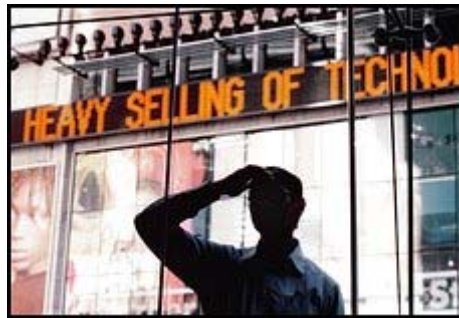


The Washington Post

Bubble: The Roots of the 90's Boom and Bust

First of Six Articles

In a Bubble Economy Recognition Comes Too Late In Euphoria, Key Players Looked Away Steven Pearlstein, *The Washington Post*, Sunday, November 10, 2002



A passerby looks in a window at the Nasdaq Stock Market on April 12, 2000, the day it lost 286.27 points -- and the great tech bust began. (File Photo/ Chris Hondros -- The Washington Post)

Mention the Bubble Economy and, for many Americans, it now conjures up images of shredded documents and half-built Houston mansions, depleted pension accounts and executives being led off in handcuffs. But it didn't start out that way.

Roughly from 1995 through the end of 2000, the Bubble Economy was known as the new economy, and nearly everyone thought it was a marvelous thing.

Billions of dollars poured in from all over the world from people hoping to get in on the ground floor of the Internet, a medium that held the promise of transforming not only the economy, but life as we knew it. Stock prices rose higher and faster than at any time in history, making the ups and downs of the Nasdaq Stock Market a national obsession.

Now, of course, we know it wasn't all real, and it certainly wasn't enduring. Twenty months after it tipped into recession, the economy is barely growing. Stock prices are back where they were four or five years ago. And nobody is sure how much of the revenue and profit growth during the bubble was real.

How could this have happened? Why did otherwise honest people resort to obfuscation, game-playing and outright fraud just to keep going? Where were the safeguards that were supposed to warn against the dangers and prevent the excesses?

This week, The Post will explore these questions in a series of stories that focuses on six individuals and companies at the center of the Bubble Economy. The theme running through all of them is that many of the key people involved in the economy got so caught up in the euphoria, so blinded by the financial rewards dangled in front of them, that they stopped doing their jobs -- or convinced themselves that the nature of their jobs had changed.

First and foremost were the corporate executives, the subject of today's installment, who began to focus more on managing their stock prices than managing their businesses. They were encouraged by pension and mutual fund managers who shed their roles as patient custodians of capital to make it big in the

quarterly rankings game. And they were egged on by a money culture that lionized CEOs who could reliably deliver quarter after quarter of double-digit earnings growth.

The list of culprits hardly ends there.

Near the front of the line were the corporate directors who grew so comfortable with the pay, perks and status that the bull market had conferred on them that they became even more quiescent than they had been before.

There were the accountants who set their sights on becoming strategic partners and advisers to the executives whose books they were auditing, forsaking their traditional role as nitpicky eyeshades hired to look out for the interest of shareholders.

And it was during this period that stock analysts began to think and act like investment bankers, investment bankers like venture capitalists and venture capitalists like masters of the financial universe.

"In all the euphoria of the bubble, the gatekeepers were so unwanted that even they began to see their roles as redundant," said John C. Coffee Jr., a corporate law expert at Columbia Law School. "They were paid handsomely to look the other way -- and many did."

A bit harder to explain is the acquiescence of the regulators who might have earned medals had they used their still-considerable powers to blow the whistle on some of the more egregious examples of corporate fraud that many sensed was going on. Ditto for business and financial reporters who, by and large, suspended their natural skepticism to join the cheerleading squad.

In these cases, it was not greed that was at play so much as an unwillingness to become the skunk at the economic lawn party -- the all-too-human desire not to be dismissed as an out-of-date crank who "doesn't get it" or called on the carpet by a congressional committee or network president who just got an earful from an angry corporate CEO.

If any one of these groups had acted the way they were supposed to and blown the whistle, it is likely the bubble would never have grown so big -- or perhaps never developed at all. But it is in the very nature of a bubble that the lapses are simultaneous and widespread.

"It was the perfect storm," said Nell Minow, a corporate reformer who heads the Corporate Library here in Washington. "A lot of things failed at once."

An Economic Mirage

Crucial to this system failure was the belief that because of globalization, deregulation or new technology the world had changed so much that the old rules need no longer apply. Suddenly bribes became incentive-based compensation, lies became aggressive accounting and conflicts of interest became "synergies." Little indiscretions and envelope-pushing by one company spawned little ones elsewhere -- and in time little ones gave way to bigger ones in places where the corporate culture was most accommodating.

"As long as everyone was making money hand over fist, people were willing to overlook things," said Richard Sylla, a financial historian at the Leonard N. Stern School of Business at New York University. "It was a good party. Everyone wanted to keep it going."

Of course, not everyone bought in to the mania. There were, as there always are, jeremiads warning that the prices were too high, the underlying assumptions ridiculous, the books cooked. And they weren't just from kooks. Detractors included respected investors and money managers such as Warren E. Buffett of Berkshire Hathaway Inc., hedge fund manager Julian H. Robertson Jr. of Tiger Management and Bill

Miller, who runs giant mutual fund Legg Mason Value Trust. Even Microsoft's Steve Ballmer said the software giant had become overpriced.

But during bubbles, people pay more attention to profits than to prophets.

What bubbles prove is that if enough people believe something to be true, they can will it to be true, at least for a while. A bubble is a collective economic mirage generated by otherwise savvy people who first con themselves and then con others -- legally, in most cases, but sometimes not. So widespread is the "buy-in" that even after the bubble bursts, the recognition that it was a bubble doesn't come in one moment of epiphany, but rather in a series of smaller, begrudging acknowledgements.

When the air began to be let out of the bubble in March 2000, for example, everyone said it was just the dot-coms that were the problem, a few thousand over-financed companies whose disappearance would hardly be noticed in a \$10 trillion economy. Then it was "just" telecoms, then "just" computer makers, and, oh, well, maybe the entire manufacturing sector, and so on, each line of defense eroding like the walls of a sand castle confronting the rising tide.

The reality is that in an investment bubble as big as this one, what begins in one or two sectors eventually spreads through the rest of the economy. Flush with cash pushed at them by investors, all those dot-commers and telecom executives not only bought computers and built office buildings -- the things picked up as "fixed investment" in the national income accounts -- they also used the invested cash to fly in airplanes, stay in hotels, retain investment bankers and consultants, take out ads in newspapers and magazines, and buy themselves fancy cars and vacation homes. In what became a frantic search to hire employees, they wound up creating shortages, pushing up wages in all corners of the labor market. And by paying exorbitantly to acquire other companies, they created a force that pulled up the price of all stocks.

Before long, it was impossible to tell where the Internet money stopped and the rest of the economy began. It had insinuated itself everywhere in the economy. And everywhere, people came to believe not only that the increased sales were real, but that their upward trajectory was assured.

Familiar Pattern

Bubbles don't develop at random. They generally require the presence of two crucial ingredients.

The first is investment capital -- and by the mid-1990s, the U.S. economy was awash in it.

This was partly the result of the democratization of finance in the past two decades, which has driven up the percentage of American households that own stock from less than a quarter to more than half at the height of the bubble. The investment surge also coincided with the arrival of the baby boom generation into that period of life when incomes are high and money starts getting saved for retirement. Much of that money ended up in stock mutual funds, which went from taking in about \$125 billion in new money in 1995 to \$300 billion in the peak year of 2000.

In addition to that domestic capital was a flood of foreign money from investors burned in the Asian financial meltdown or disillusioned by Europe's slow progress in deregulating its economy and reforming its labor markets. From 1995 to 2000, \$1.2 trillion more investment capital flowed into the United States than flowed out. Some of that money went directly into the stock and bond markets; but just as much came in the form of the direct purchase of American companies by foreign ones -- Daimler-Benz AG's purchase of Chrysler Corp., for example, or Vivendi SA's takeover of Seagram Co. Both types contributed significantly to the run-up in stock prices, in the process lowering the cost of capital for U.S. firms and stoking over-investment in new companies, plants and equipment.

The other crucial bubble ingredient was a new and economically transforming technology. The railroad, electricity, the automobile and the radio all spawned investment bubbles when first introduced, with each

bubble giving way to a market panic or crash -- and revelations of corporate fraud and misconduct. So, too, would the breakthroughs in computer software, hardware and telecommunications technology that would come together under the rubric of the Internet.

The pattern each time was about the same. With too much money chasing too few good investment opportunities, too many companies got started and too much capacity was added, driving prices down to unsustainable levels. In the end, virtually none of the long-term investors made money. In the case of the railroads, for example, so much was spent on duplicate tracks and excess rolling stock that it wasn't at least until the 20th century that the industry finally turned a collective profit. And in the case of the Internet, one need look no further than the 75 percent decline in the Nasdaq to understand that very little of the economic benefit of this new technology has flowed to any but the earliest investors.

In the end, according to J. Bradford DeLong, an economic historian at the University of California at Berkeley, it turns out that consumers are the big winners -- initially, consumers who enjoy the low prices that flow from the ruinous competition, but eventually, consumers who reap the benefit of lower prices and improved products and services that result when companies use new technology to operate more efficiently.

DeLong notes that it was cheap freight rates offered by the railroads that made possible Gustavus F. Swift's model for the modern meatpacking industry and the Sears national catalogue operation. Now, in ways that are just becoming clear, the Internet promises to revolutionize activities from auto sales and fashion design to education and entertainment.

Already, DeLong says, advances spurred by the computer and the Internet have boosted the economy's rate of productivity growth by 1.5 percentage points a year, beginning in 1995. Through the magic of compounding, that translates into close to a trillion dollars a year in higher living standards. Most of that, DeLong argues, has been widely distributed to American workers in the form of higher pay, to American consumers in the form of cheaper goods and services, and to American investors in industries largely outside of tech and telecom.

"The big benefits to these transforming technologies go to those who use them, not those who invest in them," DeLong said.

New technology, over-investment, economic boom, market crash, corporate scandal, recession -- in each bubble, the pattern is pretty much identical. That hardly means it's easy to predict bubbles, or to tell when you're in one.

After all, if people knew it was a bubble, it would never happen in the first place.

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A CEO's Lesson: What Goes Up . . . Telecom Company's Trajectory, Descent A Symbol of an Era

Michael Leahy, *The Washington Post*, Sunday, November 10, 2002.



Clark E. McLeod addresses employees and guests at the site of the McLeodUSA headquarters expansion in 1997. With an iconoclast's charisma, McLeod won admirers and investors who were drawn to his ambition, savvy and promise of integrity.

(File Photo/ L.w. Ward -- The Gazette)

Before their money vanished with their faith, Clark E. McLeod's investors could sometimes find him just by glancing skyward. It was spectacular to stand there on the edge of a cornfield, crane the neck and look up at his cream-colored jet hurtling by. A state-of-the-art Gulfstream G-5, with sleeper cabins and a flight attendant, it glinted in the sun, the \$39.5 million chariot of a CEO who had joined the ranks of American technology demigods.

A snapshot of an epoch: the great American ride, not long before the crash.

"He's up there," someone would say, and there would come gruff murmurs of awe from men seldom amazed by anything.

A self-made billionaire who had risen from hard days when he pattered around in a sputtering Volkswagen, McLeod seemed above them, somehow, and this they didn't mind -- in the way lucky people seldom resent a man they regard as a benefactor. McLeod's luck seemed to float down to his hometown, so even when he exercised stock options to the tune of about \$98 million in February 2000, who could begrudge him when middle-income investors in his company, McLeodUSA Inc., and other telecoms sometimes made \$50,000 in a day, and riches seemed to be their reward for simply believing? And he was one of their own, after all, a former schoolteacher who grew up just three miles away in the town of Marion, in the middle-class home of his educator parents.

Speed and ascent, ambition and acquisition: They were the paramount ethics during the 1990s in technology and telecommunications, where a titan's climb seemed limitless and his fall improbable, where no one had forecast the spiral coming. Up in the pantheon of American chief executives, McLeod pushed hard, and harder still -- too fast, as he later acknowledged -- and on borrowed wings at that, far beyond a safe and rational point.

Competing in the Midwest and Rocky Mountain region against the established Baby Bell titans, McLeodUSA had gained an impressive 20 to 30 percent market share of local phone business in several key markets, fueling optimism reflected in its soaring revenue, acquisitions and aspirations. By early 2000, offering local, long-distance, data and Internet access, the company had grown to 10,700 employees, a fivefold increase in four years, as it headed toward becoming a 25-state operation and eventually a national network.

At Clearwater Farm, where McLeod and his wife, Mary, raised thoroughbred dressage horses, cars stopped and dreamers furtively spilled out to stare, able to see the horses roaming in meadows near McLeod's recently built equestrian arena, with exotic Teflon-coated, dust-free gravel. Inside, his friends reported with awe, a mirror nearly the length of a football field offered a rider a flattering view of himself atop his steed.

Those not fortunate enough to be among his official visitors queued up nearby to glimpse slivers of his house. It sat behind white pines and evergreens he had ordered uprooted and trucked in from out of state, only heightening the sense of a great man's remove. Tucked out of sight were man-made ponds he had stocked with bass and koi, near a 20-foot waterfall. He lived like Gatsby.

A few called it garish, but many didn't mind any of it, not the ponds or his stock options -- not then, anyway, not with their own portfolios so fat. "You thought with Clark, well, here's a real chance to change things in a big way for yourself," recalled Doug Bean, a Cedar Rapids real estate agent and investor. A new paper millionaire who had decided that his stock gains in McLeodUSA could fund his retirement, Bean happily sought out McLeod at the Cedar Rapids Country Club, congratulating him on his vision and helmsmanship.

Hold on to your stock, McLeod told anyone who asked, and when the price began dropping slightly in early 2001, Bean did just that, his faith in McLeod's talents absolute even as the company's debts ballooned and worries escalated.

Only later, after the company's investment money ran dry and the resulting panic took Bean's stock down from its \$35-per-share, post-split high of 2000 to less than \$1 a share, did he and others even begin to think about the options McLeod had exercised in 2000, a windfall shared in by the company's vice chairman, Richard A. Lumpkin, who took home about \$119 million when he sold his. There was always this moral relativism at work in the bubble economy, first during the promiscuity of the boom and later in the rage and piety of the bust. Stock options and other rewards widely regarded in good times as acceptable, a CEO's kingly entitlements, were suddenly seen as disreputable when stock in a company like McLeod's tanked.

In October 2001, McLeodUSA laid off about 1,600 employees, 400 of them in the Cedar Rapids area. But company officials assured everyone that rumors of financial calamity were groundless, assuaging jittery investors, even buoying the faithful, like Bean, who responded by buying more stock. Its price rose, to 77 cents, before quickly sinking.

By early this year, McLeod's wealth looked like spoils to many ruined investors. By then, McLeodUSA was in bankruptcy, the stock was worth 18 cents a share and the 55-year-old McLeod had retired to Clearwater Farm.

Since then, the company has emerged from Chapter 11 protection from its creditors, with \$3 billion of its debt wiped out. McLeodUSA officials have argued that they should be individually exempt from liability lawsuits filed by shareholders, to which a federal judge answered no. Shareholders could go after McLeod if they wished.

The lawsuits charged that McLeod had not said what needed to be said when it was not easy to say it -- that he had failed to be candid when the company began careening, and that when he did speak, he and others materially misrepresented the company's ills.

McLeod has not spoken publicly for months, and McLeodUSA officials refused to communicate messages to him. It was left to his 84-year-old mother, Jane McLeod, to defend her son. "Clark's always had integrity," she said.

In 2000, when he was riding high, McLeod talked about the virtues required of a great CEO in a self-published book called "This Way Up." Integrity was high on his list, he wrote, but it was also the value that people "fail at most." He pledged to lead the way to success.

"Integrity is doing what's right. Always. . . . Integrity requires saying what needs to be said, when it needs to be said, even when it's not easy to say it."

Sipping a glass of Beaujolais recently at a Cedar Rapids restaurant, Doug Bean carefully considered the man he had once congratulated in the locker room. When things were at their sunniest, when his \$400,000 in McLeodUSA stock peaked in value at a million-four, Bean left Cedar Rapids in favor of easy living with his wife in Florida. His stock is now worth \$8,000, and Bean is back in real estate, working part time, as is his wife, who starts her day at 5:30 a.m. in a bakery shop.

But with his silver mustache and neatly coiffed, bushy gray hair, Bean still looks like a well-heeled 58-year-old right off the cover of *Town & Country*, with the wine and the natty, sheer cream polo shirt.

"You entrust your money to another man and a company, well, you can do the researching, but some of that takes faith," he said softly. "I guess I wanted to believe."

'He Could Really Sell You'

McLeod's story radiated ambition and tenacity: the restless schoolteacher who, 25 years ago, was bagging groceries on the side to supplement his \$6,000 annual income, then chucked it to become in time an unlikely telecommunications entrepreneur. He led his first company, TeleconnectUSA Co., through a merger in the late 1980s to create TelecomUSA Inc., the fourth-largest long-distance company, before it was sold to rival MCI Communications Corp. for \$1.25 billion in 1990. His eponymous company, founded in 1991, appeared to be his second major telecommunications triumph, and McLeodUSA stock jumped from \$20 to \$25 a share on its first day of trading in 1996. Buying was frenzied. "We didn't have to say anything to pump [the stock] up," a Cedar Rapids broker recalled.

Admirers believed McLeod had astutely taken advantage of what would be a new wave of deregulation in telecommunications, taking on the Baby Bells by contracting to use Bell equipment and then selling the phone service for less than the Bells would, presumably ensuring a steady, if smaller, margin of profit.

A similar strategy had worked for him in the '80s, when his long-distance Teleconnect had seized upon the breakup of AT&T Corp. to buy lines and undercut rivals. But this time, in the '90s, there would be more competition, not only from the Bells but from other telecom upstarts, known, like McLeodUSA, as CLECs - - competitive local exchange carriers -- that would compete in some instances for the same market share with McLeodUSA against the incumbent Bells.

McLeod's ambition dwarfed that of most of his rivals and gave him an early advantage. Determined to build his own network to handle not only phone calls but also data services, video transmission and Internet connections, he had his company embark on laying and acquiring the necessary fiber-optic cable -- nearly 31,000 miles' worth across 25 states. In the meantime, he looked to buy companies with their own fiber-optic systems and data networks, evidence of his commitment to expansion, McLeod officials told pleased investors.

He was usually low-key, even shy to the point of being aloof, in many social settings. "But when he started talking to 600 people at a business meeting about telecoms, he could hold them good," recalled Bean. "He could really sell you. And he had the city's respect."

Wealth alone inspires envy, but wealth that bears others aloft makes a man a patriarch in a small city like Cedar Rapids, and this, McLeod had become. About 8,000 of the locals worked for him. He gave millions to charities and, still dabbling in education, opened his own school in 1993, the McLeod Academy, which closed five years later because of lack of revenue.

Long-faced, with his thinning gray hair slicked back, he had prominent ears, some noted, which only heightened the sense that he was preternaturally attentive and caring. Around the academy, he talked about his "30,000-foot view" of things, the sense that a man could gaze down on the world, if only in his mind, and envision the next great idea below. His book included a photo of himself posing as a mountain climber, accompanied by cartoons of a climber leading his charges up a metaphorical Mount Everest. Heights represented inspiration to him. Thinking was free-form. You needed to be a little bit of an iconoclast, some of his admirers thought, to take on the Bells.

One day, aboard one of his company's planes, he blurted, apropos of nothing, "Where is Kilimanjaro?"

Dream Turned Nightmare

The believers included McLeod's old teaching colleague Dick Ramsey, now a 62-year-old real estate agent who invested most of his savings in McLeod stock, envisioning a tidy twilight, and has lost more than \$580,000 of the approximately \$600,000 he started with.

A man who frequently speaks of himself in the third person, who views his frailties from a wry distance, Ramsey partly blamed himself. "Ramsey got in too deep; Rambo thought he was set," he said, shrugging.

Ramsey wore a loose-fitting, black-and-gold Hawaiian shirt, a sartorial symbol of the good times. He remembered wearing a Hawaiian shirt on another day, when his broker told him his McLeod stock had fallen badly. "My mind said sell," he recalled, "but my body said no. Because Ramsey still believed in Clark."

When, after all, had McLeod ever failed at anything? Ramsey asked himself, remembering those days when they had taken their breaks together at the Franklin Middle School alongside a hot radiator with chipped white paint. "I don't think either Clark or Rams could've seen this coming 20 years ago," he said, laughing wanly.

Leaving the school to do stints selling radio advertising, Muzak-like systems and telephone equipment, McLeod told people he wanted to run a business of his own where he controlled the numbers.

By the time he had formed McLeodUSA, he excelled at business numbers, an art form in the speculative sector of telecoms, where as many interpretations -- and thus explanations -- existed for a company's fiscal ills as an imaginative man nimble with figures could sell his investors on.

EBITDA (pronounced ee-bit-da) -- earnings before interest, taxes, depreciation and amortization -- was one of his company's favorites, an index of growth and operational efficiency. It was cherished across the telecom sector, particularly by telecom stock analysts who saw "positive EBITDA" as a harbinger of lofty days ahead for a company. But EBITDA never told the full story, because it stopped short of accounting for many capital expenditures and stubborn debt. EBITDA had nothing to do with profitability, or lack of it.

For the time being, profitability was necessarily beside the point for McLeodUSA, particularly since the company hadn't made money since going public in 1996. The competition among rival telecoms to build broadband networks capable of ushering in high-speed Internet access required tremendous investment in fiber-optics and new personnel -- billions of dollars, in McLeod's case -- which meant taking on substantial debt. McLeod acted as if he had no other choice. "If you're going to be a real competitor to the Bell companies, you need to get [market] share," he said.

Winning market share and acquiring networks became essential for sustaining analyst support and investor confidence. A company's stock price could not rise, otherwise. Debt was viewed less as a liability in the late '90s than as growth's instrument, a necessary precondition for building the networks and subscriber bases that, theoretically, would lead to extraordinary profitability later. The outlook fueled short-term stock gains but courted long-term disaster, especially if patience with debt, and love of EBITDA, were to wane.

For a long time it looked like that day would never come. "Our EBITDA number came in above expectations for the first quarter," McLeod confidently said in a taped interview with Bloomberg News in April 2000, three months after his company spent \$2.1 billion buying Splitrock Services Inc. The acquisition gave McLeod a large data network -- a "broadband platform" -- that put his company closer, he proclaimed, to its goal of expanding into a national operation. Within another three months, he would finish a \$532 million acquisition of CapRock Communications Corp., another broadband provider.

But the Splitrock numbers in particular raised questions about whether, at \$2.1 billion, the executive had bitten off too much. He responded by citing more positive EBITDA, declaring with verve that new revenue projections were strikingly higher.

He spoke in his slow, resonantly authoritative Midwestern voice -- like listening to an oracle, as Dick Ramsey and others observed. In retrospect, his declarations had an emperor-has-no-clothes quality. But on that day, the financial analysts, investors and venture capitalists were still deeply in love with EBITDA and growth; they were smitten suitors who could not see the flaws in the object of their infatuation -- especially all that red.

Doubt, when it arose at all, was veiled. In a pipey, innocent voice, a reporter asked the simplest of all the day's queries, but one seldom posed to a telecom executive in the 1990s.

"When will you break even?"

There was something childlike and electric about the moment. The nakedness of McLeod's dilemma revealed itself, if only for an instant. No number could serve as a big enough fig leaf. The new emperor of telecom took his time. His voice softened. He kept his answer short and unresponsive. "We are not going to put out specific projections or bottom-line numbers, and we wouldn't care to do that today," he said.

The spending craze in the telecom market continued unabated, fueled by gushers of investment from the many Doug Beans. "I thought everything was going well," Bean remembers. "My stock was way up, and all the analysts who mattered said the investment money would keep coming and coming. It was like a dream."

Hitting a Brick Wall

Throughout the winter of 1999 and spring of 2000, McLeodUSA stock climbed, tripling its price from the year before. The analysts at big brokerage houses were enamored. Citing the company's acquisition of Splitrock, David Heger of A.G. Edwards & Sons Inc. gave McLeodUSA stock a favorable "buy" rating.

Any worries about the debt load borne by McLeod's buying spree had been allayed by reports of new venture capital streaming in, money that meant the company would be able to expand its growing network. James Henry of Bear Stearns & Co., another analyst giving McLeodUSA stock a "buy" rating, said the company had demonstrated its "free flow access to capital markets."

Free flow. No single phrase said more about the headiness of the times. "The economy was hot and the banks were killing each other trying to loan [McLeod] money," said an ally of Theodore J. Forstmann, a New York venture capitalist and buyout specialist whose firm led a mammoth investment in McLeodUSA in 1999.

No one understood this better, or reveled in it more, than McLeod himself. With his confidence at its peak, he proudly wrote about his effortless money chase in "This Way Up," which he finished in December 1999 by having his signature printed with a flourish in the introduction of the book -- *Clark* . . . followed not by the scrawl of his last name but by a scribbled arrow jutting up, way up, a kind of hieroglyphic signaling destiny and the heights he urged his acolytes toward.

A colleague had coined an acronym that McLeod said defined his values, and he evoked it in talks to employees and the local business groups: GRIP. He used the G, R and P to talk about growth, relationships and passion. The I stood for integrity.

He told readers that nothing stood in their way, his words a paean to the free-flow times.

"Could we come up with the money we needed to buy the newest technology and put it to work?" he wrote. "Absolutely. Would finding the dollars required be a problem? No way! Thanks to a strong economy, there had never, *ever* been a financial market like what we were experiencing. . . . Whether it was \$1 million, \$1 billion or \$10 billion, we could get all the money we wanted."

Soon, each dollar of equity he raised from shareholders was more than offset by \$3 to \$4 of debt -- most in high-yield-bond debt, but tens of millions in bank notes, which did not include hundreds of millions in annual interest payments owed. He bobbed in his own Red Sea. About two years later, when his company would file for bankruptcy protection, its debt would hit \$4.57 billion. But on his best days, McLeod always found the money, as with the Forstmann investment.

McLeod "was kind of blah when you met him," a Forstmann colleague recalled. "But when he made a presentation, his eyes lit up. Teddy was wooed by Clark's command of the telecom business."

In the first of several investments, the firm of Forstmann Little & Co. bought a 12 percent stake in McLeodUSA, a merging of Theodore Forstmann's instinct and Clark McLeod's need. "He looked me in the eye," McLeod later recalled, "and said, 'How much funding do you need to execute on your existing plan?'"

"A billion dollars," McLeod answered.

"That's what we want to put into the company," Forstmann said, and it was done.

With news of Forstmann's intervention and analysts' delight, the stock, heading toward its all-time, post-split high, climbed another dollar a share to \$32.75.

No assessment of the company at that time left a greater impression on Bean than that of the star telecom analyst of Salomon Smith Barney Inc., Jack Grubman, currently under investigation by both federal and New York state authorities for writing flattering reports of McLeodUSA, WorldCom Inc. and several other Salomon investment-banking clients headed toward fiscal catastrophe.

"People cited Grubman as a big authority," Bean remembers, "and I really paid attention. I remember this one teleconference when I could hear this voice on the phone say, 'This is Jack Grubman from Salomon.' People talked about him on TV. *Jack Grubman*. And then he said to the McLeod [officials], 'Congratulations, guys, on a great quarter. Nice to see a company that meets its promises.' You knew that if Grubman said something good, that was good" for the stock price.

Salomon's kindnesses to McLeod, documented in a 1999 internal Salomon memorandum obtained by congressional investigators, included giving him what it offered to WorldCom's former chief executive, Bernard J. Ebbers, and other prominent corporate executives: the first opportunity to buy shares in initial public offerings of limited, highly prized technology stocks, a favor tantamount to free money. McLeod took advantage by receiving shares in Rhythms NetConnections Inc., which opened at \$21 per share in April 1999 and hit \$93 in a week before heading toward bankruptcy.

In early 2002, with his credibility in tatters, Grubman left Salomon.

By then the investment spigots had run dry and McLeodUSA was in ruins. "Beyond 2000, a lot of dot-coms had failed; it was a bad time for tech," observed a former telecom analyst who once enthusiastically

trumpeted McLeodUSA. "The market wasn't ready for any more investment. . . . EBITDA had made a few telecoms popular for years. But none was *net* positive. Suddenly debt was a big consideration, capital was harder to get and people started screaming, 'We want profitability.' If McLeod made a mistake, it was that he didn't see it coming; he ran right smack into a brick wall. . . . By midyear [2001], you could see he and the company were done."

Not everyone did, actually. Even as the stock dropped steadily, McLeod officials steadfastly preached optimism. Listening carefully, Bean resorted to an old investor's gambit: He would buy as the stock went down, ready to reap the profits once the stock climbed. In February he bought 1,000 shares at about \$14, and when the stock slid to about \$9 in April, he bought 1,000 more. He bought 500 shares at about \$7 in late spring and 1,500 at \$1.75 in August.

By then, even McLeod acknowledged that the company had spent too much. "We were going faster than was prudent," he said.

The value of Bean's McLeodUSA stock was down to \$40,000, roughly 10 percent of what he'd invested. His Florida dream was over. He despaired that he had lost too much to give up and altogether sell his shares, deciding to hang in while Forstmann increased his firm's investment and took a larger role in the company. It was like trying not to drown by staying on the Titanic.

In early October 2001, the announcement came during a teleconference that 15 percent of company employees had lost their jobs. The company, said officials, would abandon McLeod's plan to build a national network.

In what many listeners regarded as a swipe at the vision of the company's leader, McLeodUSA's new chief operating officer, Chris A. Davis -- who had helped preside over a successful reorganization of the ailing Gulfstream Aeronautics Corp. for Forstmann and would later become McLeodUSA's chairman and chief executive -- reported that McLeodUSA suffered from "operational inefficiencies." Privately, a pair of Forstmann's colleagues later said that McLeod had overspent. McLeod remained as chairman for the time being, but the teleconference spelled his end as the leader.

'It's All Gone'

Bean had been listening carefully for weeks, particularly when McLeodUSA's Stephen C. Gray, denying rumors of bankruptcy, confidently repeated that the company had the cash to carry on through 2003.

Sitting at home, Bean thought, what could be better news? Relieved, he logged on to the Internet, posting a message on Yahoo that Gray's assurances meant the company remained intact, with McLeodUSA stock certain to rise. People should buy, he urged.

People did buy, and the stock climbed, but only briefly, before bankruptcy struck.

In April, McLeod announced his "retirement" from the company he founded, looking drawn and forlorn as he stood next to Forstmann, whose firm had taken 58 percent voting control of the company.

The once stoic people around Cedar Rapids started talking, bitterly: A grandmother complained that the tens of thousands she'd invested for her grandchildren's education was gone; a once heavily invested McLeod employee lost a house, settling into a trailer. "One morning the realization comes it's all gone," Bean said, "and that's a big hill to climb."

He felt betrayed. "I believe we were being misled by McLeod people, especially during [2001]," he said, wondering why McLeod did not or could not rein in colleagues when they fervently denied the company's ills. "I don't expect people to say, 'We're in trouble.' But I do expect them *not* to say 'We're *not* in trouble' if there is trouble. Don't tell me you're going to be funded if you're gonna be bankrupt in a couple of months.

Somewhere along the line someone like Clark had to know that what they were putting out was not true. Maybe there's a moral obligation not to just save your own skin. People got greedy. Maybe I got a little greedy, too."

His mustache twitched. He didn't want people to think his existence was dire, given he still took off Wednesdays and Thursdays to fish and golf. After insisting he'd never invest in McLeodUSA again, he recently bought some of its stock on the cheap, at 54 cents a share. Thinking of the company's former leader, he confessed, wincing: "If Clark started up another company, I'd probably be tempted -- because maybe I'd hate to miss out on one more chance. You know a guy like Clark can't sit around. . . . I wonder what he's doing."

What McLeod mostly does these days is maintain a low profile and keep moving, part of the new American Diaspora -- that trail of failed and ousted CEOs pondering their next moves. At McLeod's request, his old company no longer distributes or sells his book.

Neighbors report they have seen him walking alone around Clearwater Farm, lingering in meadows where the grass nowadays sometimes looks higher, leaving them to wonder whether he is cutting back on mowing and maintenance.

"He's still busy," his mother said. "But things are complicated now."

Few around Cedar Rapids express sympathy for him, some privately wishing that he hurt more. There are the lawsuits, but the fall from grace is worse. His reputation took a further hit with the news that New York Attorney General Eliot L. Spitzer has sued him for his IPO gains from his controversial relationship with Salomon and Grubman.

His messes appear likely to grow: A former McLeod salesman, ready to testify in the shareholders' suits, has alleged that McLeodUSA employees created fictitious sales orders to bolster revenue statements, with a former sales manager in Illinois charging in an interview that immediate superiors instructed him to double-bill and back-date orders.

"He's fallen from the pedestal," Bean said. The paper losses of the former golden boy have taken him off Forbes's "wealthiest" list, reducing him to just another mega-millionaire. The Gulfstream jet has vanished, McLeod quietly taking his three-quarters share of the sale.

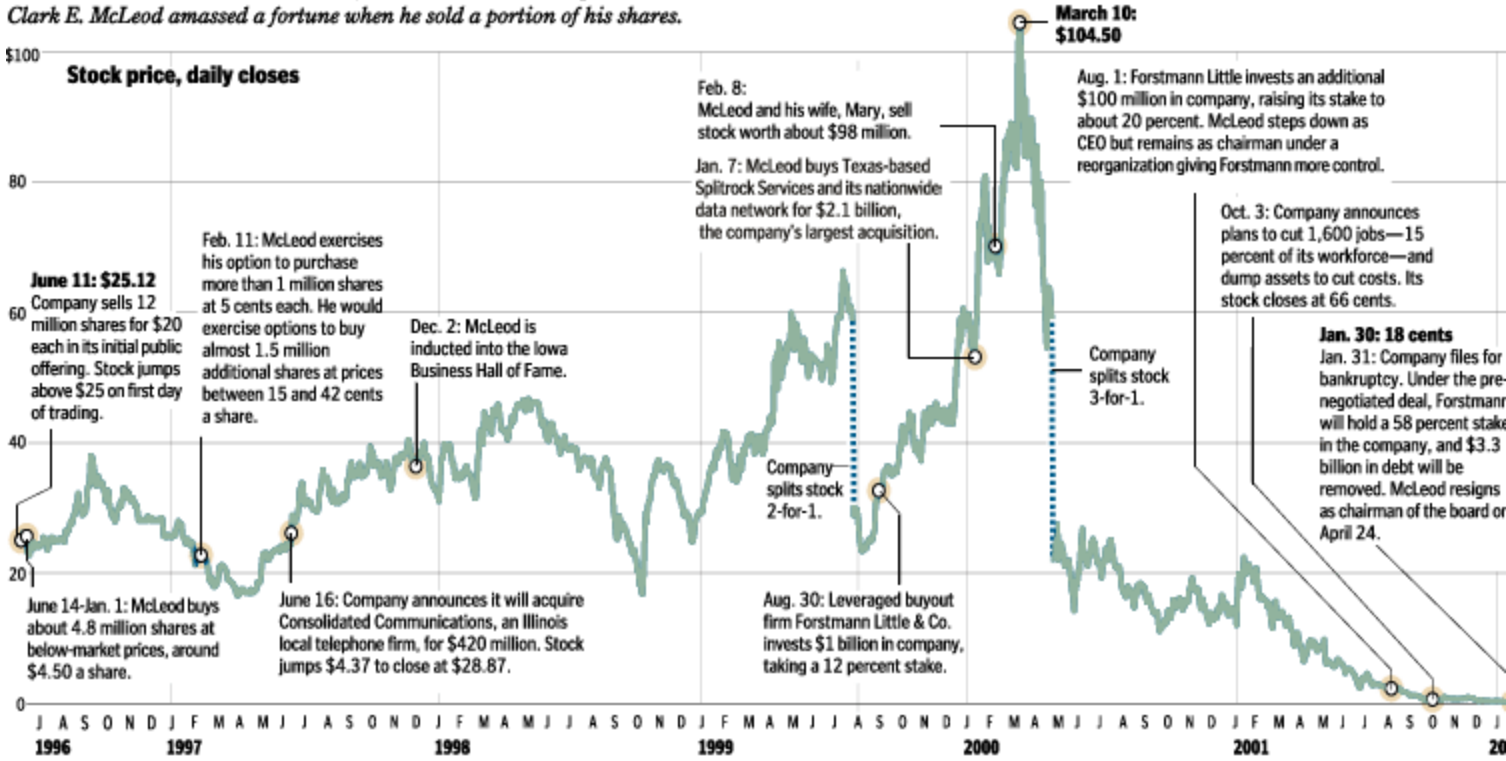
McLeod never realized, say his friends, that the language of the business had changed -- that "growth" and EBITDA had lost their dazzle, that stock options now looked to some like innovative looting. The faith of the many Doug Beans succumbed around the same time the stock price had sunk below a half-dollar. "I'm not sure if Clark saw it all coming," Bean said, genuinely saddened. Like many of his telecom brethren, McLeod saw it all too late, at which point, his company no longer belonged to him -- by which time, in the cornfields, the once entranced stopped looking up for a blur.

Staff researcher Richard Drezen contributed to this report.

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McLeod's Rise and Fall

McLeodUSA, founded in 1991 to provide local and long-distance telephone and Internet services in the West, rode the bubble after it sold shares to the public in 1996. Founder Clark E. McLeod amassed a fortune when he sold a portion of his shares.



SOURCE: Bloomberg News, Post research NOTE: Historical stock prices not adjusted for splits.

THE WASHINGTON POST

The CEOs: From Heroes to Villains?

Economic historians divide the rise of modern American business into three phases.

First came Entrepreneurial Capitalism, when the leading companies were run by charismatic, often dictatorial founders—men like Henry Ford and Andrew Carnegie. The 1950s ushered in the era of Managerial Capitalism, with large corporations run according to scientific principles by teams of highly trained and largely interchangeable executives.

Finally, the 1980s introduced Shareholder Capitalism and with it the era of the all-powerful chief executive, whose

interests were tightly aligned with those of shareholders through compensation based on massive grants of stock and stock options. "CEO" entered the common lexicon, and business leaders began to be treated like rock stars and sports heroes by an investing public that celebrated their single-minded focus on boosting the stock price. It was an arrangement perfectly suited to creating and sustaining a bubble—and turning those heroes into villains.

—Steven Pearlstein



Joseph F. Bernardino
Arthur Andersen
Presided over the implosion of one of the world's largest accounting firms amid accusations that it cared more about collecting lucrative fees than informing investors about Enron's financial shenanigans.



Albert J. Dunlap
Sunbeam
"Chainsaw Al" got his comeuppance when he paid more than \$15 million to settle fraud charges and promised to never again darken the door of a corporate suite as CEO.



Bernard J. Ebbers
WorldCom
Disgraced and \$400 million in debt to the company he once dominated, Ebbers was forced out in April and is now under investigation for the biggest accounting fraud in history.



Martin L. Grass
Rite Aid
His indictment in June on multiple counts of conspiracy and accounting fraud portrayed him as a kind of corporate thug: destroying evidence, creating phony documents, paying hush money.



L. Dennis Kozlowski
Tyco
Tax-evasion charges were just the beginning. Now prosecutors allege a wholesale looting of the company he ran. Did shareholders pay for a \$6,000 shower curtain?



Kenneth L. Lay
Enron
Would Enron still be alive had he acted differently when he was warned in August 2001 that his company could "implode in a wave of accounting scandals"?



John J. Rigas
Adelphia Communications
With \$2.3 billion in loans from the company he founded, Rigas and his family financed a lavish lifestyle, prosecutors allege in their indictment on multiple counts of fraud and conspiracy.



Michael J. Saylor
MicroStrategy
When he became one of the first CEOs to settle accounting fraud charges, Saylor's hype about his company "purging ignorance from the planet" symbolized the bubble's excesses.



Martha Stewart
Martha Stewart Living Omnimedia
What did she know when she sold \$230,000 worth of shares in ImClone, the company run by her pal Sam Waksal, the day before the stock tanked? Not a thing, she says.



Samuel D. Waksal
ImClone Systems
Tipped off to news that would trash his company's stock, he raced to sell before it became public knowledge—implicating his father, his daughter and perhaps others in the process.



Jack Welch
General Electric
His stellar reputation was tarnished when his messy divorce battle revealed the imperial life he led in retirement—largely paid for by current GE shareholders.

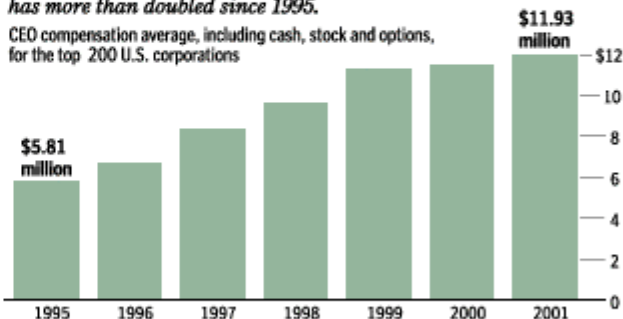


Gary Winnick
Global Crossing
His employees lost their retirement savings when his company went bust. He pledged \$25 million to help them—about 3 percent of the \$750 million he grossed selling company stock.

Twice the Price

The average compensation for chief executives at large U.S. companies has more than doubled since 1995.

CEO compensation average, including cash, stock and options, for the top 200 U.S. corporations



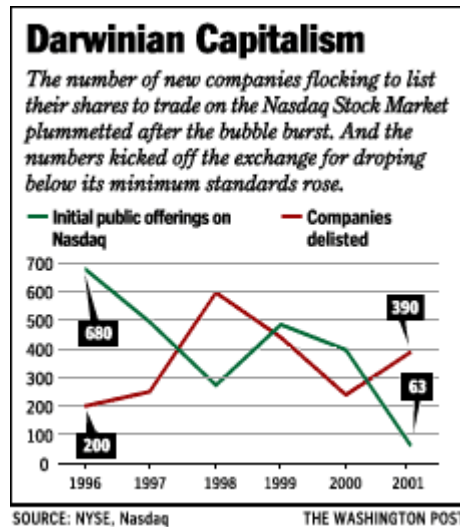
SOURCE: Pearl Meyer & Partners

Second of Six Articles

Nasdaq 'Casino' Had Few Safeguards

Zarb Says Markets Did All They Could

Paul Farhi, *The Washington Post*, Monday, November 11, 2002.



It was an auspicious day, in a most auspicious year. On Dec. 28, 1999, Frank G. Zarb, the chairman and chief executive of the Nasdaq Stock Market, stood beside New York Mayor Rudolph W. Giuliani in Times Square and threw a ceremonial switch. All at once, a giant video display, \$37 million in the making, began pulsing, crawling, kaleidoscoping.

It was the debut of the Nasdaq's MarketSite, an eye-popping electronic messenger bearing the news of rising stock prices in lights seven stories high. "This is kind of Main Street coming to Wall Street and not the other way around," Zarb declared that day. "It truly is a people's place."

No matter that MarketSite was a glitzy illusion, a sort of capitalist Potemkin village. There was no actual stock market at this site; no trading of any kind took place there. Its primary purpose was to serve as a sparkly TV backdrop for the financial news networks feeding America's new obsession with stocks. In essence, the massive edifice had been contrived by the Nasdaq's marketing department as an elaborate advertisement.

In all its gaudy glory, the pulsating exterior might have been mistaken for something else: a casino.

To many investors, it wasn't a specious comparison. No stock market in history climbed as fast as Nasdaq did from 1997 to early 2000 -- and almost none took away the winnings as quickly. In 1999 alone, the average Nasdaq stock more than tripled in value. Since the peak in March 2000, Nasdaq's 3,800 listed companies have lost about 75 percent of their value, bottoming to a six-year low in October. The Dow Jones industrial average lost only slightly more during the same period following the crash of 1929.

Nasdaq's top officers cite the usual culprits in explaining the market bubble: low interest rates, cheap and plentiful investment capital, optimism about the post-Cold War world. Also, they say, investors came to believe that an increasingly popular technology, the Internet, was about to change the world. Now retired, Zarb calls the central problem "an investor greed mentality."

But such overviews sidestep another contributing factor: the Nasdaq itself. By its own mandate, the Nasdaq encouraged and enabled thousands of small, highly risky companies to list their shares on the market. Many of these -- primarily dot-coms, but representing other fields as well -- had few hard assets,

irregular or nonexistent earnings and unproven management. With almost shocking frequency, they also had -- usually by their own admission -- questionable accounting.

As these chancy stocks crowded the market, they sailed straight into the speculative frenzy, driving the market to its manic heights.

Some of the Nasdaq's new listings would survive and thrive -- the Amazon.coms, eBays and Qualcomms. But many were merely Roman candles, burning brightly and colorfully for a few moments before flaming out. The shooting stars included Value America Inc., a now-defunct Internet department store, and Pets.com Inc., which raised \$82.5 million in 2000 in its initial public offering on the Nasdaq, only to announce it was going out of business 10 months later.

The Nasdaq's creators and overseers -- the National Association of Securities Dealers, now known simply as the NASD -- were well aware of the perilous heights the market was attaining. As early as mid-1998, officials began discussing how -- and if -- to take some of the air out of the inflating bubble. The Nasdaq would eventually issue a series of memos, warning investors and trading firms about the risks of "day trading," "margin" buying (the purchasing of stocks with borrowed funds) and stock volatility.

But stronger medicine never arrived. The Nasdaq declined to raise its listing standards to stem the flood of shaky dot-com stocks on the market. It discussed, but never acted on, internal suggestions that it raise its margin requirements, which might have dampened some of the most speculative buying.

As for the accounting problems, the Nasdaq churned right by them; to this day, only a tiny minority of companies have been disciplined by the Nasdaq for spurious accounting.

Today, Zarb gives the NASD better than passing grades for its efforts during the bubble years. "In my opinion, the markets did everything they could, knowing what they did," he says. "Could we learn from what happened? I think so. But when you're in the middle of it, it's impossible to see the future."

"Whenever you have an autopsy like this," he adds, "everyone wants to blame everyone."

In fact, the Nasdaq had good reason not to spoil its own party: It was enriched by the bubble, too. The Nasdaq, a nonprofit organization owned by its member trading firms, collects fees for processing trades and for listing a company's stock. As trading volume soared during the boom year of 1999, and as a parade of new dot-coms made their way onto the market, the Nasdaq's revenue hit a record \$1.2 billion.

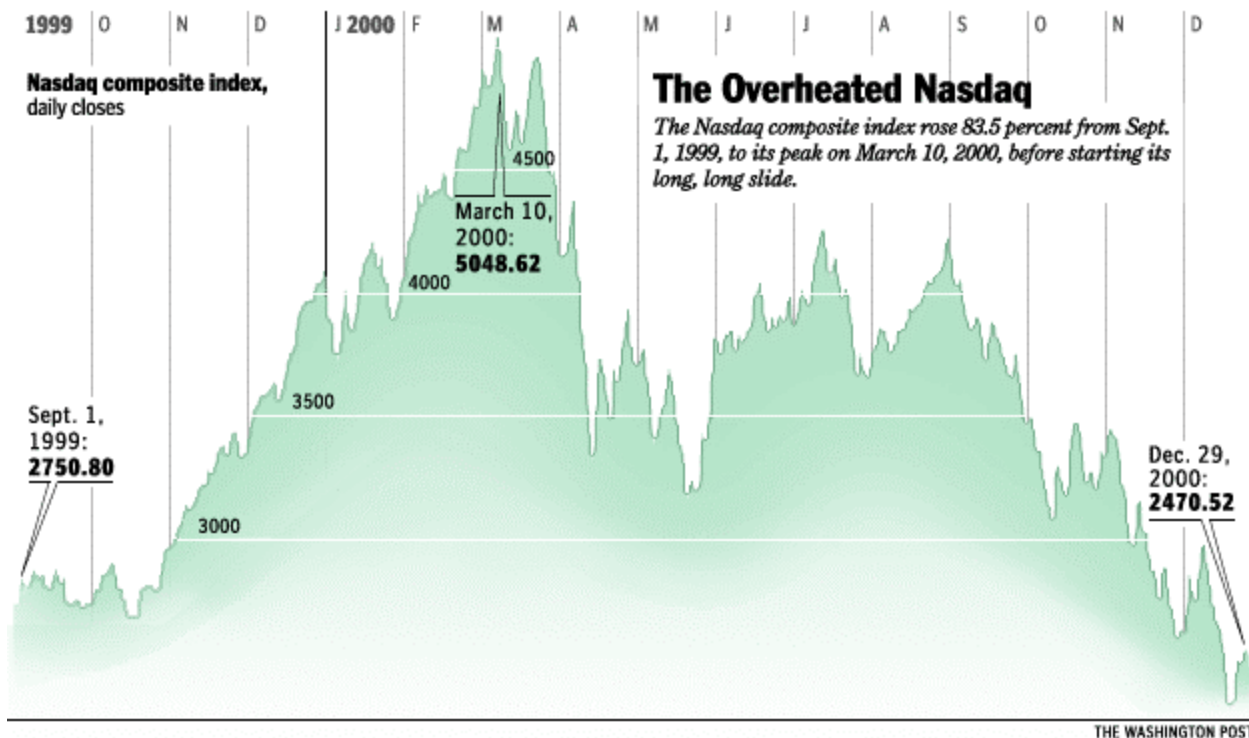
It was enough to make people believe the slogan the Nasdaq adopted and broadcast via a multimillion-dollar TV campaign: "The market for the next 100 years."

Cheap, Easy and Risky

There were, quite literally, thousands of wobbly companies on the Nasdaq in the years immediately before and during the boom.

Anyone who looked closely enough at the Nasdaq's own data could see the rot accumulating. In 1996 the National Association of Securities Dealers "delisted" (in effect, kicked off the market) 200 companies, mostly because their stocks had fallen so low they no longer met the market's minimal listing requirements.

This was a relatively small portion of the Nasdaq's total listings -- just 3.5 percent. But soon the numbers started piling up. In 1997 the delistings reached 250 stocks. In 1998 they hit 596, then 440 in 1999 and 630 more over the next two years. All told, from 1996 to 2001, NASD delisted 2,116 stocks.



This number surprised even Alfred R. Berkeley III, the Nasdaq's vice chairman and the highest-ranking official to stay with the market throughout its boom-and-bust years. "It wasn't that high," he said. But shown NASD's own figures, he reconsidered. The furious turnover on the Nasdaq, he said, reflected "Darwinian competition."

Why were so many marginal companies listed on the Nasdaq in the first place? The short answer is twofold: because it was profitable, and because the Nasdaq made it easy for them to be there.

The Nasdaq, an acronym for the no-longer-used National Association of Securities Dealers Automated Quotation System, was born in 1971 with the prodding of the federal government's market overseer, the Securities and Exchange Commission. The SEC had hoped to create a sort of middle ground between the New York Stock Exchange, then, as now, dominated by large, mature companies, and the over-the-counter market, at the time a slow, disorderly and often fraud-laden system for stock trading.

The Nasdaq was and is different. There is no Nasdaq trading floor, no bustling central marketplace filled with gesturing traders and bell-ringing celebrities (that's the New York Stock Exchange). The Nasdaq is a "virtual" market, both nowhere and everywhere at once. It's an interconnected system of tens of thousands of brokers and traders who electronically funnel investors' buy and sell orders to "market makers," the registered representatives who act as middlemen for trades, competing with each other to offer the best prices. Unlike the telegenic chaos on the NYSE floor, all the Nasdaq's trading is done online (computer farms in Connecticut and Rockville complete the millions of transactions made each day).

The Nasdaq differs in another important way: While a few big, glamorous names dominate its daily trading -- Microsoft Corp., Cisco Systems Inc., Intel Corp. -- most of its listings are of the stocks of small companies, typically in high-tech fields. This was the Nasdaq's revolutionary innovation.

Before the Nasdaq, a small company that wanted to raise capital had few options. It could borrow from a bank or float a bond issue, which meant it had to pay interest.

A better, though more restricted, way was to sell stock to the public and essentially collect interest-free money. If the company was big enough, it might qualify for a listing on the NYSE or the American Stock

Exchange. If not, it could take its chances on the over the counter market, a kind of Wild West of financial markets where information moved slowly (or not at all), and share prices often swung crazily.

The Nasdaq created a mechanism outside the big exchanges to determine and transmit the prices of small, lightly traded stocks. By continually flashing price quotes on computer screens far and wide, it gave investors confidence that they were getting reasonably up-to-date, accurate information and could be assured of a market if they wanted to sell.

"Nasdaq, or something like it, is vital to the American economy," said Mark Ingebretsen, the author of "Nasdaq: A History of the Market That Changed the World." "The amount of wealth it generated, the jobs, the growth, is enormous."

In fact, the Nasdaq made it relatively easy to get a listing, and it still does. Today a company can list on the Nasdaq National Market if its publicly held shares are worth just \$8 million (the NYSE minimum is \$60 million) and if it has 400 shareholders holding at least 100 shares each (the NYSE requires 2,000 such shareholders).

Further, while the NYSE requires its newly listed companies to have at least \$40 million of net tangible assets and \$2.5 million of pretax earnings from continuing operations, some Nasdaq entrants aren't required to have *any* pretax income.

Companies often "graduate" from a Nasdaq listing to the NYSE, but many (like Microsoft) have stayed put, enamored of the Nasdaq's image as the home for fast-moving, high-tech companies.

"Each exchange can make an argument for why you should list with [them], why they're better than the other guy," says Gene Riechers, a Washington area investment banker who successfully took several companies public during the 1990s. "Would you rather be associated with the traditional and reliable companies on the New York Stock Exchange or the aura of being associated with the high-growth companies of the Nasdaq?"

For most investment bankers and high-tech entrepreneurs during the late 1990s, it was no contest. The Nasdaq made it cheap, easy and, during the boom at least, extremely lucrative for company insiders and their investment bankers to list. It was hard not to gawk, for example, when the IPOs of obscure outfits surged. VA Linux Systems Inc., a Silicon Valley software start-up, shot up from \$30 per share to \$288 in one day (the company, since renamed VA Software Corp., now sells for about \$1).

In 1999, the boom year, 89 percent of all companies that went public listed their shares on the Nasdaq.

The problem was, Nasdaq shares had always been risky investments, and Nasdaq IPOs riskier still.

Many of the new entrants were downright flaky. Some of the dot-coms, as well as other high-tech firms, used unconventional accounting methods, such as booking cross-advertising deals with other dot-coms as revenue.

Earnings restatements -- effectively an admission that previous revenue reports were inaccurate or possibly fraudulent -- were common among Nasdaq-listed companies during the boom. From 1990 to 1997, for example, there were 49 accounting restatements a year among all public companies, on average, according to a study conducted by New York University's Leonard N. Stern School of Business. In 1998 the number grew to 91, then jumped to 150 the next year and 156 in 2000.

The study found that tech companies, the Nasdaq's primary constituents, made up 39 percent of the companies that restated financial results from 1999 to 2000.

"I throw the most blame on the accounting profession, but you can't let the exchanges completely off the hook," said John E. Karayan, an accounting professor at the University of California at Riverside. "They could have done more policing. They could have said, 'The information being provided here is inadequate; you need to explain what you're doing here.' "

The Nasdaq was aware of the problem. In 1997 it formed its listing investigations department, which Berkeley, the Nasdaq vice chairman, calls "a financial SWAT team" of accountants and analysts. "We were facing some very slick lawyers and accountants and we needed to watch people," he says.

But keeping up with the hundreds of companies that gained listings on the Nasdaq from 1998 to 2000 may have been more difficult. At any given moment, Berkeley said, the SWAT team was working from eight and 10 cases, a fraction of the potential chicanery.

It wasn't until this past summer, long after a series of high-profile accounting scandals broke, that the Nasdaq proposed a rule requiring company audit committees to be composed entirely of independent directors.

In the meantime, the Nasdaq was blindsided by a series of conflicts of interests and other questionable practices that grew out of the Internet IPO market of the late 1990s.

As an investigation by New York state Attorney General Eliot L. Spitzer has subsequently shown, analysts at some Wall Street firms publicly touted stocks of companies that they disparaged ("such a piece of crap") in internal e-mails. In many cases, the companies that were touted were paying lucrative investment banking fees to the analysts' firms. (Merrill Lynch & Co. in May paid \$100 million to settle such charges.)

Spitzer and the NASD are also investigating whether some Wall Street firms awarded valuable IPO shares to important individual clients in return for those clients' investment banking business. Such kickbacks are known on Wall Street as "spinning."

In 1999, however, many investors didn't know any of this. It's possible they weren't in the habit of looking too closely, anyway, given that a kind of market madness was afoot. The total value of all IPOs on the Nasdaq had quadrupled from the previous year, streaking past \$50 billion, half of it in the last three months of the year alone.

Everything seemed dusted with gold.

"A lot of people didn't look at what they were buying, and that's not Nasdaq's fault," said Karayan, the University of California professor. "In a free market you've got to let [investors] take chances, even do dumb things."

But in a market comprising so many small companies, in new types of businesses, "you're dealing with a different category of risk. There's a lot less information out there about these companies," Karayan says. As such, it demands the highest standards of disclosure: "Nasdaq could have raised its listing standards" to screen out the riskiest entrants.

"It could have demanded more," he said.

Trouble Afoot

Zarb knew the bubble could blow up in the Nasdaq's face. But there wasn't much he could do about it, he said.

"Whenever you look at it, you always get back to the same thing," he said. "No matter what we said or did, we couldn't talk people out of it. If I had said 'sell your stock,' people would have told me either that I didn't know what I was talking about or they'd accuse me of causing panic selling."

Publicly, Zarb never commented about the market mania and warned others within the Nasdaq not to "cheerlead," either.

He had assumed the chairmanship of the Nasdaq in early 1997, well before there was a bubble to contend with. In fact, a bull market was the least of his concerns. From late 1991 to 1996, the Nasdaq had been tarnished by accusations that its market makers were colluding to fix prices on trades, thus overcharging customers. After a two-year investigation by the SEC, the Nasdaq's member firms agreed to settle the matter by paying some \$900 million. The Nasdaq itself agreed to spend \$100 million over five years to improve its oversight.

Few people had shuttled the New York-to-Washington power corridor for as long, or as skillfully, as Zarb. In 1971, he had left the investment banking firm Cogan, Berling, Weill & Levitt, whose partners included Arthur Levitt, the future head of the Securities & Exchange Commission, to become an assistant secretary of labor under President Richard Nixon, the first of many government posts.

He was 39 in 1974, when President Gerald Ford named him "energy czar" in the middle of the first oil crisis. A lifelong conservative, Zarb was a soft-spoken but vigorous advocate of free-market measures, such as lifting federal oil-price controls. Although he stayed in the job through half of the Carter Administration, Zarb left in 1978 with deregulation incomplete. Without it, he predicted, "we will have \$3-a-gallon gasoline" by 1985.

Zarb's decade of public service then gave way to a succession of lucrative Wall Street jobs--partner at Lazard Freres & Co., chief executive of Smith Barney, Primerica Financial and the insurance broker Alexander & Alexander.

In his understated way, Zarb recognized his success as a triumph of toughness, a validation of the American dream. The son of immigrants (his father was from Malta, his mother from Italy), he came from neither wealth nor connections. Zarb had worked his way through Long Island's Hofstra University, sometimes working with his father, a mechanic and refrigerator repairman. None of the Zarbs owned stock.

"My father helped build the value of the companies he worked for," Zarb says now,

"and never participated in it."

It was almost a divine match when Nasdaq turned to him in late 1996. The market was still woozy from allegations that its market makers, the dealers who complete investors' trades, were colluding to fix prices on commissions. Nasdaq, under pressure from Washington, needed a white hat to clean up the mess. And Zarb, who had the blessing of his old friend Art Levitt, seemed to have just the right blend of probity and experience.

The Nasdaq job, he thought, would be his swan song in private and public life.

"I'm here to make a difference, and not to feather my nest," he said upon his appointment. "This isn't a stepping stone to higher office."

He never saw the tidal wave that was about to hit. When the Nasdaq offer came, Zarb was considering retirement. But friends urged him to "fix" the Nasdaq.

In fact, Zarb had an ambitious agenda. Besides smoothing the ripples left over from the price scandal, he talked up the idea of taking the Nasdaq worldwide, with investors able to trade its issues at all hours of the day, anywhere. Private online exchanges, known as electronic communications networks, or ECNs, were already starting to do this, eating into the Nasdaq's business. Someday, Zarb said, entrepreneurs would have access to "global pools of liquidity" thanks to the Nasdaq.

In 1998 the Nasdaq took over the venerable but stodgy American Stock Exchange. Advancing Zarb's global vision, it next formed partnerships with exchanges in Canada, Japan and Europe. There was talk about Hong Kong, Latin America and the Mideast as well. Zarb even toyed with the idea of turning the Nasdaq, which is privately owned by its market-maker firms, into a publicly traded company -- an IPO of the house of IPOs.

But by early 1999, Zarb could see trouble afoot. Many traders were buying on "margin." Stock "quality," all those dot-com IPOs, was questionable. Thousands of people were day trading, moving rapidly in and out of stocks. And thanks to the Internet, anyone with a computer and a brokerage account could now trade nearly instantly via online accounts; millions of new investors were in the market.

All of it added to the great pile of risk and speculation that had been building. Even Zarb and one of his top deputies, Berkeley, avoided investing in Nasdaq stocks.

The NASD, which Zarb headed, said it responded appropriately and in timely fashion. In response to inquiries from The Washington Post, the organization prepared a 12-page synopsis of its official actions related to "market conditions" from early 1999 to 2002.

As the list makes clear, almost all of these actions took the form of notices to Nasdaq member firms. These weren't direct orders, but simply "reminders," "reiterations," "advisories" or "alerts" about existing NASD rules covering margin requirements, stock volatility, risk-management practices, day trading and mutual-fund advertising claims.

Critics could argue over whether these were tough enough measures. With the NASD and Nasdaq under the same roof, there was always a potential for a conflict of interest. Investors had to trust the NASD, the regulatory side of the organization, could be counted on to police Nasdaq, the trading side.

Short of changing its own rules, the Nasdaq periodically broadcast its concerns to the public in print ads in the Wall Street Journal. "Above all," read one, "continue to ask yourself, 'Do I have all the information I need to make an informed investment decision?'"

The NASD did propose one new internal market reform during this period. It required firms that promote day-trading strategies to furnish risk-disclosure statements to new customers. It also required firms to assess whether day trading was "appropriate" for a customer. The SEC eventually adopted NASD's proposal -- on Oct. 16, 2000, well after many day traders had been sent packing by the market's decline.

As for the underlying problem, the poor quality of many of the companies listed on the Nasdaq, the market's overseers remained unconvinced that their listing standards were too weak.

"We looked at it," Zarb said. "There was a time when great companies -- Starbucks, Intel, Dell -- companies that are major parts of our life now came through that window. You have to be sure you're not impairing a perfectly good company [by setting the entry rules too high]. . . . I think we had it right."

Berkeley, a former investment banker who helped take Microsoft public, brands as "paternalism" the suggestion that the Nasdaq should have been more selective. "You want me to decide which company is [a future] Apple Computer and which isn't?" he asked.

As for further reform, it's not entirely clear what role the Nasdaq or the NASD should play now. The accounting abuses and alleged conflicts of interest are being pursued by the SEC, state and federal prosecutors, and the media. Berkeley is certainly right when he says the popping of the Nasdaq's bubble has taken care of the IPO market. Last year, only 126 companies listed their IPOs on the Nasdaq. Through six months of this year, the number has fallen to 29.

The bear market has also taken care of Zarb's global vision. Though the Nasdaq's partnerships in Canada and Europe are up and running, it closed its market in Japan in early September, citing low trading volume. For now, talk of expanding to Hong Kong, Latin America and elsewhere has quieted.

But the postscript to the boom years may have come last year. With its trading volume falling and listing income reduced, the Nasdaq had to tighten its own belt. It announced it would lay off 140 people, or about 11 percent of its staff.

Zarb's nearly five-year tenure at the Nasdaq covered what may have been the most remarkable stretch in stock market history. It saw scandal and turbulence, great fortunes won and wiped out. Zarb himself emerged without a blemish. His name is even being floated as a possible replacement for SEC chairman Harvey L. Pitt, who offered his resignation last week.

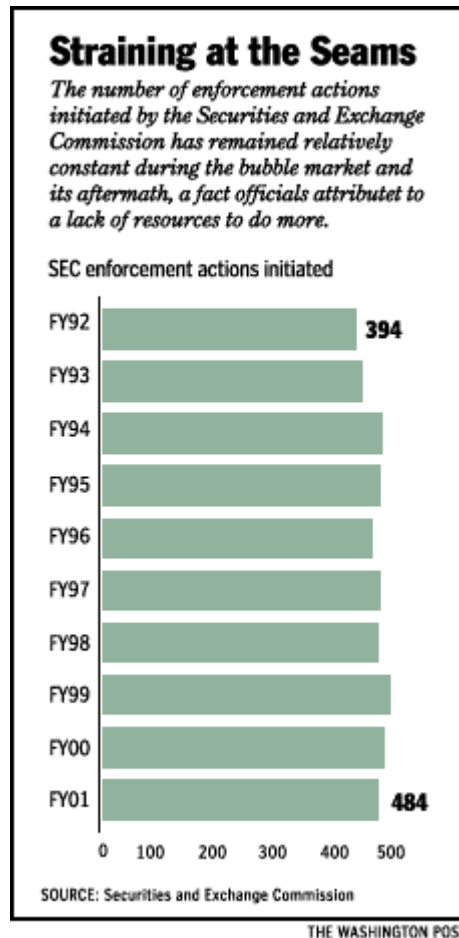
When Zarb took early retirement in September 2001, his board voted to award him a severance package that included \$4.7 million and options to buy 1 million shares of Nasdaq stock.

The options, in effect, were a marker for a bigger potential payoff: the day when the Nasdaq would sell stock in itself to the public. But the options are worthless now, the market far too bearish for the Nasdaq to consider an IPO.

Like much else after the bubble's bursting, it's another rich dream deferred.

With Deregulation, the First Stage of a Disaster Waiting to Happen

Steven Pearlstein, *The Washington Post*, Monday, November 11, 2002.



In hindsight, it is likely there would have been no Bubble Economy without the move toward economic deregulation that began 25 years ago.

The idea was that markets, freed from the shackles of government mandates and restrictions, would produce more competition, innovation and economic growth—so much more that it was worth the added risks to consumers and investors.

In time, the benefits of deregulation could be calculated in the falling prices of long-distance phone calls, mortgages and airfare, the increased returns earned by savers and investors, and the surge of investment capital to the entrepreneurial side of the economy. And although the risks were laid bare in the collapse of the junk-bond market of the 1980s, the savings and loan crisis of the early 1990s, and the financial crisis surrounding the demise of Long-Term Capital Management LP in 1998, they were insufficient to shake the political consensus that had formed around deregulation.

Certainly no single act of deregulation contributed more to the bubble than the Telecommunications Act of 1996, which aimed to create competitive markets for voice, data and broadband services. The act unleashed a flood of investment in wireless licenses, fiber-optic cable, satellites, computer switches and Internet sites, and accounted for much of the new capital that poured into the economy through Wall Street's stock and bond markets and major commercial banks.

But even as the extent of the over-investment became clear and the telecommunications industry began its financial meltdown, the Federal Communications Commission maintained its faith in deregulation,

arguing that it would be folly for government to step in and try to rescue the industry or attempt to manage the transition.

A similar outlook held sway at the Federal Reserve Board, which as far back as September 1996 began to debate whether it should try to prick the developing stock market bubble. But in the end, nothing was done beyond Fed Chairman Alan Greenspan's gentle warning about "irrational exuberance"-a view the chairman seemed to subsequently disavow as he embraced the idea that a revolution in productivity was indeed creating a New Economy.

The primary responsibility for policing the markets and corporate behavior rests with the Securities and Exchange Commission, whose chairman, Arthur Levitt Jr., warned early and often during the boom about the accounting games being played by public corporations, with the connivance of auditors, directors and Wall Street analysts. But Levitt's efforts to reform the accounting rules and beef up enforcement were thwarted by both Republicans and Democrats in Congress. They repeatedly turned aside his requests for enough funding to allow enforcement to keep pace with the increase in volume and complexity of the securities being offered.

Although Levitt identified the worst areas of corporate abuse, he was unable or unwilling to use the resources he had to make a high-profile example of companies that had engaged in major-league obfuscation and earnings manipulation. To some extent, the SEC that Levitt inherited had, under the banner of self-regulation, subcontracted some of its oversight and rule-setting responsibilities to industry organizations or boards largely controlled by them. These included the Nasdaq Stock Market, the Financial Accounting Standards Board and the Public Oversight Board.

The theory behind self-regulation was that nobody had more incentive to assure the integrity of public equity markets than the professionals whose livelihoods and status depended on it. But what the theory overlooked was that the self-regulatory bodies, operating in the name of market competition, had no competition themselves. When push came to shove, they realized it was possible to ignore their members' involvement in corporate chicanery, knowing that their franchise was safe and investors had no alternative organizations to turn to.

Third of Six Articles

On CNBC, Boosters for The Boom

Howard Kurtz, *The Washington Post*, Tuesday, November 12, 2002.



CNBC's Maria Bartiromo, shown on the air in March 2000, was referred to as the "Money Honey" in tabloid headlines. (File Photo Courtesy Of Cnbc Via AP)

Joe Kernen had barely slipped into his chair in the color-splashed CNBC studio here when he started needling the Wall Street fund manager across the set.

"What about AT&T Wireless?" he asked Vince Farrell Jr. of Victory Capital Management Inc., who was sitting in as co-host of the morning show "Squawk Box." "That was one of your top picks about six months ago." Since then, the stock had plunged from \$14 a share to \$5.

"A horrendous and a terrible pick," Farrell admitted. "But I do believe at this price it offers significant opportunity for the next couple of years."

The exchange captured what traders might call the upside and downside of CNBC, the business network where Kernen serves as stocks editor. Kernen and his partner, David Faber, are among the network's most skeptical voices, often deflating the airy assessments of Wall Street prognosticators with a vested interest in pumping up stocks. But the network continues to spotlight many of the same relentlessly optimistic traders and analysts who have been telling investors to buy, buy, buy stocks since the market imploded in the spring of 2000.

Back in the heady days of a stampeding bull market CNBC was a driving force, a cultural phenomenon, a ratings success, the play-by-play announcer for America's new pastime.

And Kernen, along with the likes of Maria Bartiromo, Mark Haines and Ron Insana, achieved a kind of cult-hero status. The "Kahuna," as he's been dubbed, was splashed on the cover of *Golf* magazine and named one of *Playboy's* best-dressed men. Barbra Streisand kept calling him for advice about her day-trading habit.

"Everyone was tripping over themselves to get into the New Economy," said Kernen, a 46-year-old former stockbroker whose blue shirt and maroon tie convey the working-stiff image of a man who never wears a jacket on camera. "We're just a reflection of that. What we were covering was what was going on in the rest of the world. In hindsight it looks like it was obvious that it wasn't going to last. But it wasn't."

All of which raises an intriguing question. Enron Corp.'s Kenneth L. Lay touted his company on CNBC, as did WorldCom Inc.'s Bernard J. Ebbers and Tyco International Ltd.'s L. Dennis Kozlowski and domestic diva Martha Stewart. CNBC played host to a steady parade of Wall Street analysts, including Merrill Lynch & Co.'s Henry Blodget, who was pushing Internet stocks -- some of them now worthless -- while he and his colleagues privately dismissed them in e-mails as "crap" and "junk." CNBC reported every time that

Salomon Smith Barney Inc.'s Jack Grubman boosted his rating on WorldCom, a major client of his brokerage firm, where he secretly attended board meetings.

If many chief executives and analysts are now discredited, is the network tarnished as well?

"CNBC was the captive of those people in the industry who were on all the time," said Yale professor Robert J. Shiller, author of "Irrational Exuberance." "The kind of people they brought on tended to be cheerleaders."

But if CNBC helped turn the Blodgets of the world into minor celebrities, it had plenty of company. Newspapers, magazines, Web sites and other networks such as CNNfn and Bloomberg all hitched a ride on the dot-com express, quoting and interviewing the same financial superstars and all too rarely examining their inherent conflicts of interest. They were filled with glowing profiles of overnight billionaires and tales of small, profitless companies whose stock was jumping by 100 percent, 300 percent, 700 percent.

Those who didn't get in the game were seen as fools. "Everyone's Getting Rich But Me," a Newsweek cover blared in 1999. New magazines with names like eCompany Now began drilling for some of the newly minted gold.

And then the bubble burst. And the media started pointing fingers at everyone else -- with perfect hindsight, naturally, and little examination of their own role.

While Kernan was often one of the dissenters, he admits that at times he was swept along by the relentless tide of higher stock prices. When he criticized companies such as AOL Time Warner Inc. as absurdly overvalued, the backlash was immediate.

"We'd get so much mail from what we called the AOLians," he said. "They would work themselves into a frenzy, like the guys outside Frankenstein's castle. They were out there, they wanted blood. The idea that CNBC was inflating the bubble, on this show we were nailed for just the opposite.

"When you're in a bull market where everyone is making money, it's human nature, people think they're geniuses. In a bear market, people don't really feel like it's their fault. They're looking for someone else to blame."

Making Wall Street Accessible

As a stockbroker, Kernan worked for Merrill Lynch and Lehman Brothers in Boston and E.F. Hutton in Los Angeles. He'd make 100 calls a day to lure five or six strangers as possible new clients. Kernan can still deliver the rapid-fire pitch:

"Mrs. Jones, our institutional research department identifies a superior investment two or three times a year. If I were to get such an investment opportunity and present it to you, what would you feel comfortable with? \$10,000? \$20,000? And on the second call you'd close. It was so stressful. I couldn't do it anymore."

Fortunately for Kernan, television was about to get into the stock market business.

In 1989, when NBC launched a cable spinoff called the Consumer News and Business Channel, regular financial news on television basically consisted of CNN's "Moneyline" and PBS's "Wall Street Week With Louis Rukeyser." Most Americans viewed Wall Street as the playground of the wealthy.

"We thought there was a niche in business and consumer-friendly information for people managing money at home and people in business," said NBC Chairman Robert C. Wright. "I had to convince Jack Welch

this was a good idea," he said, referring to the former head of parent company General Electric. "There was a lot of skepticism. Quite frankly, at NBC they thought it was the worst idea in the world."

Critics were unimpressed, especially when the first day included a segment on how to cook stir-fried chicken in a microwave oven. CNBC reached just 13 million homes and wasn't even carried in Manhattan. USA Today declared it "a pale imitation of CNN" with a "drier-than-dry style."

"In broadcast, if you don't get it right off the bat, you're cooked," Wright said. But it's easier to improve, he said, "if nobody's watching."

Kernen, meanwhile, signed on with the Financial News Network as a freelance writer for \$125 a day. When CNBC bought the bankrupt cable channel the next year, Kernen was among the few staffers brought here to New Jersey.

While he had made as much as \$170,000 a year as a stockbroker, Kernen was earning about \$36,000 -- and enjoying life in a television studio. "I was so glad someone would pay me just to follow stocks without having to sell anything on the phone," he said.

Kernen begged producers to give him one minute of daily airtime to deliver the kind of stock advice he was writing for the anchors. The initial reviews were terrible -- "If the teleprompter went down, I would freeze" -- but few noticed.

"It was pretty Mickey Mouse back then," Kernen said. "We didn't have much of a grasp on what we were doing."

As CNBC grew in influence, Kernen grew more comfortable in front of the camera, and within a couple of years a worker carving the roast beef at a Broadway hotel was excited to meet him. The country was undergoing a quiet financial revolution. More people were getting into the stock market, through either their 401(k) retirement plans or an exploding array of mutual funds.

"Every day, there were thousands of people who had just signed up to manage their own future," Wright said. CNBC wanted to be their network.

For the first time in history, cable networks and Web sites were giving small investors access to the kind of real-time information -- analyst reports, quarterly earnings, executive pitches, Street chatter -- that had only been available to Wall Street brokers. As the bull market took off, fueled by technology stocks such as Microsoft and Intel, the media began celebrating the notion that this was a game anyone could play -- and win.

By the late '90s, as CNBC took an irreverent, sportslike approach to covering business. "Squawk Box" was cast as the pre-game show before the market opened, and Kernen's mixture of geeky stock analysis and goofy stunts was a hit.

He and Faber, nicknamed "The Brain," teased each other about their hair, clothes, favorite foods and TV shows. Kernen would play with lava lamps at his desk or brandish a sword. When four or more analysts downgraded a stock that had already plummeted, the duo would show videotape of penguins, waddling along in unison.

Faber often spoke with Grubman, who hugged him at parties, but he repeatedly criticized the analyst for his dual roles as supposedly objective researcher and reliable rainmaker for Salomon Smith Barney. He handed out "Lame-O Awards" to Grubman, Blodget and other analysts for downgrading stocks they had long championed after the shares had skidded to a dollar or two.

"There was a disconnect between what Wall Street knew and what people out there didn't seem to understand, the conflicts I was pointing out year after year," Faber said. "Nobody cared."

Stocks, in fact, were becoming a national obsession. People were watching CNBC's blue-and-white ticker in bars, restaurants and health clubs, drawn by the slogan -- "Profit From It" -- and a sense of being inside the casino.

Things got so wild that when Kernen did a satellite interview with Mark Breier, chief executive of the software firm Beyond.com, Breier showed up wearing only boxer shorts. (The company filed for bankruptcy this year.) CNBC briefly overtook CNN in the ratings, fueled by a small army of investing amateurs who, with the advent of cheap online trading, could buy and sell with the speed of Wall Street pros. Thousands of people would gather at terminals in small brokerages, some having quit their full-time jobs, and trade stocks dozens of times a day, often using borrowed money, with CNBC as their electronic lifeline. As many as 5 million people were estimated to be trading daily.

Money managers, meanwhile, would bet on the analyst recommendations unearthed each morning by Bartiromo -- known in tabloid headlines as the "Money Honey" -- from her glass-enclosed booth above the New York Stock Exchange.

In August 1999, Bartiromo reported that Merrill Lynch's Blodget was urging people to "buy the 1999 holiday basket of Internets," including America Online Inc., BarnesandNoble.com and eToys (which would later go bankrupt). Eight months earlier, when Blodget was an obscure analyst at CIBC Oppenheimer, the network and other news outlets had trumpeted his bold prediction that Amazon, then selling for \$243 a share, would reach \$400. When Amazon skyrocketed 128 percent and smashed through the \$400 target within a month, Blodget jumped to Merrill Lynch, succeeding an analyst who believed Amazon was worth \$50 a share. (Shares now sell for \$19.) Even as the latest Blodget call boosted Web stocks again, Kernen was skeptical. Blodget had gotten his Merrill Lynch job, he said, "because they want somebody at the firm positive on Internet stocks."

Soon everyone wanted to be the next Blodget. In the last week of 1999, a 28-year-old PaineWebber analyst named Walter Piecyk predicted that the wireless technology firm Qualcomm Inc., whose stock had begun the year at \$26 and was then selling at \$503, would hit \$1,000 within 12 months. The "Squawk Box" team ridiculed the call, complete with sound effects, as Faber declared that "analysts don't know much of anything." But the buzz they generated helped boost Qualcomm to \$575 in pre-market trading that morning, and Piecyk was immediately interviewed by CNBC, CNNfn and the Wall Street Journal.

"We were trying to make fun of this ridiculous period we were in," Faber said. "We sat there in the morning scratching our heads, trying to explain why it was so absurd. It was the bubble. And it was amazing."

Kernen was always careful not to recommend stocks himself, lest they drop and make the network look bad. "I had been a stockbroker," he says. "Now I just play one on TV."

But in this supercharged atmosphere, the mere mention of a stock could produce what became known as the "Squawk bounce." An optical component maker named OSI Systems jumped from \$14.50 to \$28 a share within an hour after Kernen talked about it, then fell to \$18 as traders took their profits, as Business Week later noted.

"You honestly think CNBC spawned the day traders?" Kernen asked. "Maybe we provided a couple of hypos for these people to mainline the drugs, but we certainly didn't invent the drugs."

What CNBC did, along with the rest of the business press, was buy into an interlocking system -- now widely viewed as flawed and in some cases corrupt -- in which all the key players had an incentive to push stocks. The network would trumpet the bullish forecasts of Goldman Sachs Group's Abby Joseph Cohen and Prudential Securities's Ralph J. Acampora (who predicted that the Dow would reach 13,500 to 14,000 by the end of 2000). CNBC relied on these and other Wall Street analysts, though less than 1 percent of

their recommendations were to sell stocks, along with fund managers, chief executives and others who took a sky's-the-limit approach. Most of the bears were in hibernation.

"The coverage we had during the Internet market was appropriate for where we were in the market," said Pamela Thomas-Graham, the network's chief executive. "CNBC really did democratize information about stocks. I think we get unfairly characterized as having cheerleaded the market."

The cheering stopped at CNBC when the market began its long decline in 2000. A ratings slide turned into a bear market after Sept. 11, 2001. Audience numbers soared at CNN, MSNBC and Fox News Channel, which were blanketing the war on terrorism.

"It was hard to concentrate for weeks following September 11 and do business as usual," Kernen said. "How important were individual stocks? Not very."

By the first half of 2002, CNBC's ratings had dropped 25 percent from the previous year. The excitement of watching stocks soar during the great bubble period was replaced by the pain of watching them sink. Kernen and friends had to tone down some of the hijinks.

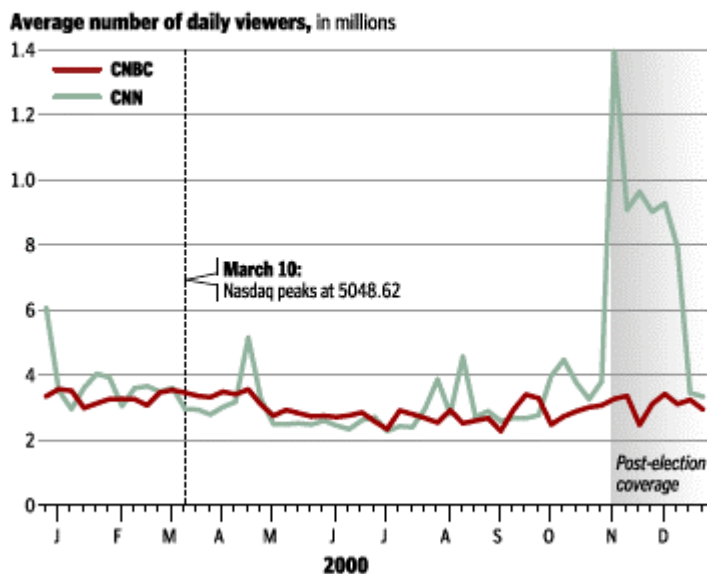
"Our coverage is quite sensitive to the emotional ramifications of people having lost real money," says Thomas-Graham, who has convened focus groups to study the matter.

Kernen, who married a CNBC producer and has two young children, jokes about being "suicidal because no one recognizes me anymore."

"The idea that we would be the most-watched cable news channel, that's not normal," Kernen said. "We were beating CNN. It's weird for business news to be in a position where global events and political events are on the back burner. It shows you how far things were out of whack."

Riding the Wave

Business-oriented CNBC frequently topped CNN as the Nasdaq surged to its peak and then plunged in 2000.



SOURCE: Nielsen Media Research

THE WASHINGTON POST

Rethinking Greed

As some of the CEO heroes of the '90s have turned into high-profile villains, Kernen finds himself having second thoughts about the big names who hawked their wares on his show. To him, they are not distant figures but business leaders he has come to know and respect over the years.

In December, Kernen talked on the phone with Samuel Waksal during the week that he is alleged to have misled investors about the stock in his company, ImClone Systems Inc. Kernen has known the flamboyant Waksal for a decade and once went to one of his famous parties. "I watched ImClone go to 70 and couldn't believe it," he said. "Every article was so glowing."

Kernen, who has a master's degree in molecular biology from MIT and had closely followed the development of ImClone's cancer drug, Erbitux, called to ask Waksal, then the company's chief executive, why the stock was nose-diving. What the public didn't know was that the Food and Drug Administration had rejected Erbitux -- and that two of Waksal's relatives, along with his friend Martha Stewart, were dumping their shares.

"He was very careful in his wording," Kernen recalled. "He got really worried about what he was saying. He knew at that point."

While Kernen didn't crack the case, he smelled something funny. "Every scandal we've had, the stock started going down before you knew why," he said.

Kernen feels sorry for Waksal, who has since pleaded guilty to fraud and obstruction of justice. He admired such CEOs as WorldCom's Ebbers, "a self-made guy I thought was pretty cool"; Tyco's Kozlowski, once touted as the next Jack Welch, who has been indicted twice; and Albert J. Dunlap, who ran now-bankrupt Sunbeam Corp. and has paid a \$500,000 fine to the Securities and Exchange Commission.

Did Kernen naively put his faith in wealthy men who turned out to be crooks? He admits as much.

"Now we realize some of the emperors didn't have any clothes, or were stealing the clothes off their employees," he said. The recent revelations have shaken his faith in the free market.

"I don't think greed is good anymore," Kernen said.

The media, of course, celebrated many of these chief executives as wizards and mavericks when they were riding high and their stocks were shattering records. But Kernen is among the relative handful of journalists who got to question the highfliers before a mass audience.

In February, when Kozlowski appeared on "Squawk Box" after the Enron meltdown, Kernen told him he had been "quite eloquent" in describing "a loss of trust in corporate America."

But Kernen also asked about a \$20 million payment the company had made to a top company official, half of it to a charity the official controlled. Kozlowski said "this will never happen again at Tyco." At the time, no one knew Kozlowski would be charged with using company money to buy expensive homes and lavish art and with selling stock at inflated prices.

"I guess he just felt entitled to all that stuff," Kernen said.

Networks Switch Gears

Still, the corporate scandals have reenergized CNBC since June 25, when Faber broke the story that WorldCom would be forced to restate \$3.8 billion in earnings, and ratings have since rebounded by about 15 percent. Suddenly a CNBC reporter was ambushing Grubman on the street, shouting accusatory questions about his support for the now-bankrupt WorldCom. The network that had given analysts like Grubman such credibility was turning on them with a vengeance.

This, says Thomas-Graham, is the new CNBC. "You'll see us covering the markets in a way that's more probing, thoughtful and skeptical," she said. "The questioning is more edgy. There's no pitching of softballs here."

But Kernen believes the media pendulum has swung too far. "The vast majority of analysts are trying to do a good job," he said. "They know more about the companies they follow than anyone else. I don't think we ever should have listened to them as market timers."

He is uncomfortable as well with the prosecutorial nature of the recent business coverage. "Are we at this point overdoing the whole corporate malfeasance story when it's 10 companies out of 5,000? Absolutely."

CNBC staffers now speak disdainfully of the "fringe" audience -- that is, ordinary people saving for college and retirement -- who pumped up ratings during the height of the bull market. They are catering to their "core" audience -- wealthy executives and traders whose average household net worth is \$1.1 million, turning CNBC into an advertising gold mine, even during the recent economic slowdown.

But how much has really changed? The network still reports the daily upgrades and downgrades, interviews the analysts and CEOs, vacuums up the tips, blips and rumors that seem to move the market.

Kernen sees little alternative. The market, he says, moves on a minute-by-minute basis, and the people who watch him are all capable of making grown-up decisions.

"No one's dying on the operating table here," Kernen said. "We don't need to be pallbearers here."

\$ \$ \$

Media Fueled New Economy, and Vice Versa

Steven Pearlstein, *The Washington Post*, Tuesday, November 12, 2002.

In the days before the Bubble -- before the Nasdaq displaced children and real estate in cocktail-party conversation, before young professionals began quitting their day jobs to take up day trading, before stock options became the compensation of choice for hard-to-find employees -- the stock market was an insiders' game.

There were the professional managers of pension funds, mutual funds and trust funds who read the Wall Street Journal and Barron's and "buy side" analysts. There were the wealthy investors who subscribed to Forbes and the newsletters and were good enough customers that analysts from the big Wall Street firms took their calls. And there were the retirees who watched "Wall Street Week" on PBS and flocked to investor conferences when the Magellan Fund's Peter Lynch was in town. This was a world in which participants divided the year into quarters, used arcane language and generally spoke in hushed tones, knowing that there was more money to be made by keeping the best ideas to themselves.

Although the seeds of the stock market's democratization were planted in the '80s, it was only with the Bubble that the market subculture finally was embraced by the mainstream society. Suddenly everyone was checking in on stocks before heading out to lunch. There were business stories on the front page, and corporate chief executives attained the status of rock stars and season-winning quarterbacks. By the

year 2000 more than 50 percent of households held stocks, directly or indirectly. And when Time magazine named Amazon.com founder Jeff Bezos the Person of the Year in December 1999, nobody thought it absurd.

What became a mass obsession required mass media. Instead of a niche Friday night audience on PBS, the market talk ran 24/7 on competing cable stations and radio networks. The kind of gossip and strategies insiders once got from monthly newsletters now was disseminated in real time on hundreds of new Internet sites. The stodgy and venerable Dow wire gave way to the interactive Bloomberg machine that let Everyman plot historical trends, find out about bond trades or check in on the latest analyst recommendations -- and find out who made the World Cup finals, to boot.

Although it was the rapidly growing audience that led to creation of the new media, before long the media were reciprocating by contributing plenty of hot air to keep the Bubble aloft. There was, after all, good money to be made selling subscriptions and advertising space in the hot new business magazines and Web sites, and even better money to be made taking them public or selling out to a major media conglomerate. Old-line newspapers and periodicals, eager to get in the game, rushed out with special sections on technology and personal investment. And in all of these media, the traditional lines between news and commentary, observer and participant, began to blur, further predisposing them to a cheerleading role.

Today, many of the new outlets survive -- shrunken in most cases, chastened, less ambitious in their reach. The notion that the new media democratized finance and let the masses play the insiders' game has been badly tarnished by revelations that real insiders quietly cashed in, leaving the suckers to ride the market down. Seminars for reporters and editors on how to spot the next Enron are oversubscribed.

And from Wall Street and the executive suite, there are now frequent and bitter complaints that the press's newfound skepticism has unjustifiably driven down stock prices and dampened the economic recovery.



Lou Dobbs

The anchor of CNN's "Moneyline" left the network in 1999 to launch his own Internet firm, Space.com, but he returned last year after the company failed to blast off.



Ron Insana

The low-key CNBC anchor interviewed presidents and Treasury secretaries. His sober advice was seen by some viewers as too bearish.



John Huey

The former editor of Fortune turned it into a hot book but also tried to ride the dot-com boom by creating eCompany Now, which tanked.



Paul Steiger

Managing editor of the Wall Street Journal, which broke most of the big merger stories of the '90s and grew fat with technology advertising.



Louis Rukeyser

The venerable "Wall Street Week" host interviewed big-name analysts but didn't ask them to disclose which stocks their companies were pushing or underwriting.



Jim Cramer

A manic Wall Street trader and commentator, he co-founded TheStreet.com and watched the Web site's stock plummet from \$71 to under \$3 per share.



Jonathan Weber

The editor of the Industry Standard ran the boom-and-bust magazine that ballooned to \$200 million in revenue in 2000 and shut down the next year.



Jason Pontin

The editor of Red Herring was hailed as a "Gucci-loving," "Jag-driving" "New Economy titan" before layoffs devastated his magazine.

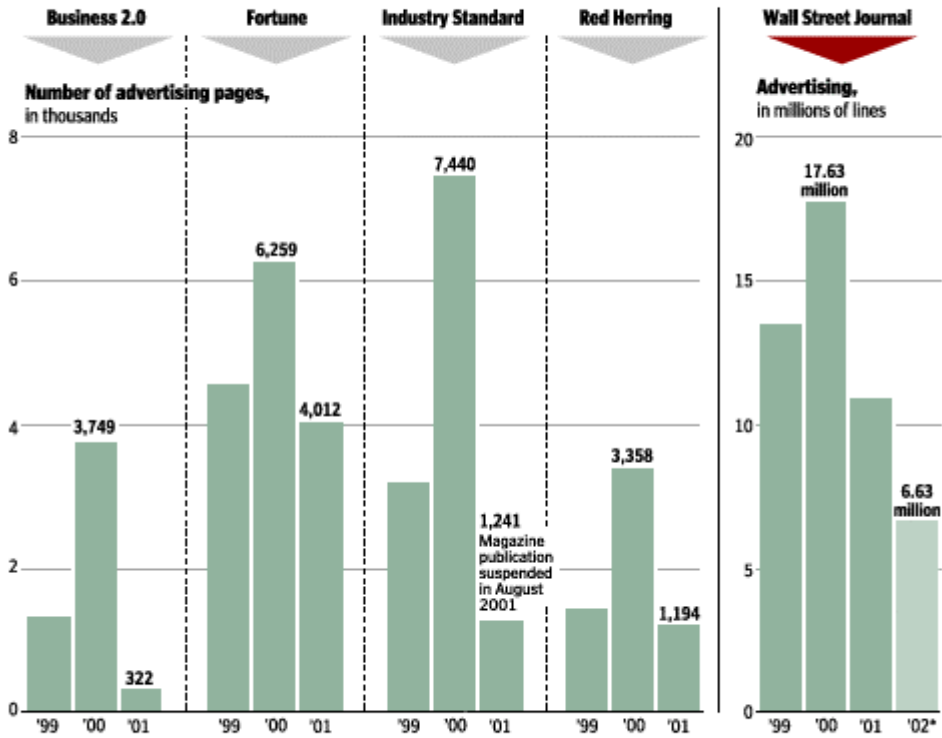


Larry Kramer

The chief executive of CBS MarketWatch.com, a former Washington Post editor, was worth \$20 million on paper until his company's stock nose-dived.

Ad Spike

The bubble spurred a dramatic rise in magazine advertising, and when it burst it caused an equally dramatic—and, in at least one case, fatal—fall. The nation's daily business newspaper, the Wall Street Journal, has also seen a sharp drop in ad lineage.



SOURCES: Competitive Media Reports; Magazine Publishers of America/Publishers Information Bureau

*Through September

THE WASHINGTON POST

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Fourth of Six Articles

'Johnny Appleseed' for a Risky Field

Doerr's Ambition Paid Off -- at First

Ariana Eunjung Cha, *The Washington Post*, Sunday, November 13, 2002.



John Doerr, regarded by many as the ultimate salesman, called election results in November 2000 with his daughter Mary, then 9.

(File Photo/ Richard Wisdom -- San Jose Mercury News)

The company was born, as were so many in Silicon Valley in the 1990s, with a single conversation.

"I have an idea for you," John Doerr said to a group of cable television executives he wanted as partners for a company he envisioned marrying cable and the Internet to bring more and as yet unimagined sorts of programming to consumers. As perhaps the most famous of the venture capitalists, the financiers who seeded the Internet boom, Doerr had the money at his disposal to make his ideas reality. In this case, he even had a name for his new venture: At Home.

Over the next three years, Doerr, through his firm Kleiner Perkins Caufield & Byers and its co-investors, pumped several hundred millions of dollars into At Home Corp. The company prospered, quickly attracting nearly 300,000 customers who paid a monthly fee to get super-fast Internet access from their houses and apartments, and banking several million dollars in revenue each quarter.

But Doerr was not satisfied.

By late 1998, nearly the middle of the boom, Doerr told some company executives that he feared At Home wasn't moving fast enough. He, along with the management team and other directors, wanted At Home to ally itself with a company that could provide the content -- the stories, sound clips and video -- it needed to become a media venture. And the time to do that was while At Home's stock was flying high.

The target: Excite Inc., a popular online search and directory site that also happened to be heavily backed by Kleiner Perkins. Excite was losing money -- lots of it -- and that made some investors skeptical: Why endanger At Home by exposing it to Excite's losses? But those concerns were swept aside. The \$6.7 billion merger, the biggest ever between two Internet companies, was overwhelmingly approved by shareholders in 1999.

Kleiner Perkins, however, did not wait around for the new company, Excite At Home, to succeed. Soon after the merger, it took company shares worth more than \$1 billion and distributed them privately to its investment partners for them to sell if they wished. Public investors who placed their bets on the company's long-term success and held on to their shares were not as lucky. Excite At Home went out of business this February, and their stock became worthless in one of the New Economy's most spectacular failures.

Charles Moldow, a former vice president of At Home who worked on Excite At Home's business development, believes At Home took a fatally wrong step. "If we hadn't merged with Excite, At Home would still be around today," he said.

But during the boom years, venture capitalists played God, and they largely decided which start-up companies lived and which ones died, which investment bankers and lawyers got the deals and which ones got rich. Doerr, an electrical engineer who became the premier financier of Silicon Valley, did all that and something more: He was the public face and ultimate salesman of the obsessively ambitious Internet world.

Doerr's imprimatur on a company gave it instant credibility. But any venture capital fund's investment began a familiar process, according to Wade Randlett, chief executive of San Francisco-based Dashboard Technology. First the fund would send money to a start-up. Then, as the start-up picked up steam, the fund would distribute some company shares to its investors, usually institutions or wealthy individuals. Those private investors would, in turn, sell their shares to the general public. If the company ran into trouble, Randlett said, "it turned out that the individual investor was the last sucker at the table."

To fledgling Internet entrepreneurs, venture capitalists held out badly needed start-up funds in one hand. With the other they pushed hard for the companies to expand quickly and jump into new areas of business. Now that many of these companies are in ruins, outsiders point to the obsession with growth and size as a major factor in the dot-com industry's undoing. And Doerr's talk of *keiretsu* -- a Japanese term that became his catchword for a network of ventures that led to unions like that of Excite and At Home -- has become an epitaph for a bygone era.

As the history of the boom is being rewritten, so is Doerr's.

He has gone from being known as the "Johnny Appleseed" of Silicon Valley (Time Digital 1999) to being compared to Henry Blodget (Barron's, 2002), the Wall Street analyst who hyped shaky stocks and now finds himself being questioned by government regulators.

Like many other prominent financiers of the boom, Doerr has found himself caught up in all the scandals that have beset the corporate world in the aftermath of the bubble. A few of the companies he funded and on whose boards he served are fighting off investigations by the Securities and Exchange Commission and shareholder lawsuits that allege wrongdoing including insider trading and accounting fraud. Attorneys for Doerr, who declined repeated requests to speak on the record for this story, have vigorously denied the allegations.

Doerr's failures -- Excite At Home, HomeGrocer -- are now as well known as his successes -- Amazon, Intuit, Sun, Netscape. But those failures don't necessarily mean that Doerr's insights about the future of technology were wrong. Dot-com-era businesses such as online retailing have found a loyal consumer base. People really do download music from the Web. And the number of homes paying for the use of high-speed Internet that Excite At Home promoted has been increasing steadily.

On the other hand, he helped create a climate in which people thought the potential riches were so large many made foolish investments and ended up losing lots of money. "The Internet is the greatest legal creation of wealth in the history of the planet," Doerr said on numerous occasions. "It's underhyped," he said. "It may hit 30 on a Richter scale."

Paul Kedrosky, a University of British Columbia business professor who is writing a book about venture capitalists, said venture capitalists -- and Doerr in particular -- created a romanticized vision of the world that was hard to resist.

"He was a blue-eyed believer but his proclamations were so full of hyperbole that there was no good that could come of them. . . . He made a lot of people lose a lot of money," Kedrosky said.

Doerr's defenders argue that he was sincere in his belief in the future of all the companies he financed and that it's unfair to blame him for the greed of others. They note that Doerr backed up his words with actions: He never sold a single share of his personal stakes in companies for which he served on the board of directors.

"It is in the nature of technological innovations for inventors and the people closest to them to be excited by what they see. . . . That John Doerr's enthusiasm was infectious is not John Doerr's fault," said Paul Saffo, director of the Institute for the Future, a think tank based next door to Kleiner Perkins.

The Origins of Hype

The Internet bubble began with a relatively simple transaction, repeated hundreds of times. A fledgling Internet entrepreneur whose company often consisted of no more than a 10-page "business plan" received seed money. In return, the venture capitalists, located along fabled Sand Hill Road in Menlo Park, Calif., or some other tech hub around the country, got a stake in the company.

But the venture capitalists were more than regular investors. In contrast to investment banks that rarely got involved in the day-to-day activities of the ventures they funded, venture capitalists nurtured their companies, recruiting top management, drafting contracts and negotiating deals. It wasn't unusual for them to take jobs as executives within the businesses.

Kleiner Perkins and the companies it funded were Silicon Valley's elite ruling party during this time, Doerr their leader. In a reversal of the usual practice, investors were chosen by the firm, which often demanded an initial commitment of at least \$1 million to get in, according to several limited partners. Among the groups that placed money in Kleiner were some of the nation's most prestigious universities and pension funds.

Venture capitalists were known as the long-term guys, the ones who kept their investments in companies for a decade or more, until they had a chance to grow into stable enterprises with robust earnings. But all that changed in 1995 with the initial public offering of Doerr-backed Netscape Communications Corp.

Netscape, co-founded by whiz kid Marc Andreessen, the inventor of the Web browser, and backed by Doerr, had no profit and only a vague idea of how it would make money. But its stock jumped 107 percent on its first day of trading, giving the fledgling company a market value of \$2.2 billion.

Over the next five years, nearly 1,000 other companies would go public in the hopes that they could duplicate Netscape's performance in the stock market.

In the not-so-distant past, venture capitalists would often take months or years to mull over investments, doing careful market studies about competitors and even surveys of potential customers. In the go-go days of the late 1990s, however, some venture capitalists say it wasn't unusual for a company to be funded almost on the spot, on the New Economy idea that whoever got the customers first would dominate a sector.

So much money was flowing into venture capital funds so fast that often companies in the same or similar businesses began to multiply, especially in e-commerce. Pets.com, Petsmart.com, Petopia.com and Petstore.com, for instance, all offered pet food and other products for animals. DellaJames.com, WeddingChannel.com and TheKnot.com offered wedding advice and gifts. Wine.com, WineShopper.com, WineCountryGiftBaskets.com, eVineyard.com and VirtualVineyards.com, obviously enough, sold wine.

E. Floyd Kvamme, a Kleiner Perkins partner emeritus who wasn't actively investing during the dot-com years, said that as an outsider he saw this haphazard investing style as one of the biggest contributors to the shakiness of the New Economy.

"For whatever reason due diligence kind of got put aside," Kvamme said. "Looking at the amount of dollars being thrown at things, it was clearly a strange time, and the bubble shouldn't necessarily have happened."

Geoff Yang, a partner with Redpoint Ventures, who, along with Vinod Khosla, one of Doerr's partners at Kleiner, was an initial investor in Excite, believes that the emphasis venture capitalists placed on size also was a mistake. To be sure, the land-grab strategy of trying to become the ubercompany worked for some ventures, such as Amazon.com, Yahoo and eBay, but those turned out to be the exceptions.

"Clearly in retrospect if we had thought smaller -- 'I will do rational pricing, I won't worry about being the uberbrand' -- clearly, I think that would have been better," Yang said.

That, however, wasn't Doerr's style.

During the late 1990s, Doerr always seemed to be multi-tasking, simultaneously trying to manage beeps on his two cell phones, laptop and pager as he sought to carry on a conversation. He rarely drove, instead riding in a chauffeured van where he could fiddle with his electronics in the back seat, invariably dressed in a dark suit with a blue tie.

Sun Microsystems Inc. chief executive Scott G. McNealy described the rail-thin Doerr as "the Energizer Bunny on steroids."

Louis John Doerr III, the eldest of five children who grew up in a middle-class area of St. Louis, studied electrical engineering at Rice University, went to business school at Harvard and then took a marketing position at chipmaker Intel Corp. Six years later, he joined Kleiner.

Doerr was an almost instant success, funding a string of successful companies in the late 1980s and early 1990s before the general public knew what a venture capitalist was. But his real fame didn't come until the dot-com years.

Between 1991 and 1993, author Michael Lewis noted in "The New New Thing," Doerr promoted "pen" computing, a technology that would allow people to enter data with a stencil on a tablet instead of typing on a keyboard. When that didn't work out, he started talking about the future of interactive television that would allow purchasers to watch shows and do things like chat online at the same time. A few years later, he hit the right trend, promoting the riches that were sure to come from the commercialization of the Internet.

A sampling of Doerr's other predictions:

"All Silicon Valley homes will be connected at high speeds by 2001 -- and still want more."

"By 2001, I believe set-top computers will be as important as PCs, only cost about \$300 to make, and may even be subsidized by the cable companies. They'll allow users to not only view programs but pay bills and purchase products as well."

"Much sooner than a PC on every kid's desk, we'll have a handheld in every kid's pocket."

Things didn't turn out exactly the way Doerr imagined. But he was so successful at making others believe in his ideas that former Netscape chairman James H. Clark once declared, "As a salesman, he's so good he can sell you just as easily on bad concepts."

Artificial Demand

No idea was more associated with Doerr, and Kleiner Perkins, than keiretsu, a Japanese term that refers to a network of interdependent ventures that help each other. Some critics now see it as a not-insignificant cause of the dot-com bubble.

During the late 1990s the Kleiner keiretsu companies, which included e-retailers, optical-networking toolmakers and software companies, would sometimes get their initial revenue from online ads, equipment and services they bought from each other.

SportsLine, for instance, had a deal with Excite At Home to provide the Web site's users with up-to-the-minute game statistics and news; Excite At Home partnered with Healthon/WebMD to create a 24-hour 'virtual health center'; fine-jewelry retailer BlueNile had a home on the merged WeddingChannel/DellaJames site; and WeddingChannel promoted WineShopper.com's selection of chardonnay and merlot.

The result, some critics say, was an artificial demand for the companies' products that was deceptive because it wouldn't have existed without the involvement of Kleiner partners.

Eric Von der Porten, a money manager with Leeward Investments LLC in Silicon Valley, says that while there is nothing inherently wrong with the keiretsu way of doing business, there are questions about whether it was abused, producing an "illusion of prosperity without the economic substance to match."

"During the bubble, [keiretsu] partnerships were one of the most certain ways to 'get big fast.' Many partnerships created enormous amounts of temporary stock market value, but it's not clear that many created lasting economic value," Von der Porten said.

Doerr was at the center of many of these cross-promotional deals.

Managers at Kleiner-funded companies say it wasn't unusual for them to wake up to find e-mails from Doerr sent in the middle of the night making introductions between two companies and suggesting why they might make good partners.

It wasn't a demand exactly, says one entrepreneur, but it wasn't a casual invitation, either. "You knew you had better respond," said Peter Sisson, chief executive of the now-defunct WineShopper.com.

"There was pressure" to work with a keiretsu company, Sisson said, but he added that he was never overruled when he chose a non-Kleiner company as a partner over a Kleiner company. "The partners always respected the CEO's final decision to do what was best for the company."

From Merger to Meltdown

In an era defined by the spectacular implosion of one upstart after another, Excite At Home's was arguably the biggest.

Within a few months of the merger's close, the company found itself on precarious ground as it used up the last of its cash, \$350 million, to purchase an online greeting-card company even as its losses were mounting. Within two years, Excite At Home filed for bankruptcy protection. Within three years, the company closed its doors, its assets sold at fire sales, its 2,500 employees left without jobs.

But when Excite and At Home merged in 1999, the \$6.7 billion stock-swap deal was celebrated as marking a new era in the development of the Internet. Excite was just a portal -- an Internet directory and search engine -- at the time, but people like Doerr had grand visions that it would become an incubator for new multimedia content that would allow a computer to act as television, radio and stereo at the same

time. With At Home's extensive distribution network, the combined company would be able to control what the country watched and listened to.

Doerr was far from alone in his belief that the convergence of entertainment systems would throw into upheaval the way Hollywood did business. He measured the new company's value not only by paid subscribers but by "eyeballs," the number of visitors to its Web site each day. Visitors were assumed to be a proxy for revenue, an idea that became the basic premise of the New Economy.

"John is not afraid to try to do things that are significant," said Milo Medin, a former NASA scientist who helped design the At Home network. "He likes to do things that make a difference. If it's incremental, he's not interested." At Home was a hybrid between New Economy and old-line companies -- it had a young, big-thinking management team that defined the era but had to clear many of its moves with the old-line cable companies that were its partners. Excite in many ways typified the "dot-com." The search-engine company was financed by Vinod Khosla, Doerr's partner, and founded by six Stanford University buddies. Lots of people were visiting the site, but the company hadn't quite figured out how to bring in revenue.

At some point in 1998, when their stocks were flying high, both companies separately began shopping for merger partners.

At Home began talks with Yahoo and Lycos. Excite looked at Microsoft Corp., Yahoo and others. But by early 1999, At Home's management had decided it wanted to do the deal with Excite. There were various reasons, people involved in the discussions say. They felt Excite's technology was superior to its competitors. Plus, it was close by -- its next-door neighbor, in fact -- which would make integration easier. The fact that it, too, was a Kleiner company was also a big part of their decision.

In retrospect, said Richard Gingras, a senior executive with At Home, "We didn't do as thorough of an analysis [of Excite's financials] because they were a Kleiner company. . . . They were on a downward slide."

Investors have grumbled on online message boards that Doerr and Khosla never really believed in the merits of the merger but orchestrated the deal to create enough buzz so the shares of Excite At Home would jump long enough for Kleiner Perkins to sell off its holdings.

But several insiders say that just wasn't the case.

Doerr and Khosla, who were members of the boards of directors of their respective companies, may have strongly advocated the deal, they say, but they did it on the belief that the combined company would thrive.

"Kleiner clearly wanted it to happen. There were folks there that recognized that Excite's fortunes were on the downswing. They thought At Home was so strong that any negative effect from Excite wouldn't matter. In fact, they felt that At Home could better leverage the Excite property," Gingras said.

The day the merger was announced, Doerr hired a plane to fly over the companies' Redwood City, Calif., offices with a banner that said "CONGRATULATIONS T.J. & GEORGE." T.J. was Thomas A. Jermoluk, the chief executive of At Home and now a partner at Kleiner. George was George Bell, chief executive of Excite.

Publicly, Doerr continued to promote the benefits of the merger, but privately his company quietly "distributed," or handed control, of many of its Excite At Home shares to the investors who had put their money in Kleiner's control. These limited partners could sell or hold their shares, but the fact that the venture capital firm distributed them is often taken as a signal to sell.

Kleiner did not have to disclose the distribution, experts say, because it is technically accounted for as a private transfer of ownership of stock and doesn't count as a sale under securities law.

Stanley Sporkin, a former head of enforcement for the Securities and Exchange Commission, said he believes that there should be more obvious disclosure about such moves by venture funds, especially if one or more of their partners sits on the board of directors of the company in question. That way other shareholders would be able to make better-informed decisions about what to do with their own investments.

"If insiders are selling or bailing out either directly or indirectly, they should be required to disclose that," he said.

The Excite At Home merger document states explicitly that venture capitalists who sit on boards of public companies may have dual loyalties: "When considering the recommendations of At Home's and Excite's boards of directors, you should be aware that certain At Home and Excite directors and officers have interests in the merger that are different from, or are in addition to, yours."

The paper, which was mailed out to shareholders, specifically names Kleiner Perkins, Doerr and a fellow partner who was also a board member, William Randolph Hearst III of the famous newspaper family.

Before the merger was announced, Kleiner's 1.6 million shares of At Home were worth \$164.2 million; its 1.4 million shares of Excite, \$94.5 million. By April 26, its At Home stake was worth \$258.5 million and its Excite holdings \$224.7 million.

Securities filings show that Doerr didn't sell any of his personal holdings: He had 576,000 shares that were worth around \$58.7 million when the merger was announced and climbed to \$92.4 million by the time the deal was completed. But Kleiner's distributions seemed to contradict what Doerr himself told everyone about the promise of the company and what he had repeatedly told people in the tech community -- that the value of good companies peaks in years five through 10.

Former employees cite many reasons for the failure of Excite At Home -- a relatively inexperienced chief executive, a series of bad acquisitions that nearly wiped out the company's cash reserves, board members who represented cable companies, specifically AT&T Corp., that sometimes had different interests. More than a few believe the idea of merging a Web portal with a cable company was flawed from the beginning.

Regardless of who is to blame, the impact on shareholders was the same: Those who believed in Doerr's optimistic view wound up losing everything.

No More Predictions

In recent months, Doerr has all but gone into hiding. Kleiner, like other surviving venture capital firms, continues to invest but does so much more conservatively. Some of Kleiner's limited partners are upset with the firm because returns are negative. The trade press has begun to write only about Kleiner's failures rather than about new companies Kleiner is funding.

Doerr, like practically every other director of a public business that has been suffering from the stock market's downturn, must now contend with corporate fraud lawsuits and government investigations into Kleiner-backed companies. He is being sued by shareholders of Amazon, Freemart, Drugstore.com and Martha Stewart Living Omnimedia Inc. At least three Doerr-backed firms, Martha Stewart, Homestore and AOL, are being scrutinized by regulators.

University of Wisconsin law professor D. Gordon Smith believes that most of the flurry of lawsuits against venture capitalists such as Doerr are unfounded.

"When something bad happens we wonder whether someone was evil or stupid. I think it's pretty clear that most of the VCs were not in the first camp. They were not manipulating markets," Smith said. "What they were doing was taking advantage of the situation."

Former congressman Rick White, a Republican from Washington state and a friend of Doerr's, insists that Doerr's views are essentially unchanged. "We don't talk about the New Economy anymore," White said, "but Doerr is a guy who still believes there is a physical power in tech."

The past few times Doerr spoke to a public audience, earlier this year and in 2001, he gave almost identical speeches. He started by saying he had come with "somewhat of an apology" for some of his previous comments. He then flashed slides of his famous "greatest legal creation of wealth" quote and revised it to say "greatest legal creation (and evaporation) of wealth."

But what may be more telling is what he is not saying.

Doerr has stopped trying to predict the future. There isn't, and hasn't been for some time, talk of the next new thing in technology.

Researcher Richard A. Drezen contributed to this report.

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Big Money Fueled Bigger Expectations

Steven Pearlstein, *The Washington Post*, Sunday, November 13, 2002.

They are the gatekeepers to the entrepreneurial economy -- the money guys with the knack for spotting a hot idea or a talented executive team.

Many people know they provide the seed money to promising young companies. What is less well known is that they also provide the wisdom of experience to the young chief executive, the imprimatur that opens the door to credit from suppliers and bankers, the connection to those all-important first customers. Starting a business has always been a who-you-know game, and the trump card is a three-year commitment from a rich and well-connected uncle or a prominent venture capitalist.

Although they act as if it's their own money they're playing with, mostly venture capitalists are an intermediary for other people's money. Not just any other people -- rich and sophisticated investors, pension funds, college endowments, the Saudi royal family. The money is bundled into separate funds, not unlike mutual funds, that invest in a number of companies, usually in exchange for a controlling share of each. When the last of the companies finally is sold, is taken public or closes its doors, the fund is retired and each investor gets his share of the pot -- minus, of course, the guaranteed fees and percentage bonus owed to the venture capitalists for managing the whole thing.

As a rule of thumb, of every 10 companies backed by venture funds, five wind up as dogs and three might be successful enough to pay back all the money invested plus a modest annual return. It is the two big hits -- the ones that return \$20 for every \$1 invested -- by which venture capitalists earn their money and their reputations.

And during the bubble, it was very big money. At the height, in the middle of 2000, venture firms as a whole could boast a 12-month increase in the value of their funds of 143 percent, according to data collected by Thomson Venture Economics and the National Venture Capital Association. Even now, after the bubble has burst and many of the promising young companies have gone bust, the winners turned out to be such big winners that the average annualized five-year return for venture funds is still 35 percent.

With those kinds of returns, it's no surprise that venture capital funds began to attract lots of wannabe investors. In 1995, the year Netscape Communications Corp. went public, venture firms invested \$7.7 billion in promising companies. By 1999, that had grown to \$55.5 billion. The next year it was \$107.3 billion. That's more money in one year than the gross national income of Singapore or Venezuela.

Most now agree that it was too much money chasing too few good investments that created the boom and the bust -- and perhaps no pot of money was more important to that dynamic than venture capital.

Venture capitalists did little to warn investors that their excess enthusiasm was likely to be self-defeating. In fact, they encouraged more investments with speeches on the limitless possibilities of the Internet and the need for companies to quickly bulk up and achieve critical mass.

But having amassed so much money, the venture capitalists found themselves in a box. Either they would lower the standards by which they evaluated companies or business plans, just to put all of the money to work, or they could leave a significant amount of the money uninvested, knowing that it would pull down their sky-high rates of return and make it harder to attract new investors in the future. The evidence suggests that many venture capitalists convinced themselves that there were still plenty of good opportunities out there.

Much of the early action revolved around the Internet and centered in the financial corridor connecting San Francisco, Palo Alto and Silicon Valley. But in time other cities attracted their own venture capitalists to support their own technology segments, including Washington, which trails Boston, New York and Los Angeles.

Until recently, most of the money made by venture capitalists was reinvested in venture funds, creating a virtuous circle in which success fed success. But with the average venture fund having suffered a 24 percent loss so far this year, the circle has turned vicious. Money is slowly flowing out of the sector, with new investments by funds running at the annual rate of about \$21 billion. Most of that money is going not to promising new start-ups but to keep alive the best of a bad lot of old investments in the hopes of turning things around.

Top 10 Venture Capital Firms

	1	2	3	4	5
	JP Morgan Partners	New Enterprise Associates	Warburg Pincus	Kleiner Perkins Caufield & Byers	Oak Investment Partners
Total invested 1/1/90 to 9/30/02	\$4.1 billion	\$3 billion	\$3 billion	\$2.1 billion	\$2 billion
Capital under management	\$25 billion	\$4.9 billion	\$10 billion	\$1.2 billion	\$2.6 billion
Minimum investment*	\$5 million	\$200,000	Varies	\$30 million	\$8 million
	Founded in 1984. This is a unit of the global investment bank J.P. Morgan Chase. It funds all stages of companies.	Founded in 1978. NEA is a classic venture firm that focuses on start-ups in the technology and health-care fields.	Its predecessor company was founded in 1939. Warburg Pincus invests globally in companies at all stages of development.	Founded in 1972. Kleiner focuses on new technologies and new applications of technology that will drive high-impact change.	Founded in 1978. Oak is a classic venture firm that funds start-ups and provides follow-up rounds of financing as those companies grow.
	6	7	8	9	10
	Goldman Sachs & Co.	Mayfield	Sequoia Capital	Accel Partners	Intel Capital
Total invested 1/1/90 to 9/30/02	\$1.9 billion	\$1.8 billion	\$1.8 billion	\$1.7 billion	\$1.6 billion
Capital under management	\$5.2 billion	\$2.4 billion	N/A	\$3 billion	\$5.9 billion
Minimum investment*	Varies	\$7 million	\$50,000	Varies	Varies
	Founded in 1869. Goldman's merchant-banking arm invests in and manages a series of funds that provide capital in many sectors.	Founded in 1969. Mayfield is a classic venture investor that focuses on communications and enterprise software companies.	Founded in 1972. Sequoia is a classic venture fund that focuses on start-ups in software and technology services and components.	Founded in 1983. Accel is a classic venture fund that focuses on start-ups in networking and software.	Intel Capital is the investment arm of Intel Corp. It focuses on financing and acquiring companies that support Intel's strategic interests.

*Smallest amount fund will invest in start-up company

SOURCES: PricewaterhouseCoopers/Venture Economics/National Venture Capital Association MoneyTree Survey; IPO.com; Post research

A Flawed Relationship

The \$6.7 billion merger between once-profitable At Home and money-losing Excite didn't fare well over the long term.

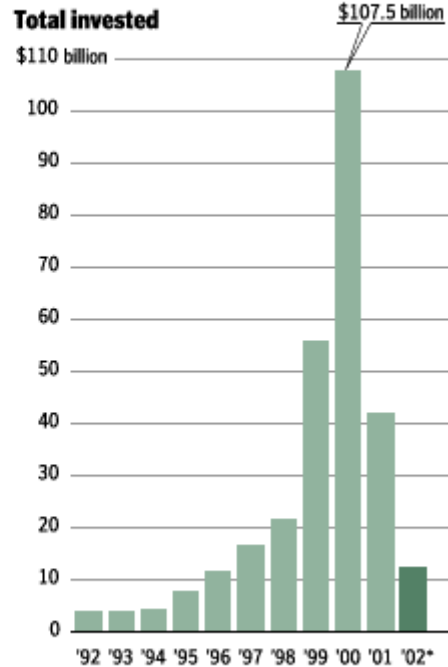
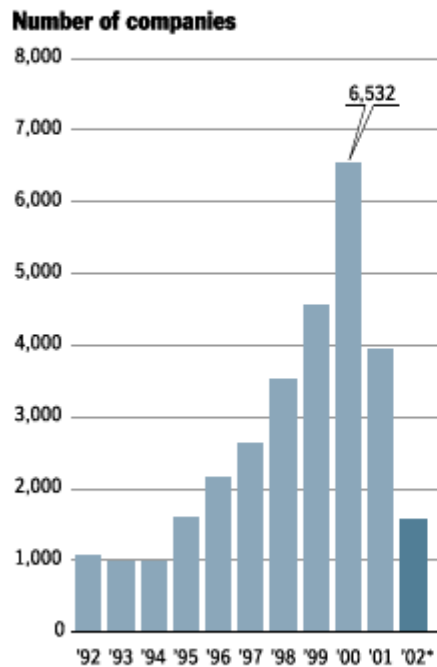


SOURCE: Bloomberg News NOTE: Historical stock prices not adjusted for splits.

THE WASHINGTON POST

Funding Comes Full Circle

Venture capital investment soared in the Bubble Economy but is now headed toward levels last seen in 1996.



SOURCES: PricewaterhouseCoopers/Venture Economics

* Through June 30

THE WASHINGTON POST

Fifth of Six Articles

Banks Go From Powerhouses to Pariahs

Jonathan Krim, *The Washington Post*, Thursday, November 14, 2002.



Credit Suisse First Boston was once Silicon Valley's leading IPO bank and Frank Quattrone one of its superstars. He's now vilified by investors. (Jeff Carlick -- Bloomberg News)

On Oct. 8, 1999, a small software start-up in Silicon Valley called Interwoven Inc. took its turn at the bellows of the nation's stock market bubble.

In a story repeated hundreds of times during the technology boom, Interwoven started trading at \$43 a share and ended the day up 141 percent from its IPO price of \$17. And as usual with initial public offerings of stock, huge amounts of money were made, both by those who were able to buy shares ahead of time and by the investment bank that handled the offering -- in this case, Credit Suisse First Boston Corp., which earned \$2.7 million in fees.

Frank Quattrone, the star technology banker who helped make CSFB the Valley's leading IPO bank, had a special interest in the success of the deal. Along with several other CSFB bankers, Quattrone, who at the time reportedly made \$100 million a year, was able to buy Interwoven shares at an even lower, pre-IPO price: \$8.49 a share, according to regulatory filings. A year later, when the stock had risen to \$90 a share after splitting twice, the bankers sold their shares for \$3.4 million, the filings show. An internal fund operated by the bank cashed in shares worth an additional \$19 million.

That year, a CSFB research analyst touted Interwoven's stock, calling the market for Web-site-building software an "explosive, multibillion-dollar opportunity." CSFB maintained a positive rating on the stock into the spring of 2001. Today Interwoven trades for less than \$3, but its performance has been remarkably consistent: It has never made money.

Celebrated in an earlier boom -- the 1980s -- as "Masters of the Universe" for their skill in leveraged buyouts and corporate mergers, Wall Street's investment bankers found lucrative new opportunities in the 1990s, an era whose hallmark was the extraordinary availability of capital.

Some sold new forms of derivatives, complex and high-risk investments that offer tantalizing returns if the buyer is willing to make a bet on, say, whether the value of the currency of Thailand will go up or down. Others advised corporations on "structured" financings that allowed companies such as Enron Corp. to raise billions in cash but also to avoid taxes and hide debt by using complicated partnerships, off-the-books transactions and related exotic investment products.

Still others pounced when the tech boom hit.

Although it was the venture capital funds that gave the tech start-ups the money to begin operations as fledgling private companies, it was the investment banks that took them to the big time -- the public stock markets -- enabling many unprofitable firms to raise billions of dollars from investors. This helped spawn a

stock market boom that enriched many in the know but ended in losses for hundreds of thousands of less-informed Americans.

Today, several major investment banks -- including such storied names as Morgan Stanley, Goldman Sachs and Merrill Lynch -- are under investigation by regulators and face multimillion-dollar fines and lawsuits for banking practices over the past five years. One of the besieged, but less well known, is Credit Suisse First Boston.

It has paid \$100 million to settle claims that it demanded kickbacks from investment managers in exchange for hot IPO shares. It is being sued by Massachusetts regulators for providing misleading or deceptive research to boost demand for stocks. Overseas, its bankers have run afoul of regulators in Britain, Sweden and Japan.

Quattrone, once a Silicon Valley celebrity, now stands vilified as an icon of Bubble excess.

In many ways, CSFB mirrored the times. Just as many tech start-ups sought to displace established industry giants through aggressive innovation, CSFB sought to topple its bigger, stodgier Wall Street brethren. It failed in that mission, but some of its bankers and tactics helped shape the industry.

CSFB "was as aggressive as it gets," said Michael Holland, a New York money manager who worked at the firm. "Wall Street is a very small place. In terms of competitiveness, these were the cowboys. It was no holds barred, take no prisoners."

Another former CSFB senior banker, who like most people interviewed for this account insisted on anonymity, said the culture at CSFB was that "you never turn down a deal."

"If the client has a problem, we can figure out a way to solve it," the banker said of the ethos.

Officials at CSFB refused to make Quattrone and other top bankers, including chief executive John J. Mack, available to comment for this story. They said that CSFB's practices were the industry standard at the time and that the bank should be judged on that basis, not unfairly singled out.

But they point to several changes Mack has instituted since joining CSFB last year. These include bringing in Gary G. Lynch, a former Securities and Exchange Commission enforcement chief, as general counsel; changing how the bank allocates IPOs; and giving research analysts more independence from bankers.

"Wall Street, like all of corporate America, is facing a crisis of investor confidence exacerbated by a protracted bear market and some shocking examples of corporate abuses," Lynch said in a statement yesterday. "In hindsight, it is easy to see that many investment banks -- together with most institutional investors, government and independent economists, the media and other market participants -- were overly optimistic about the anticipated performance of some high-growth sectors in the economy. To help restore investor confidence, our industry must now do a better job of assuring investors that we are properly managing any potential conflicts of interest and that our research meets the highest standards of independence."

[Changing the Calculus](#)

The New York Stock Exchange sits on Wall Street. Investment bankers *are* Wall Street.

In richly appointed, dark-wood-paneled offices they are investment advisers and portfolio managers for wealthy private clients. In branches around the world they facilitate corporate mergers and buyouts and underwrite IPOs. On raucous trading floors they buy and sell securities of every color -- basic stocks, junk bonds and derivatives.

These transactions, executed for clients and for the banks themselves, make the markets run. Bankers conceive complex financing deals that help companies raise money. Through their research arms they advise clients on the prospects of stocks. They lend money. There are hyperactive dealmakers who seek ever-higher fees with cutthroat zeal. And there are salesmen who earn hefty commissions selling high-risk investments.

Modern-day investment banks trace their roots to post-Depression reforms in the financial system, when regulators prohibited traditional commercial banks -- whose primary role was making loans and taking deposits -- from being involved in the securities-and-trading side of the business. But those lines blurred over time and would be formally wiped away with the repeal of the Glass-Steagall Act in October 1999.

By then, Morgan Stanley, Goldman Sachs and Merrill Lynch were entrenched as the heavyweights of Wall Street, the "bulge bracket" players. In 1998, Morgan Stanley netted \$3.3 billion in profit; Goldman Sachs recorded \$2.4 billion.

For years, CSFB had tried to break into the rarefied top tier.

It was just First Boston Corp. during most of the 1980s, a firm that, by one account, was the prototype of the aggressive suspenders-and-slicked-back-hair culture popularized in the movie "Wall Street." In 1988, First Boston was bought out by the Zurich-based financial conglomerate Credit Suisse Group. First Boston got a deep-pocketed partner from the deal, and Credit Suisse gained a strong foothold in the United States, particularly in mergers and acquisitions.

The combined CSFB went on an acquisition spree, adding smaller trading and banking firms around the world to fill holes in its areas of expertise or market share. In 1996 it had roughly 5,000 employees. By the end of 1999, that number had nearly tripled.

Leading the charge to become a global powerhouse was the bank's then-chief executive, Allen D. Wheat, a blunt-spoken expert in trading derivatives. Wheat was famous for raiding whole teams of professionals from competitors, and just as the technology sector began to hit overdrive in 1998, he hired Quattrone to run CSFB's technology banking group.

Philadelphia-born, Quattrone was educated at the Wharton School and Stanford University. He started work on Wall Street at Morgan Stanley. He was not a typical Wall Streeter, heading west in the early 1980s, eschewing the rough and tumble of New York for the embryonic center of technology growing in the apricot and prune orchards of Silicon Valley.

When Quattrone arrived on the West Coast, the personal computer was making its debut, and a handful of successful companies such as Apple Computer Inc. and chipmaker Intel Corp. were riding the first wave of the tech boom.

Quattrone cultivated relationships with venture capitalists and tech executives, dressing casually and grasping technology's growth potential before his colleagues back in New York. Eventually, he persuaded Morgan Stanley to underwrite tech-company IPO deals that by major-bank standards were still so small they would normally be ignored by the Wall Street giant.

Traditionally, banks did not take companies public until they had been profitable for at least two or three quarters. Instead, companies were expected to wisely spend and ration the private funding they had received until their businesses proved viable. Only then would they be offered to public investors.

Then, in 1995, Quattrone took Netscape Communications Corp. public. The stock soared 107 percent on the first day and helped change the calculus.

Unlike the computer hardware companies that provided appliances that would make work and life more efficient, the Internet threatened to scramble the foundations of commerce itself, not to mention those of its major players. The technology of the Internet and a networked world was in its infancy, but its potential seemed certain -- and limitless. And investors were eager.

A new kind of alchemy was born. The requirement for near-term profit -- Netscape, for example, was giving away much of its software and losing money -- was replaced by almost any measure of growth that hinted at the promise of domination later.

Enabling a large portion of the public to invest in these stocks minimized the risk for the financial institutions and early investors who helped launch the companies. Regardless of how a business fared, its stock usually soared high enough, and for just long enough, for many on the inside to cash out.

In the process, risk was transferred to investors who came in at later stages, ponying up for stocks at prices that would prove unsustainable, even as they were told by bankers' research analysts that prices could go higher still.

In 1996, emboldened by the success of Netscape and the dizzying array of Internet-related innovations, Quattrone began to get antsy, according to those who worked with him. By then a Silicon Valley fixture, he believed his bosses in New York still didn't understand tech's potential, didn't give him enough control and didn't pay him enough.

"As part of the Bubble, investment bankers got a lot of leverage with their employers," said one person who knew him. "In 1996, Frank put the screws to them pretty good."

Quattrone wanted control over the entire tech-banking universe at Morgan Stanley, including analysts who followed tech companies, according to several people familiar with his operation. Combining authority over banking functions and research was a novel idea; conventional wisdom held that analysts served as important checks against bankers whose compensation came from doing deals with companies regardless of their prospects.

But Quattrone, according to those who worked with him, believed the relationships needed to be integrated so that a potential client with an IPO would have some assurance that if the bank took the company public the bank would support it with research.

Other banks did the same, and, as several regulators have charged, stock research was compromised or deceptive. Decisions to take companies public were reinforced by the bankers' research units.

Quattrone's demands were turned down by Mack, who was then president of Morgan Stanley. Quattrone jumped to a firm that gave him a better deal and some of the control he wanted: Deutsche Morgan Grenfell, a German-owned bank with aspirations to grow in the United States. In 1997, Quattrone scored another major tech IPO: Amazon.com Inc. The following year, Wheat called and persuaded him to join CSFB.

Quattrone took so many members of his team with him in July 1998 that CSFB simply took over the offices they were in and changed the name on the doors. Bankers said he got control over tech banking, tech trading and tech stock research, as well as the commitment of at least \$25 million from the bank to invest in internal funds that traded stocks for the bankers and other special clients.

Such was Quattrone's independence that a CSFB insider described it as having "a company within the company."

The results were remarkable. In 1998, CSFB handled six domestic tech IPO deals, valued at \$269 million, putting it sixth among the banks, according to financial data from research firm Dealogic Inc. By the end of

1999, at the height of the Bubble, it jumped to first, handling 51 deals -- twice the number handled by Goldman Sachs or Morgan Stanley.

In 2000, CSFB again handled nearly twice the number of issues as its top competitors, although in overall dollar terms it was never able to topple its big rivals.

For two years, demand from companies seeking to go public was "insatiable," said one banker, and Quattrone "was feeding the market what it wanted to eat."

"Frank didn't care about anything else. . . . It was buyer beware. He got paid for the IPO," the banker said.

Quattrone was willing to let some people in on the action, through what became known in the Valley as "Friends of Frank" accounts. Quattrone promised shares of IPOs the bank was handling to wealthy potential clients, such as chief executives and venture capitalists, if they would open private bank accounts at CSFB, people familiar with the firm said.

According to the bank, the client could not cherry-pick among the offerings and had to decide whether to accept all IPO shares or none.

In a 1998 interview with Fortune magazine, while still at Deutsche Morgan Grenfell, Quattrone said that standards for bringing companies public had loosened, which he attributed in part to investor demand. Nonetheless, he maintained that the bank turned down a majority of the companies seeking to go public.

"Investors have become more aggressive because of the Internet," he told Fortune. "They're so afraid they'll miss something." A CSFB spokeswoman rejected the notion that the bank was less rigorous than its competition in its decisions about which companies to take public.

Working the Footnotes

In addition to getting the action he wanted in the tech arena, Wheat wanted to build up CSFB's capabilities in other areas that could earn the firm fees for supplying capital to companies in unusual ways. So he bought a second-tier competitor, Donaldson, Lufkin & Jenrette Securities Corp., better known as DLJ, in 2000. With it came a creative team of bankers in an esoteric area known as "structured finance."

"DLJ was way out there . . . more aggressive than CSFB" in areas such as structured finance and junk bonds, according to a former CSFB banker. DLJ had taken on many of the bankers from Drexel Burnham Lambert Inc., the infamous home of Michael Milken that imploded in scandal in the 1980s.

One prominent team leader at DLJ was Laurence Nath, known in Hollywood as a brilliant banker who, while working for Citigroup Inc., did innovative financing deals for the movie industry. In 1998, Nath's team developed a close working relationship with an energy company called Enron Corp.

Nath was one of a cadre of bankers in the industry who, steeped in the arcane rules of accounting, would be called in to help companies meet particular needs, such as raising cash, transferring debt or reducing taxes. At CSFB, the structured-finance experts executed dozens of complicated financings for several clients.

"These are very sophisticated people who are experts in taxes, experts in legal structures," said Jennifer E. Bethel, a finance professor at Babson College who served as chief economist for the SEC's corporate finance division. "They could make a deal that otherwise couldn't get done."

CSFB declined to make Nath or any banker on his team available for comment.

Structured finance can be a legitimate way for companies to get capital from sources other than their core operations, allowing them to invest more in their businesses.

This form of financing might, for example, allow a company to place an asset, such as a power plant, into a special entity such as a partnership, trust or subsidiary. By selling or transferring the asset to the entity, the company raises cash. To pay for the asset, the entity issues bonds to investors. Since the obligation to pay off those bonds resides on the balance sheet of the special entity, not of the parent company that got the cash, the company's overall debt looks smaller.

In some cases, especially Enron's, partnerships were wrapped up in subsidiaries owned by trusts in a seemingly endless maze. Some were incorporated offshore. Some were run by Enron employees, and Enron was able to take large deductions for entities "sharing" administrative costs and other expenses.

At the core of many of the structured deals, though, was that the primary company was ultimately on the hook for paying off bondholders. Depending on how much a company disclosed about these entities and how they worked, identifying how much that commitment to pay might affect a company's bottom line would be difficult even for experts.

Lynn E. Turner, a former chief accountant of the SEC, told Congress in July that "many of these structured or engineered transactions are done to circumvent existing accounting rules."

"I can't tell you, Mr. Chairman, how often . . . I heard the common refrain 'Where does it say in the accounting literature I can't do it?' " Turner said.

Nath and his team were not involved in some of Enron's most infamous off-the-books transactions, with names such as Chewco and Jedi, through which Enron executives allegedly enriched themselves. CSFB argues that Nath was a bit player, developing three partnerships out of thousands for Enron, and that they were transactions fully cleared by credit agencies and disclosed to the financial markets.

But a senior Enron official said that for the company, "CSFB was one of the go-to investment banks in terms of some of the more complex off-balance-sheet structures."

The Enron executive said that Nath and an associate, Dominic Capolongo, were deeply involved in structuring several deals for Enron, with Capolongo spending a great deal of time at Enron's Houston headquarters, working with top Enron executives.

CSFB was also an investor in one of Enron's many partnerships, was a significant adviser on Enron mergers and acquisitions, and handled \$1 billion worth of Enron stock and bond underwriting.

Some experts say most disclosures of these kinds of deals are not adequate, especially because they often appear in footnotes to financial statements.

"The 'big-think' was that as long as disclosure was in the footnotes, the market would correct itself," said Frank Partnoy, a finance professor at the University of California at San Diego and a former derivatives trader. "That turned out to be totally false." The special entities, he said, "were explicitly designed in the mid-'90s to make the financial statements look better and push details off into the footnotes."

Paying the Penalties

The first rupture of the Bubble came in March 2000. And although many companies continued to go public that year, the markets began their relentless slide. By mid-2001, the banks were hurting.

That June, CSFB announced that it was firing three of Quattrone's tech brokers amid an SEC investigation into the bank's IPO-allocation practices. The bankers were accused of demanding kickbacks from money

managers for allocations of hot IPO shares. Two of those fired subsequently sued CSFB for allegedly sacrificing them as scapegoats.

Under the scheme, the SEC said, money managers were required to pay inflated commissions to buy shares of other stocks through the bank's trading operation. The inquiry would prove to be an early insight into an array of industry IPO-trading practices that regulators say helped power the raging bull market and reinforce its momentum.

The most serious of these was a practice known as "laddering," in which clients were told that in exchange for IPO allocations, they had to agree to purchase shares of the stock after it opened for trading, thus heightening demand and driving the price higher.

CSFB denies it engaged in the practice, although it is accused in shareholder lawsuits of having done so. To date, the SEC laddering inquiry has focused primarily on Goldman Sachs and Morgan Stanley.

The banks are also being investigated for allegedly using IPO allocations as a reward for getting other banking business from companies.

A month after CSFB fired the three bankers, it fired Wheat. The SEC investigation was but the latest in a string of international embarrassments that resulted in regulatory action against the bank in Sweden, Britain and Japan.

In one case, a group of traders in London who called themselves the Flaming Ferraris -- after an exotic cocktail at a bar they frequented -- would loudly flaunt their trading riches at social clubs around the city. Then, one of them attempted to execute, by cell phone, a major trade on the Swedish stock market without a license.

In place of Wheat, CSFB hired Mack, whose stated intention was to restore the bank's integrity and improve its bottom line, which was suffering after the stock market's steady decline. Tech banking had essentially dried up.

One of the first issues Mack dealt with was the lucrative compensation contracts that had been given to Quattrone and other star bankers. Many of these bankers were the most highly paid on Wall Street, which was keeping CSFB's costs high even as revenue plunged, according to Rachel Barnard, a financial industry analyst at Morningstar Inc.

Mack tore the contracts up and rewrote them, saying the bankers could leave if they didn't like it.

Quattrone's control over tech research already had been loosened, after Wall Street's trade association recommended changes to industry practices.

This January, CSFB formally settled the SEC investigation by agreeing to pay \$100 million in penalties. The settlement does not single out Quattrone, although former employees say he controlled virtually every activity of the tech banking group. About nine months later, the SEC fined and suspended two CSFB bankers in connection with the case. CSFB said it did not find sufficient cause to fire Quattrone or the other two bankers, although the firm reportedly increased the size of the fines and the length of the suspension of the two already disciplined by the SEC.

Quattrone remains head of global tech banking and was elevated to the bank's executive board late last year.

Mack, who was known as Mack the Knife at Morgan Stanley, has seen his reform plans complicated this year by the aggressive pursuit of the bank's research practices by Massachusetts regulators as part of a coordinated inquiry into the major investment banks.

In a series of embarrassing disclosures, internal e-mail from CSFB and Merrill Lynch has been released, showing how research analysts were pressured by bank superiors to tout stocks even when they knew the stocks were suspect.

"It was reckless," said William F. Galvin, the Massachusetts secretary of state who is heading the securities investigations. "They were very disinterested in fulfilling their fiduciary duty and totally driven by the need for profit," Galvin said of CSFB. "They were boastful about the deceptions and deceits."

The state has filed formal civil charges against CSFB. Bank officials deny the allegations, calling them riddled with inaccuracies. They argue that individual analysts had the power to reject banker pressure.

Bank officials also stress the many changes at the firm since Mack took over, including that analysts are now prohibited from owning stock in companies they cover. The officials say they are cooperating with the various investigations and have adopted changes recommended by New York Attorney General Eliot L. Spitzer, who has spearheaded the probes.

And they say they are prepared to follow whatever global settlement is reached between the industry and regulators, which is under negotiation.

Galvin said he filed his action separately because he isn't convinced by the claims of any investment banks.

"History has shown that they pay a big fine, make some personnel changes and then find a way to do what they are going to do," he said. "We need to make some real changes.

"You can't just say we have a few new people and then say, 'Are we okay now?'"

Staff researcher Richard Drezen contributed to this report.

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Neglecting Their Watch, the Sentries of the Markets Fall From Grace

Steven Pearlstein, *The Washington Post*, Thursday, November 14, 2002.

Since the days of J.P. Morgan, investment bankers have been the kingpins of Wall Street. As the gatekeepers of the financial markets, they determine which companies can issue stock and bonds and which investors get an inside track on the best deals. Corporate mergers and acquisitions could not be consummated without their involvement and blessing. Their services are so highly prized that they can routinely generate returns on equity of 25 percent.

Investment banking was a business built on trust. Companies issuing stocks and bonds needed to know that their bankers had a large stable of potential buyers for their securities as well as a reputation for pricing them fairly. Buyers relied on the bankers to scrub the issuers' financials to ensure that the frauds and charlatans had been weeded out. Investment bankers staked their money and their reputation on the deals they underwrote.

All that began to change in the 1980s with the emergence of the "junk bond" market and the upstart investment bank that effectively created it, Drexel Burnham Lambert Inc. Suddenly, companies once considered too small or run by the wrong sort of people were given keys to the financial kingdom. And when too many sank under the weight of too much borrowed money, the junk-bond market collapsed with them, bringing financier Michael Milken and the entire Drexel firm, too.

For investment bankers, what distinguished the 1990s bubble was the size and complexity of the deals they brought to market and the number that proved to be disappointing for investors.

In 1995, for example, the combined value of all corporate mergers and acquisitions plus the amount of capital raised through Wall Street firms totaled roughly \$1 trillion. Five years later, the figure soared past \$3.5 trillion, generating an estimated \$28 billion in fees. The economy of New York City and its environs literally floated on a sea of Wall Street paychecks; employment by securities firms increased by 50 percent.

There was more to this than traditional merger work and initial public offerings. The repeal of the Depression-era Glass-Steagall Act in 1999 opened the door to the re-integration of banking with investment banking, allowing newly combined entities such as Citigroup Inc. and J.P. Morgan Chase & Co. to provide companies with financing packages that incorporated stocks, bonds, commercial loans and all manner of complex new arrangements under the banner of "structured finance." These new instruments allowed companies to turn paper assets into cash and to hedge risks of all sorts, from the direction of their own stock price to the vicissitudes of the weather. In less scrupulous hands, however, they could also be used to avoid taxes, skirt accounting rules and shift debt off the corporate books.

Now the bursting of the bubble has humbled these masters of the financial universe. Investment-banking fees may fall as low as \$16 billion this year, reflecting a reduction in both the flow of deals and profit margins. Securities firms have already shed 70,000 jobs while writing off billions of dollars in bad loans and worthless paper in their own portfolios. Compensation packages for investment bankers are likely to come in this year at about a third of what they were at the peak. Much of the energy once put into structuring deals is now devoted to fending off investigations by regulators and lawsuits by stock- and bondholders whose money has been lost.

So far, none of the major Wall Street firms have been threatened by this assault on their balance sheets. But the damage to their reputations is another matter. The virtual closure of the window for new stock and junk-bond issues reflects, in part, a view among investors that they can no longer rely upon the investment banks to act as the gatekeepers and honest brokers of financial markets. In the future, they are likely to be ranked not based on the traditional metric of how many deals they have brought to market, but on how many of those deals actually made money for investors.

The Bankers

CREDIT SUISSE FIRST BOSTON



Frank Quattrone
Chief, technology banking,
Credit Suisse First Boston,
July 1998-present

Quattrone became the powerhouse technology banker in Silicon Valley in the late 1990s. He helped put the Internet on the investing map by taking Netscape Communications public in 1995.



Allen D. Wheat
Chief executive,
Credit Suisse First Boston,
1997-2001

Wheat, a derivatives specialist, joined the bank in 1990 and became CEO in 1997. He quickly sought to make the bank a top-tier player, acquiring smaller firms and hiring top talent such as Frank Quattrone.



John J. Mack
Chief executive,
Credit Suisse First Boston,
2001-present

Known as Mack the Knife, Mack took over last year with a mandate for reform amid revelations about the firm's banking practices. He recently was named co-CEO of CSFB parent Credit Suisse.



William F. Galvin
Massachusetts
secretary of state,
1995-present

Galvin has taken the lead role among state regulators in investigating CSFB's research and has sued the bank, charging deceptive practices. CSFB says the charges are unfounded.

OTHER TOP WALL STREET EXECUTIVES



David H. Komansky
Chief executive,
Merrill Lynch,
1996-present

Earlier this year, Merrill paid \$100 million in fines in connection with its research practices. Of the major investment banks, Merrill is the most active in serving as a brokerage for individual investors.



Henry M. Paulson Jr.
Chief executive,
Goldman Sachs,
1998-present

Goldman has long been one of the top two Wall Street banks. Paulson has said research deteriorated in the bubble years, but he blames companies that pressured research analysts.



Philip J. Purcell
Chief executive,
Morgan Stanley,
1997-present

Morgan Stanley frequently jockeys with Goldman Sachs for top honors in the investment-banking world. Both Frank Quattrone and John Mack worked at Morgan Stanley before going to CSFB.



Sanford I. Weill
Chief executive,
Citigroup,
1998-present

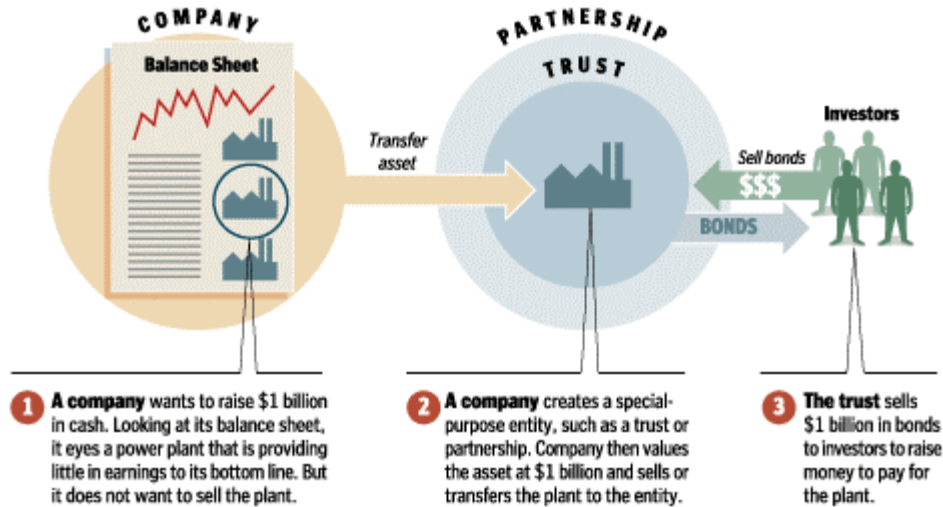
Citigroup has been in the spotlight over the actions of its star telecommunications analyst, Jack Grubman, who was forced to resign. The bank recently gave its research unit full autonomy.



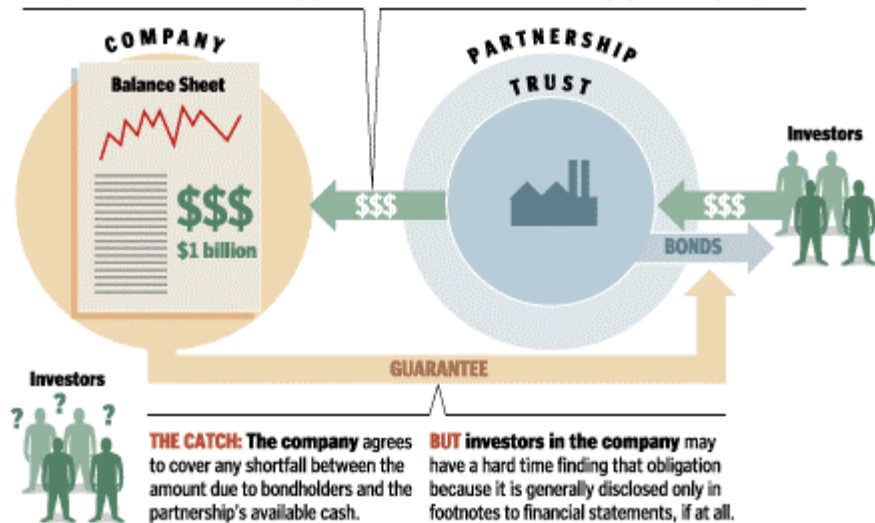
William B. Harrison Jr.
Chief executive,
J.P. Morgan Chase,
2001-present

In the aftermath of Enron, Harrison has defended structured finance practices, writing in an op-ed article that the banks were victims, not architects, of Enron's questionable financing deals.

How a Typical Structured Finance Deal Works



4 The \$1 billion in cash raised by the bonds is then passed back to **the company** to "pay" for the power plant. The trust makes interest payments to bondholders from the earnings generated by the plant.



Last of Six Articles

The Market Scholars' Star Turn

A Blurring of the Lines Produced Troubling Conflicts

Paula Span and Ben White, *The Washington Post*, Friday, November 15, 2002.



Analyst John E. Olson was censured for being skeptical about Enron. "The business has been so hopelessly compromised," he says. (Michael Stravato For The Washington Post)

John E. Olson, a senior natural gas analyst at Merrill Lynch & Co., wasn't surprised to see his boss walk into his 27th-floor office first thing in the morning. He'd mentioned that he'd be flying in from New York to interview a job candidate.

What shocked Olson that morning in May 1998 was that his boss closed the door and sat down, "and the first word out of his mouth was 'Enron.' "

"How could you do this?" his boss said.

"Do what?" Olson wondered.

"You've blown this deal," he remembers his boss, the firm's research director, saying. "We're missing this thing." He meant that Olson's stubborn resistance to giving Enron Corp.'s stock a "strong buy" rating -- which Olson knew had infuriated the energy giant's top management for years -- was having unacceptable repercussions for Merrill Lynch.

His boss, Andrew J. Melnick, then threatened to strip Olson of his stock options and other benefits critical to his eventual retirement, Olson says. Alternatively, Melnick, who declined to comment on the encounter, said he would consider allowing Olson to take early retirement at age 56. Either way, after six years with Merrill Lynch, he was out.

There didn't seem to be much room for negotiation. Olson went home and told his wife he'd been forced out of his job. "If your choice is to walk the plank and get eaten by alligators or to take early retirement, what are you going to do?" Olson says now.

In retrospect, perhaps he shouldn't have been so shocked.

Hadn't he tangled at analysts' meetings, sometimes even at social occasions, with top Enron executives who asked when he was going to raise his recommendation? Instead, he'd downgraded its rating from "accumulate" to "neutral" the summer before. Hadn't he heard "rumors, backdoor things" about how ticked off Merrill Lynch's investment bankers were at his intransigence?

But Olson, who'd been an equities analyst for more than 30 years, hadn't quite grasped the extent to which his profession, and the financial industry itself, had changed around him. He was still relying on "Chinese wall" policies that traditionally protected analysts' independence, insulating their research from

their firms' banking and trading interests -- and the wall was crumbling as the '90s brought more deals, more money, more pressure.

Not until this spring, when Senate investigators obtained internal memos and e-mails indicating that Enron and Olson's own colleagues were gunning for him, did he realize just how out of step he'd become.

Now resettled at a smaller Houston securities firm, reading press revelations about what some analysts have done and what's been done to them, about multimillion-dollar fines and "spinning" and lawsuits, he almost mourns. "The business," he says, "has been so hopelessly compromised."

'Analyst' Redefined

Once, in the years before federal, state and industry regulators began scrutinizing them for conflicts of interest, analysts were Wall Street's scholar-geeks, poring over balance sheets and running financial models.

"Good securities analysts," Olson says, "are crossword-puzzle people and chess players." They didn't expect to get paid nearly as much as investment bankers or traders; in 1966, when Olson received his Wharton School MBA, the thought of an analyst ever earning seven figures in a year was laughable. They were not public figures. They liked quietly figuring things out.

Olson still does. An exemplar of the breed, he is unassuming, thoughtful. Everything about him is long and thin -- face, limbs, torso -- and a pair of schoolmasterly tortoise-shell reading glasses heightens the resemblance to Ichabod Crane. Neat stacks of prospectuses, trade journals and regulatory filings cover much of his office floor at Sanders Morris Harris Inc., where he is the director of research.

He learned the trade during nearly five years at Smith Barney in New York, then spent several years at investment firms in Atlanta, doing what analysts did: talking to company managers and customers, examining quarterly reports and other documents, doing legwork, issuing data and forecasts. Always concentrating on the energy industry, he was excited to be recruited by a regional firm in Houston, which in the late '70s was "the energy capital of the planet." He visited oil fields in Guatemalan jungles and on Alaska's North Slope.

Like most on Wall Street, he didn't foresee that federal legislation in 1975 would have a seismic effect, eventually transforming the analyst's job description. Amendments to the Securities Exchange Act of 1934 deregulated the fixed commissions that brokers charged for stock trades, and the commissions promptly "fell off a cliff," said John C. Coffee Jr., a Columbia University securities-law expert. Since firms' trading departments had paid analysts' salaries, and the profit margins from trading were shrinking, someone had to pick up the tab. The upshot was that investment-banking divisions began paying an increasing proportion of "sell side" research costs and expected certain services in return.

(Sell-side analysts like Olson work for brokers and dealers who sell securities; those who manage mutual funds and pension funds hire analysts, too, but that "buy side" research stays in-house and rarely reaches the public.)

The changes began affecting Olson's career, but in small, almost imperceptible ways. Throughout the '80s he felt few ripples, though he did catch a glimpse of the way corporate chieftains had begun expecting analysts to sound perennially upbeat. Working for Drexel Burnham Lambert Inc. in Houston, he crossed paths with one of its more colorful clients, oilman T. Boone Pickens. Olson didn't think Pickens's attempt at a hostile takeover of Gulf Oil L.P. would succeed, and he said so; he says Pickens subsequently collected his skeptical published comments and sent copies to Drexel Burnham's board members -- and to Olson. Olson's packet included a note from Pickens complaining that his remarks were "singularly inappropriate." (Pickens says he remembers Olson but not the incident.)

Whatever its later problems -- the firm imploded in the midst of the junk-bond scandal -- Drexel Burnham supported its analyst and, according to Olson, "never once told me that I needed to recommend anything."

But the growing influence of investment banking was becoming more evident. In 1990, by then working for First Boston Corp. in Houston, Olson gave an interview to Forbes magazine, recommending eight natural gas stocks he considered likely to prosper after the Iraqi invasion of Kuwait. Enron was not among them.

He'd covered the energy company and its predecessor firms for years, "since before Enron was Enron," knew many of its people, and had even attended chief executive Kenneth L. Lay's wedding reception. And he'd already begun to hear from Lay about the lukewarm recommendations. Lay, he'd found, was "very affable and amiable" with analysts but would call their bosses or investment bankers when he had complaints. But concluding that Enron "was still having trouble earning its dividend," that "it still had a lot of leverage" -- meaning debt -- "and it was very expensive," Olson left the stock off his list.

First Boston's head of energy investment banking was in his office shouting almost as soon as the magazine hit the stands. "He'd just been visiting with Ken Lay," as Olson remembers the conversation, "and Ken was saying he paid First Boston millions of dollars a year in investment banking, and its blankety-blank analyst couldn't have Enron featured in Forbes magazine?"

If Olson didn't give Enron a "strong buy" recommendation by the end of the year, he'd be fired, the banker warned. He called Olson's boss -- First Boston's research director in New York, who confirms Olson's account -- and made the same threat.

His boss, however, "was right there, telling these bankers to get out of his business, that they were way beyond the pale," Olson said. Ignore the blustering, Olson's boss told him. The Chinese wall held.

But for how long? As Olson worried that his small team didn't have a future at First Boston, Goldman Sachs & Co. called with a job offer, and Olson and his group moved over. "Many sell-side analysts spent their careers on roller skates," Olson explains, "because the opportunities kept getting better and better."

At Goldman he experienced no pressure to upgrade stocks, but the structural changes affecting analysts were becoming more apparent. Olson felt "an implicit sense" that his primary role was no longer to produce research but to help secure new business -- underwriting initial public offerings and advising on mergers and acquisitions -- for the investment bank. That's how Goldman made the bulk of its money, and that's how its better-paid analysts, whose compensation was determined largely by how helpful they'd been to the banking division, made theirs. Olson spent much of his time on "bake-offs" -- new-business presentations.

So when Merrill Lynch called in 1992 with "a very, very generous offer," he and his team roller-skated over. He thought the switch would mean a return to a more traditional research role. He was wrong.

Stars Are Born

By the mid-1990s, the pressures on securities analysts were Wall Street's open secret. Investment bankers seeking to underwrite a deal not only wanted analysts' advice beforehand, they wanted their analysts to be high-profile stars who could help fend off competing underwriters and land deals. Afterward, they wanted the analysts' reports to stay bullish enough to keep the stock moving and the new banking clients happy.

One who saw this firsthand was Thomas K. Brown, an analyst at Donaldson, Lufkin & Jenrette Securities Corp. during the '90s who specialized in regional banking stocks and repeatedly won the coveted top slot in Institutional Investor magazine's annual All-America Research Team rankings. "I'd go on calls with investment bankers," Brown recalls, "and they'd say, 'Here's the number one regional bank analyst in the country. He can do wonders for the valuation of your stock if he follows your company. But Tom only has

so much time, so if he's going to follow your company, we would want to do your investment-banking business.'

"And everybody knew -- myself, the bankers and the company -- that [I] was going to 'follow the company' with a favorable investment opinion," Brown says.

At many firms, analysts' rewards for their cooperation with bankers were reflected in their annual bonuses. At DLJ (as at some other firms), however, analysts say they were promised a percentage of the banking fees.

Their boss made the rounds of analysts' offices each quarter, reviewing just how much an analyst would receive -- usually six figures -- for each deal completed. Brown's biggest payout was more than \$100,000 (on top of his \$1 million-plus annual salary and bonus) for helping to take the now-faltering Affinity Technology Group Inc. public in 1996. He was fired in 1998 for being, he said, "a big wet blanket" on mergers and acquisitions. Credit Suisse First Boston Corp., which acquired DLJ in 2000, declined to comment.

The '90s certainly fattened analysts' wallets. Salaries ballooned for those highly ranked by Institutional Investor, the "axes" who could move markets. And it was easier to be a star, as new financial media outlets such as CNBC, CNNfn and Fox News needed talking heads. Many senior analysts were making \$1 million to \$2 million a year by the late '90s, and in hot sectors like telecommunications and technology, the Street was gossiping about "three-by-five" deals (a three-year guarantee at \$5 million a year) and "three-by-sevens."

An old hand like Olson watched in astonishment as Mary Meeker, Morgan Stanley's Internet analyst, graced the cover of Barron's ("Queen of the Net," it proclaimed) and was profiled by the New Yorker. Henry Blodget made his rep by predicting in December 1998 that Amazon.com Inc. (then at \$242) would trade at \$400 within a year; when it got there within three weeks, Merrill Lynch promptly hired him for \$3 million. As Blodget made waves and media appearances -- about 125 on CNBC and CNN -- over the following two years, his compensation rose to \$12 million, according to an affidavit filed in New York state's lawsuit against Merrill Lynch.

At Salomon Smith Barney Inc., telecom analyst Jack Grubman was quite open about being a dealmaker -- "banking-intensive" was the way he described himself to BusinessWeek -- and later told a House committee that he made more than \$15 million a year. The underwriting deals such stars could attract were so enormous that firms found them worth the investment.

But while analysts prospered financially during the '90s, many also felt the heat.

They were expected to pitch in with marketing efforts. The sales force wanted them to make scores of phone calls to banking clients and to alert investors to market developments that could help sell stocks. Marketing calls and client visits ("roadshows") were important for snagging top Institutional Investor rankings, since the buy-siders they schmoozed with were those the magazine polled.

Nobody in this environment liked "sell" ratings. Not the bankers, who needed rising stock prices to please their clients. Not the clients, who wanted their companies to be worth more. Not the sales and trading staff, who could unload more shares when profits seemed inevitable. Not even the investor customers -- either institutional or "retail" (translation: small individual investors) -- who didn't want to hear that they'd bought losers. Any of these parties might call spoilsport analysts to complain. Investors trashed analysts on Web sites. A few analysts even reported death threats when they downgraded stocks.

Feeling bullied from all sides, most analysts simply stopped using "sell" ratings at all. The proportion of those recommendations fell below 1 percent in 2000, according to Thomson First Call. Meanwhile, analysts complained that all their new responsibilities meant they no longer had time to do quality research.

Exacerbating this, of course, was the long bull market, which rewarded -- for a while -- relentless optimism. The tech field, in which more infant companies went public each week, was uncharted territory: Nobody could really be an expert, so anyone could plausibly claim to be. An analyst skeptical about an Internet company's prospects -- as veteran Lise Buyer, most recently at Credit Suisse First Boston, sometimes was -- was simply a party pooper. "People around you could point to 10 other companies with the same math and they'd gone public and were doing well," she says. "It was very hard to say no."

Buyer's moment of truth -- she left CSFB two years ago -- was Blodget's call on Amazon. "That was the ringing of the bell: It was the cheerleaders, not the analysts, that were the stars in that market," she says. "The fundamentals of analysis went by the board."

"Cheerleader" was the comparatively nice way to put it. On the buy side, money managers like Robert Gensler, who runs T. Rowe Price Inc.'s Media and Telecommunications Fund and its Global Technology Fund, were growing increasingly mistrustful. Office doors at Price were sprouting cutout photos of tulips, reminders of an earlier case of market mania. "Certain shops, it was just known that their analysts were banking whores," Gensler says. "That was the term we all used."

Because analysts often did have valuable insights, even if they didn't feel free to express them, Gensler and other clients learned to "drill down" during lengthy phone calls. Eventually, "you could find out what they really knew," he says. "But the public, how would they know?"

For the most part, the public didn't. "The individual investor had to send in a box top to get his secret decoder ring," says Charles L. Hill, director of research at Thomson First Call.

Savvy investors understood that an analyst's "buy" rating probably meant "hold," that "hold" was a cue to sell, that "sell" might never appear. They could decipher red flags included in a research report, even when the rating was positive. Certain academics were on the case, too: A 1999 study co-authored by Dartmouth College and Cornell University professors in the Review of Financial Studies concluded that analysts' recommendations on other banks' IPOs were reasonably reliable, but on deals their own firms were underwriting, they showed "significant evidence of bias." But ordinary investors watching CNBC or trolling the Net for tips might well remain in the dark, unable to interpret what they were seeing.

Still, most analysts thought they could "manage the conflicts" -- a common phrase -- and if they were senior enough or powerful enough, some did resist the pressures. Olson thought he could, even when the same investment bankers he'd jostled with at First Boston moved over to Merrill Lynch shortly after he did.

Olson wasn't a star. He ranked third or runner-up in Institutional Investor's All-America poll most years; he wasn't on TV. He never had a million-dollar year, or even an \$800,000 year, and suspected that his skepticism about Enron -- a minority opinion among energy analysts -- cost him hundreds of thousands of dollars annually in reduced bonuses. Certainly Olson had heard from Lay and his successor, Jeffrey K. Skilling, when he sought explanations about Enron's baffling financial statements at analysts' meetings, that he "just didn't get it."

Olson, says a fellow energy analyst, "can be very pointed in his questions."

"Pointed is not necessarily a bad thing, but in that environment it was not acceptable," the analyst says.

Yet Olson was willing to play ball to some extent, dutifully making scores of marketing calls in April 1998, when Enron was issuing a common-stock offering. It was a pointless exercise, given that everyone knew his doubts, and one that made him uncomfortable; he didn't think it a proper role for an analyst. "Do I endorse it? Not really," he says of the practice. "Was it part of the job description? Yes."

So while he knew he wasn't popular with his bankers or with Enron, Olson didn't expect to be ousted. "People trashing you, making allegations, that's part of Wall Street," he says. "But you thought your boss would protect you, that you'd have a fair hearing. None of that happened."

In his last months at Merrill Lynch in the summer of 1998, and thereafter, his health took a beating along with his self-esteem. He slept poorly; his doctor issued warnings. Never hefty, he dropped from his normal 175 to 185 pounds to 138. "I'm the only person in Houston," he says, "on a cheeseburger-and-chocolate-milkshake diet."

Conflicts Exposed

By 2001, Olson had regained much of his weight and his equilibrium, but he was still getting the occasional jibe from Enron. A framed note to his current boss from Lay, disputing a comment Olson made in the June 18 issue of U.S. News & World Report, hangs on his office wall. "John Olson has been wrong about Enron for over 10 years and is still wrong," Lay wrote in black pen. "But at least he's consistent [sic]." Four months later, Enron's enormous losses, hidden deals and accounting abuses came to light; the company filed for bankruptcy in that December.

Olson had finally given Enron the "strong buy" it had long sought that fall, when the company's stock fell so low that it briefly looked alluring. But if anything, he'd been too kind to Enron for years. "You couldn't see how bad some of the failures were," he says, "because they'd buried the bodies."

When a House energy subcommittee held Enron hearings this February, Olson agreed to testify. He put on his reading glasses, introduced himself and proceeded to condemn the changed culture of sell-side research. "Enron paid out lots of investment-banking fees," he told the legislators. "The bankers loved Enron. Enron loved analysts' 'strong buy' recommendations. Guess what happened: It got them. Lots of them. This is an abuse."

How much Merrill's bankers loved Enron emerged a few months later, when investigators for the Senate Permanent Subcommittee on Investigations called Olson with word of internal Merrill Lynch communications. The month before his May 1998 showdown with Melnick, investigators found, two Merrill investment bankers sent a memo to President Herbert M. Allison Jr. The firm was being excluded from a \$750 million common-stock offering by Enron, the memo said, because "our research relationship with Enron has been strained for a long period of time."

Olson, it continued, "has not been a real supporter of the Company" and made "snide and potentially embarrassing remarks about the Company." The two bankers asked Allison to call Lay to intervene; after he did, Merrill Lynch became a co-manager on the offering.

With Olson gone, Merrill's new analyst upgraded Enron's stock. A few months later, in January 1999, one of the bankers e-mailed Allison to say that "any animosity in that regard seems to have dissipated in the ensuing months." He noted that Merrill Lynch had since been awarded Enron business worth \$45 million to \$50 million in banking fees. For Olson, who knew nothing of those communications until this summer, "a great beacon went on."

Merrill Lynch insisted to the Senate subcommittee this July, and still insists, that its research was not compromised, that Olson's departure was due to a "consolidation" and that his replacement's upgrade on Enron was entirely unrelated. But even before the Senate hearings, it agreed to pay a \$100 million penalty -- while not admitting guilt -- and to enact reforms aimed at eliminating investment bankers' influence over analysts' pay. New York Attorney General Eliot L. Spitzer had charged that Merrill's Internet analysts had done exactly what Olson wouldn't: issued biased and misleading stock ratings to secure investment-banking business.

As Spitzer's investigation broadened -- along with parallel efforts by congressional committees, the Securities and Exchange Commission and NASD, an industry self-regulatory body -- Olson was reading the news like everyone else and learning that the conflicts ran deeper than he knew.

Spitzer more recently has focused on "spinning," in which analysts at certain firms, allegedly including Salomon Smith Barney and Credit Suisse First Boston, distributed shares of companies about to go public -- and to instantly soar in value -- to executives who also steered millions in banking fees to the firms. Some analysts took shares in about-to-go-public companies for themselves as well, other analysts say; they bought in during venture capital funding or took seats on the companies' advisory boards.

Shareholders have filed lawsuits, as have analysts who claim they were fired for lack of banker cooperation. The Manhattan district attorney, in an indictment of two top executives from Tyco International Ltd., has charged that the company's CEO prevailed on Merrill Lynch to replace an agnostic analyst with a Tyco supporter; the new analyst and the CEO then exchanged gifts of wine.

"What were these people thinking?" Olson wonders. "Do they think they can get away with this? That investors won't get wise to what's going on?"

Now, the Fallout

Things are quieter on Wall Street. Since the Bubble burst, IPOs have grown scarce. It's easier, these days, for an analyst to be negative. The number of "sell" recommendations has crept past 10 percent and will probably level off in the mid-teens, said Thomson First Call's Hill.

Henry Blodget left Merrill Lynch and is writing a book; his group's e-mails privately disparaging companies the firm was publicly recommending formed a key part of Spitzer's case against Merrill. Jack Grubman was forced out of Salomon this summer with a \$30 million severance package; he faces multiple investor lawsuits and possible criminal prosecution. Mary Meeker is keeping a low profile at Morgan Stanley.

Announcements of reforms have become purification rituals. Most brokerage firms quickly adopted the changes Merrill Lynch agreed to, now sometimes called the Spitzer Principles, though questions remain about how effective they can be. The SEC also approved analyst reforms.

Meanwhile, regulators and a dozen major Wall Street firms are negotiating an unprecedented "global settlement," under which banks would each contribute \$10 million to \$20 million annually to purchase research from independent companies to distribute to their brokerage customers. In an attempt to deter the conflicts that have caused post-Bubble scandals, the settlement would further limit interactions between bankers and analysts. Harvey L. Pitt's resignation as SEC chairman may delay the process, but basic questions -- how analysts will function in the future, who will pay them, how many there will be -- are on the table.

Olson, who likes his work too much to retire yet, is still at it, and he's arguing for strict separation of church and state. At his new firm, he rarely even has to speak to an investment banker, and that's the way he wants it. "Otherwise," he said, "we're subject to all the four winds."

Researcher Richard Drezen contributed to this report.

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As Finger-Pointing Continues, the Refrain Goes: 'Don't Blame Us'

Steven Pearlstein, *The Washington Post*, Friday, November 15, 2002.

By temperament and tradition, research analysts were the nerds of Wall Street, the back-of-the-house professionals content to let others take the big risks and earn the really big money. They earned enough

to own a comfortable house in the suburbs, send the kids to college and rent a nice place on the beach every August. What mattered to them as much as the money, however, was the pride they took in their firms, their profession and their own reputations within the financial fraternity. Jeopardizing that for -- what? -- another \$50,000, \$100,000, would have been unthinkable.

The Bubble changed all that. Suddenly it was no longer just a \$50,000 raise or a \$100,000 bonus that tempted them. Now it was a small piece of the action on a billion-dollar deal -- if only they would give it their seal of approval. Or a million-dollar bonus for writing up the glowing research reports that snagged a couple of initial public offerings. Or the doubling of salary that came with the regular gigs on CNBC. If you didn't want to reach for the brass ring, there were others who would.

It is impossible to know how many times during the Bubble that an analyst's refusal to tout a new issue, or an insistence on pointing out a financial problem, acted as a restraint on questionable corporate behavior. What is known, however, is that plenty of the bad advice was foisted on the investing public. And while some analysts have lost their jobs, very few have been called to account.

And how could they be? It wasn't just one analyst here or there who overweighed his list with "buy" recommendations or held back on questioning the performance of a company to maintain easy access to its executives. Among star analysts in the major firms, such practices became unexceptional; if anyone was guilty, everyone was.

In this respect, the research analysts were much like the lawyers and accountants, two other groups of professionals who got co-opted by the Bubble. In the face of recriminations and reform efforts, all three maintain loudly that they did nothing wrong, while in the same breath promising not to do it again.

The line from the accountants, for example, is that they were victims, just like the shareholders, hoodwinked by conniving executives or left helpless by poorly drawn accounting rules. After failing to thwart accounting reform legislation that sailed through Congress, they have waged a rear-guard action to soften it in its implementation. But even before a new federal oversight board begins its work, it is clear that the prosecution and implosion of the venerable Arthur Andersen LLP, and increased scrutiny from corporate audit committees, has already stiffened the spines of auditors.

As for the lawyers, a task force of the American Bar Association has acknowledged that corporate counsel may have construed their ethical standards and professional obligations too narrowly. The association does not oppose the new congressional standard requiring lawyers to report violations of securities law to top executives or, if necessary, to the board of directors. But it does oppose giving the federal government the lead role in enforcing ethics guidelines, preferring the current system that leaves it to state-by-state judicial panels better known for disciplining ambulance chasers than for second-guessing the ethics of high-powered corporate attorneys.

Speaking for the analysts, the Securities Industry Association continues to deny -- even in the face of embarrassing internal e-mails and conclusive academic studies -- that analysts routinely shaded their stock picks to gain access and win investment-banking business. Although the association signed on to a stricter code of ethics for analysts, it has drawn the line at demands that research departments providing advice to investors be spun off from firms with investment banks. Potential conflicts of interest, they argue, can be managed.

Such resistance to wholesale reform should hardly be surprising. Firm size, pay structures, lifestyles and self-images were all built around the assumption that the Bubble would continue -- and along with it the looser professional standards that made it possible.

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The Analysts

THE HYPEMASTERS



Jack Grubman

*Telecom analyst,
Citigroup/Salomon
Smith Barney*

His rosy assessments and potential conflicts of interest are under investigation by the New York state attorney general. He was forced out of Citigroup in August.



Henry Blodget

*Internet analyst,
Merrill Lynch*

Famous for predicting that Amazon.com's stock would soar past \$400, he became infamous when private e-mails revealed what he really thought about some companies he touted.



Mary Meeker

*Internet analyst,
Morgan Stanley*

Proclaimed "Queen of the Net," Meeker pushed companies to "get big fast" before focusing on profit. She worked constantly and comfortably in the blurred line between analyst and investment banker.



Phua Young

*Multi-industry analyst,
Merrill Lynch*

Young, an avid bull on Tyco, accepted a gift of expensive champagne—and reciprocated with his own gift of expensive wine—from Tyco CEO L. Dennis Kozlowski. Young was fired in April for an unrelated issue.

BULL-MARKET BELIEVERS



Ralph J. Acampora

*Director of technical research,
Prudential Securities*

His bullish exhortations that the market could climb ever higher were steady drum beats throughout the Bubble. He wrote a book in 2000 calling this era the "fourth mega-market."



Abby Joseph Cohen

*Chief market strategist,
Goldman Sachs*

One of Wall Street's most bullish strategists, Cohen urged heavy investing in stocks even during skittish Bubble moments, like 1998's Asian financial crisis. But she urged caution at the Nasdaq's peak.



David Maris

*Pharmaceuticals analyst,
Credit Suisse First Boston*

Maris warned investors against buying shares in Elan, prompting sharp attacks questioning his competence. CSFB stuck by Maris, and Elan's stock subsequently plummeted.



M. Carol Coale

*Natural gas analyst,
Prudential Securities*

An early Enron skeptic, she pressed the energy company's executives for answers about their complex partnership deals and was first to slap a sell recommendation on Enron's stock.

GRUBMAN, BLODGET, COHEN PHOTOS BY BLOOMBERG NEWS;
MEEKER PHOTO BY FRANK VERONSKY; YOUNG PHOTO BY MARC BRYAN-BROWN;
MARIS AND COALE PHOTOS BY INSTITUTIONAL INVESTOR MAGAZINE; ACAMPORA
PHOTO BY THE WASHINGTON POST

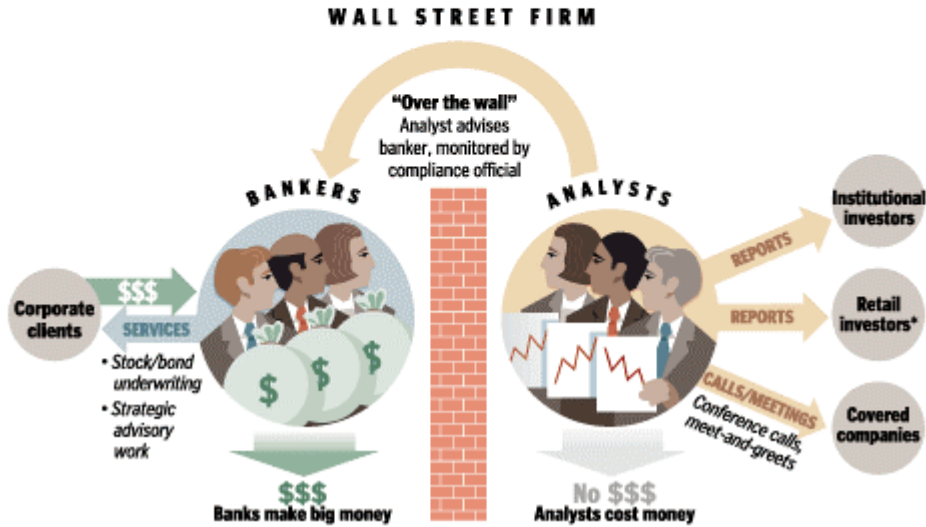
Breaching the Wall

Large Wall Street firms have different divisions—including investment banking, research, trading and principal investments—that traditionally were separated. During the Bubble, they worked together more closely to generate profit.

How It Was Supposed to Work

During the stock boom of the late 1990s, no formal rules separated research analysts from investment bankers. But most firms claimed to maintain a “Chinese wall” to keep bankers from pressuring analysts into writing rosy reports on otherwise dubious companies to generate big banking fees.

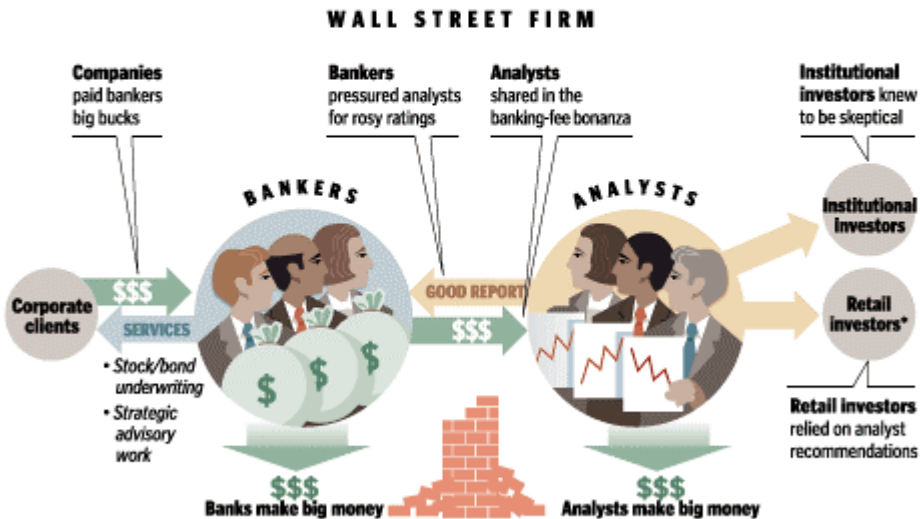
Occasionally, analysts were allowed “over the wall” to advise bankers on which deals to do and which to avoid. Such interactions were supposed to be monitored by internal watchdogs. At most firms, analysts were supposed to report to the research department’s executives, not to bankers.



How It Often Worked

At many firms, the mad scramble for banking fees reduced the Chinese wall to quaint fiction. According to internal e-mails, analysts often came under intense pressure to assign inflated “buy” ratings to please current or prospective banking clients, regardless of

the underlying strength of the company being covered. Many analysts scored big bonuses based at least in part on their contribution to banking deals. In some cases, analysts allegedly received checks for specific deals.



*Some big firms such as Goldman Sachs, J.P. Morgan Chase and Credit Suisse First Boston serve few retail clients