Getting Robbed at the Pump

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Walk a few blocks west of Times Square on a sunny afternoon and you will undoubtedly find the deal of the century – $100 for a gold Rolex. Tourists have fallen victim to this and similar schemes for generations. The authorities know it's happening, but somehow the phony watch business continues to thrive. The same holds true for the fraudulent pump-and-dump stock schemes that have plagued the securities markets since their inception.

A pump-and-dump scheme requires surprisingly little time and effort. First, the "organizers" form a corporation, which generally requires nothing more than filing a few forms and cutting a modest check to the state. These organizers then sell the company's stock to themselves and a few friends, often for fractions of a penny per share. Next, the organizers drive up the price of the stock on the OTC markets by continuously trading with each other to create a false market or by spreading rumors via the Internet or "Spam" email. Finally, the organizers and their friends sell the inflated shares to unsuspecting outside investors, often for enormous profits.

To operate this scam, the organizers rely on a loophole in the SEC rules that allows the shares issued in small offerings to be freely traded. The SEC places onerous resale restrictions on unregistered shares sold in larger private offerings, but shares sold in the small pump-and-dump offerings are often issued under Securities Act Rule 504, which imposes few restrictions. The ability to freely trade these shares allows the pump-and-dump market to thrive.

Under Rule 504, the "seed capital" rule, a company not otherwise subject to SEC reporting requirements can issue securities to an unlimited number of people. The aggregate offering price of the securities must remain under $1 million in any 12-month period. The SEC enacted Rule 504 to provide small businesses the opportunity to raise money while beginning operations. The Rule gives these companies a break from many federal securities laws, instead counting on state regulation to keep the companies in check.

The Restrictive Legend Debate

Unregistered securities sold by non-SEC reporting companies outside of Rule 504 cannot be resold until the initial purchaser holds the securities for one year and the company makes certain financial and other information publicly available. To ensure the shares are not improperly sold, each certificate evidencing a share is marked with a legend detailing the restrictions. The company's transfer agent is prohibited from removing this restrictive legend on each stock certificate until it receives an opinion of counsel stating that the company and shareholder meet the applicable requirements. Pump-and-dump schemes rely on Rule 504 because it allows for the sale of stock without requiring the purchaser to hold it for any period of time before resale, and in some cases without requiring the company to publicly disclose financial or other information.

Over the past decade, the SEC, microcap issuers and other interested parties have argued over whether shares sold under Rule 504 should be marked with the same restrictive legends as other unregistered securities. Those in favor of the legends contend they will curtail pump-and-dump schemes. The theory goes that the restrictive legends would provide notice to investors, deterring them from purchasing shares of the fraudulent companies.

Those against mandating the restrictive legends argue that the legends will make it more difficult for legitimate start-up companies to raise much needed seed money. Investors in microcap companies often want the ability to resell their stock at any time. Resale restrictions could drive away key investors and leave small businesses with no source of capital. So far this argument has prevailed, and restrictive legends do not appear on stock certificates sold under Rule 504. In August 2007, however, the SEC again proposed adding restrictive legends to stock sold under certain provisions of Rule 504.

Many believe that securities fraud is inevitable, and that con men will always devise a way to beat the system. To some, that fact alone suggests that the SEC should put the issue to bed and leave Rule 504 alone. That sort of reasoning is flawed, though. Congress charged the SEC with regulating the securities markets. Giving up because the crooks are getting smarter can only lead to disastrous results. Imagine what they'd sell on the sidewalks of Manhattan if the NYPD just stopped patrolling.

If the SEC wants to help small business owners raise capital, it should devise a more creative solution than sticking with a rule that opens the door to fraud.