How does the stock market operate? A typical experience might begin with a broker telephoning you about a hot stock tip. Being a diligent person, you conduct a little research on the company by reading up on the latest research analyst reports. The analysts provide a strong “buy” recommendation so you telephone your broker to finalize the deal. On your behalf, the broker purchases stock from a buyer on the stock exchange at the best market rate. Independent auditors verify the legitimacy of the firm’s financial statements, the board of directors protects your investment by making sure that management focuses on improving company operations, and government regulatory agencies overlook everything to make sure it’s kosher.

In *Take on the Street*, Arthur Levitt, the former Chairman of the Securities and Exchange Commission (SEC) under the Clinton Administration, suggests he has a bridge in Brooklyn for you to purchase if you believe that is how the market operates. The book is a “buyer beware” primer on how the stock market really functions. According to Levitt, the market consists of a “web of dysfunctional relationships,” [p. 70] most of them to the disadvantage of individual investors. The SEC sometimes tries its best to create rules of fair play, but the money makers within the system are always a step ahead of the game, manipulating rules to their own advantage.

Importantly, Levitt is not a cynical academic or an anti-business activist. Instead, he knows the system inside out, having lived and worked within it his entire life, his father having been elected Democratic comptroller of New York six times. Levitt’s Wall Street career includes being a broker, a brokerage firm executive, chairman of the American Stock Exchange, and four years as publisher of a Congressional newspaper, before his seven-and-a-half year term as SEC Chairman. He’s seen it all, from a variety of perspectives, and steps away to mostly damn, rather than praise, the system.

Whereas Adam Smith drew a clear distinction between selfishness and self-interest, with one’s conscience serving as the invisible border between the two concepts, many on Wall Street have pursued the almighty dollar across the border into selfishness. When push comes to shove,
truth and honesty often evaporate, and all that matters is making more money right now for the insiders. Levitt writes:

I had spent twenty-eight years on Wall Street, and I understood the culture. Actually, there were two conflicting cultures. One rewarded professionalism, honesty, and entrepreneurship. This culture recognized that without individual investors, the markets could not work. The other culture was driven by conflicts of interest, self-dealing, and hype. It put Wall Street's short-term interests over investor interests. This culture, regrettably, often overshadowed the other. (p. 7)

Let's understand how the system misfunctions step-by-step, with each of the following being a false assumption.

1. **Broker Contacts You about a Good Stock Deal**

   There are a variety of reasons why brokers and investment advisors recommend buying a particular stock, and most of them are in the broker's best interests. Levitt writes that brokers are "good people in a bad system" [p. 19]. They are "first and foremost salespeople [who] are paid a commission, or a service fee, on every transaction in accounts they manage" [p. 17]. In 2000, the average commission paid to Merrill Lynch brokers was $200 per transaction, or about a 33 to 45 percent gross commission on every trade.

   This financial incentive system has several misdirected ramifications for those purchasing stocks from brokers. Differential commissions, end of the month or year bonus systems, and internal sales contests tend to favor stocks and bonds that a broker's firm owns; the broker either wants to dump the stock or increase its value by creating demand.

   Or you may play it safe by investing in a mutual fund rather than a particular stock. Not so fast. Seventy-five percent of the mutual funds sold by Dean Witter are house funds. Mutual fund prospectuses are written for a legal audience, rather than investors, and tend to have many hidden fees. Mutual fund marketers overemphasize past performance, ignoring the fact that 80 percent of the top 10 percent performers in any given year are not in the top 10 percent the following year. In addition, fund portfolio managers manipulate prices by purchasing large amounts of stock already in the fund on the last day of quarterly reporting periods, increasing its value to make the fund more attractive to future investors. Naturally, they first purchase the stock for their own accounts to financially benefit from the last-minute price manipulations. Sadly, Levitt notes that "many of these were not isolated acts committed by rogue fund managers" [p. 45].

2. **Objective Research Analyst Reports**

   Rather than rely on a broker's questionable biases, you decide to thoroughly analyze all of your investments by reading independent research analyst reports. Not so fast, it is important to follow the money flow, which this time means the compensation system for both the CEO of the company under consideration and the research analyst; both are busy devising win-win situations for each other. According to Levitt, research analysts are nothing but "glorified salespeople" [p. 28], offering favorable recommendations in exchange for investment banking business. In return, companies leak good news to these analysts, which builds the analyst's credibility in the investor community.

   Favorable research reports, in turn, increase the value of the company's stock and, thus, the CEO's compensation, which is increasingly based on stock options. High stock prices benefit the

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brokerage firm, which typically includes the stock in its own investment portfolio. A stock market "bubble" is created when CEOs selectively offer information to brokerage firms whose investment bankers are providing debt and arranging mergers and acquisitions, whose brokers are selling their debt and equity to the public, and whose research analysts are writing glowing reports.

This explains why research analysts recommended a "buy" for dot.com companies that weren't close to offering a viable business plan. As a Morgan Stanley corporate finance director instructed his research analysts, "we do not make negative or controversial comments about our clients as a matter of sound business practice" [p. 74]. For example, while Morgan Stanley was earning $9.3 million in investment banking underwriting fees from Priceline, its high profile research analyst Mary Meeker recommended "buy"

1. when the stock was selling at $134 a share despite reporting losses of $25 million on revenues of $49 million (imagine how much the stock would be worth if it earned a profit!),
2. when the stock nosedived to $80 a share (what a bargain for a stock originally worth $134!), and
3. when the stock further nosedived to $9 (what a tremendous bargain at that price!).

Then there are those quarterly research predictions. Analysts, who earn around $725,000 a year with five years of experience, look good when they correctly predict how well companies are performing, and companies look good when they meet analyst predictions. Another match made in money. As Levitt describes, corporate managers privately leak information to analysts to make the analysts' predictions accurate and then massage the accounting numbers to appear slightly better than the predictions.

In the rare instances when analysts recommend a sell, they are discouraged from doing so until after their firm's brokers have dumped the stock at the prevailing higher price. But even then, they must be careful, as CFOs of firms whose stocks have been downgraded may refuse to do future business with the brokerage firm and encourage their business partners to do likewise.

3. Purchase Stock on the Stock Exchange at the Best Market Rate

Once again, one must understand the compensation system to grasp why decisions are not always in the best interest of individual investors. According to Levitt, stock exchanges "operate to benefit listed companies and the middlemen" [p. 176]. This is why exchanges resisted a change in listings from fractions to cents. For instance, floor traders made 6.25 cents a trade when they bought at $75 5/16ths and sold at $75 6/16ths. Now they only make a penny if they buy at $75.31 and sell at $75.32. But don't feel sorry for the floor specialists' lost income; they compensate by buying and selling their own shares based on floor trends they can detect before the typical investor, or by creating the appearance that a particular stock is rising or declining.

Other problems remain. Levitt notes that "many [buy and sell] orders are matched off-exchange, then centrally reported to an exchange" [p. 175]. On-line brokers send their orders to the off-exchange dealer offering the best commissions rather than the best price. Similarly, mutual fund managers buy from higher priced brokers, whose fees are charged to investors, because the mutual fund manager's firm receives favorable deals on research or software from the brokerage firm.

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4. Managers Focus on Improving Company Operations

With stock options now accounting for 80 percent of management’s compensation, CEO’s are tempted to spend more time managing the company’s share price than the fundamentals of their business operations. One would hope that the relationship between company operations and share price would be direct, but it is not always the case given the stock market bubble phenomenon described earlier. Enron represents the epitome of this sham, with its executives cashing out their stock options while research analysts issued glowing reports, and auditors turned a blind eye toward the firm’s hiding of troublesome assets.

5. Independent Auditors Verify the Legitimacy of Financial Statements

Accounting firms receive more than half their revenues from consulting projects, creating a strong financial incentive for auditors to avoid negative audit reports on companies that pay them millions of dollars in consulting fees. Auditors approved accounting tricks such as “pooling of interest” for mergers and acquisitions, inflating earnings with pension fund returns, not dating contracts until determining what quarter it would look best to report it in, and lending money to customers to buy products without reporting the likelihood of the loan being defaulted. In addition, poorly paid auditors are unlikely to issue unfavorable reports on former managers when the possibility exists that these former supervisors might offer them a better paying job with their new corporate employer. For example, Waste Management employed fourteen ex-Arthur Andersen employees in key financial positions; they managed to hide $1.7 billion in expenses from former subordinates auditing the company.

A new, troubling, issue is the reliance on “pro forma” earnings to guide investor decisions. Pro forma earnings were meant to provide a picture of a company’s health by ignoring some temporary bumps and bruises, such as depreciation, amortization, and one-time restructuring expenses (i.e., a one time charge to close a facility). These statements are inflated or deflated based on the firm’s best short-term financial interests. For example, Cisco claimed a pro forma net gain of $230 million, rather than highlighting a net loss of $2.7 billion, by adding back into earnings inventory purchases it did not intend to sell, only to sell $290 million of this supposedly unsellable inventory the following year.

6. Board of Directors Protect Your Investment

Levitt writes that “self-regulation by the accounting profession is a bad joke” [p. 127], so investors must rely more heavily on Boards of Directors and government regulators to look after their interests. Alas, this too is problematic. CEOs often recommend board members who, in turn, recommend the CEO for their board. The board members are often too busy with their own firms to adequately monitor the operations of others. Due to their business ties and stock ownership, board members have a financial incentive to make the firm look good to outside investors.

7. Government Regulatory Oversight Protects the Public Interest

That leaves government regulatory authorities to look after investor interests. But Levitt observes that “only a few lawmakers truly care more about individual investors than about their corporate patrons” [p. 14]. During the 2000 election period the securities industry donated $53 million
to individual candidates and another $39 million in soft money to political party campaign committees. Levitt himself helped raise $750,000 at a Democratic Party fundraiser prior to his appointment as head of SEC by President Bill Clinton. Senators who don’t like a particular SEC ruling can slash the enforcement budget associated with the rule. Levitt fell victim to this intense political pressure and confesses to having threatened to not impose fines if a particular Financial Accounting Standards Board rule addressing abusive practices was passed.

Is the search for ethics on Wall Street hopeless? According to Levitt, “the evolution of our markets is like the nine innings of a baseball game—and we’re only in the top of the third inning” [p. 177]. Indeed, the unethical activities highlighted in this book, though practiced by a broader number of people, are less individually harmful than the greedy wealth management practices exhibited in the 1600s when the London-based Virginia Trading Company colonized Jamestown.

The evolving nature of rule-making is evident in the most egregious violation on which Levitt focuses: research analysts and investment bankers doing sales calls together. On April 28, 2003, less than a year after the book’s publication, the SEC and New York’s attorney general announced a $1.4 billion settlement with ten Wall Street firms and two prominent stock analysts for luring investors to buy billions of dollars of stock in companies they knew to be troubled or in decline. Brokerage firms had received secret payments from companies in exchange for favorable research reports and gave their best investment banking clients a head-start on purchasing initial public offerings.

The government’s settlement terms were quite extensive. Sanford Weill, Citigroup’s Chairman and Chief Executive, and other top executives were prevented from talking with their own research analysts about the firms they cover unless a lawyer is present. Several prominent research analysts received lifetime bans from the industry. Research analysts must now be compensated based on the quality of their research and not on their contribution to the firm’s investment banking business and their quarterly performance measures are now posted on company websites. Securities firms must disclose whether they do business with companies they are analyzing. In addition, the practice of allocating shares of “hot” initial public offerings to corporate executives and board members as a way to court investment-banking clients has been abolished.

Unfortunately, on the following day, the Wall Street Journal warned in its April 29, 2003 editorial that: “The public would draw the wrong lesson if it concludes that the stock-touting industry really has been fixed.” If the financial markets are like a nine inning baseball game, and it was the top of the third inning at the time of Levitt’s SEC presidency, there is now one strike on the next batter, with many more innings to go. Settle in for a long game.