Jordan Belfort – Master Manipulator

Reading Project MVE220 Financial Risk 18/19

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1. Introduction

The report focuses on the life and financial schemes of Jordan Belfort. It begins with an introduction to Belfort's life, followed by more specific information about the schemes which he was convicted of. The report then gives clarity in how Belfort could have done what he did and then discusses how to prevent similar actions in the future.

2. Jordan Belfort

Jordan Belfort was born 1962 in Queens, New York (Reiff, 2018). He intended to become a dentist at first, however he was dissuaded when he learned that dentists rarely became rich. He soon after started working with sales, more specifically as a door-to-door salesman. According to Belfort himself the business was good, but when he was 25, he had to file for bankruptcy (Reiff, 2018). It was at this point Belfort's interest for the stock market started growing. He worked at a number of stock brokerage firms: L.F. Rotschild, D.F. Blair and F.D. Roberts Securities and eventually ended up at Investor Center, a small brokerage firm in Long Island in 1988 (Solomon, 2013). It was there he was introduced to penny stocks (stocks that usually trade over the counter and are therefore less regulated than stocks traded on a centralized exchange (Murphy, 2019)), which would be of great interest to him.

A year later (1989) Belfort started a small-time broker shop in the franchise "Stratton Securites" together with a partner (Solomon, 2013). Within 5 months the two of them had earned enough to buy the whole Stratton franchise. From this point and forward Belfort's financial intake started to grow substantially.

With the buyout of the Stratton franchise Belfort renamed the company to Stratton Oakmont. He started hiring new, young brokers and provided them with his infamous sales pitch, the "Kodak pitch" (Solomon, 2013). This pitch intended to use a "blue-chip" (a stock of a financially sound and large company who is usually market leading in its sector (Chen, 2018)) to lure the investor in, only to then recommend stocks with higher margins for the seller, such as penny stocks (Solomon, 2013). The name "Kodak pitch" came from commonly using the blue-chip stock Eastman Kodak as the bait. However, during the time of these events Belfort himself claimed that he only tried to help his clients to invest in the future of America.

Furthermore, it was during the time as founder of Stratton Oakmont in which Belfort participated in the activities which later led to his sentencing to jail (Reiff, 2018). Stratton Oakmont did on multiple occasions inflate the price of different penny stocks through "Pump and dump schemes". The whole firm was as a type of "Boiler room" as they pressured investors to invest in certain stocks. More specifically Belfort himself was also indicted for acts of money laundering in the year of 1999 (Reiff, 2018).

Even though Belfort were under a lot of scrutiny during the 1990s it wasn't until 1998 he was finally arrested. According to one of the investigators a big part of why they managed to catch

Belfort, was thanks to his private attempts of trying to move some of his own money out of America. In addition, according to Coleman, one of the investigators, they managed to get some of the people that helped Belfort smuggle his money out of America to inform the investigators of which banks in Switzerland Belfort used. They then had to get information from said banks, which at the time was no easy task, as there was strict bank secrecy in Switzerland. (Harding, 2014).

In 1999 Belfort admitted to charges of money laundering and securities fraud, including running a pump and dump scheme, which lead to his conviction in 2004 (Leonard, 2008). He was sentenced to four years in jail, but only needed to serve 22 months because his cooperation with the investigators. Through his restitution agreement Belfort also had to pay 50% of his earnings through 2009 back to his defrauded investors (Harding, 2014). Furthermore, as late as 2013 complaints had been filed from federal prosecutors regarding his payments. This led to Belfort making a separate deal with the authorities, which is unbeknownst to the public (Reiff, 2018).

Today Belfort works as a motivational speaker, speaking about ethics in the business world. He also talks about motivation and sales techniques (Reiff, 2018).

3. Schemes

In this section, descriptions of the various schemes performed by Belfort in cooperation with Stratton Oakmont will be presented.

3.1. Boiler room

A boiler room operation is a high-pressure sales tactic where a broker tries to inflate the price of a stock with false or misleading premises and sell them to investors (Baldridge, 2018). These investors are usually contacted through “cold calls”, which means that they are chosen randomly. This is to make sure that the investor has no reference or information about either the broker, the company or the information given, which makes it easier for the broker to fraud the clients, because they can not refute what they are being told (Chen, 2017).

The intention with the call is to only give positive information about the stock and sometimes even promote the stock by using false or misleading information to encourage the investor to buy the stock immediately (Baldridge, 2018). The caller might even promise that there is no risk and only high returns from the investment (Chen, 2017). The stocks are usually stocks that trade over the counter and are not listed on large-scale stock markets (Baldridge, 2018). They are commonly known as penny stocks. The fraudster uses these stocks because the exchanges are less regulated and require less disclosure than stocks on, for example, NASDAQ and this makes it easier for the broker to stay under the radar. The stock price is also easier to manipulate because of the less frequent trading and the commission on penny stocks is bigger than on other stocks, that is, the percentage a broker gets on a sale is higher for penny stocks than for stocks on NASDAQ (Dhir, 2019). The commission and the easy manipulation of the stock is the underlying reason why a broker especially wants to sell penny stocks.

In the case with Belfort and Stratton Oakmont, as mentioned before, they did a variation of a boiler room scheme, where they first got the investors trust by selling a trustworthy stock and then pressure them into buying the penny stocks (Solomon, 2013). There was also another underlying reason, other than high commissions, that made Belfort want to inflate the price of penny stocks, and that is a method known as "pump and dump".

3.2. Pump and dump

A pump and dump scheme is similar to a boiler room scheme, with the addition that the company, or broker, owns the stock which they try to sell (Dhir, 2019). This sort of scheme is considered to be illegal. The person behind the scheme raises demand for a stock, and by doing so also raises the price and the volume traded, but before they do this, they make sure to acquire the stock at a low price (Dhir, 2019). When the scammers think that the price has reached high enough, they sell their shares of the stock to make a huge profit (Investor.gov, n.d.). After the perpetrator sell their stocks, the price usually falls drastically, causing the investors to lose a lot of money, because they bought the stock at a high price. Although a pump and dump scheme does not have to incorporate a boiler room, this is how Belfort did it. He made the brokers at Stratton Oakmont drive up the price of stocks which he owned and then Belfort would sell his substantial amount of shares at a high profit (Leonard, 2008).

3.3. Money laundering

Money laundering in its most basic form could be described as separating money from the illicit activities through which it has been obtained from. Commonly there are three different parts of laundering money: Placement, layering and integration. The first part is about placing the money in a legitimate financial institute. Layering could be done through various methods, but the aim of layering is to distance the money from the illegal activities. Lastly integration is when the money comes back to the culprits, who are then able to use the money and integrate them into society. (Sharman, 2011)

There are many ways to launder money, and since there are still illegal activities conducted around the world, money laundering as a phenomenon is still evolving. However, we know that Belfort attempted to move some of his money to Switzerland with the help of other people. The money laundering method he attempted to use is simply known as "bulk cash smuggling". It is a very simple method in its core. It is based around moving "dirty" money, in its physical form, through the border to another country where the bank secrecy laws are much stricter. There are multiple ways to move money outside of a country. Cash can be hidden on a person, in various vehicles, and of course further hidden in other stuff, for instance in a television set (Sullivan, 2015).

4. How could this happen?

Even though the Securities and Exchange commission began to investigate Stratton Oakmont during 1990 it took 8 years until Jordan Belfort was arrested (Solomon, 2013). It is definitely feasible that it takes time to gather an adequate amount of evidence when dealing with a case of this proportion. However, at the same time one would think that a case of this scale would also be prioritized.

Furthermore, actually convicting someone for running a boiler room is quite difficult. Running a boiler room is not a morally justifiable practice, but it is in a gray zone because it is hard to prove that the broker has committed a legal offense, as the fault many times can be put on the buyer for being too gullible.

Pump and dump, as well as money laundering, on the other side are clearly more well-defined criminal activities. The problem however, seems to be the access to information needed to prosecute such cases. As mentioned in earlier sections about Belfort, it was not until an investigator managed to get information from a person smuggling money for Belfort, that they had the necessary facts to prosecute him. One can therefore conclude that there was a lack of information which the investigators could obtain. As a result of this the schemes could continue for an extended amount of time.

5. Discussion & preventing the schemes

As mentioned before, arresting and convicting someone for running a boiler room scheme is not a clear-cut case. However, if there actually is false information leading to action (for instance a sale of a stock) there might be cause for investigation. Due to a boiler room being of this complicated nature, we see no obvious solution, other than informing the society about high risk penny stocks and deceivers, as in the case of Jordan Belfort and Stratton Oakmont. In comparison to the late 80s and the 90s, there exist more accessible information about the stock market today. This should make it more difficult to perform a boiler room scheme in current time, as a person easily can validate or invalidate the information given by a broker.

Considering the case where a person runs a pump and dump scheme, it is easier to detect than a boiler room, since the high returns are usually cause for a red flag. We believe that more regulations, especially regulations about transparency concerning the flow of money should be imposed on traders. This would, of course, mean more work for the traders as well as for investigators of illegal activities but it might contribute to a healthier trading environment. Monitoring big price changes in stocks could also be a way of preventing pump and dump schemes. Although it is difficult to say to which extent this is already being done, it could always be more thorough.

The introduction of wide spread use of the internet has made the flow of information faster and therefore pump and dump schemes today differ from the methods used during Belfort's time.

Since both the spread of information and the pace of transactions on the stock market has become faster, the amount of time a pump and dump scheme require should decrease. Because of this, more pump and dump schemes could theoretically happen, but more of the schemes should also be exposed, since more data is being saved and analyzing the data is easier.

A common regulation to prevent money laundering is by adding a limit to the amount of money which can be processed without further implication. For instance, the European Union has a limit of 15,000 Euros or more on individual transactions (The European Parliament and the Council of the European Union directive, 2005/60/EC on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing [2005] EUT L309/15). This is also the case for several small transactions that in total exceeds said limit, if they appear to be linked. We believe that lowering this limit could improve the results. However, this would obviously increase the amount of work needed and would therefore also cost more.

What we can conclude is that no matter the action, if we want improvements against these schemes, it is going to require more work and probably cost more. Furthermore, it is most likely going to restrict the free market. What needs to be done is to weigh the pros and cons of the regulations and find a compromise where it is financially sustainable to uphold the law while still maintaining a free and flexible market. And when it comes to avoiding schemes like a boiler room, a good rule of thumb is: ”If it's too good to be true, it probably is” (Investopedia staff, 2019).

6. Further reading

If one still wants to know more about Jordan Belfort, we recommend reading an interview called the “Sunday Profile” in the ABC Local, where Belfort, in hindsight, answers questions about his private and business life. We also recommend the movie “The Wolf of Wall Street” which is a movie based on Belfort’s life. Since it is a Hollywood production, we advise to watch it with a pinch of salt, as some parts may be altered and blown out of proportion to make it more interesting. All the references from our part about Jordan Belfort should also provide greater insight into his life, which can be found in the reference list.

Regarding money laundering there exist a vast amount of literature about this topic. We recommend either reading the books we have referenced in the money laundering part, for a wider view of the topic, especially “Methods of Money Laundering” by Kevin Sullivan. Although, it is good to keep in mind that money laundering practices can differ depending on the country. However, if one wants to explore more specific and recent cases (for Scandinavia), one can look at articles about the money laundering in the Scandinavian Banks.

For further reading about market manipulation such as pump and dump and other modern financial crimes we recommend the website Investopedia.com, which explains the different schemes in a comprehensible way. Examples of such articles can be found in our references.

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