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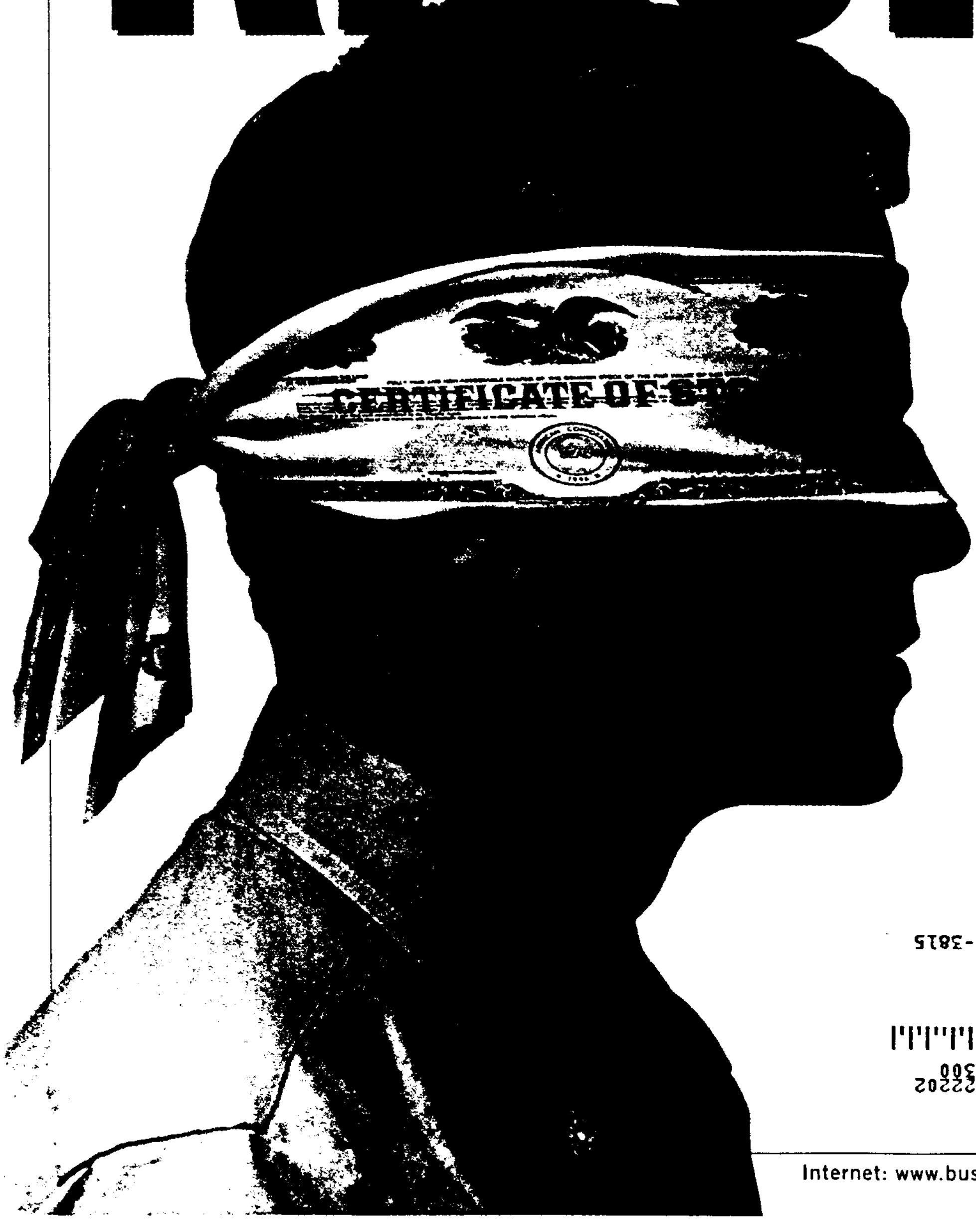

The secret world of **CHOP STOCKS**— and how small investors are getting fleeced

A SPECIAL INVESTIGATIVE REPORT BY GARY WEISS

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Special Report

INVESTORS BEWARE CHOP STOCKS ARE ON THE RISE

An inside look at how scamsters are taking billions from small investors

BY GARY WEISS

It has become almost routine. On Nov. 13, the U.S. Attorney in Brooklyn charged 13 people—brokers, Mob associates, and officials of two brokerage firms—with manipulating the prices of thinly traded micro-cap stocks. On the same day, in New Jersey, federal authorities announced a similar indictment. And then, on Nov. 25, came this bombshell: A federal grand jury in Manhattan handed up an indictment charging 19 people with multiple counts of racketeering and securities fraud. Among the accused were stock promoters, alleged mobsters, corporate officials, and six brokers at a firm that had managed to avoid the limelight, Meyers Pollock Robbins Inc. Not since the insider-trading scandals of the 1980s has Wall Street faced such a sustained legal juggernaut.

Throughout the multitude of charges in the assault on fraud in micro-cap stocks, there is one common theme. It's not just "pump and dump" stock-rigging schemes, or financial-statement fraud, or profiteering on hot initial public offerings. Nor is the problem confined to what the public experiences—the ubiquitous, forked-tongue cold-callers. Bribery is another element, but not the crucial one. Neither is the Mob the common factor, though it feasts on this corner of Wall Street.

Behind all the charges lies a simple fact that has received surprisingly little attention—even from regulators. Vast, interlocking networks of brokers are managing to obtain shares in hundreds of companies at dirt-cheap prices and are unloading them on the public. Among the people who make their living by pushing them on the public, the rogue brokers and stock promoters and mobsters, there's a name for these stocks. It is brutally simple: chop stocks.

"Chop" is slang for spread—the difference between the prices the brokerages pay for stocks and the prices at which they are sold to the public. In the world of the "chop houses" that sell these stocks, the real spreads often bear no relation to the numbers that appear on stock-quote machines. Often the stock is obtained by the brokers from corporate insiders or offshore accounts at a fraction of the price listed on the quote terminals. They then sell it to the public, illegally, at massive, undisclosed markups. It's fraud of the most fundamental kind. The public doesn't know that they are buying stocks that are worth nothing more than the pennies shelled out by their brokers.

To regulators, this is a small if troublesome fringe of the securities industry. Even Mob infiltration, they assert, is "relatively isolated, and does not threaten the overall stability of our markets," as U.S. Attorney Mary Jo White maintained in a press conference on Nov. 25. But this is a problem that goes well beyond the Mob on Wall Street.

LOW RISKS. In fact, BUSINESS WEEK has found that chop stocks constitute a vast underworld of the securities markets—a $10 billion-a-year business that regulators and law enforcement have barely dented in their recent prosecutions. Chop stocks are increasingly exploited by organized crime, and for a good reason: The profits are huge, the chances of incarceration low. Guaranteeing the "chop"—the immense profit margins—requires cooperating networks of brokerage firms employing uncounted thousands of cold-callers that are the public's main exposure to this world. Behind the cold-callers

ILLUSTRATIONS BY JOE SORREN

are an array of stock issuers, offshore accounts, and the barred brokers and stock promoters who are the middlemen between brokers and companies.

How serious is this problem? How is it being handled by regulators, in their well-publicized assault on small-stock fraud? Who are the players—the brokerages and stocks involved and the stock promoters who bring them together? BUSINESS WEEK sought answers to these questions in a six-month investigation involving interviews with present and former chop-stock brokers and customers, review of massive quantities of public documents and internal records and tape recordings, and interviews with traders, clearing-firm executives, and current and former securities regulators and law-enforcement officials.

BIG NAMES. One former chop-house exec, who requested anonymity, shared a graphic tale of illicit trading and payoffs—including a bribe that he said was paid to a National Association of Securities Dealers examiner (page 118). Another broker provided BUSINESS WEEK with a rare account of what he asserts was the purchase of a hidden stake in his firm by a leading behind-the-scenes power in the chop-house business—Jordan Belfort, former head of the now-defunct Stratton Oakmont Inc. penny-stock house. Sources also painted a disturbing picture of alleged customer overcharges and trading abuses at Paragon Capital Corp., one of the largest dealers in micro-cap stocks. And other sources maintain, in allegations being probed by regulators and state and federal law enforcement, that stock promoters dominated a Florida cold-calling operation run by the president of Meyers Pollock Robbins, the large micro-cap brokerage whose brokers were indicted on Nov. 25. Meyers Pollock declines comment on the indictments.

What emerges is a shocking picture of a problem that has spun out of control. Among BUSINESS WEEK's findings:

- The bull market in chop stocks has spawned a new generation of stock promoters, some still in their early 30s, replacing the Meyer Blinders and Robert Brennans who dominated the heyday of penny stocks during the 1980s. The new promoters gain control over cheap stock, or dominate the markets for thinly traded stocks, and then push them on the public, using crews of brokers reporting to them.
- The NASD and Securities & Exchange Commission's highly visible campaign against small-stock abuses and the recent spate of criminal prosecutions have failed to have a significant impact on chop houses. Although regulators have shut down a handful of cold-calling powerhouses, the vast majority of questionable firms—totaling perhaps 200 nationwide, according to state securities regulators—remain untouched.
- Although officials have downplayed Mob infiltration of Street firms, the Mob remains a troublesome presence on Wall Street (page 130).
- Payoffs to brokers have emerged as a commonplace method of bringing chop-stock companies into the marketplace. Some of the stocks that BUSINESS WEEK has identified as recent subjects of broker payoffs are listed here (table). None have been named in the recent prosecutions.
- Some of Wall Street's best-known firms—notably Bear, Stearns & Co. and Schroder Wertheim & Co.—clear trades for chop houses, processing trading records that sometimes show massive commissions and excessive price markups.

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Are Brokers Being Paid Off To Sell These Stocks?

Here are some of the stocks that sources say have been the subject of payoffs to brokers within the past few months. Company officials who could be reached for comment denied knowledge of any payoffs.

COMPANY	PRICE DEC. 1	52-WEEK HIGH
APPLETREE ART	3¾	10
AXXESS	2½	8¾
HARVEST RESTAURANT GRP.	1⅛	8¼
IMMEDIATE ENTERTAINMENT	4¾	7
JUNGLE STREET	4⅛	7½
LEGEND SPORTS*	NA	8
SCOTTSDALE CIGAR	4 15/16	9½
TCP RELIABLE	5⅛	7¾
TELLURIAN	5 9/16	7½
TTR	9 11/16	16 23/32

*Not trading DATA: BW; BLOOMBERG FINANCIAL MARKETS

At the NASD and SEC, officials say they are hard at work addressing the problem of small-cap fraud. And, they say, they have made great strides—particularly in eliminating the large firms that used to be a major source of small-stock abuses. Testifying before the Senate investigations subcommittee late in September, NASD Regulation's head of enforcement, Barry R. Goldsmith, said he would "readily acknowledge that there are some dishonest individuals and firms in the securities business today." But they also have systematically minimized the problem. In his Senate testimony, Goldsmith asserted that "the problem firms represent a tiny portion of the more than 5,500 securities firms."

By contrast, BUSINESS WEEK's investigation shows that chop stocks are a vast and growing industry. The NASD and SEC won't even hazard a guess on the scope of the problem. But according to people familiar with the business, chop stocks make up perhaps half the 85 million-share daily volume of the OTC Bulletin Board, plus dozens of stocks on the NASDAQ Small Cap Market. By that reckoning, there would be perhaps 700 actively traded chop stocks on the OTC Bulletin Board alone, and perhaps another 200 NASDAQ Small Cap stocks. With dollar volume of trading in domestic OTC Bulletin Board stocks—the shares not traded on NASDAQ or the exchanges—exceeding $20 billion a year, the portion consisting of chop stocks might well exceed $10 billion.

Cheap stock is fueling the chop-stock explosion. Restricted or "letter" stock, issued under Rule 144 of the securities laws, is commonplace at many perfectly legitimate companies as a way of rewarding key employees and giving them an equity interest—often in lieu of a high salary. Stock and warrants are also issued to compensate consultants in lieu of cash. And stock issued overseas, under Regulation S of the securities laws, is a widely recognized way of raising capital for emerging companies. Reg. S stock is cheap for a simple reason: Since it cannot be legally traded for two years, it is commonly issued at a steep discount. Rule 144 stock is cheap be-

ANATOMY OF A 'CHOP-STOCK' DEAL

Stock of XYZ Corporation is trading at $9.60 bid, $10 asked.

1 **THE STOCK PROMOTER** obtains 100,000 shares of "cheap stock"—either issued overseas under Regulation S of the securities laws, or issued to insiders under Rule 144. The price: 25¢ a share, or $25,000.

2 **STOCK PROMOTER** sells the stock to the **CHOP HOUSE** at $9.60 a share, or $960,000.

3 **COLD-CALLERS** at the **CHOP HOUSE** sell the stock to the **CUSTOMERS** at $10 a share, or $1,000,000.

cause it is usually issued at little or no cost and also must be held for one or two years.

The chop houses make their profits by simply breaking the law and getting that stock on the market immediately. "People violate the restriction. [They] basically launder it and dump it," says the SEC's enforcement chief, William R. McLucas. Another form of abuse, he notes, involves misuse of the rule allowing companies to compensate consultants with stock instead of cash—a rule that was put in place to help cash-poor high-tech startups. The "consultants" are often stock promoters. The Meyers Pollock indictment, for example, alleges that stock-promoter "consultants" were issued shares and warrants in one chop stock, much of which was immediately dumped on the public.

How does cheap stock make its way to the cold-callers? As told by chop-house brokers, one common method is simple enough:

Rule 144 stock certificates carry a legend marking it restricted stock, and the legend can only be legally removed at the end of the holding period. Among the chop houses, however, the restrictions are often ignored and the "legend stock" is traded in an illicit black market. The stock is available at a cut rate because it cannot be legally sold to the public. If the stock is trading at $6 a share, the chop-stock house may buy it at $2.50—never reporting it in the daily runs to NASDAQ. They can swiftly trade it to another chop-stock house at $3, making a swift profit.

When the legend stock is sold to the public, chop houses go for big profits. The price to the customer might be, say, $7 a share. The official bid would be $6 bid and $7 asked. But the actual cost to the brokerage is $2.50. The real, humongous spread never appears on the stock-quote machines.

If customers were to see the stock, they might realize that it's not supposed to be sold to the public. So the chop houses have a simple solution: They don't show the customers the stock. The shares are only a book entry.

OFFSHORE BANKS ARE REPOSITORIES FOR PROFITS REAPED BY CHOP HOUSES

The illicit nature of the stock is one reason shady brokers are notoriously reluctant to execute sell orders. If the customers want to sell, or obtain the certificates, or transfer the shares to another firm, they are discouraged. If the customer insists on selling, the firm simply does another book entry and "washes" the stock into another account—the brokerage's own "house" account, or sells it to an allied firm.

Whether the cheap stock originated overseas or from insiders, the procedure for getting it to the public is the same (chart). According to brokers familiar with the process, the massive profits are often split—in cash—between the brokerages involved. And the payments are often made in strip bars and other nontraditional Wall Street locales.

BALM. Warrants are the other major chop-stock moneymaking machine. Because of the leverage they afford, they become gold mines when the underlying stock is manipulated upward. They are often issued for pennies or no cost at all, making warrants a cheap way of compensating brokers and stock promoters. Warrants are also provided to favored investors in chop-stock deals, and sometimes are used to mollify unhappy chop-house customers.

That is what allegedly happened a couple of months ago to a customer of a New York-based firm named PCM Securities Ltd. The customer, a California resident who asked that his name not be used, had been in another stock sold to him by PCM that was a disaster. To make up for some of his losses, he says, PCM offered him warrants in an outfit called Medley Credit Acceptance Corp., which has filed for an initial public offering of its stock but has not yet gone public. The broker, he says, offered him the opportunity to buy the warrants, when the company went public, for 15¢—and assured him that the warrants would then be sold at $3. The customer says he was offered 15,000 to 20,000 warrants—a guaranteed profit of $45,000 to $60,000. PCM officials did not return repeated calls requesting comment. The Miami phone number

THREE BUSINESS DAYS LATER:

4 CUSTOMERS deliver $1,000,000 to **CHOP HOUSE.**

5 CHOP HOUSE delivers $960,000 to **STOCK PROMOTER.**

6 STOCK PROMOTER delivers the stock to **CHOP HOUSE.**

7 CHOP HOUSE delivers stock to **CUSTOMER's** account.

THEN, THE PROFITS ARE DIVIDED

8 STOCK PROMOTER'S profits—$960,000 minus $25,000, or $935,000—are wired to an **OFFSHORE BANK.**

9 OFFSHORE BANK wires half the profits—$467,000—to **CHOP HOUSE's OFFSHORE BANK,** or **STOCK PROMOTER** gives **CHOP HOUSE** its split of the profits in cash.

STRIP BARS AND OTHER UNCONVENTIONAL LOCALES ARE OFTEN USED AS SITES FOR PAYOFFS

for Medley—whose president is a PCM officer—has been disconnected.

For chop houses, warrants are a form of cheap currency. But in order for them to have any future value, the underlying stock has to climb. In the case of the Medley deal, the stock would have to rise from its initial price of $5.50 to $8.65 a share. The ability to drive up share prices is crucial. That is where the stock promoter comes in.

Stock promoters are the middlemen and fixers of the chop-stock world. Investors rarely have contact with them. They put stock in the hands of brokers, and on occasion they perform old-fashioned investor relations—the "promote" in stock promoter. But when Carol Ann Kandell, a bookkeeper at a college in Colorado, bought a stock called Java Centrale in 1995, she didn't come into contact with a promoter. It was simply on the sell list of her broker in a Long Island (N.Y.) office of Meyers Pollock Robbins—the 160-broker national firm that had escaped attention until the Nov. 25 indictments.

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"GOOD STUFF." Java was not a penny stock—it went public at $6 a share, $1 above the official definition of a penny stock. The broker "was always pitching that it was really good stuff," says Kandell. And then—guess what? The stock price dropped into pennies in the months that followed.

Investors had no way of knowing that a stock promoter was pushing Java and a host of other stocks destined for the cellar. According to sources familiar with his activities, the promoter was James Peter Minsky. In his file in the NASD's Central Records Depository (CRD), the 30-year-old Minsky has a typical record for a low-level chop-house broker. Minsky worked at 16 brokerages over a four-year time span, ending with a one-month stint at Westfield Financial Corp. in early 1994. Among the firms where Minsky worked was Joseph Roberts & Co., a Chicago-based firm where, one former regulator notes, he worked closely with Claudio Iodice—one of the stock promoters indicted on Nov. 25. Efforts to reach Iodice and officials of Westfield and Joseph Roberts for comment were unsuccessful.

Meyers Pollock appears nowhere in Minsky's CRD record. But according to people familiar with his activities, by 1995, Minsky was working at Meyers Pollock, pushing marginal stocks through Meyers Pollock brokers reporting to him. In the chop-stock world, stock promoters are an intriguing amalgam—part investment banker, part stock retailer, and part investor-relations publicist. They often have "crews" of brokers working for them and often work closely with chop-house execs. In Minsky's case, the venue in 1995 allegedly was the Fort Lauderdale office of Meyers Pollock, which was run by the president of the firm, Michael Ploshnick. Also working there, sources have told investigators, were two allied stock promoters—W. Fred Ballou and Leonard Ruge.

Ploshnick denies that the three men pushed stocks at Meyers Pollock. Minsky and Ballou could not be reached for comment, and the NASD declined to release the name of the attorney representing Minsky in recent NASD disciplinary proceedings. Ruge's attorney, Michael Bachner, says that "Mr. Ruge denies any involvement in the promotion of any stocks at Meyers Pollock."

According to one account of the stock-pushing process at the Fort Lauderdale branch, which was furnished to federal and state investigators, a typical manipulation of a hot IPO would begin well before the stock began trading. Minsky and Ballou and the brokers reporting to them, would work with other Meyers Pollock brokers to line up as many other chop houses as possible to support the stock and increase the share price as much as they could. But IPO or not, the stocks pushed by the brokers in that office of Meyers Pollock all seemed to have one inevitable outcome. With one exception—a "vegetation management" firm called Aquagenix Inc.—the stocks pushed by the brokers all plummeted in the months to come.

LUCKY INSIDERS. One IPO allegedly handled by the Minsky-Ruge-Ballou crews at Meyers Pollock was Multi-Media Tutorial Services Inc. That offering consisted of "units," each made up of one share of stock and one warrant to buy one share for $5.60, with an initial offering price of $4 a unit. As a result of the enthusiastic selling by Minsky's brokers and others at other firms, the units ended the first day of trading on Apr. 13 at $5.75 a unit—a one-day profit of well over $500,000 for the handful of brokers and insiders lucky enough to trade the units on the opening day. The units are now worth 7¢.

The stocks allegedly promoted by the three men at Meyers Pollock were considerably more substantial than the shell companies that were foisted on investors in the penny-stock era. Aside from Multi-Media Tutorial and Aquagenix, there were NuMed Home Health Care Inc., an Ohio-based home-care company, and American Resources International of Delaware, an energy exploration company. Others included Protosource Corp. and Grace Development, which is headed by Ruge. (In November, 1996, Ruge was arrested in an FBI sting, accused of attempting to bribe an undercover agent who was posing as a stockbroker. Bachner says Ruge is vigorously contesting the charges.) Officials of Aquagenix, NuMed, and Protosource denied knowledge of the promotion of their stock at Meyers Pollock, while officials of the other companies could not be reached.

When Meyers Pollock's South Florida operations shifted from Fort Lauderdale to Boca Raton in May, 1995, sources say the Minsky crew did what stock promoters always do when offices close—they simply changed firms. The next stop was at the Miami offices of J. P. Milligan, and then the Boca Raton office of Euro-Atlantic Securities Inc. A branch office of a firm called Brauer & Associates opened up at the same location, with some of the same brokers, and, sources maintain, Minsky. At Brauer and Euro, his brokers allegedly continued to push stocks, just as they had at Meyers Pollock and other firms. An attorney for Brauer, John Kiefner, confirms that Minsky worked briefly for Brauer in South Florida, but in a legitimate "investment-banking capacity." He denied that Minsky had any role in retailing stocks. Efforts to reach officers of J. P. Milligan and Euro-Atlantic, which ceased operations in mid-1997, were unsuccessful. Minsky's odyssey

HOW BRIBES WORK—FROM ONE WHO'S BEEN THERE

Bribes grease the wheels of the chop-stock business. How does bribery work? How commonplace is it? What follows are excerpts from an interview between BUSINESS WEEK *Senior Writer Gary Weiss and a veteran of the chop-stock business, who has worked for five chop houses since 1993.*

Q: *When corporate officials are confronted with charges of market manipulation, they protest that they don't know anything about it. What's the real situation?*

A: In my experience, there has been an incestuous relationship between the small, unproven, speculative corporation and the broker backing his company.... Say Company A needs to get its stock up for many reasons: (1) to allow insiders to sell their own positions at a handsome profit; (2) to make an acquisition; or (3) to remove fear of a declining stock. It's not rare for a corporate officer to approach a broker and, in nonincriminating language, ask: "What will it take to have you recommend my shares?"

Q: *What is that supposed to mean?*

A: Compensation. The corporate representative might suggest to the broker there might be additional compensation to the broker if he can "put away" [sell to customers] so many shares of the company's stock. It could be 10,000, 100,000, 1 million shares. The payoff occurs as the broker can document the amount of shares he put away. Usually, the broker is asked to supply a copy of each transaction sheet, each customer confirmation, showing the amount of shares that were purchased. And on that basis, a forum would be arranged in which the broker would be paid off in cash or in near-cash items. Near-cash items would be a trip to Hawaii, maybe a luxury car, and so on.

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Q: *Would payoffs come direct from the company?*

A: It could be either way. A cautious company, of course, would always use intermediaries. It could be another broker at the same firm. It could be the brokerage firm itself.

"THEY FIND A CORRUPT BROKER [AND PAY] $5,000 FOR EVERY HALF-POINT THE BROKER CAN SHOW HE LIFTED THE STOCK"

Q: *How much are the payoffs?*

A: That depends on the amount of shares put away and the price of the shares. Say the stock is 2 [bid] 2¼ [asked]. The company wants the stock to go from 2¼ to 5. They find a corrupt broker... [and pay] maybe a $5,000 cash payment up front and maybe $5,000 for every half-point the broker can show he lifted the stock.... The deal calls for the broker to buy, say, 100,000 shares of the stock, 200,000 shares of the stock. The broker shows copies of customer confirmations. That way, the intermediary is convinced the broker is doing what he said.

Q: *How knowledgeable were officials you encountered from the National Association of Securities Dealers (NASD)?*

A: I would say very weak in their knowledge—not in the rules and regs of the NASD but in the actual goings-on in the brokerage firms. They didn't have a clue as to what was going on! When I was there, my experience was that they were easily deceived by the broker-dealers, particularly chop shops. The chop shops would work overtime just to cover the books. They're not fools. They're notified by the NASD that they're going to be examined, so they know when to prepare. They know which trades to eliminate from the books. They know how to work the capital out.

Many brokerage firms were in a rush to get into the business. New brokerage firms, in many cases an offshoot of a firm that had gone out of business, would need a PMI—that is, a "pre-membership interview"—by the NASD. This can be a long process because each of the principals' backgrounds is thoroughly examined, [they] have to be in compliance with rules and regs, proper forms have to be filed, and so forth.

And in many cases, there were certain members of the regulatory authorities who were known to approve the PMIs in a relatively short period of time. So in many cases, those officials might have been short of cash, and intimations were made that the PMI process would be speeded up if certain things were done.

Q: *Such as?*

A: Some kind of cash gratuity, usually $10,000, $15,000, as high as $25,000. Remember, what you're talking about here, you're talking about the entrance of a hot broker-dealer into these markets. The quicker they can make it, the faster they make money.

Q: *Do you know of specific instances where this has happened?*

A: Yes, I do.

Q: *Did you see it happen?*

A: I was there.

COLD-CALLERS PERSUADE GULLIBLE CUSTOMERS TO BUY THE NEARLY WORTHLESS STOCK AT BLOATED PRICES

through a succession of firms is an example of a phenomenon that has vexed regulators since the demise of the huge cold-calling powerhouses. One ex-regulator notes that the NASD and SEC can lose track of the dozens of stock promoters who work behind the scenes. And even when regulators act promptly, it isn't always promptly enough. Take Euro-Atlantic, which was expelled from the securities industry last month. In this case, the NASD acted fairly quickly—filing a complaint in March, 1997, only a few months after the trades that were the subject of their investigation. But by the time the firm was expelled a few weeks ago, Euro had been out of business for four months.

Regulators do not always act so swiftly, or at all. For example, in 1992 and 1993 the NASD became aware of possible payoffs to a 150-broker California firm called LaJolla Capital. According to an internal NASD memorandum obtained by BUSINESS WEEK, NASD examinations found that the brokerage had accepted "due diligence fees" and "investment banking fees" from companies for which it was a market maker. But the NASD never acted on those findings—which officials suspected were illegal payoffs. A LaJolla spokesperson, Janet Frazier, denied LaJolla had ever accepted payments for making a market in companies, but said the company continued to accept due diligence fees—in return for carrying out due diligence on companies.

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The NASD's Goldsmith says that he does not know why the LaJolla case was not pursued. But he observed that a federal appellate court ruling in 1994—on alleged payoffs to another firm—required the NASD to issue a formal rule banning such conduct before prosecuting payoffs to brokerages. The rule was not issued until last July. In the interim, he noted, the NASD did not pursue such cases. Goldsmith pointed out that the NASD fined LaJolla in September for violating penny-stock sales rules, in a decision that LaJolla says it is vigorously contesting. However, the recent action makes no mention of payments from companies.

Payoffs to brokers and brokerages by corporate officials and stock promoters are some of the most invidious practices in the chop-stock business. How widespread are they? Regulators at the NASD minimize their prevalence. "When you're talking about payments or bribes—we take that very seriously. But to characterize that as widespread, as sort of the practice or the norm, or as endemic, even to the small, micro-cap stocks—we just don't see that," says the NASD's Goldsmith.

But former chop-house execs maintain that such payoffs are pervasive throughout the world of micro-cap stocks. Chop-house brokers say that corporate officials, directly or through intermediaries, frequently pay off brokers to drive share prices upward, or to obtain offerings of their shares for listing on the OTC Bulletin Board. At one brokerage, a former chop-house manager maintains, every OTC Bulletin Board stock offering involved a payoff. "It's a very thin market, usually there's very little on the buy side initially—that's why they have to enlist the help of a lot of brokers to get the buyers for these things," says one former chop-house broker. The brokers have the whip hand—and thus can demand payoffs. In one case, according to the former chop-house official interviewed by BUSINESS WEEK, even NASD examiners are not immune from accepting payoffs. However, NASD officials contend that they have heard no such allegations—which, they say, they would promptly refer to law enforcement.

One problem the NASD does pursue fairly vigorously is common at chop houses—excessive commissions and markups. But the cases they handle appear to be the tip of the iceberg—and point up the sensitive role served by the Wall Street firms that process trades for chop houses. The firms often process trades that appear to show excess markups and commissions—but insist that they are in no position to monitor the activities of the firms that trade for them. Regulators are studying ways of chipping away at this long-established, legally sanctioned "see no evil" policy—for often, there is a lot of evil that passes through their trading systems.

A LOT OF HEAT. In its recent prosecution of Euro-Atlantic, markups of as much as 63% were alleged. The NASD complaint does not specify when the trades took place, but they appear to have been in the latter half of 1996—at a time when the trades were processed by Schroder Wertheim. A Schroder spokeswoman declined comment on whether the firm was aware of the overcharges or even whether Schroder processed the trades—though the spokeswoman said the firm "apparently" did so.

One firm that has been subject to substantial heat for its chop-house clearing activities—particularly at the now-defunct A. R. Baron—is Bear Stearns. Bear has been the clearing agent for a host of chop houses, including PCM Securities, Meyers Pollock, and another major dealer in small-company stocks—Paragon Capital—where, regulators have been told by a former Paragon employee, massive overcharges have taken place. These charges are significant because Paragon is believed to be one of the largest dealers, possibly the biggest, in OTC Bulletin Board stocks.

Internal Paragon trading records from late 1994, which were recently submitted to the NASD and were obtained by BUSINESS WEEK, show apparently massive commissions. Some

PARAGON CAPITAL CORPORATION
(212) 742-1500

BEAR, STEARNS SECURITIES CORP
ONE METROTECH CENTER
BROOKLYN, NEW YORK 11201

Trade Blotter
For Trade Date Aug/19/94

B/S	Quantity	Symbol	Price	410	T/C	Rep	Party Name	Commision	T_Date
B	3000	ENVR	$0.73	62017	10	532	[redacted]	$600.00	8/19/94
B	3900	ENVR	$0.73	62161	14	532	[redacted]	$780.00	8/19/94
B	1700	ENVR	$0.73	62406	19	532	[redacted]	$340.00	8/19/94
B	3000	ENVR	$0.73	62516	16	532	[redacted]	$600.00	8/19/94
S	500	TOWV	$4.63	62516	16	532	[redacted]	$80.00	8/19/94
B	5500	ENVR	$0.73	95592	13	532	[redacted]	$1,100.00	8/19/94
B	12000	ENVR	$0.72	55151	93	534	[redacted]	$2,325.00	8/19/94
B	17700	ENVR	$0.75	62009	10	534	[redacted]	$3,982.50	8/19/94
S	700	EVTCW	$1.63	62009	10	534	[redacted]	$43.75	8/19/94
B	17300	ENVR	$0.72	62268	16	534	[redacted]	$3,373.50	8/19/94
S	700	EMG	$12.88	62268	16	534	[redacted]	$170.00	8/19/94
S	300	EMG	$12.75	62268	16	534	[redacted]	$80.00	8/19/94
B	5000	ENVR	$0.75	62580	17	534	[redacted]	$1,125.00	8/19/94
B	5900	ENVR	$0.73	[illegible]	[illegible]	587	[redacted]	[illegible]	[illegible]
B	100	LDDS	$23.50	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

DID PARAGON OVERCHARGE ITS CUSTOMERS ON TRADES CLEARED BY BEAR STEARNS?

This is a "trade blotter," processed for Paragon Capital by Bear, Stearns & Co., for Aug. 19, 1994. Highlighted is the purchase by a customer of 3,000 shares of Environmental Technologies USA at 73¢ a share, or $2,190. The commission, $600, would appear to indicate an unusually high rate—27%. Of the 16 trades on the blotter, 10 show high commissions. Paragon officials did not respond to requests for comment. Bear Stearns said it simply processed, and didn't review, the blotter.

were as high as 25% or more. One trade went as follows: On Aug. 19, 1994, one customer bought 17,700 shares of Environmental Technologies USA Inc. for $13,275. According to the trading records furnished to the NASD, as shown above, he paid a commission of $3,982.50—30%. Similar high commissions were charged for trades that took place on other days that month.

According to the trading records supplied to the SEC by a former Paragon employee, customers were similarly overcharged in a host of other stocks—Evro, Paramark Enterprises, Apogee Robotics, La-Man, Eco2, First Standard Ventures, and quite a few others. There was no indication that the firms had any knowledge of the overcharges. Repeated calls to Paragon President Danny Levine for comment on these allegations were not returned.

The trading records were routinely churned out by Bear Stearns, which could have noted the size of the commissions at Paragon by making a simple calculation. Two former Paragon officials, who were unacquainted with the former Paragon employee who submitted the records to the NASD, said that the trading records show the magnitude of the commissions clearly and that they would be obvious at a glance. However, an official of a rival clearing firm—no friend of Bear—notes that there is "no obligation of a clearing firm to look at anything like that." Bear Stearns's position is that it simply processed the Paragon trading records and did not review them. Asserts Bear Stearns's general counsel, Mark E. Lehman: "It is our view that the responsibility for determining markups and commissions is that of the introducing firm and not the clearing firm." According to Lehman, Bear Stearns is still clearing trades for Paragon.

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"GRAVY." One former Paragon manager observed a nefarious practice that, he maintains, has been common at the New York headquarters of Paragon in recent years. According to this ex-manager, who personally witnessed the practice, Paragon would postdate and predate time stamps of trading tickets, to make markups as large as possible. According to this ex-manager, the scheme worked like this: A customer would buy 10,000 shares of a Bulletin Board stock when the market was $5 bid and $6 asked. If portions of the order were filled at a lower price, the order was supposed to be time-stamped to reflect that, and at the end of the day the orders are submitted to NASDAQ. The former manager maintains that Paragon would accumulate the stock during the day—paying, say, $5 for the first thousand, $5.50 for the next, and so on—and show the entire order at the highest price. "Everything else is gravy for the broker," says the ex-Paragon manager.

No one seems to have sopped up the gravy that flows from chop stocks more than Jordan Belfort, who founded the Stratton Oakmont penny-stock brokerage in the 1980s. Just 35, he is believed to be a millionaire many times over. "Investment banker" was how *Yachting Magazine* characterized him in its May issue, in detailing the sinking of his 150-foot yacht, the Nadine. A publicity release from United Film Distributors, one of Belfort's many enterprises, calls him a "private investor." The Queens (N.Y.) native is the executive producer of several of United's movies, which have titles such as *Santa With Muscles.*

But there is another side to Belfort. According to numerous chop-house execs and traders interviewed by BUSINESS WEEK, Belfort has remained a hidden power whose influence in the chop-stock world has hardly waned since he sold his stake in Stratton and was barred for life from the securities industry by the SEC, nearly four years ago. (Belfort agreed to the ban without admitting or denying the SEC's allegations of securities fraud.) He has managed to retain his power and wealth while apparently remaining within the letter of his agreement with the SEC. Indeed, his name does not appear on a single scrap of paper associated with any brokerage—except Stratton.

After he left Stratton, Belfort continued to draw vast sums from the firm—something that is currently being investigated by Stratton's bankruptcy trustee, Harvey Miller. Under a "noncompete" agreement that he signed with Stratton in March, 1994, Stratton agreed to pay Belfort a staggering $180 million, payable in monthly installments of $1 million. In return, Belfort could not open a competing brokerage. The timing of the deal was fortuitous, to say the least—it was signed one week before Belfort was banned from the securities business. The SEC ban, one state regulator observes, was no doubt pending at the time the noncompete was signed. Belfort and the former attorney for Stratton who negotiated the deal, Ira L. Sorkin, declined comment, with Sorkin citing attorney-client privilege.

Belfort kept up his side of the bargain by keeping out of the securities business—at least on paper. Sources on Wall Street assert that Belfort continues to exert control, through intermediaries, of some of the leading brokerages in the micro-cap stock business. Among them are D. L. Cromwell Investments, Monroe Parker Securities, and Biltmore Securities. Allegations of Belfort control are not new for Monroe Parker—they were raised in 1992 by the NASD when the firm applied for membership, notes Monroe Parker attorney Bill

Singer. But Singer says that the NASD was satisfied that Belfort had no hidden role at the firm. Attorneys for Biltmore and D. L. Cromwell deny that Belfort has any tie to the firms.

But Amr "Tony" Elgindy, head of a Fort Worth-based firm called Key West Securities Inc., has alleged in court papers that Belfort bought a silent partnership in his firm early in 1997. He maintains that the relationship fell apart after he resisted pressure by Belfort to open up an office in New York City to sell stock to the public in the time-proven way, by high-pressure cold-calling. According to Elgindy, Belfort bought into his firm using a trusted associate named Robert LoRusso as a "front man." LoRusso and Belfort vigorously deny Elgindy's allegations.

LoRusso and Belfort both maintain that Elgindy is no angel. Indeed, in September, Elgindy settled NASD charges of alleged trading abuses by consenting to a fine and a one-year ban as principal of a brokerage firm. He neither admitted nor denied the charges. The NASD complaint alleges that "Elgindy was suffering from severe mental illness" at the time of the trading abuses. Elgindy maintains that was a reference to severe depression. LoRusso also asserts that Elgindy misappropriated funds and failed to disclose regulatory problems, which resulted in a suit by LoRusso to rescind his deal to buy into the firm. LoRusso's allegations are denied by Elgindy, who settled the suit by agreeing to rescind the deal.

PASSIVE? Although Elgindy is anything but an unbiased observer, his allegations support the assertion of chop-house brokers and traders that Belfort remains a powerful presence in the chop-stock business. According to Elgindy, Belfort is a well-capitalized short-seller of chop stocks—an adventurous brand of trading that is Elgindy's specialty. But, say Elgindy and other sources familiar with Belfort's activities, Belfort also has had access to cheap stock in numerous companies and has pushed a host of stocks through retail firms—particularly Monroe Parker, D. L. Cromwell, and Biltmore. In a phone conversation with Elgindy in December, 1996, that Elgindy taped, Belfort seems to imply that he is more than just a passive observer of activities on the Street. Referring to one stock deal, Belfort told Elgindy: "I have access to a lot of small firms."

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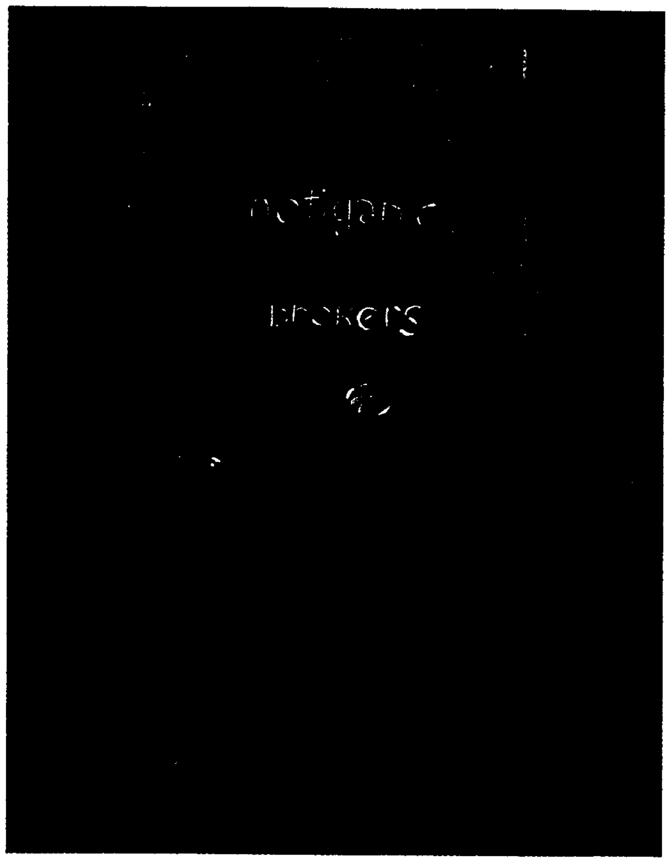
Elgindy and others familiar with Belfort's activities maintain that Belfort has been a hidden power behind the retailing of a host of stocks. Among the stocks that Elgindy says were Belfort favorites were Big City Bagels, Luma Net, Grand Havana Enterprises, and the company that was the subject of the possible Paragon overcharge—Environmental Technologies. Elgindy says Belfort would sometimes supply brokers with cheap stock in the firms, which would be sold to customers at huge markups. Belfort says he legitimately owns shares in some of those companies but denies having access to "cheap stock" in any. The chief executive of Grand Havana, Harry Shuster, says that he knows of no Belfort involvement in the company for the past two years. Officials of the other companies did not return phone calls.



CHOP HOUSES MOVE FAST AND MAY BE GONE WHEN CUSTOMERS COMPLAIN

Elgindy maintains that Belfort sometimes would wax sentimental about the good old days at Stratton. And taped excerpts of those conversations, which Elgindy shared with BUSINESS WEEK, are revealing. In one conversation in December, 1996, Belfort speculated why one particular stock both men were shorting was doing so well. "They're paying people off," said Belfort. "They're definitely paying people off with stock. I know. I owned a very large OTC firm.... I made a zillion dollars off my deals."

In another taped conversation, Belfort made a startling disclosure. According to Belfort's taped account, a company called Builders Warehouse Association Inc.—which since has become a unit of Osicom Technologies Inc.—once offered him a huge bribe in return for Stratton selling the stock. Said Belfort: "This guy came to me, this... kid from Utah came to me.... He offered me three shares in Switzerland for every share I sold.... I had like 500 brokers," Belfort continued. "I could have sold a zillion shares." Belfort declined to discuss the alleged bribe offer. Osicom and Barry Witz, former chief executive of Builders Warehouse, did not respond to requests for comment.

Whether Elgindy is a whistle-blower or a sore loser, one thing is sure: The conduct that he describes is common in the world of chop stocks. In their efforts to clean up the world of micro-cap stocks, the regulators have always seemed to be a day late and a dollar short—or perhaps more accurately, years late and billions of dollars short. Their efforts to crush micro-cap fraud are well-intentioned, sometimes vigorous—but they have failed to put more than a dent in the problem. Driving brokers out of the industry does little good when they stay active behind the scenes. Shutting firms does little good when other firms open to take their place. The money is simply too good: The indictment on Nov. 25, which alleges the involvement of four ranking Mob figures in pushing a single chop stock, proves that. And it is coming from a seemingly bottomless pit—the pockets of small investors.

THE MOB IS BUSIER THAN THE FEDS THINK

How prevalent is the Mob on Wall Street? It's a question that was first raised a year ago, when BUSINESS WEEK revealed widespread Mob infiltration (BW—Dec. 16, 1996). The issue has again reared its head in the aftermath of the Nov. 25 securities fraud indictment of 19 people, including four alleged Mob figures. At the press conference announcing the indictment, the U.S. Attorney in Manhattan, Mary Jo White, maintained that the Mob presence is "isolated." But is it?

BUSINESS WEEK's chop-stocks investigation shows that the Mob is far more active on Wall Street than might appear from the public pronouncements of regulators and law enforcement officials. Among the firms that have allegedly been subject to Mob influence or ownership are the New York office of Brauer & Associates Inc., a Florida-based brokerage where stock promoter James P. Minsky was briefly employed, and Adler Coleman Clearing Corp., a former clearing firm. Adler went out of business in 1995, after the demise of Hanover Sterling & Co., a noted chop house.

The alleged Mob connection to Adler apparently had its genesis three years ago. In a deal brought together by Stratton Oakmont Inc., Adler Coleman was funded through a company called Atrium Holding Co. According to private-placement documents obtained by BUSINESS WEEK, one of Atrium's largest investors was Philip Barretti Sr., an alleged associate in the Gambino crime family. In July, Barretti pleaded guilty to charges that he participated in a cartel that controlled New York City's

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trash-hauling business and agreed to a prison sentence of 4½ to 13 years and $6 million in fines and court costs. Edward J. Cohan, chief executive of Atrium and Adler, says he was unaware of Barretti's involvement in the financing. Barretti was unavailable for comment.

The Mob has also allegedly found its way into short-selling of chop stocks. According to traders and chop-house officials, Barry Gesser, a close friend of Stratton founder Jordan Belfort, has systematically shorted chop stocks. He has allegedly demanded cash from chop houses in return for not shorting the stocks, or has demanded cheap stock to cover his shorts, threatening to "crush" the stocks if he doesn't get his way.

The alleged Mob link is a Gesser associate—a 28-year-old native Long Islander named Michael Reiter. Reiter's very presence at Gesser's side gives him clout by dint of Reiter's link to the Gambino crime family, Street sources say. Reiter's father, Mark Reiter, is a friend of former Gambino boss John Gotti and is serving two life terms in a federal prison for narcotics trafficking.

PHOTOGRAPH BY HELAYNE SEIDMAN

INVESTOR? *Alleged Mafia associate Barretti (far right) helped finance a now defunct clearing firm*

FAMILY TIES. Michael Reiter and Gesser both deny that they have ever engaged in anything that smacks of extortion. "The conversations that you're referring to—I'm not going to say it's a figment of everyone's imagination when you're saying people come to us or we go to people about cheap stock," says Gesser. As Gesser tells it, he is often approached by chop houses whose stock he has shorted and asked: "'What will it take for you guys to go away—to drop the stock?' That kind of conversation takes place." Gesser asserts his answer is: "You can't buy me." But he says that if he has shorted a stock and is offered cut-rate stock to cover it, he takes it. That, he maintains, is not extortion.

Brauer's alleged ties to the Mob are being examined by investigators. According to sources familiar with the FBI's probe, federal agents have identified Brauer's New York office as being controlled by elements of the Colombo crime family—notably Joseph M. Baudanza, a broker there who is described by a law-enforcement source as an associate in the Colombo crime family. Law-enforcement officials say Joseph Baudanza is a son of a reputed Colombo family member and a cousin and close associate of 27-year-old John Baudanza, an alleged up-and-coming member of the Colombo family.

John Baudanza is described by law-enforcement sources as working with his cousin and other kinfolk on the Street. Neither John nor Joseph Baudanza returned BUSINESS WEEK's calls. John Kiefner, an attorney for Brauer, denies organized crime involvement in the firm and says the New York office is independently owned.

The Baudanza ascendancy is in sharp contrast to the fate of another alleged Mob figure from recent Wall Street history—reputed DeCavalcante family capo Philip Abramo. Abramo, who was jailed on tax evasion charges in January, allegedly held sway over several brokerages in New York and Florida. But since his release from prison a few weeks ago, he has been studiously avoiding his old haunts in Manhattan's financial district and in the glitzy office complexes of South Florida. And that makes sense—the feds are starting to turn up the heat. Abramo may be gone, but he won't be missed. There are plenty of his colleagues who are only too happy to take his place.

By Gary Weiss in New York