FOLLOW THE SMART MONEY

UNUSUAL OPTION ACTIVITY: #1 WAY WE CHOOSE OUR TRADES

WORKS FOR BOTH STOCKS & OPTIONS
FOLLOW THE SMART MONEY

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#1 WAY WE CHOOSE OUR TRADES

JON & PETE NAJARIAN
Follow the Smart Money
Unusual Option Activity: #1 Way We Choose Our Trades

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Pete and I would like to acknowledge with gratitude our mother, Mignette Najarian and our father Dr. John S. Najarian for their love, support and guidance. Similarly, we’d like to thank our wives, Brigid McGrath and Pete’s wife Lisa Najarian for their insights, stability and enthusiastic support of our entrepreneurial spirits. We also love and appreciate our children, Alexis, Kole, Tristen and Finola Najarian and how they love us unconditionally and keep us centered.

This book could have not been completed without the help of our business partners and colleagues at Market Rebellion™, Ron Ianieri, Bill Johnson, Dirk Mueller-Ingrand, Chris Tsiolis, Mike Yamamoto, Laura Peters, and Andrew Coffey, who with their tireless efforts keep our subscription and educational businesses operating at such a high level. Thanks guys.

We’d like to thank the host of CNBC’s Halftime Report™, Scott Wapner, and our producer Jason Gewirtz for allowing us highlight how the derivatives markets are, in many cases, the tail that wags the dog. They understood like few others that there’s a difference between volumes and unusual volumes and we appreciate their support and that of our network CNBC.

Lastly, we must acknowledge the many mentors throughout our lives in sports, Coach Richard Robinson, Coach Levain Carter, Coach Dennis Raarup, Coach Lou Holtz, Coach Jerry Burns, and Coach Tom Osborne, that provided the discipline that is so critical for all aspects of our business lives.

Jon & Pete Najarian
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In Memory of Ron Ianieri

In March 2019, our partner, friend, and colleague Ron Ianieri, who was the Co-Founder and Lead Educator at Market Rebellion™, passed away suddenly and unexpectedly. He was an extraordinary force in options education and continually fought for the individual investor by providing quality education and guidance for our members.

Throughout his career, Ron developed renowned options education content, authored the book Option Theory and Trading, and was considered one of the industry’s leading educators and mentors. We want to recognize the immense contributions Ron’s educational leadership brought to the development of this book and to the Market Rebellion™ community.

On behalf of myself, Dirk and Pete: “Ron, you will be missed brother.”

— Jon Najarian
When I was asked to write the preface for Jon and Pete Najarian’s book *Follow the Smart Money*, I was not only honored, but flattered. After all, Jon and Pete are the pioneers in finding unusual option activity and determining if it’s meaningful activity that could be the result of inside information that has leaked into the market. While it’s illegal to trade on inside information, it’s not illegal to use publicly available information – option activity – as a way to follow those who know – the *smart money*.

Besides telling the story of Jon and Pete Najarian and how they discovered and developed unusual option activity, *Follow the Smart Money* shows how to use their revolutionary techniques to identify potentially strong trading opportunities and increase your chances for making larger profits in the stock market.

It gives insights into the algorithm they used when they first developed it – and how they’ve modified it over the years – to find potential trades. From there, the book shows how they analyze and interpret the data to increase their chances for success and eliminate the majority of false signals. You’ll also learn how to pick and execute the proper strategy to use along with the correct construction of that strategy. Finally, the book shows how to manage your positions up through the exit strategy.

For you, the investor, learning how to find great trading opportunities – following the *smart money* – should be exciting enough. Since the first days of trading, back when dinosaurs walked the trading floors, there were basically only two ways to find trading opportunities – fundamental analysis and technical analysis. You either read income statements and sales projections or you simply read stock charts. There are no guarantees because ultimately, these two ways of finding trading opportunities are subjective and rely more on personal
interpretation. Further, these techniques are known to everyone, so all of that information gets readily absorbed into prices.

But when you follow the smart money, you’re following the information potentially known only to insiders and market participants with access to a massive amount of resources. One of the nice things about using unusual option activity to find opportunities is that you may truly identify an order from someone in the know. Jon and Pete will show you how to find and identify “that guy.”

Finding winning trades that have the potential for quick returns obviously has an advantage over a trade that starts off as a loser and needs to be managed and massaged over time. Jon and Pete share decades of experience and how they’ve made a career by profiting from unusual option activity. Just think about how important and valuable it will be to you! This is why you should not only want to read this book but why you need to read this book. I am honored to write the preface. Jon and Pete are thrilled to share their amazing journey with you. You can continue to follow your current strategies – or you can follow the smart money.

Ron Iannieli
MEET JON AND PETE NAJARIAN

JON “DR. J” NAJARIAN

When I finished college, I wanted to take my football dream to the next level – I wanted to play linebacker in the NFL. It was a big dream, but I’m always up for challenging myself. I never got drafted, but was later contacted by four NFL teams, so I was allowed to sign with any of them. I thought my best chance was in Chicago, as the Bears had a few older linebackers, so maybe I could earn a permanent spot. I had never been to Chicago, other than an occasional connecting flight at O’Hare Airport.

I only played four pre-season games with the 1981 Bears before getting cut and replaced by Mike Singletary, who was later inducted into the Hall of Fame in 1998. While the team may have had some older linebackers, they also had some extreme talent. In the short time I was there, I fell in love with Chicago, but unless another player was seriously injured, I was probably going to be sidelined for the season. I wanted to stay but didn’t know what to do. My agent had helped several pro athletes get positions on the prestigious trading floors of Chicago’s financial district. He said they liked hiring professional athletes because of their disciplined drive and commitment to excellence – perfect qualities for making money in markets.

Sounded interesting, but finance? I went to college to get a degree in architectural design. I could design a trading floor but wasn’t sure I could work on one. The first three months were dreadful. I didn’t know what was happening on the trading floor. I understood when someone bought or sold shares of stock – that was easy. But the options is where things got technical. How much should an option move? Volatility? I didn’t know a thing about it. But I did have a great time at night on Rush Street, which made for more miserable days at work.
I was a clerk and had to get to work each day at 6am to print trading sheets, which were computer printouts of theoretical option values for the guys I was working for. How much should an option’s price move if the stock price moves one dollar? What would the new delta be? I didn’t even know what a delta was.

To make things more confusing, most stocks only traded call options. It’s hard to imagine now, but back then, only 20% of stocks had put options, which meant traders had to create the puts “artificially,” or synthetically, by using short shares of stock and long calls.

Fortunately, my clearing firm had licensed about 60 different training videos that clerks could borrow. They were always loaned out, so I had to get to work even earlier and watch them before my trading day began. I learned calls and puts, verticals, diagonals, calendars, butterflies and condors. Then they got more advanced with ratio spreads. On one of the tapes, there they were – delta, gamma, vega, and theta. It took months of repetition to learn it. If I didn’t have tapes, it may have taken years. I still didn’t understand it, but at least I stopped hating going to work every day.

As I learned the business, I eventually gained the confidence to commit my own capital of about $15,000 I received playing for the Bears. I bought a little seat at the Midwest Options Exchange for about $10,000. On those seats, you could only trade 16 stocks. If you wanted to trade all stocks, you had to buy a big seat, but it also came with a big price tag – about $150,000. The first few months I barely broke even, but then started making about $2,000 a month, then $5,000, and eventually $20,000. I banked some profits and eventually rented out my little seat and bought a big seat at the Chicago Board Options Exchange (CBOE), and traded in the IBM pit. I was now making more than I could have made playing for the Chicago Bears.
The CBOE was created by the Chicago Board of Trade (CBOT), or commonly known as the Board of Trade, which traded only commodity futures. Like most markets, it went through cycles. If a drought developed and crops were turning to dust, trading was frenzied. If weather was normal, it was nearly empty, and many of the traders would take off at 10am to go golfing. To avoid these dull markets, when stock trading began to heat up in the 1970s, the Board of Trade created the CBOE. Because of the affiliation, CBOT traders had the right to trade at the CBOE for no charge. There were close to 2,000 CBOT seats and only 931 CBOE seats, so when seats were tight, we’d go apply to become a member of the CBOT. That way, we could trade on both exchanges.

The first part of the application was easy. Just a lot of paperwork and a background check. The final stage was where things got rough. Each applicant had to do a face-to-face interview before the membership committee, which was renowned for not approving people. Your goal was to become a member of the Board of Trade. Their goal was to make a mockery of your application and send you on your way. Before you could get the interview, though, you had to find two existing members to vouch for you and say you’d make a good board member. Most of the time, the clearing firm would find them for you since most applicants didn’t know anyone.

I met with a couple of recommended traders, who said they’d sign for me. “Fair warning,” they said, “the committee is insistent on professional appearance. You’ll need to show up with a full suit, pressed button-down shirt, tie pulled all the way up to the top button, and polished shoes. And be sure to have no holes in your resume. Every minute of the past 10 years must be accounted for. Don’t embarrass us. If you don’t pass, it will be your worst nightmare, and we will not sign for you again.”

If an interview at the CBOE was like lunch at the country club, the CBOT was a dinner invitation to Buckingham
Palace. The rules were so different, and they wanted to make sure I understood. If I didn’t pass, it was a bad reflection on them, and I’d have to pay another $2,000 to try again in a month. Part of the reason for the tough interview was that the Board of Trade had rigid rules, so part of the selection process was to see if candidates could follow instructions.

A few days later, I was anxiously waiting in the big Star Chamber outside the interview room with other applicants. The guy who went before me showed up in his CBOE trading jacket and tennis shoes, which was, let’s say, not fitting to appear before the queen. We could hear the yelling going on inside the interview room. “So… you want to be a member of the Board of Trade? We tell you to show up professionally dressed, and this is what you call business attire? If we tell you to buy $5 million in wheat or $50 million in bonds, how can we trust you to do it? You can’t even follow simple steps!”

The agonizing grilling went on for another 10 minutes. They chewed him up and spit him out like ticker tape. After it was done, he still had to thank them, and moseyed out with his tail between his legs. I was next.

“Mr. Najarian?”

“Yes, sir.”

“It says on your resume you played football for the Bears in 1981 – is that true?”

“Yes sir, that is true. I played football for the Bears.”

“Did you ever tackle Walter Payton?”

“Yes sir, I did.”

“Congratulations, you’re a member of the Board of Trade.”
That was it! Just two questions, and I walked out as a new member. While I didn’t know anyone at the Board of Trade, I did know Walter Payton, so my short stint with the Bears may have been just long enough to launch a different career. It’s not always about what you know. Sometimes, it’s who you know.

In 1989, I ventured out on my own to create a trading firm and had to come up with a business name. I researched Greek and Roman mythology and found that Mercury was the god of commerce, markets, and protector of traders. No need to look further.

Pete joined me in late 1992, and we noticed that when big firms came in with big orders, they were on the right side of the trade an awful lot of times. We’d compare tickets from a few days before and concluded they must have known something. We hired some programmers to create a search algorithm, or algo, for unusual option activity, which we called \textit{Heat Seeker}\textsuperscript{TM}, that would tip us off if anyone was placing unusual trades. This was especially important as we were making markets in 60 stocks on the CBOE, PCX, AMEX and Philadelphia exchanges. Our \textit{Heat Seeker}\textsuperscript{TM} algo was the edge we needed, and we continued running Mercury Trading for 15 years before selling to Citadel, one of the largest hedge funds, in 2004.

During my Mercury years, I made a friend, Bob Sirott, who was an anchor on FOX 32 in Chicago, and asked me to speak with him about being the “stock guy” on his morning talk show. I passed his test and the next thing I knew I was indeed “The Money Man” on FOX from 1994 until 2005. Then I began doing both FOX News and CNBC. They were quite competitive, and eventually I had to choose one over the other. My friend Dylan Ratigan was to host \textit{Fast Money}\textsuperscript{TM}, which would become one of the biggest shows in finance, so I chose CNBC where I’ve been a member of the family since 2008.

Pete and I later developed option\textit{MONSTER}\textsuperscript{TM} which was a provider of market intelligence, commentary, and trading
strategies, mostly based on unusual option activity. We then formed the brokerage firm tradeMONSTER™, and in 2014 brought in General Atlantic Partners, a private equity firm, to help us finance acquisitions and grow the business. We acquired OptionsHouse™ and two years later, the merged firm was sold to E*TRADE™ for $750 million!

Most recently, in 2017, we launched Investiture™ (now Market Rebellion™) to help individual traders master the markets by creating professional-level option training, and also sharing our unusual option activity that made us successful. Anyone can learn it with the right mentors.

It’s not always what you know. Sometimes, it’s who you know.

PETE “PIT BOSS” NAJARIAN

Trading floors have a reputation of being disorganized, but my experience shows that is an extreme understatement. They’re chaotic madness wrapped in pandemonium. Fortunately, I thrive in chaos, and it’s helped me become a successful option trader.

For me, the educational process started a long time ago, and not from the place you’d expect. It wasn’t from the trading floor. It wasn’t from professional football. It was from home. I grew up with three older brothers who had two speeds – fast and faster. They made it a daily point to put me into situations where I had to think even faster. We lost a few windows and lamps, but it was a small price to pay for an early education in thinking fast.

If that wasn’t enough, my mom and dad were overachievers. My dad attended the University of California, Berkeley, on a football scholarship and graduated within a couple of years – all while playing football. He even made it to the Rose Bowl in 1949. He later turned down an offer to play for the Chicago Bears so he could attend medical school at the University of California at
San Francisco. After graduation, he became one of the early pioneers in a new field of medicine – kidney transplants.

My mom was a nurse, and after she graduated from college in Minnesota, she wanted to travel the world. She started by taking a job in a surgical lab in San Francisco where she met my dad. It was the end of her world trip, but the beginning of our family.

We were fortunate to have such great parents. It’s one of those things that most people don’t realize while growing up, but when you see the tragedies that strike so many families, we were truly lucky. My dad accepted a job offer at the University of Minnesota, so we went to a big high school in Minneapolis. It was a great eye-opener to how diverse the world can be.

By now, I had a true appreciation for what my dad had accomplished, as he was busy flying to medical conferences all over the world to present thousands of doctors with the latest innovations surrounding kidney transplants. One of the most remarkable memories I have is that, on several occasions, he flew to Paris for a conference, and rather than hanging out for a few days, he’d stay for three hours, then turn around and fly home – just to make it to my high school football games. I thought it was impossible, but it taught me to be disciplined, make decisions, and be calculated – it’s a process. He always said, “no excuses.” That was the motto for our family.

The discipline my dad had was difficult to understand sometimes. If anyone can be that sharp and that good in football and medicine, it’s something to aspire to. What I learned from him, and his examples, shaped my future.

In 1983, I played linebacker for the University of Minnesota, and these lessons were re-lived. I arrived at a failing team with one win against 10 losses – dead last in the Big Ten standings. The following year, we were fortunate enough to play under Coach Lou Holtz who’s mostly remembered by his respected career
at Notre Dame, which included a 12-0 season in 1998, a Fiesta Bowl victory, and the national champion title. What many people don’t know, however, is that before he coached at Notre Dame, he spent two years – 1983 and 1984 – at the University of Minnesota. He was hard-core about making sure people were doing the right thing in the classroom as well as on the football field.

Coach Holtz had an amazing ability to inspire players. He played linebacker for Kent State University, but you’d never know it by looking at him. When once asked to describe himself, he said, “I stand 5 feet 10, weigh 152 pounds, wear glasses, speak with a lisp, and have a physique that appears like I’ve been afflicted with beriberi or scurvy most of my life.”

Rather than motivating the team with other sports figures, he brought in people from the business community. It stuck with us. Not everyone’s born on third base just waiting to make the run. We learned that many people have worked hard to get where they are. When he left to coach Notre Dame, we beat Clemson in the 1985 Independence Bowl, a big feat considering Clemson beat Nebraska three years earlier in the 1982 Orange Bowl and were National Champions the year before.

Not only was Coach Holtz inspirational, he was known for thinking fast and delivering well-timed responses in a pinch. During his first year coaching the Arkansas Razorbacks in 1977, his team was invited to play in the Orange Bowl as a 24-point underdog against the Oklahoma Schooners. It was a true David and Goliath story, and his team pulled off an unbelievable 31-6 victory. Fans celebrated by bombarding the field with oranges. Holtz watched and said, “Thank God we didn’t get invited to the Gator Bowl.”

He left quite an impression on the student athletes – and the coaching world as well. He was the only college football coach to take six programs to bowl games and the only coach to take four different programs into the top 20 rankings.
This background created a solid foundation in my early years that taught me many things are possible if you have discipline. Discipline comes in many forms, from focusing on what needs to be done, or pushing away from the things you’d rather be doing, to be sure you can do your best. After graduating college, I went on to play professional football for the Tampa Bay Buccaneers and Minnesota Vikings.

After the NFL, I played in the World League after being the number one draft choice of the Sacramento Surge. I played two years in the World League, winning the World Bowl in 1992 as we beat the Orlando Thunder. After leaving professional football, I wasn’t sure what I wanted to do. But my experiences told me I could accomplish it once I decided.

During this time, my brother Jon was trading options at the CBOE. The trading floors can get rough and aggressive as all traders compete for space and attention. Prices move quickly, so traders must move faster. It was all about speed, aggression, and fast thinking – much like the NFL. At the time, many of the exchanges were hiring ex-football players, pro wrestlers, or anyone who could muscle their way – or intimidate their way – into the crowd. Jon thought I’d do well, so he invited me to trade options. And no, I didn’t start on third base. But he was my mentor.

I started at the bottom as a runner, then a clerk, then finally, years later, a trader. Once I was comfortable with the markets, Jon asked me to join him in business as the risk manager at our firm, Mercury Trading, where I was the specialist in Micron Technology. If there’s one thing I’ve learned, there’s no place where more discipline is required than the stock market.

In 2007, I started as a commentator on CNBC. Many of the hosts weren’t excited about adding another option trader to the mix. It just didn’t seem like an active market. When I started trading in 1992, an average of 800,000 option contracts were traded per day. By 2007, it was 11 million contracts per day, and nobody
wanted to discuss the VIX (The CBOE Volatility Index) on television. I would actually get into heated arguments about why we should discuss the volatility of the markets, as it can be a great indicator as to broad market direction. And now, for 2018, we’re on pace for 20 million option contracts per day,¹ and guess what we talk about every day on our Unusual Activity segment during the Halftime Report™ or on Fast Money™?² That’s right, the VIX, as it’s become one of the most active of any derivatives contracts.

It’s been an amazing journey, and I never would have succeeded in the option markets without Jon and Coach Holtz as mentors. I had no knowledge, no experience, and no financial background. But there is one thing I did have.

No excuses.

*The Halftime Report and Fast Money are the property of CNBC, LLC, A Division of NBC Universal.
When I first walked into the Chicago Board Options Exchange (CBOE), I was mesmerized by the thousands of computers mounted across the ceiling of the 40,000-square-foot trading floor. Connected to these screens were what appeared to be miles of pipes, which looked more like the I-90 Chicago Expressway than a trading floor. My mentor said, “Jon, the computers generate so much heat that the architects designed them to distribute the heat from the computers – enough to heat the trading floors during the ruthless Chicago winters.”

Each screen had columns of numbers, which were the quotes for every stock and option contract, flickering back and forth from green to red. My mentor said, “Stare at those screens for just a
moment. They tell the story of why it’s important to keep your positions hedged. You never know when they may turn red.”

He explained to me that stock prices follow an unpredictable pattern – an idea academics call a random walk. It’s as if a drunk man is trying walk to the front door of his home. He won’t walk a straight line, but instead, meander in an unpredictable zig-zag manner. It was all new to me, but it made a lot of sense.

That was in 1981.

But after more than three decades of trading, I have a different view. I’ve learned that stock prices are moved by more than just random events. When you see the greed, corruption, and manipulation that occurs, it’s not really a random walk. History has shown that as long as we have financial markets, we’ll have those who try to influence prices.

“President Obama signed a bill preventing members of Congress from profiting from insider trading. Didn’t you think that was already illegal?”

– Jay Leno, 2012²

Fraud and unscrupulous people didn’t just spring up in the 21st century. Over 2,300 years ago, a Greek merchant named Hegestratos bought an early form of an insurance policy known as a bottomry, or bottomage. It was an arrangement where the ship’s master borrows money upon the bottom or keel of it, so as to forfeit the ship itself to the creditor if the money plus interest isn’t paid upon the ship’s safe return.

While insuring cargo might have helped investors feel comfortable about financing a delivery of goods, Hegestratos had no plans to buy and deliver corn. Instead, he plotted to sink his empty boat, keep the loan, and sell the corn in another port. As fate would have it, his plan didn’t work out, and he drowned
trying to escape his crew and passengers when they caught him in the act. It was the first recorded case of financial fraud, but it wouldn’t be the last.

Flash forward 2,000 years and American colonies were issuing bonds to help finance the fledgling nation. These bonds fluctuated up and down with the fortunes of the colonies that issued them. As always, there was more money to be gained by those that had more information about a particular positive or negative event that hadn’t been widely circulated. Long before he became the talk of Broadway in the brilliant Lin Manuel Miranda’s *Hamilton*, then—Treasury Secretary Alexander Hamilton had calculated that he could reduce volatility and thus borrowing rates if he restructured the debt by replacing individual colony debt with bonds from the new central government. Immediately, large bond investors sought out people who had access to the Treasury to find out which bond issues Hamilton was going to replace.

One such investor, William Duer, was a member of President George Washington’s inner circle and Assistant Secretary of the Treasury. Thus, Duer was ideally placed to profit from insider information he could glean from his role with the Treasury and its pending actions.

Duer would tip off his friends and trade in his own portfolio before leaking select info to the public that he knew would drive up prices. Post release of that information he would simply sell for a tidy profit. Mr. Duer eventually left his post but kept his inside contacts - sounds familiar, right? He continued to invest his own money, as well as that of other investors, doubtlessly including those that provided him with the inside info on debt issues. Investors from all over the world were buying bonds and stocks of U.S. banks, overwhelming the market, and creating that speculative bubble that history has shown can only end in tears.
But Mr. Duer’s greed blinded him to this, and he borrowed heavily to leverage his bets. That inevitable bursting of the speculative bubble left Duer and his conspirators with huge debt – and nearly worthless holdings. Hamilton had to step in, providing that governmental backstop that Hank Paulson provided during our financial crash of 2008. But back then we had debtor’s prisons, and that’s exactly where Mr. Duer ended up until he died in 1799.

The list of sordid stories has continued to grow – and always will. The world was in disbelief when Nick Leeson single-handedly broke Barings Bank, Bernie Ebbers plundered WorldCom’s stock with false financial reporting, and Kenneth Lay embezzled funds by falsifying Enron’s accounting statements leading to one of the world’s largest bankruptcies in history. And of course, Bernie Madoff’s devious Ponzi scheme robbed investors of billions of dollars. Wall Street manipulations, however, don’t just take the form of jaw-dropping headlines. They can be subtle, but just as devious.

**SHHHH! HERE’S THE REAL NUMBER**

You don’t need to be a long-time investor to realize there’s often a big disconnect between earnings releases and the crowd’s reaction. How many times have you held a stock through earnings, hear that it’s beaten the estimates – then watch it fall on the opening bell? How could investors be so dumb as to sell when the company is beating its numbers?

Ratings analysts are people who work for big corporations, some of them brokerage firms, while others offer only investment research. You’ll hear firms like JP Morgan Chase, Goldman Sachs, Morgan Stanley, Citigroup, Credit Suisse, UBS, Nomura, and Zacks announcing their findings to the public. They may announce they raised their outlook on Microsoft, lowered the
price target on Tesla, or initiated coverage of Facebook with a buy rating. Analysts provide a benefit to investors by researching a stock or industry’s value by creating sophisticated financial models that account for everything you can imagine including company sales, costs, taxes, interest rates, product demand, competition, and other factors that are likely to affect a stock’s price. They have entire teams of CPAs, MBAs, CFAs, and other concoctions of alphabet soup, who are hired to figure out the best estimate of a company’s value. By passing this information along to investors, it creates a more informed investor pool, which benefits everyone. At least, that’s the theory. Wall Street, however, has figured out a way to make it more lucrative by cutting retail investors out.

Analysts release their estimates on a company’s value by publishing lengthy reports. While no estimate is perfect, they’re a whole lot better than any single person could produce. A problem arises, however, as new information reaches the market - whether factual, speculative, or a complete rumor. For example, on August 7, 2018, Elon Musk sent a tweet saying he was considering taking Tesla (TSLA) private at a cost of $420 per share, which would make it the largest buyback in history – by a long shot. The stock price shot up over 10% – and Elon, who owns roughly 20% of TSLA shares, instantly became $1.4 billion richer. Well, that’ll have an impact on the company’s value and get the attention of the regulators. Elon Musk and Tesla settled for $40 million with the Securities and Exchange Commission (SEC) on September 29, 2018.

Analysts update their financial models as new information arrives into the market, but they don’t publish new reports, as they’re time consuming and costly. However, when large clients or institutions, who sometimes have an equal number of CPAs, MBAs, or CFAs working for them, phone the analysts, they give these top clients the updated numbers, not the ones published to everyone else. These unpublished numbers are called the
whisper numbers, and it’s these numbers the company’s earnings must beat before the institutions begin buying. Critics say the problem is that they’ll know the numbers – you won’t. When a stock releases great earnings and it’s not responding like you’d expect, it’s a possibility it simply didn’t beat the whisper number, so while you were holding, institutions were selling. Trying to predict how investors will react to earnings is nearly impossible because different groups are acting under different expectations. Wall Street, however, makes it even more difficult to focus on results, as the earnings numbers themselves are a little fuzzy.

THE EARNINGS RELEASE GAME

Regulations require that companies release quarterly reports, or 10-Q filings, which are detailed summaries of the company’s earnings and financial conditions for the most recent quarter. It’s the most important day for any publicly traded company, as it’s the day investors get to see the financial report card. Depending on the information, investors can greatly reward – or punish – the stock in seconds. If you look at any stock chart and see large gaps, whether up or down, it’s almost certainly due to an earnings report – and probably from beating or missing the whisper numbers.

In January 2018, FactSet reported that 81% of companies had beaten Wall Street estimates, putting it on track for a record pace of earnings surprises since 2008. A trend has developed where companies are not just beating analysts’ expectations, they’re shattering them. On July 26, 2018, Amazon (AMZN) released earnings of $5.07 per share, but analysts had expected $2.50 per share – doubling the expectations. Shortly after on August 9, Booking Holdings (BKNG), formerly Priceline.com, reported earnings of $20.67 per share versus a consensus of $17.34 – beat by $3.33. How can analysts who are tied so tightly to the companies be so far off on the estimates?
Two researchers, Professors Paul A. Griffin of the University of California at Davis and David H. Lont of University of Otago in New Zealand, found that the number of S&P 500 companies that have beaten estimates by five to 15 cents have doubled over the past 17 years. Some claim it’s due to the tremendous growth of the U.S. economy, but the researchers say it defies belief to think that the growth has been so strong that companies have taken analysts and investors increasingly by surprise every quarter with better-than-expected earnings for nearly two decades.

How can companies beat by such large margins? Well, their earnings game has become two-fold. Analysts are biasing numbers downward, but Wall Street biases them upward. Twenty years ago, it was a big deal to see a company beat estimates by a penny or two. Not anymore. Investors are demanding better performances if they’re to continue pushing stock price higher. Wall Street gladly delivers – but how?

Companies are increasingly moving away from Generally Accepted Accounting Principles (GAAP), which is the Gold Standard for accountants so investors can make fair comparisons. When standards are lowered, numbers are raised. The researchers said roughly 90% of S&P 500 companies use at least one non-standard GAAP measure in their earnings reports.

While the researchers’ study included more than 4,700 companies, the effect was most pronounced in the S&P 500 firms where earnings surprises (ES) increased over 25% in 2016 from only 12.2% in 2000. Further, the number of companies that met or exceeded expectations by one cent fell 15%, and those who beat by one or two cents fell by 5%.

It’s a disturbing trend, say the researchers, “...because given their focus on strong corporate governance practices and accounting controls, one might predict that S&P 500 firms as a group should be the least likely to reflect an increasing trend in positive Street earnings surprises driven
by a growing gap in Street earnings and Street expectations. Apparently, S&P 500 firms are driven by a stronger need to generate positive earnings surprises than are other firms.”

The researchers said if it points to earnings manipulation, it’s because of a growing acceptance of non-standard measures. Interestingly, they also said that one of the explanations for that many earnings surprises could be, “…that analysts increasingly bias their Street expectations downwards to generate a more positive market response for their clients – that is, they engage in strategic pessimism. This reason has merit if the reporting firms reward analysts with more business or more access to firm information as a result of helping firms create a positive ES.” It shouldn’t surprise anyone that earnings numbers are not only manipulated by the companies, but also by the analysts who make their livings making the companies look great.

FACEBOOK IPO DISASTER: BE SURE TO CLICK “LIKE”

On May 18, 2012, Facebook (FB) had one of the most highly anticipated IPOs, or Initial Public Offerings, in history. It was the largest IPO in technology and one of the largest among Internet stocks. Shares were priced at $38, which gave it a valuation near $100 billion – a number that many analysts repeatedly warned was highly overvalued. Interestingly, nearly every retail investor received phone calls from brokers letting them in on this historic event. Normally, those calls are reserved for the firm’s biggest and most profitable clients. This time, however, it seemed that everyone was offered shares. Shares opened for trading at $45, but by the end of the day, closed at $38.22, just 22 cents higher than those purchased on the primary market.

As far as hot IPOs go, it was considered a disaster. Nearly all stocks see their price “pop” on the opening bell but continue to climb from there, and there are sound economic reasons for it.
Most of the time, shares must be underpriced to give the IPO investors the incentive to buy. It’s part of the expected return for instantly laying a bunch of money on the company’s lap in a matter of days. Even lesser-known companies get higher valuations on day one. On October 12, 2012, Workday (WDAY) had its price set at $28 for the IPO but popped to $48.05 – a 72% jump – on the opening trade and closed even higher at $48.60.\textsuperscript{13}

Facebook was different.

Granted, there were some technology “glitches” reported by Nasdaq that didn’t help matters.\textsuperscript{14} Some traders weren’t getting orders filled that otherwise appeared like they should. Others reported receiving prices much higher than they thought based on the quotes at the time of the trade. The exchange did issue an apology admitting there were delays due to a “technical error,” but that’s about all investors got. Anyone who bought shares watched them fall to about $20 by August 2012:

The big issue, however, wasn’t the exchange glitches. It was the IPO itself. On May 21, 2012, only days after the disaster opening, Reuters posted a report that alleged lead underwriter
Morgan Stanley received privileged information that wasn’t shared with others.\textsuperscript{15} The Reuters article also was alleging that Morgan Stanley, along with Goldman Sachs, JP Morgan, and Bank of America, simultaneously reduced their earnings outlooks to nearly identical levels just prior to the IPO.\textsuperscript{16}

On May 23, 2012, some shareholders launched a class action lawsuit against Facebook alleging that the company shared forecast revisions with the underwriters ahead of the IPO, and that the underwriters then subsequently lowered their estimates for 2012, “\textit{..which revisions were material information which was not shared with all Facebook investors, but rather, was selectively disclosed by defendants to certain preferred investors.”} \textsuperscript{17}

The lawsuit also alleged that Facebook told analysts to “\textit{materially lower their revenue forecasts for 2012.”} \textsuperscript{18} In other words, the analysts were right, and the IPO price was overvalued. What’s the rational thing to do when prices are too high? If you said “sell,” that’s exactly how Facebook and the underwriters answered.

Facebook announced on May 16 – two days before the IPO – that it planned to sell an additional 25% of the authorized shares to raise an additional $3 billion, which increased the IPO share count from 337.4 million to 421.2 million.\textsuperscript{19} That wasn’t all.

The underwriters had a “Greenshoe” clause, also called an overallotment clause, in the contract that allowed them to oversell by another 15%. In other words, the underwriters had the right to sell short these shares – and they did. With this clause, the number of shares increased from 421 million to 484 million. However, the clause also said the underwriters may buy the shares back for the $38 IPO price.\textsuperscript{20} In essence, it’s a free $38 call option. What’s the reason for a Greenshoe clause?

Underwriters use them to support prices if an IPO isn’t well received. If prices fall in the first few days, those who bought the IPO shares take losses, and the underwriter who charged a small
fortune to take the company public simply looks bad. So just in case prices fall, many contracts include a Greenshoe clause.²¹

If the IPO is a success and the share price rises, the underwriters exercise the option and buy the short shares back at $38 and cover their short position. No harm done. But if it’s a flop, they’ll buy shares in the open market to cover their short positions – and earn a big fat profit in the process. These purchases are called stabilizing bids because they support the falling share prices. Greenshoe clauses are a form of insurance, so if prices fall in the first few days, there will at least be some buying pressure coming in at the IPO price. The term “Greenshoe” came from Green Shoe Manufacturing Company, now called Stride Rite, which was the first company to use the clause in a 1919 underwriting agreement.

While these clauses sound like they help investors, the reality is that any price drops are caused by the IPO purchasers immediately flipping shares for a quick profit. It’s a risk they take, so they should bear the cost. The SEC, however, sees the practice as promoting market stability:

“Although stabilization is a price-influencing activity intended to induce others to purchase the offered security, when appropriately regulated it is an effective mechanism for fostering an orderly distribution of securities and promotes the interests of shareholders, underwriters, and issuers.” ²²

Stabilizing bids, however, are simply a way of transferring risk from the IPO buyers to a relatively naïve segment of the investor population. Few investors know that stabilizing bids are often used, so when stock prices are only allowed to artificially fall so far, it gives the secondary market the illusion that it’s a level of support. Uninformed investors get the impression that the price probably isn’t going to fall below that, but they have no idea it’s artificially supported. Who would have guessed that so much goes on behind the scenes of an IPO? In the case of Facebook, you can’t help but think these additional sales were done because everyone – including
Facebook – wanted a profitable piece of the highly overvalued shares. Of course, if a company’s stock isn’t performing well, there’s always the upgrade and downgrade game.

**UPGRADE AND DOWNGRADE: A WAY TO GET PAID**

On May 6, 2008, with oil prices pushing $122 per barrel, a prominent investment bank’s energy equity team upgraded oil with a price target of $141 for the second half of the year and reiterated their prediction for a “super spike” ranging from $150 to $200 within two years. It was an open invitation for investors to jump on board for the next big wave of profits. But oil only climbed $18 higher to $140 – and then instantly did a U-turn. Later that same year, on December 12, with oil at $46 per barrel, the same team predicted it would fall to an average price of $45 per barrel for 2009. It quickly climbed to nearly $92:

![Crude Oil Chart](chart.png)

Keeping in mind that the goal is to buy low and sell high, how could an investment bank have a long history of an uncanny ability to upgrade oil at market tops and downgrade it near market bottoms? Is it a coincidence? In 2008, we were in the
middle of the 2007-2009 bear market, the S&P 500 lost 50% of its value, and we were seeing record single-day drops. On September 29, the Dow lost 778 points, making it the worst point-drop since Black Monday in 1987. Investors were worried about the banking system from Wall Street’s overwhelming exposure to bad mortgage debts. This bank received billions from the U.S. Department of the Treasury as part of the Troubled Asset Relief Program (TARP). Would falling oil prices drive it under?

Oil markets are easier to move than stock prices. Stock prices are based upon future earnings, and that’s a hard thing to predict. Oil is different. Its price is determined by what must clear the market today, and that’s a much easier thing to predict. Roger Diwan from the consulting firm PFC Energy noted that financial players are in a unique position, as they don’t need to own ships and tanks; they can just bid up prices on the New York Mercantile Exchange, where they can buy on margin. “The paper market is infinite, and you don’t have to pay for storage.”

We couldn’t agree more, and that’s what makes it a perfect commodity to influence – provided you have the power to move prices. But would any of the large market participants actually try to move prices? If you must ask, you haven’t been following the markets long enough.

**BIG BANKS MANIPULATE KEY INTEREST RATE**

The London Interbank Offered Rate, or LIBOR, is considered the most important interest rate in the world, as it impacts trillions of dollars’ worth of worldwide loans, including mortgages.

In 2018, Citibank reached a settlement with 42 states to pay a $100 million fine for manipulating the key rate. According to the settlement Citi made millions of dollars by fixing the rate,
which was discovered through a series of text messages and emails as they misrepresented what they were paying for loans in 2008 and 2009. The regulators also said Citi made millions of dollars in “unjust gains” through government and non-profit firms by fixing the rate. New York Attorney General Barbara Underwood said, “Our office has zero tolerance for fraudulent or manipulative conduct that undermines our financial markets. Financial institutions have a basic responsibility to play by the rules — and we will continue to hold those accountable who don’t.”

Citi wasn’t alone. There were a number of banks which were implicated. For example, Barclays reached a $453 million settlement over rate fixing in 2012, and UBS agreed to pay a jaw-dropping $1.5 billion fine for fraud and bribery linked to LIBOR manipulation to regulators in the United States, United Kingdom, and Switzerland. Another bank was Deutsche Bank, which agreed to pay $240 million to settle private U.S. antitrust litigation accusing it of conspiring with other banks to manipulate the LIBOR benchmark interest rate.

Some have speculated that these fraudulent manipulations contributed to the 2008 mortgage crisis by artificially driving up home-loan rates. Whether rates were driven up or down, you can be sure profits were driven higher.

**THE FINANCIAL WATCHDOG PROTECTS THE BROKERS**

Investors can borrow money to buy shares of stock by using a margin account, which just requires an additional document to be signed, and a minimum of $2,000 equity. One of the ideas behind margin trading is that it allows investors quick access to cash in falling markets, which would add some price stability for the days when the bears are loose.

If you have a margin account, you only need to pay for half
the amount of the trade, and the broker automatically loans you the balance. The margin account acts like a line of credit established with the broker. For instance, you could buy 100 shares of a $100 stock, or $10,000 worth of stock by only using $5,000 worth of cash. At this point, your account equity is 50%, which is found by $5,000 worth of cash divided by $10,000 worth of stock. Most brokers require that your account equity stay above 30%. If it falls below, you’ll be required to deposit more money – or sell shares – to make up the difference, which is called a maintenance call, or margin call. For instance, if the stock’s price falls to $70, you’ve lost $3,000 worth of equity. Your equity percentage is now $2,000/$7,000, or about 29%, and you must bring your percentage back up above 30%.

However, let’s say you have 10 different stocks in a margin account, all doing well, except for one. It plummets after a bad earnings report, which sends your account equity below 30%. In most cases, the broker requires that you meet the margin call by close of business that day, but the broker may immediately begin closing any positions – even without notifying you – to bring your account equity back to the required level. Here’s where the bias against traders begins.

You’d think the broker would close the position that’s creating the margin call. If nine stocks are up and doing well, it seems that the broker should first close the one that’s causing the trouble. The Financial Industry Regulatory Authority (FINRA) does not require this. The broker may close any positions that are creating the most risk for it – not you. FINRA’s reason is that traders borrow individually, but brokers loan collectively. It sounds profound, but what does it mean?

It means that while individual investors may hold a troubled stock, the broker isn’t required to close it from their accounts. Instead, the broker may choose positions which are creating the
biggest risks to the firm. Where’s the logic in that? If the broker agreed to the loan when the stock was looking good, the broker should share in the losses when things are bad. Being able to choose which stocks to close based on the risk to the broker is the equivalent to someone being behind on a car loan, but the bank being allowed to choose among repossessing the car, boat, or home depending on which loans are creating the biggest risk to the bank. If a car dealer makes a bad loan, the car dealer takes the losses. If a bank makes bad mortgages, the banks take the losses. But if a broker makes bad loans, the customer now bears the risk. This practice wouldn’t work in any other industry.

THE SECRET SOCIETY OF THE SOES BANDITS

In 1984, the Small-Order Execution System, or SOES, was created by Nasdaq to automatically execute orders of “...500 shares or less received from public customers...”. As a result of the crash of 1987, Nasdaq implemented it as a mandatory order execution system for all small orders as a result of the lack of market liquidity.

After all, it doesn’t make sense to have market makers monitoring a stock that may have little to no volume for the entire day. Still, if an investor places an order, the exchange needs a way to execute the trade, and the SOES system was the answer. It was a computerized trading platform that would either sell shares on the asking price or buy them at the quoted bid, most of the time limiting the order to 1,000 shares or less. For instance, say ABC stock is thinly traded and the exchange posts a bid of $20 and asking price of $21. If you place an order to buy up to 1,000 shares “at market,” you’d instantly buy shares at the quoted $21 price. If your order was to sell, you’d receive the $20 bid. It gave retail investors a preference in the trading queue, as it was mandatory for market makers to fill orders at the quoted prices. Market makers, on the other hand, usually
traded larger lots, and normally had to walk orders out to the trading floor, haggle with prices, return with trades, which were then relayed back to the broker and finally to the client. The process took time.

The SOES system, however, created a loophole because it automatically routed investor orders to the dealers with the highest bids or lowest offers. Because SOES systems weren’t closely monitored, traders could buy or sell shares at favorable prices before the SOES systems were updated. For example, traders might wait for an uptrend to develop, buy on the SOES system, and immediately lay off the trade on another exchange at a more current higher price. It was a way of stealing from the exchanges, and these traders were dubbed the SOES Bandits. As a result, many market makers were caught off guard, and wound up losing money by buying high and selling low.

Sheldon Maschler and Harvey Houtkin were two of the original SOES Bandits. Sheldon founded Datek Securities in 1970, but in 1989, hired two software programmers, Jeff Citron and Josh Levine, who created Watcher, which was one of the first programs to provide real-time quotes for Nasdaq stocks through SOES. In 1996, Watcher was used as the foundation for Datek Online, and the growth was explosive, employing 500 traders in its first year, many fresh graduates from Ivy-league schools, making $750,000 per year. By 1999, it was the fourth largest Internet broker. Later, Citron and Levine created a similar platform called Island, which captured 15% of the Nasdaq’s volume by 1998. From 1995 to early 1998, Datek Securities executed about 12 million SOES trades, over 30% of all SOES trades. Not surprisingly, it was purchased by Nasdaq in 2005.

Harvey Houtkin, another early SOES Bandit, created All-Tech in 1998 along with another platform called Attain, which was sold to Knight Trading in 2005 and renamed Direct Edge. Knight sold it to Goldman Sachs and Citadel Investments and
the ISE. It merged with BATS Trading to become the third largest stock market in the U.S. behind the NYSE and Nasdaq.

The problem with many of these computerized trading systems back then, or Exchange Traded Networks (ETN), is that some of them allegedly engaged in various forms of price manipulation including spoofing, layering, and quote stuffing. The details aren’t important, but they all involve forms of creating fake orders to get other computers to alter prices. Rather than using SOES for its intended purpose of executing trades on behalf of retail investors, these early bandits engaged in fraudulent schemes to make proprietary trades. In 2003, the SEC charged Sheldon Maschler and Jeffrey Citron, among others, with participating in an extensive scheme to defraud investors from 1993 to 2001. The defendants agreed to pay over $70 million and disgorgement to settle the charges. Sheldon Maschler was ordered to pay over $29 million and Citron over $22 million, representing the largest penalties the SEC has ever obtained from individuals.

The bigger problem, however, is that these platforms that allow flash orders have been granted exchange status. While it appears that it’s a benefit for investors to have other competitors, these platforms are there to gain access to the proprietary market data of the NYSE, Nasdaq, and BATS. Sometimes it isn’t just about bending the rules, tilting the playing field, or slanting the news. Sometimes it could be outright fraud.

**BAYOU HEDGE FUND SCANDAL**

In 1996, Sam Israel founded the Bayou Hedge Fund Group by raising $300 million, which he swindled for personal use. Investors were given bogus reports, saying the fund would grow to $7.1 billion in 10 years, representing a healthy 37% annual return every year. Considering Madoff’s steady 10% raised a
few eyebrows, you’d think investors would have known better about believing 37%. Just two years later, in 1998, the fund’s poor performance led Bayou to create a dummy accounting firm, which they hired to send fake statements to investors. When the fraud was finally exposed, Israel tried to fake his own death to avoid prison. His abandoned truck was found on Bear Mountain Bridge in 2008 with the cryptic message “Suicide is Painless” scribbled in dust on the hood. Debra Ryan, Israel’s girlfriend was suspected of helping him escape, and the two were featured on America’s Most Wanted. Israel was finally captured, convicted, and required to serve 20 years in prison – plus pay a $200 million fine. But cons don’t go down easily. He failed to report to prison as ordered on June 9, 2008 and only turned himself in 24 days later on July 2.

**BUNGLE IN THE JUNGLE**

In late 1993, geologist Michael de Guzman ordered rock samples from a remote site in the jungles of Indonesia on behalf of Bre-X Minerals, a Canadian mining company. Independent auditors assessed the deposits as the richest gold deposit ever discovered, with some reports showing the potential for 200 million troy ounces valued at nearly $7 billion. The stock went from valuations below one cent to CAD $40 in late 1995.

With his newfound wealth, de Guzman used the money to expand the company with sophisticated excavation equipment. Investors knew that with every piece of equipment, every new core sample estimate, and every new Wall Street article, the stock was bound to be worth far more – and they continued to buy. What they didn’t know, however, is that the entire operation was a fraud. There wasn’t a single ounce of gold on the site. Instead, de Guzman used an age-old mining scam called “salting” where miners would sprinkle gold near sites, much like you’d sprinkle salt on food. What made his scam so
ingenious is that he didn’t just salt the surface of potential sites. Instead, he ground up the core samples and sprinkled hand-filed shavings from his wedding band into the mix. He was careful with the proportions, not too little to not have value, and not too much to raise suspicion. It fooled everyone, including seasoned independent auditors, geologists, and scientists.

His wedding ring, however, would only carry the scam so far. To keep the scam going, more gold was needed to salt the samples, so he eventually contacted a few local gold panners and bought more than $61,000 worth of gold over a two-year period.

The con was on, and perhaps would still be going today had it not been for the corrupt Indonesian government when President Suharto wanted a piece of the action. In 1996, he revoked Bre-X’s mining license and opened the property for bidding by other companies. Eventually Bre-X was forced to share the site with Freeport – conveniently along with Suharto’s daughter. Freeport-McMoRan would own 55% of the site while Bre-X would have rights to the remaining 45%. In a single day, the stock dropped from roughly $50 to $37, losing one billion dollars in market capitalization.

Cons never give up, and de Guzman countered by increasing the estimated amount of gold reserves after releasing new drilling results. Previously, he stated the company was sitting on 57 million ounces in reserve but increased to over 70 million ounces, which offset the drop in the stock’s price. The stock, once again, began a steep rise.

In 1996, Bre-X was listed on the Nasdaq, and in December, Lehman Brothers alerted investors with a “strong buy” recommendation based on the “gold discovery of the century.” The stock shot up like a rocket, eventually trading for a split-adjusted high of CAD $286.50 in May 1996.

In 1997, de Guzman was invited to speak at Bre-X’s annual
shareholder meeting in Toronto. In the meantime, Freeport-McMoRan was eagerly drilling just a few feet away from de Guzman’s site but found no gold. Not a single flake. Upon hearing the news, Bre-X shares were halted for trading on March 25.

Freeport-McMoRan demanded de Guzman get back to Indonesia to explain his results. After returning to Indonesia, he took off in a helicopter piloted by an Indonesian military man. After reaching an altitude of about 500 feet over some of the thickest rainforests in the country, the pilot claimed to have looked in the back seat – and de Guzman had jumped to his death. Bre-X’s stock opened for trading on May 6 at four cents, down 97%. With zero answers and zero gold, the stock was delisted in May 1997, leaving many investors penniless, some committing suicide, and wiping out billions from Canadian pension plans.

It was the end of Bre-X, but the beginning of a new conspiracy. To this day, rumors continue to swirl: Was it a suicide, murder, or just another perfectly planned deception? Even though a body was discovered, the government declared it “too gruesome” for the family to see, and only one geologist who
knew de Guzman verified the remains. No DNA or other testing was ever done, and the body was cremated. To add to the conspiracy, a suicide note was supposedly left behind – with his wife’s name Teresa misspelled. No criminal charges have ever been brought against anyone, and despite the many civil suits, not one investor has ever been compensated. Michael de Guzman, however, had sold shares totaling over $100 million. The story of de Guzman is such a grand deception that few frauds will ever match it. The Matthew McConaughey movie *Gold* was released in 2016, and several documentaries have been produced on this scandal.

**THE MINDSET OF THE THREE-COMMA CLUB**

To understand why so many Ivy Leaguers are attracted to Wall Street, you need look no further than the level of compensation the best traders and managers can earn. This is why the biggest traders and best corporate honchos regularly make Forbes’ list of billionaires – the three-comma club. Inside this elite club is a level of wealth unmatched anywhere else, but it’s all created for one reason – get the stock price higher.

Jack Welch was the highly-acclaimed CEO at General Electric (GE) from 1981 to 2001. During his tenure, he received millions of dollars per year, a Manhattan apartment valued at $80,000 per month, court-side seats to the New York Knicks and U.S. Open, box seats at Red Sox and Yankees games, seating at Wimbledon, country club fees, security services, and all restaurant bills were comped, whether for business or not. If that wasn’t enough, when he retired, he received severance pay of $417 million – the highest ever paid to any U.S. executive at that time. To his credit, GE shares did rise 4,000% during his tenure.

In 2017, Broadcom’s (AVGO) Hock Tan was the highest-paid CEO, earning $103.2 million – more than 2,000 times the pay
of the average U.S. worker. However, as part of that pay, Tan received bonus shares worth over $98 million, but won’t be fully vested until 2021, and the final number of shares he’ll receive will depend on Broadcom’s value at that time. If Broadcom shares perform better than 90% of the S&P 500 companies, he’ll receive shares worth nearly $180 million. But if the company ends up on the bottom 25% of the S&P 500, he’ll get no shares. Broadcom did perform well in 2017, with the company increasing nearly 47% versus 22% for the S&P 500 index. But he still has four years to go. Strong incentives are always in place to get share prices higher.

The problem is that these incentives aren’t balanced with equal risks. CEOs also receive generous severance packages – regardless of the cause. The result is that CEOs can’t lose, so they have the incentive to take unwarranted risks to move the stock price higher. If they fail, they win, but investors lose.

In 2015, United Airlines’(UAL) CEO Jeff Smisek stepped down after the company was accused of trading favors with Port Authority official David Samson. United was trying to get public funding for improvements to its Newark Liberty Airport, where it is the largest carrier. During a Manhattan dinner meeting, Samson said he wished the airline would restore one of its twice-weekly, money-losing flights between Newark and Columbia, S.C., known as the “Chairman’s Flight,” since he owned a weekend home near the Columbia airport. In other words, United was willing to charge shareholders for the costs so a public official could get more convenient flights. If average employees were found guilty of such egregious acts, they’d be fired immediately. How did it work out for Smisek, a Wall Street insider?

He walked away from United Airlines with $36.8 million in severance and benefits. But there was more, and it was these extravagant perks that rubbed investors’ nerves raw. He received free first-class flights for himself plus a companion, free airport parking, and will drive a company car – all for life. He won’t even
pay the taxes on the free flights, as United agreed to pay those too.

In 2016, when Wells Fargo’s (WFC) CEO John Stumpf lost his job over the company’s credit card scandal, the Golden Parachute netted him $133 million. In return, investors got a statement from the new CEO Tim Sloan, “We apologize to everyone who was harmed by unacceptable sales practices that occurred in our retail bank.”

To succeed on Wall Street, financial knowledge doesn’t win the game. Sales do. If a company can spin a great story, deliver smooth pitches, and convince clients to buy its products, it’ll survive and grow. Wall Street has evolved into a sales machine of promised profits because that’s what people want to hear. The salespeople are usually not financial experts, but those who are masters at getting you to do one thing – buy. As Warren Buffett observed, “Wall Street is the only place that people ride to in a Rolls Royce to get advice from those who take the subway.”

The harsh reality is that Wall Street doesn’t survive by making money for you. It survives by making money from you. Pete and I have learned through the years just how far Wall Street will go to become a lethal opportunity employer. Someone is always trying to alter perceptions, play on emotions, and hype up the opportunity to get you to take the losing side of the trade. It’s the way most of them pay for their subway ticket. It’s not really a random walk. It’s based on talk: Do whatever it takes to get the stock prices higher.

Comedian Robin Williams summed it up best, “Carpe per diem – seize the check!”