OPINION

# How the 'Wolf of Wall Street' Really Did It

By Ronald L. Rubin

The swindler known as the "Wolf of Wall Street" taught me how to pull off his boiler-room fraud, down to the smallest details. Movie director Martin Scorsese's lurid version of the tale now showing in multiplexes doesn't capture how the scams really worked.

In early 2000, Jordan Belfort and Danny Porush (renamed Donnie Azoff in the movie) were under house arrest. Faced with overwhelming evidence, they had cut deals with the government to reduce their jail sentences by ratting on their friends. One such friend was Steve Madden, the shoe designer who had played a supporting role in many of their crimes. I was the Securities and Exchange Commission enforcement attorney assigned to put together the SEC's case against Madden.

As "cooperating witnesses," Belfort and Porush spent many hours explaining to me the finer points of how they used their brokerage firm, Stratton Oakmont, to steal millions of dollars from investors, and convincing me that Madden had been a knowing participant in their schemes. Madden eventually paid millions to the government and spent considerably more time (30 months) locked up in federal prison than Belfort (22 months).

The Scorsese movie glosses over the nuts and bolts of how Jordan and his merry men bilked seemingly hapless suckers out of their life savings en route to the more entertaining sex, drugs and partying that his crimes financed. Today, in the era of Occupy Wall Street protests and seemingly daily multimillion-dollar regulatory fines against financial firms, it is tempting to view Jordan Belfort as emblematic of Wall Street's greed. In fact, he was nothing more than a thief who found a way to steal from anyone who trusted him and to blame it on the stock market.

The stock scam wasn't emblematic of greed in the Financial District. These guys were just shrewd crooks working out of Long Island.

Stratton Oakmont was not a real Wall Street firm, either literally or figuratively. Its offices were in Long Island, and it bore little resemblance to even the most no-holds-barred investment house, Bear Stearns, where I once worked. Furthermore, my experiences as a criminal prosecutor, at the SEC, and more recently at the Consumer Financial Protection Bureau, have taught me that every business, especially those involving large sums of money, attracts criminals. For example, after the real-estate market collapsed in 2008, scammers began peddling worthless loan-modification products to impoverished homeowners facing foreclosure. Such predators were no more characteristic of the mortgage industry than Jordan Belfort was of Wall Street.

Top: Associated Press/Paramount Pictures, Mary Cybulski; Bottom: Associated Press

Jordan Belfort, depicted by Leonardo DiCaprio above in 'The Wolf of Wall Street,' and at right in an undated photo.

Belfort and his accomplices fine-tuned his signature fraud through dozens of repetitions. Here's how it worked, in five easy steps:

*1. Create IPO Stock:* The first thing Stratton Oakmont needed was a business to sell, and the definition of "business" was very flexible. A judo school, a bagel maker, a newfangled water purifier, or a recovering alcoholic selling shoes out of the trunk of his car would do. What was needed was not so much an actual business as a business entity with a story that could be converted into publicly traded shares of stock through a Stratton initial public offering.

An important element of the scheme was that the Stratton IPO stock was not really sold to the public—it was sold to Stratton. Securities laws forbid underwriters like Stratton from buying more than a small percentage of the IPO stock they issue. To avoid this roadblock, Stratton sold all of its IPO stock to friends (nicknamed "flippers") like Madden, who immediately sold the stock back to Stratton for a small profit. The IPO stock was usually issued to the flippers at $4 per share, and then sold back to Stratton for $4.25 per share. This was a pretty nice deal for the flippers, who could pocket $50,000 or so from an IPO without breaking a sweat or risking a loss.

*2. Line Up the Victims:* Suckers aren't born, they're trained. Stratton Oakmont's salesmen would first gain the confidence of investors by letting them make a small profit on one or two Stratton IPOs. Once trust had been established, the Stratton salesmen would inform these customers that a really hot IPO was coming soon with a $4 issue price. Like all Stratton IPOs, the stock's price was expected to take off when it began trading in the aftermarket. An excited customer with $100,000 of savings might authorize the Stratton salesman to buy 25,000 shares of the IPO stock, and then transfer the $100,000 to his Stratton account. By totaling up all such commitments, Jordan Belfort knew exactly how much buying power Stratton's customers had.

*3. Bait and Switch:* Shortly before an IPO, the Stratton salesmen would call these customers and inform them that the IPO was so hot that the salesmen could offer only a (very) few shares at the $4 IPO price. However, the salesmen could create purchase orders to be executed as soon as the stock began trading on the open market. Many customers assumed that such orders would result in stock purchases near the $4 issue price, so they simply agreed. Some balked at giving the salesmen permission to invest their money without knowing the purchase price, or simply refused to buy stock in the aftermarket.

This was when the boiler-room hard sell depicted on screen began. The pressure on customers could be overwhelming, especially since they had already agreed to buy the same stock at the issue price: "What do you mean you don't have the money to invest in this stock? You already gave me $100,000 to buy it at $4 per share!" "I made money for you before, and now you don't trust me?" "I'm never going to let you in on another IPO if you back out on me now!"

The Stratton brokers could have just placed orders in these customers' accounts without their permission, but they rarely did. Unauthorized orders were more likely to trigger complaints to regulators, and the move would have violated some unofficial boiler-room code of honor. These guys took pride in their ability to talk suckers into parting with their life savings.

*4. Market Manipulation:* Stratton Oakmont could have made millions of dollars just by selling its customers stock in nearly worthless companies for $4 per share, but after a couple of such IPOs, investors and regulators would have caught on. Instead, Jordan Belfort used the stock market to camouflage his theft.

Let's say that one million shares of the IPO stock had been issued, and Stratton's customers had committed to buying $12 million of the stock in the aftermarket. Belfort would therefore want the stock price to rise from $4 to $12 per share before selling it to them. Having bought all of the IPO stock back from the flippers, Belfort and Porush could make the stock trade in the aftermarket at any price. The simplest way to do so was to buy and sell shares between Stratton accounts at increasing prices, but that would have been too obvious. The same result could be accomplished by having friends buy small amounts of stock using "market orders," which buy shares at the lowest price offered from any seller. The only seller was Stratton Oakmont.

As soon as aftermarket trading commenced on IPO day, the friends of Belfort and Porush started placing these small market orders. Stratton would simultaneously sell its stock using "limit orders," which offer stock for sale only above a specified minimum price. After each sale, Stratton would place another (sell) limit order with a slightly increased minimum price, and the friends' market orders would execute at each higher price.

What the market recorded was a steady progression of trades at $4.25, $4.50, $4.75, all the way up to the $12 target price. The run-up from $4 to $12 could be accomplished in minutes. This was a common first-day trading pattern for legitimate hot IPO stocks during the 1990s, so the manipulation wasn't obvious.

*5. Sell High and Shut the Door:* When the IPO stock price hit the $12 target, Stratton executed its customers' buy orders. This was the payoff moment when Stratton got the victims' money and the movie's over-the-top partying began.

Had customers holding the inflated stock tried to resell it quickly on the market, they would have found almost no real buyers, and the stock price would have plummeted about as quickly as it had risen. Such an early price crash was rare for legitimate IPO stocks and would have attracted regulatory scrutiny and scared away future Stratton victims. So Stratton made a practice of supporting the high price for a while—usually about a month—by buying any of its IPO stock offered for sale on the market.

But letting customers sell their stock for $12 while Stratton Oakmont was the main buyer would defeat the entire purpose of the scheme; the victims had to be discouraged from selling too soon. Stratton brokers could usually do so by heaping more hyperbole onto investors who called to place sell orders. (Stratton operated before Internet self-service brokers like E*Trade enabled most investors to place their own orders).

When customers couldn't be talked into holding on to their stock, their sell orders would usually just be lost and their phone calls ignored. When the sell orders were finally executed, there would be few buyers, the stock would crash, and the customers would be wiped out. By that time Belfort had the next IPO ready and was lining up new lambs for the slaughter.

Would this boiler-room fraud work today? The simple answer is no, so long as the Securities and Exchange Commission and the Financial Industry Regulatory Authority (Finra) did their jobs, but the same was true in Stratton Oakmont's time. Regulators are now armed with more powerful computers and years of exposure to the scheme. But creative con artists are always inventing new variations on old scams, and regulators are much better at preventing yesterday's crimes than anticipating tomorrow's. Jordan Belfort told me that he never worried about the SEC, and only occasionally the FBI. When I inquired about the National Association of Securities Dealers, (Finra's predecessor), he laughed.

I once asked Jordan if it bothered him that he was stealing old ladies' life savings. Without missing a beat, he replied: "Of course. Why do you think we took all of those drugs?" It was my turn to laugh. Maybe we'll see that remorse in the deleted scenes on "The Wolf of Wall Street" DVD.

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