

1 Why You Should Read This Book

On a bright late summer's day the islands off the northeast coast sparkle like diamonds set in a blue chain. A yacht swung on its mooring directly off a dock jutting out from the water's edge just below a newly renovated mansion. On board the yacht, so new that everything glimmered in the sunlight, maids in white uniforms hurried about their tasks, and the captain and crew were preparing to sail. The owner of the boat, the pier, and the house sat in his shorts, shirtless—his tanned chest dark in the bleached noonday light, his hands gripping the wheel of the ship; his new wife stood pert and pretty beside him, an admiring smile on her lips.

An English guest stood beside the owner; he wore slacks, a polo shirt, and a yachting cap. The owner grinned up at him. "This is how bankers live in America," he said, smiling broadly.

His guest smiled in return and cast an admiring glance around the boat, house, sea, and sun; he even took a peak at his host's wife.

In the distance was an even larger yacht. "Whose is that?" asked the visitor.

"That belongs to the CEO of one of our client companies," his host replied.

"Oh," responded the Englishman. "So everyone makes lots of money." He looked around again, as if searching for something in particular, and then asked, "But where are the investors' yachts?"

There was a sudden embarrassed silence. The beautiful wife looked away. The banker cast a suspicious glance at his guest and then, seeing that the man was in earnest, responded, "Well, you see, in America it doesn't work that way."

Many of us have lost money in stocks. I'm continually asked, "Who took our money? Is it true that some people got very rich off this? Why did that happen?"

People add, "I thought the system was supposed to protect investors—why didn't it? I thought CEOs of companies were supposed to make money if their shareholders did, and not make money if the shareholders lost. But it didn't work that way. Why not?"

And as they warm to the topic, they ask, "What's been going on in the market? Will it continue? Do I want to be in the market? If not, what else can I do to build a retirement nest egg? Is there a safe way to do it? Whom can I trust?"

Finally, the most important question of all: "Is there any way I can get any of my money back?"

These are the topics of this book.

Investors Aren't Primarily to Blame for Their Losses

It's common for the media and financial professionals to blame investors for their losses. Investors were greedy, they claim; investors didn't do their homework about the companies in which they invested; it was investors' own fault they lost so much. People could have done more and been less gullible, it's true, but still investors aren't primarily to blame for their losses.

Some of the arguments that make investors responsible for their losses begin by trivializing what happened in the stock market boom. "Bosses will always be greedy," wrote the editors of a major business magazine, "auditors will always be fallible, boards will always miss things..." It follows, goes this argument, that an investor must presume the worst and exert constant scrutiny and questioning, and by implication, if he or she loses, then it's his or her fault for being willing to "suspend disbelief and be fooled."²

But the evidence in this book will show that much more happened in executive compensation than is captured in the phrase, "Bosses will always be greedy." Evidence will also show that auditors were not simply fallible, missing some things, so to speak, but were actively engaged in long-term efforts to mislead investors; and that boards of directors didn't merely miss things, but supported executives in manipulating financial reports to enrich the executives and themselves. It was not business as usual, and it wasn't something from which an investor could protect himself or herself by more vigilance. There was (and is, for similar behavior continues today) generalized deceit and deception and wholesale self-dealing at the expense of investors. What happened was generally prohibited by ethics and by law, but neither self-restraint nor regulatory agencies were effective in preventing deception and self-dealing in order to protect investors.

Other arguments that make investors responsible for the bubble and burst are very sophisticated. For example, an analysis now making the rounds of invest-

ment banks begins with the assertion that investors have become more willing to accept greater risk, and from that assumption the analysis shows that markets will then behave differently—exhibiting more volatility and bubbles and crashes. Thus, it's investors' fault that the market crashed—investors began to seek more risk, and the bull market and crash were the result.

This argument turns the actual causality upside down. In fact, investment banks, brokerages, venture firms, and companies promoted rising stock prices in a variety of ways (including fraudulent accounting and technology hype) and thereby enticed more investors into the market at rising prices. It was the bubble that turned investors into speculators (just as had happened during the tulip mania, the South Sea bubble, and other speculative manias hundreds of years ago), not investors who suddenly became speculators and created the bubbles.

In recent years it was the failure of investors to realize certain things about American stock markets as a whole that was the source of their losses. Investors failed to realize that the deck had been stacked against them; that they were the turkey at a Thanksgiving dinner held by CEOs and professionals in the financial markets.

Investors didn't realize that CEOs would fake the financial reports of their companies—that banks would help CEOs do this and accountants would permit it. Investors failed to realize that government wasn't paying attention, and that Congress was helping dishonest executives. Investors failed to realize that stock market analysts whom investors consulted about their investments had major conflicts of interest that were not disclosed to investors and so misled investors intentionally. Finally, investors failed to realize that many mutual funds also had conflicts of interest that turned them against their investors. It was their failure to realize these things that caused investors the enormous losses they took in the past few years. This book tells how and why it happened, and it will help investors avoid being turkeys again.

The question of the degree of investor responsibility for losses is one of the most controversial that is tackled in this book. Many executives in the securities industry and their supporters in Washington and New York believe that investors are let off too easily. They insist that bubbles happen in part because investors are greedy and readily feed on the hype they are fed.

The answer given in this book is twofold: first, that there is a legitimate role for the securities industry—to bring investors and businesses together for the purpose of building economic value. But for securities firms, banks, and corporate executives to encourage and exploit the weaknesses of people (certainly there is some greed in almost all of us) for their private gain is by far the greater sin. Leaders in the securities industry are in much the same position as executives in the gaming industry—there is a legitimate role for gaming as entertainment, but when gaming executives exploit chronic gamblers, they cross a line. The same is true of the alcohol industry—there's a legitimate role and there's exploitation of human weakness.

Second, exploitation of investors by banks, brokers, and corporate executives as described in this book goes far beyond mere hype to intentional, considered, and long-going deception. It's akin to a gaming company not only enticing a problem gambler to gamble, but going so far as to insist that the odds are in his or her favor; it's akin to a liquor company insisting that there is no harm from excessive drinking of its products. That is, it's pure deception—intolerable in almost any business.

Further, as we'll see in many of the chapters that follow, it's quite a spectacle to watch executives of banks and brokerages condemning their customers for excessive greed.

Why is the question of investor greed and investor responsibility for the stock market bubbles so contentious? Because there is a great deal of money involved.

Most bankers, analysts, and brokers cannot make a substantial living in the investment business without resorting to systematic deception. The average investment return is modest; the economy grows at only about 3 percent per year, and so there's rarely a killing to be made in matching investors and companies. Yet the securities industry has for many years delivered outsized compensation to many people. For decades now a large portion of the graduating classes of the major business schools have gone to Wall Street and many have made fortunes. What about the securities business makes bankers and brokers rich? The answer is clear from the history of the stock market bubbles of the nineties—deception.

This is why it's so important to those who profit from the industry to insist that their customers are greedy and insist upon being deceived.

Power Is at the Root of the Corporate Financial Scandals

The theme of this book is that though today's corporate scandals appear to be limited to accounting fraud, they're really part of a fundamental clash between top executives of American corporations and investors. The problem goes far beyond a group of well-publicized scandals and involves the stock market crash as a whole. In this broad perspective, the crisis is about power as well as about money—the basic cause of the scandals is that CEOs used their enormous power in large firms to enrich themselves at the expense of investors. Shareholders are supposed to own American firms, and executives are supposed to be their agents in running them. In reality, executives used their power to make fortunes and used the fortunes to expand their power—and investors were left farther and farther behind in the process.

There's much in this book about accounting, because investors need to understand the techniques used to defraud them; but so-called “creative accounting” was only the mechanism of the theft—its roots lay in a shift of power from investors to CEOs, so there's also much in this book about power in today's

American corporation. The principal story this book tells is about the misuse of power on a large scale. CEOs initiated the misuse, but they were joined by institutions and professionals that investors trusted and that owed responsibility to investors—accounting firms, attorneys, and investment banks.

Since the securities market crisis is largely about power, it must be resolved in those terms or it will reoccur. From the point of view of investors, it's crucial to jettison the too-powerful CEO—the imperial CEO—in favor of a management team that will be more responsive to corporate boards of directors. It's equally important to change CEO compensation packages by providing the right kind of stock options. (An option is a legal contract between a company and an executive that allows the executive to buy stock from the company at a specified price. How to fashion options that will reward executives, but only for real performance and only when investors gain, is discussed in Chapter 14.) Also, because regulators have been largely ineffective in protecting investors from fraud, there's a need for a total overhaul of the system by which securities markets are regulated (the topic of Chapter 13). President George W. Bush reminds us often that at the heart of the scandals is a failure of ethical standards among executives. So this book says much about ethics and about how business schools might help improve business ethics.

The Internet Bubble and The Big Company Scandals

This book is not about the Internet bubble, which occurred in the so-called “new economy,” but rather about the scandals that have cost investors trillions and undermined confidence in the heart of the American economy—the “old economy” of the blue ribbon companies.

This book supplements my previous book, *Buy, Lie, and Sell High*. Together they present a complete picture of the boom and bust in America's stock market during the late 1990s and early 2000s. *Buy, Lie, and Sell High* explains the bubble in technology stocks; *Wheel, Deal, and Steal* shows how investors lost out in other sectors of the economy. There were major differences in what happened in the two sectors. The Internet bubble was driven by a continual barrage of publicity about the promises of the new technology, but hype played a much less significant role in the old economy. Venture firms and investment banks were the principle source of the bubble in the Internet sector; large-company CEOs and accountants were the principal sources of the fraud among the blue chips, although the investment banks again played a major role. The method used to mislead investors about the dot-coms was to inflate expectations; investors were misled about the blue chips by misrepresentation of their financial situations.

The titles of the two books reflect the difference between the two manias. To create and exploit the technology mania, venture firms bought into entrepreneurs'

ideas to obtain significant positions in their companies; joined with investment banks and the business press to tout the Internet and the supposedly wonderful prospects of the startups that they then sold to the public; and sold out when investors had pushed the share prices to unjustifiably high levels. Hence *Buy, Lie, and Sell High*.

To mislead investors, executives in large firms had to develop compliant boards of directors and accountants, and banks prepared to support their efforts; then they had to do deals that would look good in their financials and get approval from auditors and boards for misleading financial reports. Finally, they had to cash in their options before the frauds and other misrepresentations were discovered. Hence the title of this book: *Wheel, Deal, and Steal*.

Not much of long-term value was created by the great bull market of the 1990s. This was not like the mania that occurred when canals first linked the East Coast and Midwest; nor like the mania that occurred when railways first tied the country together coast to coast (though Internet propagandists pretended that the many miles of fiber optic cable laid in the late 1990s rivaled the canals and railways in importance). Nor was it even like the repeated stock market booms and busts that accompanied the building of our great manufacturing industries or the market boomlets that accompanied each new generation of computer technology (though considering the Internet as a new generation of technology helped set off the Internet craze). Instead, this was primarily a financial bubble, like that of the late 1920s, not an element in the growth of the economy, but a sort of parasite upon it. These two books together constitute a complete, contemporary story of the manipulations that resulted in the great bull market. Probably a better label for the experience is the manipulated market, because manipulation is what happened. The investor excitement that is said to be the cause of the bubbles was in fact the result of careful manipulation undertaken by top corporate executives, boards of directors, and every element of the financial services industry.

In the course of the chapters that follow we will explore the American financial securities system as it's supposed to operate—in behalf of investors—and as it has operated in recent years in which conflicts of interest have been exploited by corporate executives, accountants, and banks at the expense of investors. Much of what is contained in the book is summarized in two diagrams that appear in the final chapter. Some readers may want to take a look at the two figures now—they allow readers to figure out the system and its abuses before going through the text.

For CEOs it has been wheel, deal, and steal. For investors it has been believe, buy, and bust.

The Decay of American Capitalism

How did American business stray so far from the powerful economic model that the world admires and that has served us so well in the past: private enterprise, investor-owned companies, honest accounting, clear reporting of financial results so that investors can choose where to put their money, and ethical responsibility of financial professionals to ordinary investors? In the past two decades honest accounting, transparency in reporting financial results, and ethical responsibility of professionals to investors went by the wayside, and the result is massive losses for ordinary American investors and a crisis of confidence in the system as a whole. How this happened is a fascinating story about two decades of evolution in American financial markets and how the markets became corrupted in the process.

This is not a book of outrage, but a calm appraisal that provides a picture of what's happening. It clarifies for the reader complex matters about which the press is often confusing. It begins with what happened and then turns to what to do about it—to reforming the system and getting restitution for investors. This book will tell you how and why investors lost so much money, why it's likely to happen again, and what can be done to try to stop it. This book will also tell you how you can try to get your money back. Finally, our financial markets require reform, which in turn requires an understanding of causes. Different causes require different responses. This book clarifies the causes and proposes remedies.

Many of the matters discussed in this book should not be the subject of ideological or partisan controversy. That the left might be affronted by corporate misdeeds is no surprise, but the right should be also. Economist Milton Friedman commented, "There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits, so long as it stays within the rules of the game, which is to say, engage in open and free competition without deception or fraud."³ The issues here are deception and fraud, on a very large scale. As such, they threaten the utility of free markets, and should affront the right as much as the left, though perhaps for a somewhat different reason.

Where there is proper reason for ideological and partisan differences is with regard to what should be done to rectify the situation. The left is likely to prefer more regulation; the right more reliance on markets. In this book I've suggested responses of each type—not more but better regulation (see Chapter 13) and greater, not lesser reliance on choice in our markets (see Chapter 16).

Returning to a More Honest America

On the fourth of July, many Americans boast of the virtues of our great country—of hard work and commitment and honesty and free enterprise. These are real and significant virtues and they are admired in much of the world. But recent corporate scandals have shown that they are fast giving way to easy money, self-interest, fraud, and dishonesty.

As a young man I served the American public during the Vietnam War in a position of business regulation. At the time I came across some clear incidents of corruption—self-dealings and bribes—and couldn't understand why the perpetrators hadn't been taken to court and to jail. A senior official of the government, a man who'd served during World War II and the Korean War in positions similar to the one I was in then, told me that whenever one came across situations of long-standing corruption in business, it was always associated with corruption in the police and judiciary as well—otherwise, it couldn't persist.

And when I came across things that were unfair, things that should have been illegal but were in fact legal, he told me that they in turn were always accompanied by corruption in the legislative process—at the local, state, or federal level. That was how things that should have been illegal were made legal.

Over the years I've seen that he was correct. The well-recognized downside of democracy is that it has in it the seeds of corruption. The court system and the legislative systems are deeply implicated in the current business scandals. The courts because the system is so imperfect that investors cannot get quick and sure restitution of money taken from them by deception. The legislatures because they help the swindlers with favorable laws—both permitting actions that shouldn't have been permitted and lessening potential penalties for those unlucky enough to get caught.

The best way to end the securities market crisis is for the government to make investors whole for their losses, have federal and state regulators punish the corporate and financial leaders who caused fraud and benefited from it, and reform the system so that it doesn't happen again. This approach, championed in the chapters that follow, is a far better method of dealing with the crisis than is lengthy class-action litigation and limited regulatory reform, which we shall see is the method now being pursued.

There are many Americans now in the stock market, and if we are sufficiently upset about our losses, politicians and courts may act. Estimates are that the proportion of U.S. households that owned stocks or mutual funds has grown from 19% in 1983 to 49.5% in 2002; and the proportion of single individuals who own stocks or mutual funds has grown from 42% in 1983 to 84% in 2002.⁴ If investors exert their potential influence, can we create a safer, more reliable, more honest America?

Talking Points

The bursting of the Internet bubble wiped out the savings of many American investors. But those who fell for the much-hyped promise of the high-tech stocks weren't the only ones who got burned. People buying shares in large, blue ribbon companies of the old economy also saw their nest eggs evaporate in the market meltdown.

When it comes to assigning blame for these huge losses, there's a tendency to find fault with the investors who are the victims. But was it really their greed-fueled desire to seek more and more risk that caused the market to crash? It's one thing to lose money through greed or irrational exuberance; it's quite another to be duped by people who were supposed to be on your side. The truth is investors didn't realize they were being systematically deceived by corporate executives who were supposed to be their agents but instead were masterminding schemes to pocket millions of dollars regardless of what happened to shareholders. Furthermore, when investors sought impartial investment advice, they were often misled by Wall Street professionals who had their own interests in mind.

This book addresses the key questions about the investment debacle: How did it happen? Why did a system that was supposed to protect investors fail them? Will investors regain their badly shaken confidence in the stock market? What can be done to help restore their trust? And last but not least, how can investors get their money back?