

December 16, 2002

After a Boom, There Will Be Scandal. Count on It.

By KURT EICHENWALD

It was, it seemed, the year when corporate America went crooked as it never had before, when chicanery took the place of integrity, when wrongdoing exploded in ways that could not have been anticipated.

Then again, maybe it wasn't.

Despite all the surprise and anguish set off by corporate scandals, for many Wall Street historians and fraud aficionados, the year almost fits into a pattern, as the re-emergence of a moment that has become something of a tradition in the financial world. Most everyone knows of the business cycle of boom and bust, but what is less well known is capitalism's cycle of scandal.

"I can't think of a previous boom period, whether it was the 20's, the 60's or the 80's, where it hasn't ended up a bloody mess, with declining asset values and cases of fraud," said Charles R. Geisst, a Wall Street historian and author of "Wheels of Fortune," a history of the futures markets published in September by John Wiley & Sons.

Indeed, experts said, the emergence of frauds after the end of a market bubble is a predictable result of human nature.

"Fraud scandals follow bumps in the market as night follows day," said Stephen L. Meagher, who has taught courses on fraud and punishment at Stanford University. "Once there are pressures put on profits, the obvious incentive for management to maintain their lifestyle or their stock prices is to fiddle with the books."

And so, long before the names [Enron](#) and [WorldCom](#) became shorthand terms for accounting misdeeds, other names in just the last century came to be used to describe whole categories of fraud.

Take Charles Ponzi. Mr. Ponzi opened up shop in Boston with an outfit named — with what might appear a sense of future irony — the Securities and Exchange Company. By the summer of 1920, he was soliciting investors with offers of "international postal reply coupons" — in Mr. Ponzi's description, postage stamps that could be sold again and again. He promised 50 percent returns in 45 days and as much as 100 percent in 90 days.

Tens of thousands of investors poured millions of dollars into Mr. Ponzi's company, with the inflow eventually reaching as much as \$250,000 a day. But the money was not actually being invested in anything. Instead, Mr. Ponzi simply paid early investors their returns with the money he received from later investors. But the game could not last forever, and eventually, after a Boston newspaper disclosed the truth about the scheme, Mr. Ponzi was sent to prison.

The market boom later that decade was a bubble of almost breath-taking proportions. Even regulators who should have known better were unwilling to put on the brakes. When the Federal Reserve in Washington decided to try to raise interest rates to cut short the stock rally in March 1929, the Federal Reserve Bank of New York countermanded the directive, instead injecting more money into the system to keep the euphoria going.

After the stock market crash, Senate hearings led by a special counsel, Ferdinand Pecora, were opened, and the American public heard horror stories about insider trading and stock manipulation by Wall Street insiders.

But Mr. Pecora's first witness, Richard Whitney — the president of the New York Stock Exchange and a man of stature and high repute in the investment world — seemed above reproach. Under cross-examination, Mr. Whitney defended the exchange's performance in the markets, proclaiming it to be "a perfect institution." There was no need, he proclaimed, for Congress to set up an agency to police the exchange; it could do the job itself.

A few years later, the exchange did ferret out a crook: Mr. Whitney himself. Throughout the boom years of the 1920's, the patrician trader had been an aggressive speculator in penny stocks, and he was hit with mammoth losses in the crash. To hide his failure, Mr. Whitney started stealing cash. He stole from his customers, including the New York Yacht Club, and he stole from a fund set up to aid the widows and orphans of brokers. And then he stole some more.

Caught by the exchange in 1938, Mr. Whitney eventually pleaded guilty to theft charges. He was the only prominent person to be imprisoned for fraud stemming from the crash; he served about three years in Sing Sing.

Some schemes, in retrospect, should have been obvious from the beginning. So it is with the one perpetrated in the late 1950's and early 1960's by Anthony DeAngelis, now known as the great salad oil swindler. Ultimately, he cheated giant financial institutions out of \$175 million.

Mr. DeAngelis was the president of Allied Crude Vegetable Oil Refining, which had been formed to buy surplus vegetable oil from the government and sell it for export. Soon, Allied was borrowing millions of dollars, which it used to speculate in the futures market for vegetable oil; to secure the loans, Mr. DeAngelis pledged salad oil that the company had purportedly stored. The American Bureau of Statistics reported that the amount of oil handled by Allied was larger than the country's entire production of the commodity; still, no one blinked.

Eventually, in 1963, the truth came out — the tanks of salad oil were mostly filled with water. The loans were secured with nothing. Mr. DeAngelis went to prison for a crime that nearly bankrupted two large investment houses.

Ten years later, as the boom of the 1960's gave way to the bust of the 1970's, the next big scandal emerged, involving a company called Equity Funding. For years, that company sold a hybrid package of mutual funds and insurance. Dividends from the fund paid the insurance premiums, and Equity Funding then sold those policies to reinsurance companies. But eventually, the folks at Equity Funding decided to focus on just the last step and started selling reinsurers the policies of customers who did not exist.

Fake insurance policies — financed by nothing and for the benefit of no one — proved enormously profitable until 1973, when a company insider blew the whistle. The fraud ultimately opened a floodgate of lawsuits against the

company's accounting firm and led to a number of changes in the ways accountants deal with their clients.

The merger boom of the 1980's produced an array of scoundrels, many of whom were discovered only after their co-conspirators betrayed them. It all started in 1986, when Dennis B. Levine, an investment banker from Drexel Burnham Lambert, was accused of engaging in illegal insider trading based on information he gleaned from his job.

Mr. Levine had not been alone in his efforts, and quickly named others with whom he had swapped information or cash. The biggest fish he named was none other than the country's most prominent arbitrager, Ivan F. Boesky.

When the government picked up Mr. Boesky, he in turn named others who had participated in illegal activities with him, including Michael R. Milken, who led Drexel's junk bond operation. A scandal that began as one involving just insider trading rapidly exposed a series of conspiracies that had festered on Wall Street, resulting in market manipulation, companies' being tricked into mergers and secret deals that allowed insiders to profit. Mr. Levine, Mr. Boesky, Mr. Milken and numerous others went to prison; Drexel ultimately went bankrupt.

The lesson of all this, experts said, is that investors should never grow so comfortable as to believe that the financial markets have been cleansed of potential scandal. Another will come along, on another day in another industry. The only question is when.

"This cycle goes back at least 300 years," John C. Coffee Jr., a professor at Columbia University Law School, said of the constant re-emergence of scandal in the financial world. "It's just part of capitalism."