

Stock Fraud and Boiler Rooms in the Internet Age

Sometimes movies do a pretty good job of describing fraud. 2015's *The Big Short* accurately described massive fraud in mortgages for residential real estate, by lenders, borrowers, and mortgage brokers, that occurred while federal regulators and ratings agencies were asleep at the switch: "The creation of the mortgage bond market, a decade earlier, had extended Wall Street into a place it had never before been: the debts of ordinary Americans." - *The Big Short*.

Likewise, 2000's "Boiler Room" showed how pump and dump stock market fraud works. Brokers create artificial demand in the stock of expired or fictitious businesses, and speculative penny stocks. When the firm is done pumping the stock, the schemers sell high, and the investors then have no one to sell their shares to in the market, as the price of the stock plummets.

In 2018, pump and dump operations are still stealing hundreds of millions of dollars. Their victims are usually unsophisticated, and are often elderly people who end up on sucker lists that are sold to telemarketers and spammers. The basic fraud is the same as always, but there has been an evolution of these operations to incorporate new technology.

The stocks involved in these schemes are almost always Penny Stocks. These are stocks of publicly traded U.S. companies that have low market capitalization and have much less scrutiny from regulators than stocks on the major exchanges. The conspirators will buy large numbers of shares of such corporations at very low prices, because the corporations are shells, which are listed on a stock exchange, but have not significant assets and no business operations.

In one recent local case, the brokerage company controlled by a conspirator purchased 50,000 shares of one company for \$500. You can see the type of profits that can be made by persuading investors to buy shares at \$2 or \$3 per share. In this case, in which the conspirators bought, pumped up, and then dumped five companies, the government alleged that the total amount of the swindle was \$147 million.

To pump up the prices of the penny stocks that they own, the conspirators manipulate the stocks by techniques such as match trades, where one conspirator buys a number of shares of the stock, while simultaneously a coconspirator sells the exact same number of shares, through a different broker, at the exact same price, giving the appearance that there is active trading occurring on that stock.

The main ingredient of the pump and dump is false advertising. Callers from boiler rooms, operating just like they did twenty or thirty years ago, convince buyers that this is a great opportunity to catch a stock on the way up, and the buyer is urged to buy immediately. The callers say things like, "I put out Twitter on the OTC 8 years ago, and this looks like Twitter", or "Disney has bought into this stock." There are also massive amounts of spam sent out, with outrageous claims about the stock in question. It has been estimated that 15% of spam is from pump and dump stock schemes.

There are also websites, newsletters and blogs published by conspirators, in which they strongly urge their readers to buy the stocks that are being pumped up. These publications contain general disclaimers about the dangers of investing in securities, but they do not disclose that the writers

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and associates own shares of the stock, and therefore have a conflict of interest in recommending the stock. These publications glamorize the penny stock industry, and tell investors that some of these stocks are going to fail, but with the advice of insiders (i.e., the writers of these publications), great riches await those who will take a flyer.

Pump and dump schemes target a different kind of victim than ponzi schemes. In many ponzi schemes, the victim investors know the head perpetrator of the scheme, or at least know someone who knows and trusts him. Ponzi schemes don't always promise outrageous returns. Bernie Madoff stole billions dollars not by promising high returns but by emphasizing the safety of investing with him. Penny stock pump and dump operators look for people who are willing to gamble that lowly capitalized stock that they are buying today will multiply in value. The problem is, it is not a gamble, it

is a certain loss. As soon as there is a good bump in the stock price, the promoters dump it. When a spam promoting a stock is sent to tens of millions of people in the hope that a tiny percentage of them will buy the stock, and the conspirators sell their stock fast, sometimes the same day the spam went out.

The SEC Enforcement Division's Microcap Fraud Task Force is active in bringing civil lawsuits against pump and dump operators, seeking injunctions against continued fraud, and disgorgement of the proceeds of the fraud. The FBI also investigates these cases, and US Attorneys' Offices indict these defendants for offenses including 18 USC 371 (Wire Fraud), 18 USC 371 and 3551 (Conspiracy to commit Securities Fraud), and Money Laundering. The dollar amounts of the losses are usually in the millions of dollars, which drives the Sentencing Guidelines loss calculations up, and the corresponding guideline prison range can get to some pretty high numbers.

In 2017, B.J. Gallison, of San Diego, was sentenced by a federal judge in Virginia to 18 years in federal prison after a pump and dump conviction. (Gallison had been sentenced to 5 years in prison for a pump and dump operation in San Diego County in 2003, and that was likely very important to the federal district court judge who sentenced him in 2017.)

Some pump and dump operators have impressive websites and newsletters in which they describe themselves as independent financial advisers. It is difficult for the average investor to know when such advisers are concealing information about their conflicts of interest or even larcenous intent. It doesn't hurt to remind friends and relatives, particularly aging ones, to never take a cold call from a telemarketer, or buy a stock based on a tip from an unsolicited email. **TBN**

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