



Pump and Dump is Alive and Well.

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Keith: Welcome to the Empowered Investor. My name is Keith Matthews, and I'm joined by my co-host Marcelo Taboada. Welcome, Marcelo.

Marcelo: Keith, I'm always happy to be back.

Keith: Great to have you back. We've got a great show today. We are discussing the pump and dump scheme. It's a concept that's been around for many years, and we're going to explore what it means, what it looks like, and the implications for today's market. We're going to contrast it to some of the other schemes out there, Marcelo, like the Ponzi scheme and general corporate fraud. There have been lots of examples in the past where I think it's relevant to make that comparison. So why are we doing a show on pump and dump?

Marcelo: I think the timing couldn't be better, Keith. When we set out to do the podcast, we always wanted to educate our clients on a wide range of subjects. And I think what we're living through now is we not only have lived through one of the most interesting times in human history, but we're also living through a period where narratives in social media, boredom, and excess money are creeping into people's lives. We're seeing a lot of the behaviors that we see in those things you mentioned, especially the pump and dump. We're seeing a lot of the narratives creeping in and hurting a lot of people financially. So I think it's super relevant to do this subject.

Keith: Okay. I agree with you a hundred percent. Let's start from the basics here. Let's define the pump and dump. What does the pump mean? And what does the dump mean? What does it refer to? And give us some classic examples.



Marcelo: That's a great question. I'm going to go with the formal definition here. So the one thing for people to remember is when you have a pump and dump, there are two sides, two parts of it. The first part is the promoters. You have a promoter or a person, which we can call the perpetrator, who's trying to boost the stock with false or misleading statements about the company he's trying to pump. Then he buys and acquires a lot of shares in the said company. Once the stock has been pumped, he moves into the second part. The second part is he starts to seek the profits, where he starts offloading the share. So he dumps the share into the market. So the first part, he pumps it via narrative or false claims. The second part is he pumps the stock or sells it, offloads it to the market or the other people who are now buying the security. Now, these schemes used to happen over the phone, and now they're happening in internet forums, things like Reddit and Yahoo forums and that type of thing.

Keith: We'll save the Reddit and Yahoo till the end of the show, Marcelo, because it's still not a hundred percent sure that we can formally state that's what's going on. But let's talk about the classic pump and dump scenarios that you just described. Can you give us an example?

Marcelo: I think everybody's watched "The Wolf of Wall Street."

Keith: I sure did.

Marcelo: Okay. So that's a great movie, a fantastic movie. That's the most famous and clearest example of a pump and dump. I couldn't forget the scene where the guy, Jordan Belfort, played by Leo DiCaprio, gets on the phone and starts trying to sell this technology stock to a person. He's going on about how cutting-edge their technology is, avant-garde and frontier-breaking. Then, as he's describing the stock, they show the actual company, and it's like this rotten shack in the backwoods with a quick banner of the company. The whole fraud in that company was exactly that. These guys would get on the phone, they would buy the security, and then get on the phones trying to pump the stock and offload it into the market. Once that happens and the fraud is uncovered, the stocks go down, but by this time, they've already sold their shares and made their money.

Keith: Yeah. To be clear, it is a fraudulent activity.

Marcelo: A hundred percent.



Keith: It is against the law. Security regulators look for this, they look for this type of manipulation, and then they pursue it with criminal activity. So usually, what does happen with these types of maneuvers is that somebody is buying typically a penny stock, buying a stock that trades at less than a dollar, buying a lot of the penny stock, a lot of it, then moving to the promotion stage, promoting it with typically false information or just simply promoting and pushing, encouraging people to push the stock higher and higher and higher. Then they sell the stock, and those that had bought the stock have no other future buyers thereafter, and the stock dumps.

Marcelo: Exactly.

Keith: A great example of this was also concepts called boiler rooms. Boiler rooms were notorious in the 1990s, particularly in Canada. Boiler rooms were groups of individuals sitting in a hot, tightly confined environment making phone calls out to individuals, trying to get them to buy these securities after they had acquired them first. They used to always target junior mining stocks, junior gold stocks, and they would promote that. They would even go to the extent of leaving false messages on answering machines, like, "Hey, Mrs. Smith, I wanted to get back to you on this incredible stock opportunity." Of course, it's not Mrs. Smith getting the message. "You've got to buy this. It's going to go up. It's going to go up 10 times. Go borrow money, do whatever you can. You must get into this." Then the other person, not Mrs. Smith, listens to the phone call, is enticed by it, and calls up the promoter, finding themselves buying into it. These were not stories; these were truths about these boiler room operations. So this pump and dump is an illegal activity. It's something that we see. It is different from other schemes that we will just define briefly for the show. It's different from a Ponzi scheme, though. So Marcelo, how is it different? What's a Ponzi scheme? Let's spend a few minutes on that and a few minutes on corporate fraud.

Marcelo: That's a very good distinction because the thing with all these three things, Keith, is that there's a lot of elements that overlap among them. Typically, in all three of them, there's good narratives around all this fraudulent activity, which makes it so confusing for people to understand. Even for us, we're in the financial industry, sometimes we have to dig a bit deeper into what they actually mean. The Ponzi scheme is an interesting example. I think anybody can remember, in Canada, Earl Jones was one of the biggest ones in the West Side of Montreal. Then in the U.S., the biggest in history was Bernie Madoff. That was a \$65 billion Ponzi scheme. What happens then is the



perpetrator of the Ponzi scheme starts getting investors and falsifies documents about particular investments, promising certain returns. It's like a pyramid scheme. The more people enter the scheme, the new money that comes in is used to pay a return to the existing people who came in first. This keeps going on and on. In most cases, these Ponzi schemes are uncovered when there is a financial crisis or a bad economic period, and people start demanding their money or new people start coming into the pyramid. That's how they get uncovered, but they end up damaging a lot of people.

Keith: You're absolutely right, and you've described it very well, Marcelo. In 2008 and 2009, when the market crashed or corrected significantly and stayed low for a while, this is where people asked for money back or did not want to give new money into the scheme, and that's when things collapsed. So yes, a Ponzi scheme is very different than a pump and dump. A Ponzi scheme, as Marcelo alluded to, is all about finding the next new sucker to give money into the scheme. That person's money is then used to give a little bit of return back to the original people and some to the fraudulent character. When you run out of new people, the scheme stops. That's very different. Now let's talk about corporate fraud and just highlight it a little bit because, again, sometimes people get confused with the pump and dump, corporate fraud, and Ponzi scheme. Corporate fraud. What's that? Let's talk a bit about that.

Marcelo: Corporate fraud is essentially insiders of a company, people who may own the stock, who work in the company, falsifying documents and engaging in illegal accounting practices. This sends false information to the market, and the stock ends up appreciating. One of the best examples in Canada is Nortel. In the U.S., you had Enron in the 2000s. Most recently in Canada, we had Valiant Pharmaceuticals. This is how it happens: it's a company that is legitimate at its root, at its genesis, then it starts falsifying documents and accounting practices. The market sees this and thinks, "Oh, this company is doing well," therefore the stock starts appreciating. When the fraud is uncovered, everything goes down, and people go to jail, people commit suicide. By the way, there is a great documentary about Enron called *The Smartest Guys in the Room*. It's a great documentary, also based on a book, that tells the story of the whole Enron fallacy. That's typically how it happens.

Keith: All right. So there are some executives who have major stakes and senior participation in large publicly traded companies. They are, in essence, falsifying and then pumping, encouraging, and falsifying, pumping, and encouraging. Their motivation is to somehow make a ton of money and then



get out. That is criminal activity. I often say they go to jail, but Canada has a history of not necessarily prosecuting white-collar criminals. This is why sometimes it still continues. I think the biggest story I've ever seen was Bre-X. I was a bond trader when Bre-X was going on. Let's talk about that one for a sec because it is interesting. This shows the type of activity that was going on. You got a stock that's trading, I think, at 30 cents, a Canadian organization bought a small mine in Indonesia, and they falsified the records. They essentially took out core samples of earth and then sprinkled gold onto that core sample. Who could do that? They sprinkled gold onto the core samples, and the geologist then basically said, "My goodness, you've discovered what could be the largest gold mine in the world." The stock went to, I think, 280, all in the matter of three years. Canadian pension funds lost money, investors lost money. This became a huge story in Canada. But that was corporate fraud because, at the end of the day, when the new buyer purchased the company, they walked in and started studying the samples and said, "How come it doesn't match with our new samples?" Whether it's Bre-X, Enron, or some of the other stories you mentioned, those are examples of corporate fraud, executives still invariably pumping up the story. But those are not what we call classic pump and dumps.

Marcelo: There is a movie about Bre-X called *Gold*. I think you can catch it on Netflix. It's with Matthew McConaughey. I don't know if you've seen it.

Keith: I have not seen it. What's it called, Marcelo?

Marcelo: *Gold*.

Keith: Very fitting title.

Marcelo: What does it tell you about all these frauds that they're fascinating, that it's worth making a movie about? That's how bad they are.

Keith: Let's switch gears and migrate towards today. Again, we're talking about pump and dump, and we obviously had a reason why we created today's episode. It has to do with what we think is going on today in some of the narratives. Things are murky because it's really hard to determine are people pumping? Is there any illegal activity? What's going on in the social platforms? What's your sense, Marcelo?

Marcelo: My sense, as I alluded to at the beginning, is we're entering a whole different realm of how people interact in the markets and how people behave.



Social media creates a massive feedback loop. I think you add that to the pandemic, plus boredom, plus being at home, plus getting stimulus checks, or even if you're a person who kept your job and now all of a sudden your expenses have gone down, you have all this time at home in front of a computer. You start hearing it from friends. We've talked about this tons of times on the show. It's the FOMO, the fear of missing out. It's the idea that somebody else is getting richer while you're on the sidelines. I think that captures people's imagination, and it's real. It is not something we should ignore. So you see a lot of those elements in what's happening today and how people get sucked into stories about certain stocks.

Keith: All right. So give me an example. You've been on some of these sites just to check them out as a financial advisor. What are the kinds of things that you see people talking about to try to hype the stock up?

Marcelo: People selling a stock saying, "This stock is going to do great because of such and such reason." Then you see the threads of people saying, "Yeah, let's get in. I'm putting in X amount," and they're not even doing the research. The person may not even be engaging in fraudulent activity there, but the elements are there where they're trying to sell a stock and pump it. People are not even doing the research; they're just coming in and saying, "You know what? Screw it. Let me put in a few G's and see what happens."

Keith: You're right. I was reading the Wall Street Journal this weekend, and there was a great article by Jason Zweig. He was speaking about the percentage of traders on these platforms that are now self-admitting, almost mocking themselves for their own ignorance about stock and information. They're basically admitting that they know nothing, but they're just throwing money at ideas and chuckling along. That's not good, but these types of individuals that are just doing that, could they end up being victims, do you think, of these kinds of flows, of pumps, and people pushing things forward? What do you think, Marcelo?

Marcelo: Listen, I think we can generalize here, and I'm sure a lot of people are putting a small part of their net worth into this type of behavior, even though we don't condone it. But I think the real tragedy here is if you're a student or a person just entering and learning how to be engaged in the market, the real tragedy is that this person is coming in and learning how to do these things, getting sucked into these things, and now their whole perception and cognitive ability towards the market is being almost damaged from this first experience



and first exposure to the market. I think that's the real danger here. A lot of people who are young may have student debts and not even a strong financial footing, and they're throwing \$2,000, \$3,000 that they don't have into these types of stocks. That can even put them more in a hole.

Keith: You know what? You raise an excellent point. We have a lot of clients whose young adult kids are now investing, and you're absolutely right. These are not the right lessons. This is not the right environment. It reminds me of when I went to change my phone at TELUS maybe about a month ago. I'm sitting with the TELUS rep, a super nice guy, and usually I don't have great things to talk about the telecommunications industry, but he was great. He was very helpful. We were both doing the social distancing, both wearing masks. He asked me what I did for a living, and I said I work at a firm, we manage investments, we do planning. He says, "Oh yeah, I'm an investor too." I said, "Where do you invest?" He said, "I'm at Wealthsimple." I said to myself, "Great, wonderful. You've bought their diversified portfolio, right?" He says, "Absolutely not. No, I'm picking a bunch of securities." I go, "What are you picking?" He listed off four companies. I go, "How are they doing?" He goes, "I'm losing on every single one of them." I go, "What did you buy them for?" "My brother-in-law told me to." We went on for 10 minutes. In the end, here's a young guy, he's maybe 25, 26, studying, a student, and he's losing money because he's throwing money at and not following the ideas. He's not doing any research. He's succumbing to the hype and buying into these concepts. He's buying penny stocks. This to me was an example, and it's got to be happening all over the country. This gets back to this narrative that you talk about. There's a speculative environment, which is perfect for this concept of pumping, pushing forward. You'd mentioned off-mic, Marcelo, the whole cryptocurrency concept as well. What are your thoughts around that?

Marcelo: Yeah, so I think that's the one that's taking... I keep bringing this up, and my mom's not going to be happy about this, but she asked me about Bitcoin the other day, and that's where a light bulb went out and said, "When your mom asks you about Bitcoin, it's getting really serious." I think the whole cryptocurrency environment and ecosystem is becoming completely bananas. There are all these types of cryptocurrencies. The forums are filled with people trying to sell the ideas of why these cryptocurrencies are going to make money. I see the appeal of some cryptocurrencies, especially on the technological aspect of them and the use it could have for a lot of industries. But as an investment, I see some narratives that are very dangerous. When you



hear things like, "This type of cryptocurrency will take over the world and will be the currency of the future," that sounds a bit grandiose to me. If you get sucked into a narrative like that, it could be dangerous because now if you're convinced that this is going to be the next great thing, you may be tempted to say, "Why would I be in a diversified portfolio and wait all this long to cash in when I can do it now in the next few years?" I think that's dangerous.

Keith: Yeah, and I agree with you, but I also think it's a great example of groupthink. When the entire group is pumping up something, and I'm talking pumping up the entire group of individuals, they'll be telling absolutely everybody they know that they have to buy this. That's like a mass group. When you get that group on the internet, whether it's cryptocurrency, GameStop, or other types of examples out there, you get a lot of people promoting, pumping. One of the interesting things is I don't even know if you can consider that a criminal activity. I don't think so.

Marcelo: There's a very subtle line between somebody coming into a forum and saying, "You know what, I think this stock is going to do well," and he's trying to pump it and engage in an illegal activity, as opposed to somebody just out of fun saying, "Hey guys, there's this stock that I think is going to do well, and let's give it a try," and then everybody just jumping in. From a legal standpoint, how do you prove that a person has fraud? This is where it gets tricky.

Keith: I agree. Let's look to wrap up here. One of the things I liked about this show is it's short, it's sweet. What we've tried to do is highlight some of these activities, specifically pump and dump, why it's a bit different than some of the other schemes that we've seen. The reality of it is all these schemes have been around for decades. They're not going anywhere. So you have to be mindful, you have to be diligent, you have to stay on top of things. What are your takeaways, Marcelo?

Marcelo: Look, I have two, if you allow me. The first one is the old adage that if it's too good to be true, it probably is. I think it's a hundred percent true, especially in the financial world. The second is going to sound a bit self-serving, but I think the value of having a financial advisor, and if I didn't believe this, I wouldn't dedicate my life to this. I think we put the guardrails, we don't allow people to fall for these things, and we put the protection guards. This is something that's hard to quantify, but it is so important. It is so important.



Keith: You know what? You're right, Marcelo. That's a very wise comment. That's an amazing comment, Marcelo, because when you were saying that, I was thinking about all the... that's what we've done. We have never let a client get involved in this stuff, ever. I think that's great. What I would add is it gets back to staying diversified. Obviously, that's what we believe in. That's our belief system, multiple asset classes. If you are going to buy an individual company, do the research. Do your research. Don't take shortcuts. If you take shortcuts, especially in hyped-up environments, you may regret that decision. So do your research. Listen, Marcelo, thank you so much. That was a great show. It was great to have you back. I look forward to our next episode together. And to our listeners, we'll see you next time. Thank you.

Marcelo: Thank you, everybody.

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