8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page xiv

CHAPTER 1

8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page 1

THE GREAT STOCK MARKET SCAM

8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page 2

The stock market decline of the early twenty-first century was caused neither by terrorists nor war. It was the direct consequence of the Great Stock Market Scam—an elaborate system of deceptions that threatened the retirement savings of millions of Americans over age 50.

Back on April 26, 1999, for example, Morgan Stanley Dean Witter plus 18 other Wall Street brokerage firms gave you a recommendation that could have transformed a comfortable retirement into a life on welfare.

They recommended Priceline.com as "a quintessential virtual business model," and gave it a strong buy rating or equivalent. When they made this recommendation, Priceline was selling at $104. Twenty-one months later, it was trading for $1.50 a share. If you listened to Morgan Stanley, or to any of the other 18 firms, and you sank $10,000 into this turkey, you'd be left with a meager $144. That's a whopping 97 percent loss.

Then there's Amazon.com (a.k.a. "Amazon.bomb"), also much beloved on Wall Street. In December of 1999, Merrill Lynch and 32 other Wall Street brokerage firms gave it superlative ratings and told investors like you to scoop it up. If you'd put $10,000 into this company, you'd have lost a whopping $8,761 by year-end 2000.

8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page 3

The battering you'd have taken if you'd followed Wall Street's advice doesn't stop there. If you'd invested in Procter & Gamble (P&G), you'd have lost 56 percent. You'd have lost another 57 percent in Cisco. Investing in Oracle would have cost you 53 percent. Intel, another 60 percent loss. Not to mention the 2,500 other tech stocks that Wall Street brokers kept telling you to scoop up as bargains.

All told, the total market value of the more than 4,300 stocks listed on the Nasdaq plunged from $7.6 trillion on March 10, 2000, to $2.4 trillion on April 6, 2001. Investors lost $5.2 trillion—more money than was lost in the worst crashes of all recorded history, the equivalent of nearly half the entire gross domestic product of the most powerful economy in the world. All in just 13 months.

A key cause was the companies' earnings, which turned out to be far lower than most everyone expected. Some companies couldn't claim a penny in earnings. Others couldn't even claim a penny in *sales*. But nearly all continued to brag about great results and get Wall Street's best ratings until virtually the bitter end.

What happened? How could the earnings information and investment advice given to so many investors have been so far off from the truth? How was it possible for so many investors to lose so much money so quickly?

Many investors blame themselves, regretting their susceptibility to greed or fear. And certainly, those emotions did play a role. But if you lost money in the debacle, you should know that it's mostly not your fault. You probably were the victim of a massive, elaborate scam, which, by sheer virtue of its enormity, is more sophisticated than even the savviest of investors.

This great scam was not planned in a conspiracy; it evolved naturally in an environment of complacency. It is not perpetrated by one, two, or even a dozen exceptional institutions; it envelops almost everyone—chief financial officers at major corporations, the most respected research analysts on Wall Street, and tens of thousands of individual brokers.

Their ubiquitous tool: *misinformation*. Indeed, the critical information you need to make sound investment decisions was—and is—passed through a series of filters, each removing some piece of bad

8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page 4

news, each adding a new layer of hype, distortion, and even outright lies.

To protect yourself, you must understand how they misinform you, when, and where. So follow the trail of information–from its source (the corporation), to the Wall Street research analysts, and finally to the brokers who serve individual investors . . . .

Thirty-One Percent of Companies Listed on U.S. Stock Exchanges Are Suspected of Manipulating Earnings Reports

The single most important piece of fundamental information that you need about a company is its current earnings. It's no coincidence, therefore, that earnings information is often the prime target for manipulation and distortion–by none other than the company officials who are responsible for compiling and issuing the data each quarter.

These company officials come under intense pressure to meet Wall Street's overblown expectations. If they don't, they fear their shares will be severely punished. So when they realize that their actual earnings are falling short, many resort to gimmicks (both legal and illegal) to twist the truth. The consequences for investors are disastrous. Here are just a handful from the recent past:

- When Nine West was investigated by the Securities and Exchange Commission (SEC) for allegedly misrepresenting revenues following its 1995 acquisition of U.S. Shoe Corporation, its stock plunged. The investigation was terminated without enforcement.
- Shareholders in Summit Medical saw their stock slide nearly 90 percent for similar reasons.
- McKesson HBOC, Incorporated, was forced to restate three years' worth of revenues because of accounting improprieties. The stock plunged 82 percent.

8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page 5

- Sunbeam Corporation falsely reported $96 million in income it never earned. Its stock was virtually wiped away–down 93.4 percent.
- Tyco fell 58 percent . . . Informix fell 89 percent . . . and Safety-Kleen lost a whopping 96 percent–all because of allegations that their earnings had been distorted.

In each case, the truth was finally revealed, and by the time most investors found out and sold their shares, it was too late.

How widespread is this problem? To answer that question, my staff and I took a closer look at over 6,000 companies listed on U.S. stock exchanges, and we compared their stated earnings with their *actual cash flow from operations*. Normally, these two measures of performance should be in sync. However, in 1,687 companies, *nearly one out of three,* we found significant discrepancies between earnings and cash flow. These are not proof positive of hanky-panky; they are a red flag, leading us to suspect earnings manipulations, legal or illegal.[1]

This is absolutely shocking to me. Once upon a time, nearly all major U.S. companies followed generally accepted accounting principles (GAAP) to report earnings. They were sticklers for accuracy when reporting key financial information to shareholders. By the late 1990s, though, in their growing desperation to meet Wall Street's expectations, more and more companies resorted to various schemes to massage earnings. That's why, in one typical quarter, the operating income of 665 major companies reviewed by the *Wall Street Journal* rose 9.6 percent. However, when adjusted for all of the costs that would normally be charged under GAAP, actual corporate earnings *fell* 4 percent.

What's the motive? Simple. The officials of America's corporations can get up to 90 percent of their compensation in stock and stock options. So they have everything to gain by putting out information that will boost the value of their own investments in the company.

Consider, for example, AOL's Stephen Case, who was paid a little over $1 million in salary as recently as 1998, but *also* was paid more than $158 million in stock and stock options. Craig Barrett at Intel earned a salary of $2.6 million, plus more than $114 million in stock and stock options. Sanford Weill at Citigroup collected

8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page 6

$10.5 million in salary and about $156 million in stock and options. Henry Silverman at Cendant received $2.9 million in salary and $61 million in stock and options.

Also, let's not forget Disney's Michael Eisner, the all-time income champ among American CEOs. His salary reached about $5.7 million. Additional compensation in the form of stock and stock options totaled a staggering $569 million!

The options portion of the executive compensation package is pivotal. If you hold options to buy your company's shares, known as *call options,* you have the right–but not the obligation–to purchase the shares at a relatively low price and then immediately sell them at a much higher level. If the company's stock fails to go up, the options could be totally worthless; if the stock soars, the options *alone* could be worth more than 10 years' base salary.

It doesn't take a rocket scientist to figure out what happens when the company's stock drops, for instance, by 30 percent: The Big Cheese loses one-third, one-half, or even two-thirds of his or her personal wealth. Depending on the company, that percentage can translate into hundreds of millions of dollars. These corporate CEOs aren't dumb. They know that there's nothing better than a positive earnings report to goose up their stock prices. Hence, once each quarter, unscrupulous CEOs massage the numbers, hide losses any way they can, artificially inflate revenues, and, when all else fails, look you square in the eye and lie their rich, well-tailored fannies off.

It's bad enough when rich corporate fat cats get richer through deceptive practices. When investors like you have to pay the price for corporate greed and deceit it's a disaster. What's most frustrating of all, though, is that the most common methods used to massage earnings are actually legal. Some examples are discussed in the following few pages.

The Goodwill Distortion

A Fortune 500 company buys up a hot, new upstart firm for $10 billion. It's an outrageous price that's 10 times the actual market value of the company's assets. The accountants are then given the

8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page 7

job of allocating the purchase price on the company's balance sheet. But they say: "Hey! We can only find assets worth $1 billion. What are we supposed to do with the other $9 billion?"

Management's response: "Create a goodwill account and slap the entire $9 billion into it." This is an asset account, right alongside items like *cash,* or *plant and equipment.* Yet it has no substance. A small amount, to represent the value of the company's good name or customer list, is acceptable. Since when is it normal, though, for 90 percent of a company's assets to be in an intangible, mostly bogus, asset? This is the deception that helped doom the savings and loans. It's the same deception that was routine in the Great Stock Market Scam.

The goodwill scheme doesn't end there, though. Each year thereafter, the accountants are supposed to charge off a portion of that goodwill. For example, if they stretch it out for 10 years, that would equate to $900 million per year in costs. But no–the managers don't want to do that because it would mean their earnings would be *reduced* by $900 million each year. So they stretch it out for 40 years, the absolute maximum allowed, finding various rationalizations for why the goodwill has such an incredibly long lifespan.

The resulting exaggeration of earnings is mind-boggling in its dimensions. If the company had a profit of $1 billion and charged its goodwill over 10 years, at the rate of $900 million per year, its profit would be $100 million. Stretched out over 40 years, however, the charge is only $225 million per year, leaving a profit of $775 million, or nearly *eight times* the actual profit.

Then, guess what! Three or four years down the road, the company has either a great year with windfall profits, or a horrendous year with huge losses. When the company has a great year, they say: "Let's declare the goodwill worthless after all and charge the whole thing off as an expense right now. Since we have such huge profits this year, no one will notice the difference." If the year is horrendous, they say essentially the same thing: "Let's declare the goodwill worthless and charge it off. Our stock has already gotten clobbered because of our huge losses. So who cares if we take an even bigger loss this year?" Either way, the 40-year asset is conveniently transformed into a 3-year asset, past and future earnings are grossly exaggerated, and investors become the losers.[2]

8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page 8

The Pooling-of-Interest Gimmick

With the surge in megamergers in the late 1990s, more and more companies weren't even creating a goodwill account to begin with. Instead, they just "pooled their interests." In other words, they combined their assets into one big account and buried the huge overstatement of values in their balance sheets. This method, called *pooling of interest,* deceived shareholders twice. First, they were led to believe that the company was worth far more than it really was, with no easy way to figure out its true value. Second, because the company didn't have to worry about goodwill charges, it was free to exaggerate earnings to its heart's content.

With this method, instead of reporting $100 million profit or even $775 million profit, the company could report the full $1 billion. Shareholders wouldn't have a clue that it was totally bogus, with no adjustment whatsoever for the fact that the company was valued at 10 times its fair market value.[3]

Sound impossible? Then consider this real-life example: Yahoo! acquired Geocities, paying a whopping $3.6 billion in stock for assets that were worth only $130 million. Under the standard and widely accepted purchase-method accounting, Yahoo! would have had to allocate the difference to goodwill, which it then would have to charge to earnings in future years. Instead, Yahoo! used the pooling-of-interest method, which let it hide the overvaluation and exaggerate its earnings in that year and *every* year for decades to come. Ditto for the megamergers of Lucent Technologies and Ascend Communications, Cisco Systems and Cerent, and Allied Signal and Honeywell. Nearly every major merger was a large investor rip-off—a landmine that was ready to explode at any time. But there's more . . . .

Padded Sales Reports

Top executives aren't the only ones getting fat compensation packages, loaded with stocks and options. Sales managers also get a piece of the pie. Therefore, to boost the value of their own shares and options, they went far beyond just tweaking their financial

8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page 9

numbers—they completely perverted and undermined their company's business model.

Tony Sagami, editor of *Stocks on the Move* and a partner in a small but profitable Web-based business, had a personal encounter with this phenomenon in 2000. He and his associates needed to buy a batch of new computer servers and invited bids from various manufacturers.

Manufacturer A came back with an offer to sell the equipment for $2 million, with zero down and payback terms over five years. Tony's reaction: "No money down? Wow! For a small, upstart firm like ours, with very little cash or collateral, this is darn attractive."

However, the reps from Manufacturer B did even better. They offered similar equipment, also for about $2 million, also with zero down and payments over five years. To sweeten the deal, they said: "Look! It's going to cost you money to hire technicians to set up your new servers and workstations. So on top of the $2 million of hardware, we'll write you a check for $100,000 to help you pay for all of the setup expenses."

Tony and his partners were ready to grab this great deal when still a third, big-name manufacturer came along and completely blew their minds with this proposal: "We'll ship you the $2 million in servers. We'll write you a check to cover all the installations and ancillary expenses. And you don't have to pay us a penny—*ever!* Just give us a 5 percent share in your company."

Hard to believe? Maybe. But remarkably common. In each case, no matter how crazy the terms, the sales managers booked the sales immediately, the financial officers boasted to Wall Street analysts about their "wonderful sales growth," and the analysts promptly raised the hype for the company by another octave. Investors ate it all up. They rushed to buy the stock in droves and sent the shares through the roof.

All this continued to snowball until one totally predictable event: Equipment buyers failed to pay up. And the game was over.

I could cite scores of examples. Here's just one: According to a recently filed lawsuit, Lucent offered Winstar a financing arrangement for up to $2 billion, half of which was available at any given time for the purchase of new equipment from Lucent. Less than one year later, Winstar was in bankruptcy, suing Lucent for $10

8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page 10

billion in damages. Result: Lucent's credit rating was reduced to junk status, with huge debts of its own, mountains of unshipped inventory, and a stock in a tailspin.

The Great Options Boondoggle

The biggest payoff for executives is the lucrative stock option deals like the ones I mentioned earlier, and therein lies an even greater deception.

If the stock options are clearly a form of compensation to the managers, they should be deducted from earnings as an expense, right? But they're not deducted. Again, earnings are exaggerated, and investors are the ones who suffer.

To sweeten the deal for themselves even further, if the stock in the company falls, the company may simply replace the old options with new, better options.

Here's how it works: Let's imagine that you're a senior executive at XYZ Corporation, and the stock is selling at $18 per share. To fatten your compensation package, the company has given you options to buy 10,000 shares at $20, only $2 above where it is now. This $20 price is the *strike price*—the price at which your options can be converted into actual shares.

If the shares rise to, for example, $50 per share, the options give you the right to buy the shares for just $20, sell them immediately for $50, and pocket the $30-per-share profit. If you have options to buy 1 million shares, that's $30 million with this one transaction alone. So you see how options can multiply the value of your compensation package by 10 or 20 times, almost overnight.

Instead of going up, let's say the shares fall from $18 a share to $8 a share. You still have the options and you still have the chance to make a bundle if the stock recovers. But you say: "I don't want to wait for the stock to recover before my options are worth something. I want the company to restore the value of my options to what they were *before* the stock fell. Instead of an option to buy XYZ Corporation at $20 per share, I want you to change it to an option to buy at $10 per share."

Unbelievable as it may seem, the board members, who themselves may have a direct interest in the options, typically vote to do

8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page 11

just that. This practice, called *rolling down the strike price,* has been widespread during market declines.

Then, if the market recovers, they get to keep the better options. The result is that they have the potential to earn double, triple, even quadruple the profits anticipated in their original compensation packages. All of this happens without deducting one penny of cost from reported earnings.[4]

The effect on the individual investor, once again, is dramatic. According to Smithers & Company, Ltd., a highly respected research institute in London, if U.S. corporations properly accounted for the costs of just the stock options they granted, their profits would have been 56 percent lower in 1997 and 50 percent lower in 1998.[5] The same thing is happening now in many of the stocks whose bubbles have been burst. While the average investor got clobbered by the decline, executives and other insiders rushed in to protect their compensation packages.

Cendant Corporation, for example, repriced 46.3 million options for its CEO, lowering the strike price from as high as $23.88 down to $9.81. This occurred just six days after the share price hit its low. Shareholders ended up paying the full price for this practice.

At Advanced Micro Devices, options were repriced not once, not twice, not even three times. Chairman Jerry Sanders had his options' strike prices ratcheted down *six* times throughout a six-year period. Although the stock was performing well, by lowering the strike price so many times, Sanders virtually guaranteed himself a nice wad of money, regardless of what happened to the stock.

Later, when the cost of these packages is finally booked, investors like you and me wind up picking up the tab in the form of sharply lower share prices caused by surprise drops in earnings. In the meantime, the company's executives, protected from the real world, are cleaning up.

Warren Buffett was so outraged by this all-too common practice that, when he acquired General Re Insurance, he decided to completely do away with stock option programs in the company. He got the managers to convert their options to cash bonuses on the spot and charged the entire expense to earnings. That's admirable. Unfortunately, however, few companies are following Buffett's example. They know that if they report truthfully, they'll have to

8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page 12

report a serious drop in corporate earnings. Their shares would be knocked for a loop, and their own riches would be history.

All of these methods that corporations commonly use to manipulate earnings–plus many more–add up to one, gigantic house of cards that is supported by little more than lies and hot air.[6] This helps to explain why so many stocks have crashed and burned: All it takes to knock down the house of cards is a whiff of fresh air–the truth. As soon as the truth comes out, down go the shares.

Most people believe these practices were limited to technology stocks, mostly on the Nasdaq exchange. In reality, they were widespread throughout the stock market.

In an address on the quality of financial reporting in corporate America, former SEC Chairman Arthur Levitt warned:

> Increasingly, I have become concerned that the motivation to meet Wall Street earnings expectations may be overriding common-sense business practices. Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation. . . . As a result, I fear that we are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting. Managing may be giving way to manipulation; integrity may be losing out to illusion.[7]

SEC Chief Accountant Lynn E. Turner put it more succinctly:

> These corporate releases are nothing more than "EBS–everything but bad stuff."[8]

Years ago, most Wall Street research analysts would typically pore through all the EBS from the companies, do their best to cull out any lies and inaccuracies, and give the stock a rating based on their own independent opinion. Unfortunately, as I'll show you in the following section, that is not the standard practice today.

8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page 13

How Wall Street Stock Ratings Are Bought and Paid for by the Companies They Rate

Wall Street's typical pattern today is to take the already-distorted data that are coming from the nation's corporations and *add on a whole new layer of hype and distortion.*[9] What changed? How were supposedly independent research analysts transformed into virtual stock promoters?

It all started when the entire nature of the brokerage business changed radically. You see, back in the old days, brokers made most of their money from commissions (i.e., revenues they earned whether you bought or sold). Starting in the 1980s, however, a whole new crop of brokerage firms (i.e., the discount brokers) began offering cut-rate commissions. Over time, that forced the entire industry to cut nearly all commission rates dramatically.

To continue to grow their profits, most Wall Street firms decided to expand aggressively into another, far more profitable business: helping companies to sell their shares to the public, either in an *initial public offering* (an IPO), or in a secondary offering.

In this business, called *investment banking,* or *underwriting,* the Wall Street firms play a totally different role. Instead of serving investors like you, they cater to big or upcoming corporate clients like Procter & Gamble, Intel, or DrKoop.com. Instead of earning a small commission, they get a share of the proceeds. And instead of making money whether you buy or you sell, they only make money when you *buy.* They have a direct, vested interest in the results. They want to see only good news about the company, only a positive reception from investors, and only a rising price in the shares. They are promoters, not brokers.

Rather than offering objective research and advice, their primary goal is to sell you a bill of goods. That means hyping up the company's performance and touting the stock. It means cherry-picking the best numbers, sugarcoating any difficulties, covering up real problems, and putting out misleading, deceptive, effectively falsified ratings.

For individual research analysts, the incentive to deceive is

8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page 14

large, and the penalty for being honest, even larger. According to the *Wall Street Journal,* analysts at Morgan Stanley get bigger bonuses when they make a positive contribution to underwriting revenues. At the same time, the *Wall Street Journal* reported that Morgan Stanley analysts who refuse to suppress negative information about underwriting clients find themselves transferred to other, far less remunerated jobs. Still others find themselves out of work and on the street, blackballed in the industry, and their careers destroyed.[10]

A few years ago, an analyst at a brokerage firm wrote a stinging report on Donald Trump's Taj Mahal casino. The report alerted investors to serious problems underlying the hyped-up issue. However, when Trump got wind of the negative analysis, he immediately threatened the brokerage firm with a lawsuit. The analyst was fired and the report was pulled.

In another situation, Merrill Lynch was slated to be the lead underwriter of a major bond issue by Conseco. As usual, it was a lucrative deal, expected to bring Merrill $1 million in fees until, that is, one of Merrill's analysts made the fatal mistake of issuing a negative report on Conseco. Merrill Lynch, to its credit, stood by its report; Conseco, however, reacted by firing Merrill as the lead underwriter and taking its business elsewhere–to none other than Morgan Stanley. The message to Wall Street was clear: Tell investors what we want you to tell them, and you win. Tell them the truth, and you lose.

Pulling away underwriting business isn't the only tactic that corporations use to keep Wall Street's research departments in line. If there is a rating downgrade they don't like, they can close their own brokerage accounts at that firm and take their business elsewhere. This practice is so well known that analysts have a special expression for it: "They put us in the penalty box."

Do these things happen every single time? Of course not. But they don't have to. The threat alone is enough to keep the heat on the analysts and have a chilling effect on objective research.

What is bothersome is not only the shenanigans that reach our attention. It's also the ones we never hear about. We happen to know about Morgan Stanley only because some employees talked to the *Wall Street Journal.* We heard of the incident with Donald

8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page 15

Trump only because the analyst who was fired had the guts to sue the brokerage firm. (He won a $750,000 arbitration award.)

But what about the hundreds of analysts who don't sue or talk? who can't pin down the *real* reasons they were fired? who don't want to be blackballed by Wall Street? or who are simply scared? What happens to them? More important, what happens to you, the investor?

You risk losing a fortune, like the millions of investors who lost over $5 trillion in the tech wreck of 2000 and 2001. Not surprisingly, the analysts themselves continue to make big bucks: In 2000, for example, an analyst at Goldman Sachs issued 11 gloriously positive ratings on stocks that subsequently lost investors three-fourths of their money, or more. One of this guy's best-performing recommendations of the year was down 71 percent; his worst was down 99.8 percent. Yet he was paid $20,000,000 (twenty million dollars!) for his efforts.

How pervasive is the bias in Wall Street's stock ratings? Not long ago, the SEC reported on a study that measured the scope of the problem. It reviewed thousands of buy, sell, or hold stock recommendations issued by Wall Street brokers. You'd expect some kind of a balance among these recommendations, for example, one-third buy, one-third hold, and one-third sell. But that's not what the SEC found. Quite to the contrary, *only a pathetic 1 percent of the recommendations were to sell stocks.* The remaining 99 percent encouraged you to hold or buy more.[11] Moreover, all of this was in a year when only about 32 percent (i.e., less than one-third) of the listed stocks on the major exchanges advanced. A startling 68 percent were losers.

Countless companies with no sales and no revenues are routinely rated as *strong buys.* Companies that are about to be decimated by obvious problems are, at worst, downgraded to *hold* or *market perform.* And when stocks are virtually falling into oblivion, the common response by many analysts is eerie silence: They quietly remove the fallen stocks from their list of rated companies, with no further comment or warning.

The conclusion is clear: Wall Street's stock ratings are effectively bought and paid for by the very companies that are rated. These ratings are then presented to you as objective opinions, but

8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page 16

are often nothing more than glorified advertisements for the rated companies.

If you were deciding about which restaurant you should go, or which movie you should see, you'd never dream of relying on a cockamamy rating scheme like this one. Yet, here we have millions of investors betting their life savings on the basis of a rating system that's fatally flawed.

Ten Thousand Active Brokers Caught Swindling Their Clients

You've seen how thousands of corporations distort their earnings information at the source. In addition, you've seen how the research departments of many large Wall Street firms add a second layer of distortion in their published ratings and reports. However, it doesn't end there. This information goes through still a third layer of hype: by the thousands of individual brokers who use them to push specific investments to their clients.

It's often difficult to pin down precisely how brokers misuse this information, but it's not hard to pin down even more serious abuses. In 1994, for example, the U.S. General Accounting Office (GAO) conducted a thorough study of the nation's stockbrokers. Their finding: Almost 10,000 currently active brokers had been caught swindling clients.[12] It's reasonably safe to assume that if they swindle, they also misuse information.

The industry's response was that these 10,000 brokers are "just a small minority." However, the GAO study covered only brokers who were caught in the act and whose offenses were so serious they had to go through formal proceedings and be disciplined. The GAO's study did *not* include brokers who were disciplined informally, let alone brokers who were cheating their customers and getting away with it.

As a rule, it is likely that fewer than 1 in 10 crimes committed by brokers is ever detected, reported, or prosecuted. Therefore, it's reasonable to estimate that at least 100,000 brokers (i.e., over one-

8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page 17

fifth of all the brokers working in the United States today) could potentially be guilty of a variety of offenses.

Many of these brokers have been found guilty of stealing hundreds of thousands, or even millions, of dollars from their clients.

- A Chattanooga-based broker was disciplined by the National Association of Securities Dealers (NASD) for making unauthorized transactions, churning a customer's account with unsuitable recommendations and/or trades, and overstating the value of the account by $146,000.
- A Florida-based broker was fined $3.65 million for collecting over $1 million in purchase payments from customers and failing to invest them as directed. He also gave forged account statements to at least one customer; he told others that their funds were invested in mutual funds and so forth, when, in reality, he was using these funds for his own business activities.
- A Mississippi-based broker was censured, fined $757,500, and ordered to pay $101,525 in restitution. He sold stock out of one customer's account without authorization, forged the customer's signature on a check for the proceeds of almost $30,000, and then changed the customer's address in his firm's records so that they wouldn't get their statement. To top it all off, he then prepared a fictitious statement that didn't disclose the sale and sent it to the customer directly. He also withdrew $96,552 from other customers' accounts, converted the funds to his own use, changed their addresses in the firm's records, and told the customers they would only get statements once every six weeks.

For many, many more examples, check the records at www.sec.gov and www.nasdr.com. When you review the list, always bear in mind two things: (1) These represent the minority who got caught. There are many more who got away with it. (2) And just because they got caught doesn't mean investors got their money back. Since 1995, the SEC has recovered only $1.69 of every $10.00 owed to investors by swindlers and schemers.[13]

8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page 18

Even more troubling, however, are the many cases in which the entire firm is involved. Take IPOs, for example, often an irresistible target for manipulators. First, the brokerage firms let their preferred clients (i.e., large investors, politicians, or special VIPs to whom they owe a favor) buy in at the offering price, which most investors can rarely get. Within a day or two, the price of the new issue goes sky-high. Then the brokers and the preferred clients *flip* the stock. They get out with a windfall profit, and the little investor gets stuck with an inflated price. In short, while you are buying, they are selling. Sooner or later, the truth comes out. An analyst says, "Hey, this stock isn't worth half of what they say it's worth," or the company just starts losing big-time dollars. That's when the stock crashes and small investors take it on the chin, over and over again.

Robomatics, which was originally issued at $7⅞, promptly plunged to 50 cents! Crescent Airways, which came out at $5 a share, also wound up at 50 cents. North American Advance, issued at $9, fell to $1.50. Perhaps the most shocking IPO disaster was VA Linux, a software company that went public on December 9, 1999, at $30 a share and closed *that day* at $239.25 a share. Just over 15 months later, on March 23, 2001, it closed at $3.44. Thousands of investors lost up to 99 percent of their money, while the underwriting firms lined their pockets.

An even more common crime perpetrated by entire firms is penny stock manipulations. In a typical scheme, stock promoters assume control of a small, struggling company and all of its stock. Then they launch a huge public relations campaign, including promotional videos, press releases, and planted news stories, while greasing the hands of brokers, independent financial advisers, and newsletter editors. Next,

> [s]tarting at . . . pennies per share, it only takes a modicum of trading to push up the stock price of one of these small companies. Sometimes the same 1,000-share block of stock moves in a circle among a number of buyers who are in on the scheme, trading slightly higher each time it changes hands, to give the impression that the share price is rising. When the price rises to a suitable level, the promoters and other insiders dump their shares and leave the company's legitimate investors holding virtually worthless stock.[14]

8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page 19

With all this going on, you'd think someone would have warned you. Unfortunately . . . .

Warnings Fall on Deaf Ears, or Never See the Light of Day

The *Washington Post* conducted a survey of the industry and reported that stockbrokers regularly lie as a "pervasive and routine part of doing business." But the response from readers was muted. *Money* Magazine, CNN, *Smart Money,* and others ran special stories about broker dishonesty. Still not much response. I wrote a special report detailing the abuses, with the headlines "Wall Street Is Ripping You Off" and "Major Wall Street Firms Deliberately Deceive Investors with False Reports."[15] Some listened. For most, however, my message fell on deaf ears.

Even the National Endowment for Financial Education (NEFE) published a stinging 16-page attack on stockbrokers. The report described sales abuses that would make your hair curl! It told of brokerage firms that took away the sales staff's shoes every morning until they met their sales quotas with high-pressure sales campaigns to investors. It talked about rampant lying and abuse throughout the industry. And it named names. Major Wall Street firms were enraged. They threatened to sue. And the NEFE immediately pulled its report out of circulation.

Regulators also tried to warn investors in an effort to combat the cheating, lying, and outright stealing. They set up a series of complex rules by which brokers must abide. They added a host of programs for educating and reeducating brokers. And they ran massive sting operations to break up the largest stock scams. It's abundantly clear, though, that all of this was sorely inadequate. No matter what they did, the regulators ran up against the reality that *the system itself undermines the relationship between the broker and the individual investor.*

The brokerage firm is represented as a source of objective research. Unfortunately, as I told you earlier, it is primarily a source of marketing hype.

8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page 20

The individual brokers are represented as investment counselors. Unfortunately, they are often forced to be little more than salespeople, that is, pushing stocks that the company wants to sell.

In short, the firm and the company want you to *buy* precisely the same investments that they want to *sell* . . . and be rid of.

Therein lie the powerful and fundamental conflicts of interest that are continually tugging at the broker to act against the client's best interests. There are, naturally, many brokers who want to do right by their customers. However, to continually achieve that goal, they must ultimately sacrifice their own financial interests. For the broker, the whole truth and nothing but the truth could mean lower sales results, fewer bonuses, and even reduced chances for promotions.

That's why, despite the GAO's landmark study, despite massive efforts by the regulators to reign in the offenders, despite the broad publicity given to broker scams by the media, there was little movement toward change.

Regulators and Legislators Finally Begin to Wake Up, but the Horse Has Left the Barn

In the wake of the tech stock disaster of 2000 and 2001, a U.S. House committee held special hearings on the threats to the independence of Wall Street analysts. The SEC issued a stern warning to all investors using Wall Street advice. The NASD immediately followed with strict guidelines to brokers to disclose conflicts of interest.[16]

Each of these efforts deserves every bit of encouragement and applause. Unfortunately, the horse is already out of the barn–$5 trillion already lost. Moreover, all the investigations, warnings, and guidelines to date have largely failed to address the underlying cause of the abuses: that Wall Street's interests are in conflict with the interests of the investors.

It remains to be seen if substantive changes will be made. In any

8905_Weiss_01_f.qxd 12/20/01 1:38 PM Page 21

event, you can't wait for the market to recover, the regulators to act, or Wall Street to reform. You must take concrete steps now to protect yourself from further damage, start recouping from any recent losses, and grow your wealth in years to come.

If you were a victim of the Great Stock Market Scam, you can either crawl into a corner and hide, or you can bounce back fighting. You can either accept your fate meekly, or you can turn the tables on Wall Street and use this calamity to your great advantage. The latter course is your better choice. Read on for specific instructions.