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## International Journal of Law, Crime and Justice

journal homepage: [www.elsevier.com/locate/ijlcrj](http://www.elsevier.com/locate/ijlcrj)

INTERNATIONAL
JOURNAL OF
LAW
CRIME
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JUSTICE

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

Paul Barnes <sup>a, b</sup><sup>a</sup> MARA, UiTM, Malaysia<sup>b</sup> Paul Barnes and Associates Ltd, Nottingham, UK

## ARTICLE INFO

*Article history:*

Received 24 May 2016

Received in revised form 26 September 2016

Accepted 3 November 2016

Available online xxx

## 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.<sup>1</sup> 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.<sup>2</sup>

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](mailto:Paul.a.barnes@btinternet.com).URL: <http://www.paulbarnes.org.uk><sup>1</sup> See <https://www.fca.org.uk/consumers/share-fraud-boiler-room-scams>.<sup>2</sup> 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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Please cite this article in press as: Barnes, P., Stock market scams, shell companies, penny shares, boiler rooms and cold calling: The UK experience, International Journal of Law, Crime and Justice (2016), <http://dx.doi.org/10.1016/j.ijlcrj.2016.11.001>

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.<sup>3</sup> 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.

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

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