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History Lesson

"The more things change, the more they stay the same"

By THOMAS G. DONLAN

How long have investors known that there's a lot of funny business on Wall Street in the IPO market? What a question. It's like asking how long have we known that gravity holds us on the earth, or how long have we known that red sky at morning means sailor take warning. And how long have investors known that Wall Street research isn't the last word on the value of stocks? It's like asking how long have we known that all that glitters is not gold, or that the real value of diamonds can be judged only by an expert.

How long have investors known that Wall Street's investment advisers and money managers aren't worth their salt until they have stayed employed through at least one entire market cycle, bull followed by bear followed by bull? It's like asking how long have we known that trees don't grow to the sky, or how long have we known that forests regenerate after devastating fires.

Wisdom of the Ages

The nice thing about a library is that good librarians don't throw out the book learning of past decades. The curious reader can wander through the shelves of the business section and find moldy volumes with everything an investor ought to have known about the New Economy and the Market Bubble.

The oldest book about Wall Street on our library shelf is "Men and Mysteries of Wall Street," a volume published in 1870 by James K. Medbery, of whom we know little except his street smarts:

"Wall Street sells what it has not in hand, but what it believes can be obtained at a lower price before the time of delivery....All the worst evils of stock manipulations have their birth and abiding-place in the secret counsels of the Rings and Cliques -- of that association of railway, steamship and telegraph directors, presidents and heavy shareholders who find it consonant with their consciences and their purses to water stock, pay dividends out of capital, to invent that anomalous feature in finance known as capitalized earnings, to utter unauthorized new stock; to do everything which will keep them outside of prison bars by means of shrewd lawyers and complaisant judges, if only in doing all this they can manage to make three dollars grow where but one grew before."

If footnotes are needed:

"Watering stock?" The practice of recording equity in excess of tangible assets, today seen as the creation and maintenance of "goodwill."

"Paying dividends out of capital?" Dividends these days are taxed heavily and therefore too lightly regarded, so corporate capital is now used to buy back a corporation's own stock.

"Capitalized earnings?" Nothing more than today's price-earnings ratio, by which a company's future prospects are built into current prices.

"Uttering unauthorized stock?" It would land a board in court today, so directors and officers now authorize vastly more stock than is outstanding. Then they issue, or "utter" in the old lingo, stock options, leaving to a later time the necessary creation of the stock that dilutes the equity of existing owners.

These concepts are so thoroughly built into today's calculations and finance textbooks that they have lost the capacity to shock that they had in 1870. And Wall Street in 1870 was no Forest Primeval. Stock-market operators back then used options to corner the entire capital of corporations so they could harvest every last dime from those who had bet the wrong way.

"In a perfect corner there is no limit, or rather the limit is the extreme verge of price at which it is prudent to force a stock," said Medbery, adding, with what passed for statesmanship on Wall Street, "It is clearly better to settle with a man at 150 than compel settlement at 200, thereby breaking him and receiving only 50 cents on a dollar."

In the years before Medbery published, he had observed corners on the Erie and several other railroads, and a corner on gold itself.

Medbery tells us everything we ever needed to know about brokers, also. The New York Stock Exchange was careful about its membership, but not too careful: "One motive for this exclusiveness was the honorable desire to preserve the integrity of their business. Dealing in values whereof much is unsubstantial, and in a class of trade where, in the opinion of a prejudiced public, a narrow margin of fact skirts a boundless space of fiction, [the members of the exchange] were justly urgent that the terra firma of capital and credit should be as solid as practicable. High above the instinct of safety, however, was the instinct of profit."

Summing up, Medbery declared, "The annals of American finance are not particularly exhilarating. The exhibition of fraud in high places, and of effrontery on the part of responsible managers bordering on the sublime, which has characterized the past few years, is not calculated to inspire over-confidence in the future."

From our perspective, 132 years into Medbery's future, we can only agree.

What's Old Is New

The newest book about Wall Street in our library is "Take on the Street: What Wall Street and Corporate America Don't Want You to Know [and] What You Can Do to Fight Back" (Pantheon Books, $24.95), by Arthur Levitt. The author is former chairman of the Securities and Exchange Commission, and, perhaps more importantly, a former broker. Now he's an investment banker with the Carlyle Group.

Echoing Medbery's caution on the instincts of safety and profit, we find this frank admission from Levitt, recalling his days as a young broker. "I embraced the craft of the broker, endeavoring to help my clients, but always mindful of how a buy or sell transaction might help our profits."

Levitt also points to himself, with more pride, as one of the first Wall Street leaders to give a speech favoring performance-based compensation, in 1972 while he was head of retail business at Shearson Hayden Stone. His firm, of course, didn't change its practices just because Levitt thought they were wrong. His partner Sandy Weill thought his speech was "ridiculous." This is the same Sandy Weill, now chairman of Citigroup, who is currently in the headlines because of allegations that he improperly influenced an analyst at Salomon Smith Barney to improve his ratings of AT&T so the firm could get more banking business.

Shearson's marketing manager Hardwicke Simmons said Levitt just didn't understand the business. This is the same Hardwicke Simmons who is chief executive of the Nasdaq Stock Market, scene of many of the worst corporate debacles in the New Economy.

As chairman of the Securities and Exchange Commission, Levitt tried again to talk Wall Street through to significant reforms in broker compensation, in auditing and accounting standards and their enforcement. As hard-headed as he was, he confesses in his book that he was playing poker with a weak hand.

Those who might have been affected by Levitt's proposals, whether brokers, exchanges, accountants, corporate CEOs or anybody else, knew they could visit sympathetic members of Congress, who would stand up for them and make Levitt and the SEC bend. He didn't have the political moxie to go up against big-foot Republican lawmakers supporting the accounting profession, such as Reps. Billy Tauzin of Louisiana, Tom Bliley of Virginia, and Michael Oxley of Ohio.

Needing More Than Muscle

By his own account, Levitt was unable to fix many of Wall Street's biggest problems, such as the conflict between auditing and consulting at major accounting firms, because the people he wanted to regulate went to Congress, and he wasn't politically intrepid enough to wrestle with leading congressmen. When the key congressmen threatened the SEC's budget, Levitt didn't have the courage to call their bluff. He just saved their letters to put in his book. Some people think of accountants as little wimpy guys with green eyeshades, but they were just too tough and too politically powerful, and they rolled Arthur Levitt.

If a chairman as strong-willed as Arthur Levitt could fail to meet his goals for the SEC, investors should be wary of ever putting much faith in the commission or its regulatory power. At any government agency, politics will always trump principle.

Fortunately, it's still the same old Wall Street that it was in 1870. The events that followed Levitt's service at the SEC -- the collapse of Enron, the accounting shenanigans at WorldCom, the alleged thievery at Adelphia and so on -- did much more to regulate the excesses of the market and to educate investors than all Levitt and the SEC could produce.

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