in which case they share the proceeds from the issue of the shares, say 50:50. Another scenario is that (B) run a legitimate business but they find it difficult to raise equity and decide to employ a boiler room to do this. It is also possible that (A) also market shares in legitimate and genuine companies. In any event, the marketing will probably be from a separate location (i.e. the boiler room) to that of the companies (if the latter exists) and the money whether goes directly to one of the two fraudster groups or agents, escrow agents or lawyers will be transferred to another/other location(s), i.e. laundered. The shares will be actively sold over a certain period of time during which the price and investor expectations will be 'pumped' (and probably fraudulently manipulated) but after which, whether this is because it becomes too difficult to keep the pretence 'alive', the boiler room finds other stocks to sell or for other reasons, the price and pretence cease to be supported and the company 'dumped'.

### **2.2 Boiler room organisation**

The average size of a boiler room is 20 staff comprising sales staff ('brokers') and managers. See Table 1. Those targeting investors in Europe will typically be in Spain, whilst those targeting the Australasian market will usually be located in Thailand, the Philippines, Cambodia or Laos where staff will have more diverse backgrounds.

	%
United Kingdom	30
United States	17
Switzerland	12
Spain	8
Germany	4

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<sup>3</sup> See Footnote 3.

A company may be formed in another country to act as a front for the boiler room. Typically, this will be an offshore company registered in the Caribbean, for example the British Virgin Islands. It may also have a PO Box to which mail is sent before being forwarded to the boiler room. The boiler room's bank may be in yet another country, 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. About 90% of victims soon accept the situation and write off the investment. Very few have recovered any of their money.

### **2.3 Boiler room staff**

'Brokers' targeting US or European investors are typically male, English speaking, not highly educated but confident with good verbal skills with a background in telesales or at least sales experience. Those in Australasia may have more diverse backgrounds. 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 provided with incentives to remain working. Many have a record for dishonesty or violence. According to 'Operation Archway', 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.<sup>4</sup> If the latter, it is through third parties. Boiler rooms operating in Asia and Spain normally recruit from backpackers passing through.

## **2.4 Victims**

Targeted victims are typically older people with money to invest such as inheritance, pension or redundancy payments. They are often well educated with previous experience of investment. 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'<sup>5</sup> in the UK has estimated that 50% are aged over 65. The average amount lost is \$30,000 (£20,000) and the largest individual loss to date is £1.8m. 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. 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 (City of London Police).

## **2.5 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.

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<sup>4</sup> 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 .....

<sup>5</sup> 'Operation Archway' is a reporting system set up in the UK by the City of London Police to coordinate intelligence-gathering around boiler room scams.  
<http://www.cityoflondon.police.uk/CityPolice/Departments/ECD/Fraud/boilerroom.htm>

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.

## **2.6 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. 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.<sup>6</sup>

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.

## **2.7 Fake Companies**

There are three types:

1. A completely fictitious company which may be registered but is a shell company with no business behind it.
2. A legitimate but defunct company, which the fraudsters have acquired. As it is moribund, it is possible for the fraudsters to acquire it from its previous owners at a nominal price.

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<sup>6</sup> Various names appear on the forum at [www.theinternetpatrol.com/new-online-investment-scam-mimics-regulatory-agencies/](http://www.theinternetpatrol.com/new-online-investment-scam-mimics-regulatory-agencies/).

The acquisition of a public company whose shares are already listed on an exchange by a private company, a 'reverse takeover/merger', enables the owners of a private company to effectively acquire a share listing but bypass the lengthy, complex and processes. Not only is a reverse takeover much cheaper than an application by a private company, if the individuals involved in the application are known fraudsters or have a dubious reputation, they may find listing on a reputable stock exchange difficult. Although the U.S. imposed tighter laws in 2005 for reverse mergers, requiring companies to increase the amount of information disclosed to the SEC after merging with shell companies, fraud is, nevertheless, believed to be still rampant (SEC, 2011).

3. A small publicly traded company whose owners wish to raise funds for genuine business purposes but because of the business risks involved investors are unwilling to subscribe. As a result, they approach a boiler room to market the shares for which they charge a large slice of the proceeds of the share issue.

Table 2 Company locations <sup>7</sup>		%
United States		37
United Kingdom		30
Spain		9
Canada		5
Hong Kong		3

See Table2. Many of the microcap or penny stock companies used are US companies known as Regulation S or 'Reg S' stocks. 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 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 U.S. persons physically located outside the US.

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<sup>7</sup> See Footnote 3.

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, then 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 in the marketplace. 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](http://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. They offer various advantages including tax benefits and a relatively liberal regulatory environment.<sup>8</sup> 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](http://en.wikipedia.org/wiki/Nevada_corporation)).<sup>9</sup>

## **2.8 Markets - where the stock is traded**

Stocks in fake companies are not listed and traded on the main highly regulated stock exchanges such as the New York Stock Exchange ('NYSE') and the London Stock Exchange ('LSE') but on alternative investment or OTC markets. The OTC markets are not stock exchanges in the way that the NYSE and LSE are. Trading occurs via a network of middlemen, called dealers or broker-dealers, who hold stocks of securities to facilitate the buying and selling orders of investors, rather than providing an order matchmaking service as occurs on large exchanges. An OTC market simply provides a means by which securities may be bought and sold. In many cases, they carry out no

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<sup>8</sup> For a discussion see Bishop, 2008.

<sup>9</sup> 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.



checks on the companies concerned and apply few or no criteria when deciding to allow shares in these companies to be traded.

Table 3 US OTC Market tiers by OTC Markets Group	
<b>OTC Link</b>	
OTCQX	Exclusively for companies that meet the highest financial standards and undergo a qualitative review.
OTCQB	The venture marketplace for companies up to date with their reporting with a U.S. regulator. There are no financial or qualitative standards to be in this tier
OTC Pink	OTC Pink is the open marketplace for a wide spectrum of equity securities.
<b>OTCBB</b>	
Grey Market	No bid and ask information is available. Due to the lack of pre-trade data, these securities are illiquid.
Caveat Emptor	Buyer beware

In the US, the OTC market is effectively run by OTC Markets Group Inc., a private company, which provides electronic quotations, trading, messaging, and information platforms. It classifies stocks into 3 tiers. See Table 3. About 20,000 companies' securities are quoted on OTC Link and around 500 are Caveat Emptor. The market and broker-dealers' activities are regulated by The Financial Industry Regulatory Authority (FINRA), the SEC and other US state regulators but OTC Markets Group Inc is not regulated by either. Also, of course, companies with SEC-registered securities are regulated by the SEC. The OTC market has no central 'exchange'. 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. These 'quotes' are placed on an Inter-dealer quotation system which are aggregated and ranked and represent the reported 'market' for a security. The highest 'bid' (purchase price) and lowest 'ask or offer' (sale price) becomes the 'inside market' or NBBO – the National Best Bid and Offer which is displayed on financial websites, including OTC Markets' own website.

The US OTC market has effectively two major Inter-dealer quotation systems: OTC Link, which is operated by OTC Markets Group, and FINRA OTCBB. Broker-dealers are able to view all quotes for OTC securities and, if desired, trade those securities through the system. The FINRA OTCBB does not have electronic trading capability and broker-dealers use OTC Link's trade messaging system to trade these securities electronically.

Boiler room shares have been listed in the UK on the Alternative Investment Market (AIM), OFEX and PLUS. AIM has less stringent listing requirements, primarily concerning the provision of financial information. PLUS Stock Exchange is a London based stock exchange providing UK and international companies with a quote-driven trading platform with competing two-way prices. OFEX is a market operated by OFEX plc which has a company information and announcement system called Newstrack for professional intermediaries including bid and offer prices and trade information. Individuals wishing to buy or sell on OFEX must do so through a stockbroker who is a member of the OFEX market.

Elsewhere in Europe they have been listed on Xetra and the Frankfurt and Berlin exchanges. Xetra (Exchange 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 for investor protection provisions on 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.

Because this may be done at a relatively small cost, shares may also be listed in another secondary market, for example, shares traded on the US OTC Market may also be traded on Xetra. This may give the impression of the company's shares being traded on international markets. 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.

## **2.9 The frauds**

As mentioned in the Introduction, most schemes involve the 'pumping' of the 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.

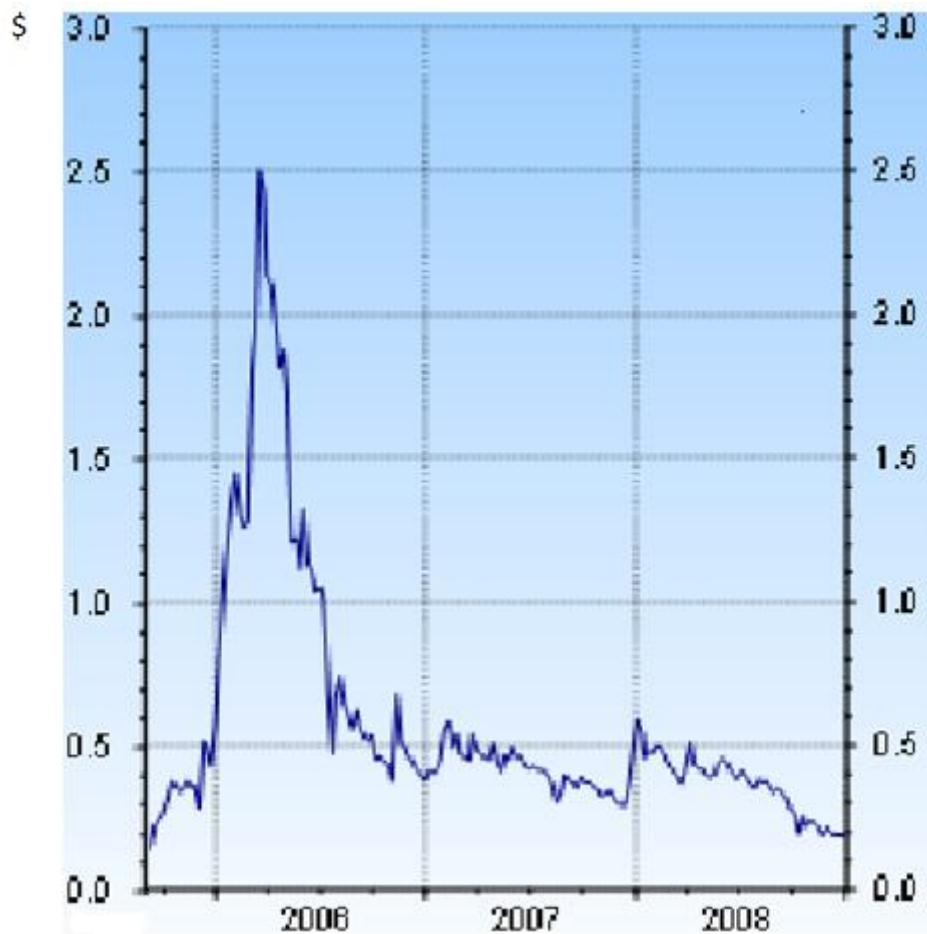
The publication of incorrect and misleading press releases to raise expectations is common. Financial statements are also manipulated – if they are reported. Many fake companies whose shares are available OTC may not comply with reporting requirements, e.g. those of the SEC.

‘Wash trading’ is an illegal form of market manipulation where a fraudster simultaneously sells and buys shares through associated or affiliated brokerage accounts in order to artificially increase the apparent trading volume and thus the stock price. It usually occurs near the end of a day’s trading so as to affect the reported closing price.

The value, and therefore price, may also be altered at a stroke by means of ‘stock splits’ and ‘reverse stock splits’, perfectly legal procedures, the former often used by listed companies to make trading in their shares easier. 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 hold twice as many shares, i.e. two. However, as nothing else has changed to affect the value of the company other than the number of its shares 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 of a stock split. For example, if you held two shares, a one for two reverse split would cause you to hold half as many shares, i.e. one, but it would now be valued at twice what it was previously. The effect on price of a stock, therefore, is to cause it to rise by the relevant proportion; here by 100 per cent.

Rationally, the share price would adjust precisely in line with the proportional effect described. However, this may not always be the case as a sophisticated market such as the NYSE and LSE may see a split or reverse split as having ‘information content’ and adjust to that as well. In a thinly traded market in which these scams occur, such price changes may not be seen for what they are but, in the case of a reverse split, believed to be real increase in price or, in the case of a stock split, a windfall increase in the number of shares the investor holds. This is the intention of the fraudsters.

Figure 2  
Example of an anonymous stock subjected to a 'pump and dump' scheme



Whether a particular scheme is fraudulent and the perpetrators are guilty of fraud depend on the situation and the law in that jurisdiction. It may not be sufficient for a share price chart to exhibit an inverted 'V'. Firms fail, smaller firms in particular, and microcaps especially. Investors who invest in microcaps know, or should know, the risks involved and they should only accept them if they believe the expected returns are sufficiently high to compensate. However, there is a difference between business risk and the risk of fraud. The share price rise needs to be shown to be the result of fraud - pumping. It also needs to be shown that the fall in price is the result of a reversion to what it should have been in the first place, that the market was false and had been manipulated. The chart in Figure 2 relates to the share price of an anonymous company whose shares were available OTC accused of boiler room operation during late 2005 and 2006. It will be seen that the price was allegedly pumped to \$2.5 but subsequently fell to \$0.25 when it ceased to be supported. Support could last for as long as the fraudsters are prepared to do so but in the case of Reg S shares, it is more difficult when they are deregulated.

### **3. Prevention, Prosecution and Recovery**

Prevention of such scams is, in the first place, by means of authorisation of those allowed to sell stocks. In the US, a stockbroker license from the Financial Industry Regulatory Authority is required. The legal requirements for persons selling investments are similar elsewhere: in Australia an Australian financial services (AFS) licence is required and firms offering financial services in the UK must be authorised by the FSA. The FSA also publishes lists of authorised and unauthorised firms, the latter being firms and individuals known to have offered services unlawfully.<sup>10</sup> However, once on the list of unauthorised dealers, they may simply decide to change their name.

There have been many warnings on regulators' websites, such as the FBI, SEC and OTC Markets in the US and the ASIC in Australia and the FSA and the City of London Police in the UK. Various other firms and organisations such as banks have also decided to issue warnings and newspapers, radio, and TV have regularly campaigned about share scams by expose cases, particularly those in which regulators have decided not to pursue.

It is not the purpose here to review the law. It is sufficient to say that in the US in addition to federal law, each state has its own securities act handling securities fraud.<sup>11</sup> Additionally, the victim may make a claim under common law. In respect of market manipulation, Section 10b of the Securities Exchange Act of 1934, states that it is 'unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails... to use a manipulative or deceptive device or contrivance ...' In respect of misleading customers, stockbrokers are usually considered to be fiduciaries and are expected to conduct themselves with a higher degree of care than would the ordinary person.

Despite the prevalence of fraudsters purporting to act as recovery agents, there are genuine organisations that attempt to recover lost money. It is possible that a fraudster's funds may be seized by a court order – but only if the action is quick enough before the money is transferred abroad out of reach of investigators, asset tracers and recovery agents. In many jurisdictions, if the fraudsters are found guilty in a criminal case, they are required to repay the funds obtained illegally and, unless or to the extent it can be shown to the contrary, all funds in the fraudster's possession are assumed to have been obtained illegally. Unfortunately, by the time the fraud has been recognised the money has been transferred abroad. However, what has happened, particularly in

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<sup>10</sup> See [www.fsa.gov.uk/doing/regulated/law/alerts/unauthorised-firms](http://www.fsa.gov.uk/doing/regulated/law/alerts/unauthorised-firms).

<sup>11</sup> The authoritative text on US law is Loss et al, 2012.

the US, is a plea bargain in which restitution of some of the lost money is bargained in return for a lighter jail sentence.

#### **4. The future**

At the present time, it has never been easier to conduct these forms of securities fraud. It is also difficult and expensive to prosecute. This is why regulators have placed emphasis on education and warnings. There is some evidence to suggest that this may be working. However, when stock market investment again becomes popular, securities fraud will probably continue to grow. In the meantime there is some evidence to suggest that fraudsters are using these techniques in other investment areas, notably bonds, land banking, carbon credits and marketable assets such as fine wines.

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