Scams, Sports, and Sponge Bob Square Pants

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This is a descriptive case that traces the progression of a microcap investment fraud operation, or pump-and-dump, that became one of the largest in U.S. history before it ended in 2010. The SpongeTech Delivery System story was remarkable for its innovative use of sports marketing sponsorships and internet communities to drive its remarkable growth in the absence of real revenue. It discusses weaknesses in the applications of current research to fraud, and suggests future research directions.

INTRODUCTION

In May of 2010, the Security and Exchange Commission (SEC) charged Spongetech Delivery Systems, Incorporated (Spongetech) and its principal officers with securities fraud. The company had, according to the court documents, illegally increased demand for its unregistered public stock by issuing false public statements about non-existent customers, purposely misstating revenues, and providing false information about the number of outstanding shares. Spongetech had sold 2.5 billion shares of stock, and had falsified its SEC reports including creating bogus sales invoices to document non-existent revenue.

The sheer size of the fraud, alleged to be the largest penny stock fraud in the U.S., was not the only reason the filing was newsworthy. Besides the defrauded shareholders, Spongetech's scam victims included 35 professional sports organizations owed $9.5 million in unpaid sponsorships. Also unexpected was the behavior of the defrauded victims. Even after trading in the stock was suspended, investors continued to buy its shares on the legal but unauthorized off-market known as the "gray market", spurred by Spongetech's false claims of conspiracy against them. As the details of scam were made public, it was difficult to understand how a company with only one genuine customer and $10,000 of annual revenue (SEC, 2010) could have escaped public scrutiny for so long. In fact, the analysis of the scam gives insights into the vulnerability of the investment community to massive fraud in a globalized, digital environment.

Spongetech began as a sponge company in 1997 in Brooklyn. The company's product line was simple. It produced soap-filled sponges infused with polymers in a patented process, used primarily for automobile cleaning. Its CEO, Michael Metter, had had a short but eventful career as an investment broker. After many complaints of malfeasance, he was fired by the brokerage and the SEC revoked his license. His leadership of Spongetech seemed equally unsuccessful—so much so that auditor's reports for 2002 through 2007 recommended it cease operations.

The company's fortunes changed dramatically when Steve Moskowitz joined the company as CFO. The first joint action after raising investment money from friends was the purchase of a shell company, RM Enterprises. The purchase of RM marked a turning point in the future of the company. At that point, Spongetech ceased to be a sponge company and became a pump and dump scheme—a special form of investment fraud taking advantage of buyers of microcap or "penny" stocks. According to the SEC (2010), the sponges were never the source of the company's revenues. The purchase of a company like RM to allow the fraudulent issuing of stock is a common practice in setting up a pump and dump according to investor warnings on the SEC website. The company was now poised to begin its rapid rise to success, but Metter and Moskowitz had plans for some new twists for their classic investment fraud. By capitalizing on the low information requirements for microcap companies, skillful marketing to link Spongetech to well-established and credible corporations, and careful timing of false messages to an online community of investors, Spongetech built a public image of a rapidly-growing business and maintained it long enough to sell over a billion shares of stock. Conventional wisdom failed to prevent the fraud.

Penny Stock Fraud Is a Rich Arena for Scammers

Penny stocks, or micro caps, are stocks trading for less than $5 a share that are sold over the counter. Pink sheet stocks are stocks too small to be required to register with the SEC, and so information about the assets, number of shares outstanding, and number of shareholders is not publicly available. Because these companies are inconsequential to industry analysts, there is little public scrutiny of these companies, making them perfect vehicles for the unscrupulous stock manipulator. Another reason for not focusing on penny stock fraud is the assumption that unlike other forms of fraud, penny stock investors choose to enter into a risky investment in hope of gain. However, with the advent of mass e-mails, and targeted advertising on search engines, the pool of potential investors has now been opened to many more naïve and inexperienced than the former penny stock speculators (SEC Microcaps).

The Pump and Dump Provides a Unique Online Opportunity for Fraud

Although the means of achieving the illicit gains through fraud have changed somewhat over the years, the basic premise has remained the same. The "pump" occurs when the price of stock controlled by a small group of insiders is sold to outsiders and driven high above its actual value by promotional activities. Traditionally, pump and dumps employed aggressive brokers operating in boiler rooms making phone calls to vulnerable clients unschooled in stock valuation. Spongetech did employ heavily-compensated brokers to sell its shares, but modern pump and dumps have added Internet appeals to their persuasive toolbox. Operating internationally, Spongetech's pump amounted to the sale of 2.5 billion shares of stock (SEC, 2010), although shareholders were only told of 1 million of them. The discrepancy can occur when stock is sold to brokers in other countries, who sell it back to investors in the United States. The effect of stock splits, stock repurchases, and acquisitions and mergers can also obscure the actual number of shares even for the sophisticated investor.

Sports Promotions Provide Credibility

Moskowitz, who handled the company's marketing, was employing a variety of techniques to build a company image to support the overseas stock sales. In late 2008, he added infomercials promoting a new product line called Uncle Norman's pet sponge. The sponge looked just like the standard auto product, but was supposed to contain a flea-repellant soap for convenient bathing of pets. The infomercials featured donated sponges being used to bathe homeless pets in high-income markets (The Balancing Act, 2008). The new product did not add much to sales in reality, but did add to the reputation of the company now calling itself "America's cleaning company." Press releases promised new product technologies on the horizon for the company now called Spongetech Delivery Systems.

The overseas sales were bringing in money, so Moskowitz moved forward with a new, creative plan to establish the firm's credibility. The New York Mets were moving into a new stadium, and Moskowitz approached them with an offer to rent a luxury suite for $250,000 a year, and signed a three-year contract for a large sign positioned ideally for television viewing and other advertising rights for $1 million a year. Perhaps the need to rent the new suites and lock in long-term advertisers during a recession made Mets management more willing to contract with an unknown company.

Spongetech paid the Mets bills promptly using the investment money flowing in from European boiler rooms. Timely payment was important to establish the company's creditworthiness. It created positive credit checks from Madison Square Garden and other sports organizations as Spongetech expanded its sports promotions to other cities. At Madison Square Garden, Spongetech advertised on the Rangers' Zamboni (Elstein, 2012). Tennis advertising proved especially helpful. During the semifinals of the women's singles at the U.S. Open in 2009, Spongetech got an unexpected bonus. Serena Williams' abusive rant was broadcast worldwide. As her alleged foot fault was rerun many times in slow motion, the backdrop for the scene was the simple white lettering on blue of the corporate sponsors rimming the courts: Olympus, American Express, and in the middle, Spongetech. The company could never have afforded such exposure. If viewers thought it odd that a small, upstart company selling soap-filled sponges was featured center court, then they hadn't been watching much sports lately. The complete list of sports organizations left with debt after the "dump" and the company's bankruptcy was published in Sports Business Daily. It reported that $ 9.5 million in unpaid sponsorships and advertising were identified in bankruptcy documents.

TABLE 1
SPONGETECH DEBT TO SPORTS ORGANIZATIONS

CREDITOR	AMOUNT OWED	CREDITOR	AMOUNT OWED
Citi Field (Mets)	$2,616,500	Red Sox	$78,125
Buccaneers	$2,537,600	Bassmaster	$75,000
D'Backs	$552,557	Blackhawks	$73,251
Madison Square Garden	$511,700	Sun Life Stadium	$60,000
ANC Sports Enterprises	$327,972	Dolphins	$60,000
Giants (NFL)	$360,000	Levy Restaurants / Billy Jean Tennis Center	$50,000
WFAN-AM	$322,748	AT&T Park (MLB Giants)	$47,500
Bears	$260,000	Rockies	$43,750
Bobcats	$195,000	WCBS Radio	$43,484
SportsNet N.Y.	$175,000	Entercom Boston	$38,802

Sports Business Daily, August 7, 2012

Why Sports Got Scammed

The use of sports sponsorships was new as a promotional tool of scammers. A luxury suite could be understood as an indulgence of an executive of a troubled business, but carefully placed advertising in sports venues across the country was clearly strategic. It was hard to understand how so many professional sports organizations could be duped. A few contributing factors can be identified. First, the move to Citi Field led Mets management to welcome a new, albeit little-known advertiser, especially when the rental of a luxury suite sweetened the deal. The timely payments to the Mets reassured Madison Square Garden that Spongetech could be trusted. The economic recession and the loss of several key advertisers may have influenced the decision. Moskowitz bragged to an employee that he had negotiated a 67% discount, a claim that Madison Square Garden later denied (Elstein, 2012). Apparently the sports organizations never checked with the SEC or they would have seen that by 2009 there were seven letters on file demanding that Spongetech provide more information on their financial statements.

Sponge Bob Offers a Sestimonial

Madison Square Garden was also influenced by an unlikely associate of Spongetech, Nickelodeon's popular animated character, Sponge Bob Square Pants, "the world's most lovable sponge." Spongetech had obtained the license to produce Sponge Bob sponges. Viacom, the parent company, was celebrating the tenth anniversary of the popular animated television series about the sponge who lives under the sea and was preparing for the release in 2010 of the first full-length Sponge Bob movie. Investors and business groups like Madison Square Garden assumed that the license for Sponge Bob sponges had been competitive and carefully vetted, thereby lending credibility to Spongetech. They also overestimated the impact of the sponge license on future earnings. In fact, few people realized that besides being a successful television property, Sponge Bob was a licensing machine, generating an estimated $8 billion in merchandise tie-ins for its parent Viacom (2014). Licenses for Sponge Bob merchandise were plentiful. Viacom, like the sports organizations, was left with unpaid royalties after Spongetech's collapse.

Besides the pressure of the recession, and the misunderstanding of the potential of the Sponge Bob license, there was one more reason that sports organizations were scammed. An executive, reflecting after the collapse, observed that they were not accustomed to dealing with companies like Spongetech. The point is significant. When contracting with familiar brands like American Express, or Canon, advertisers saw little reason for due diligence. By categorizing Spongetech as a corporation like their usual sponsors, they not only lost money, but they participated unwittingly in a campaign that convinced their fans that Spongetech was trustworthy and successful.

Sports Promotion Helps the Pump

According to research, sports sponsorship is not expected to have lasting effects on fan attitudes (Pracejus, 2004). Companies selling real products have to satisfy consumer needs to maintain customer loyalty, although initial sponsorship may give them an initial boost. However, consider that spurious companies like Spongetech are not seeking long-term customer relationships. For a pump and dump, an initial rapid increase in stock price yields great benefits. The association of the unknown company with the fans' favorite team cloaked it in respectability. Spongetech listed only its website on its sports ads, leading interested viewers to the investment opportunity. Few fans had ever seen a Spongetech product, but the association of the company with the team suggested it was as legitimate as the other established sponsors. After the company's stock had dropped to less than a penny, one investor posted to an investment website that it must still be a good company because he still saw the advertising in the Mets' stadium.

When sports organizations failed to recognize the difference between the usual corporate sponsors and Spongetech and did not perform due diligence, they unwittingly introduced the company to the world as a corporation on a par with Canon, Olympus, and other well-known and respected companies. This allowed Spongetech to parlay a few months of payments into a very effective advertising campaign that lasted long enough for the company to achieve its goal.

Internet Communities Maintain Victim Delusions

Victims of many frauds are isolated. What was unique about many of the defrauded investors in the Spongetech case was that they were part of Internet communities through the investment newsletter sites or bulletin boards that maintained threads for Spongetech,

The Role of Touters

Stock promoting companies often describe their companies as investment newsletters, although their income is derived from payments by companies or third parties to promote or hype a particular stock for a particular time period. Little is known about this industry because many promoters operate under multiple names. One recent study estimated that fifty companies operate in the United States, and that the average promotional fee paid per stock promotion is $50,000 (Leach, 2010). Promotion companies are legal and are required by the SEC to include a disclaimer in each promotional e-mail, message, or mailing that discloses the payment received and whether the analyst owns the stock. These disclaimers are usually in fine print at the end of the message. Because most web page readers do not scroll through the entire page, information at the bottom of the page is less likely to be read.

One such site offered a headline in large font “Spongetech Poised to Surge.” Later in the newsletter the reasons for the surge were described in detail along with a false start date for Spongetech. The message concluded with a complicated general disclaimer at the bottom of the day’s messages ending with “OTCPicks.com has been compensated eight thousand five hundred dollars by the company for SPNG advertising and promotion” (OTCPicks, 2011). Using the stock symbol instead of the company name and spelling out the payment instead of using numbers drew even less reader attention to the bottom of the webpage, reducing the likelihood that the reader would read through the entire disclaimer.

Many times the descriptions in the messages themselves contradict the disclaimer; for example, the analyst may take credit for discovering a stock ready to dramatically increase. Most promoters offer reasons for the stock’s likely increase. Reasons given may include chart analysis, or more often, rumors of new products, patents, or partnerships that would increase profits. Because touters are hired to promote on certain dates, company officials may combine press releases to coincide with the tout to heighten the effect. Leach found that touters enlisted other touters to promote the stock as well, to create bandwagon effects. Touters planned promotions to arrive in e-mailboxes after the closing of the trading day, or just before the opening of the next trading day so that the effect of the promotion was concentrated and magnified volume.

Undercapitalized but legitimate businesses may employ touters to raise needed funds for business operation, but touters are a necessity for pump and dumps. The SEC documented some of Spongetech’s transactions with its stock promoters. Spongetech combined touting with skillful promotional methods to amplify the demand for its stock.

Investment Communities of Interest

Investment message boards also promoted Spongetech stock. Forum threads devoted to Spongetech exchanged news, rumors, and offered advice. Since anyone could post anonymously, paid touters often joined forums and posted messages to drive up prices without having to disclose their financial compensation (Leach, 2010). Most forums became communities of interest, and frequent posters became influential in steering group opinions.

Corporate pages on Facebook and similar social media sites are viewed as valuable interaction between consumers and company. Instead of companies advertising “one too many” in the traditional way, social sites allow communication “many to many” (Botha & Mills, 2014). For companies anxious to build customer loyalty, feedback on such websites is valuable information, allowing them to improve products or services to better satisfy customers’ needs. Not surprisingly, research suggests that social media provides important benefits to consumers as well.

This many-to-many communication did not benefit the participants in the Spongetech investment forums. False rumors and favorable interpretations were repeated and amplified. Reframing of bad news took place, as well, often led by paid promoters posting anonymously without disclosing their financial connection. When the SEC added the E to the Spongetech ticker symbol as a warning to investors of the company’s financial non-compliance, two frequent investment community participants published a report explaining why Spongetech was still a valuable investment. Because it was difficult for community members to evaluate the expertise of other posters, much misinformation was circulated and repeated. Rather than openly discuss the critical news about Spongetech, many community members responded by purchasing more shares on the gray market (SEC, 2010).

The Rise of the Spongetech Cybercult

In the 1970s, the proliferation of religious cults led to an interest in the psychology of what has been termed the charismatic group. Some of these groups created fear and inspired a new industry of cult-deprogramming, as concerned family members sought to win back their estranged loved ones. However, other groups operated without coercion and seemed to have positive effects on group members. Alcoholics Anonymous is among the best-known of these charismatic groups.

Marc Galenter (1999) studied charismatic groups for 15 years, to understand the psychology behind the powerful influences such groups exerted on group members. Some contemporary financial fraud depends on similar face-to-face group interactions, for example, the naïve recruiters in pyramid schemes. However, Galenter's work also has relevance when applied to online groups like the Spongetech investment communities.

Charismatic groups, Galenter posited, are systems of strong shared beliefs that include close-knit communication systems where dissenting views are suppressed and interpretations of events are offered that promote social conformity. Strong members of the group encourage commitment, and take actions to preserve the group. The strong cohesiveness, defined as "the result of all the forces acting on members to keep them engaged in the group" (p.74). leads individual members to deny reality or rationalize inconsistent information to maintain the group's common view of events. Social influence beyond the group add to the impact. Galenter found that group members were influenced by the perceived presence of outside supporters that made the group views seem like well-accepted positions. Likewise, the imagined presence of outside opponents could create a stronger bond among group members. In this way, social influences extended beyond the group itself. Galenter used the term "pseudo-community" to describe this phenomenon of both positive and negative imagined outsiders. In this way, he built on the research of psychologist N.A. Cameron in his 1943 research (The paranoid pseudo-community, *American Journal of Sociology,* 49:32).

The shared goal of gaining wealth through the dramatic rise of an unknown penny stock gave the Spongetech groups a common focus. Unlike the Spongetech forums, most investment forums devoted to a single company remain open to outside influences and critically consider information. What made the Spongetech groups different was the active manipulation of the conversation by company officers and their paid touters, and possibly the inclusion of less-experienced investors in the forum discussions. The Spongetech persona as "America's cleaning company" was appealing to many novice investors who associated it with Uncle Norman's pet sponge, American sports, and Sponge Bob Square Pants. The investment groups were provided with video clips where business analysts predicted dramatic stock increases, not knowing that the stations sponsoring the analysis were owned by Spongetech executives. Frequent posters to the forum, some of them paid touters, offered explanations for any adverse information making the news. The result was a "distorted consensus" that made the Spongetech investors unreceptive to strong evidence that the company was not what it seemed to be.

The biggest challenge to them was the publication of an investigative series in the Washington Post. In early September, 2009, when Serena Williams was berating the line judge in front of the Spongetech ad, Kaja Whitehouse of the New York Post was quietly investigating Spongetech's surprising 900% revenue increase. While other business analysts were congratulating Michael Metter on his success, Whitehouse was looking into the industry and Spongetech's client list. She started with Greg Popovsky, CEO of Spongeables, LLC, who called Spongetech's $40 million revenue projection impossible. Total industry sales, he said, were in the $5 million to $10 million range (Whitehouse, Sept. 17, 2009).

She found that while Popovsky's company had contracts with CVS, WalMart, and Rite Aid, Sponge Tech listed only one customer whose name she recognized—Walgreen's. Other customers included New Age Media, said to be "based in Europe", SA Trading in Caracas Venezuela, US Asia Trading, Dubai Export Import Company, and Fesco Sales Corporation. Whitehouse was unable to verify any address or phone number for the companies, and found that two of three company websites had been created on the same day two weeks before. Follow ups with the Dubai Chamber of Commerce, which regulated all trade, and with office building managers where corporate headquarters were allegedly situated found no record of any such companies (Whitehouse, Sept. 25, 2009). The SEC would later charge Spongetech with fabricating companies, websites, and invoices of these companies. SEC estimated that 99.4% of reported sponge sales were completely false, and that the best estimate of sales to Walgreen's was $10,000 (2010).

The SEC suspended trading in Spongetech stock on October 7, 2009. It might have been expected to end the fervor for Spongetech shares but the reverse seemed to be true. Message boards were full of messages asking how they could purchase more Spongetech stock and blaming the short sellers for the company's troubles. Michael Metter quickly responded to the investors on the forums, explaining that their financial statements were late to the SEC because of a problem with the past year's auditor. The company had already made arrangements to have the current statements audited by Deloitte, he claimed.

Deloitte denied they had agreed to audit. Whitehouse then interviewed a former attorney for Spongetech who claimed that the company was using his name on forged documents for shareholders, and that he had turned over this evidence to the SEC (Sept. 22, 2009).

After the September articles, Whitehouse came under attack by the Spongetech believers. In what could only be termed cyber mobbing, community members sent defamatory e-mails about Whitehouse to the SEC, and to news organizations. One critic, alleged to be Alan Palmer, Jr. a shareholder and frequent poster to the Spongetech message boards (Boyd, 2010) accused Whitehouse of a variety of crimes, sent pictures of her family members to other message board members, and claimed her father was short-selling the stock. The drum beating for the short sales motive continued, and in April of 2010, Metter filed a $1 million lawsuit against Whitehouse and the New York Post, charging them with purposely driving down the price of Spongetech stock.

After the SEC filed charges against the company in May of 2010 and the detailed story of the scam came out, Palmer, the instigator of the cyber mob, e-mailed another community member to apologize, saying that he regretted more than losing his money the pain that he had caused the group members (Boyd,2010). Their fantasy had collapsed at last.

After the collapse of the Spongetech pump and dump, one analyst marveled that so many people had been misled about the prospects of a soap-filled sponge. He concluded that many investors were attracted to a company that sold something that they could understand (Boyd, 2010). After all, the infomercials promoting the carwashing sponge were straightforward. The product was dipped in water and suds appeared. The technicalities of the space-age polymers and the patented processes were unclear, but the product itself was tangible, not technical, and functional. The actions of touters accepted as experts by naïve investors, and the power of a cohesive group of Spongetech believers fed by planted news from anonymous promoters, led to many investors holding the stock long after the general public had seen the light. The implausible explanation for Whitehouse's news reports offered by Palmer allowed the group to persist a few months longer in a shared delusion and even led to cyber mobbing.

CONCLUSION

After the charges were filed by the SEC, the stock price fell from its high of $.28 in June of 2009 to less than a penny per share. The company declared bankruptcy. Neither of the principal officers served any jail time, and shareholders and sports organizations are still waiting for their money. Some analysts, noting that the company had opened a Swiss office in 2009 despite doing no business there, suspected that the extraordinary expenses for that year not accounted for in the records had been deposited in a Swiss bank, but U.S. authorities were unable to untangle the company's convoluted financial arrangements (Boyd, 2010).

DISCUSSION

If the story of Spongetech is morally unsatisfying as is the case with many modern scams, it may prove to be a valuable cautionary tale. First, in a world where fraud as well as business is increasingly globalized, preventing and prosecuting fraud is much more difficult. The use of the Internet to cheaply contact potential shills makes high-volume, low-return frauds like penny stock frauds more attractive, especially when regulators and analysts focus on higher-priced targets. Finally, the nature of the research that underlies our attempts to prevent fraud and to understand its dynamics is fragmented and often irrelevant. The Financial Fraud Research Center in its 2012 research review of consumer financial fraud observed that the understanding of financial fraud is hampered by assumptions not supported by research, by research separated from practice, by poor definitions of fraud that focus on organizations rather than on individuals, and by research that is not unified across fields of study (p.5). In the Spongetech case, the realities of the way individuals process information online left people more likely to miss important financial disclosures by touters, more likely to make judgments about company credibility through their association with other trusted organizations, and more susceptible to planted messages in online social media. In a setting like the pump and dump, where favorable first impressions are all that are needed, and where perceptions rule in the absence of real products, conventional marketing wisdom failed to predict its impact.

A future research agenda should include the abuse as well as the use of today's modern marketing methods; regulation that accounts for the speed, global reach, and anonymity of the internet; and the remarkable impact of cybercults in fraud.

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