

PBS documentary probes initial public offering swindles of 1990s

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Following the Enron bankruptcy and Congressional inquiries into the fraudulent practices of its executives, increasing public attention is being paid to the financial maneuvers that fostered the rise and eventual collapse of the US stock bubble, particularly in the financial and high-tech sectors. A documentary that aired on US public television in January shed greater light on the collapse of the “tech stocks” by revealing that many of their initial public offerings (IPOs) were manipulated by venture capitalist firms, investment banks and big investors to pocket billions of dollars at the expense of smaller investors.

In the program “Dot Con,” part of the PBS series “Frontline,” producer Martin Smith and his colleagues assembled an impressive amount of material and put together a concise description of the financial malfeasance carried out by major US institutions.

The “con” was not a one-time event, but a pattern of behavior on the part of investment banks and venture capital firms, repeated hundreds of times in the late 1990s and the year 2000. It went as follows. First, an investment bank, collaborating with a venture capital firm that had provided initial funding to an Internet start-up, urged a young company to go public quickly, long before it would have otherwise sought to do. (One firm, Mothenature.com, told “Dot Con”’s producers that investment bankers were urging it to go public before it had even purchased office furniture!).

This marked a departure from traditional business models. Kara Swisher, news writer for the *Wall Street Journal* and consultant to “Dot Con,” explained: “Most companies in Silicon Valley used to take six or seven years of losses to finally get to profitability [during which time they were funded by venture capital] and then a little bit longer to go public. There was a more measured quality in moving these companies into the public space.” Swisher added: “Presumably, the people that are in the public markets, they’re buying fully baked companies, and these weren’t even in the oven 10 minutes ... and they [the investment banks] were offering them up as cooked.”

Many of the companies realized that their initial public offerings were premature. Said Brian NeSmith, CEO of CacheFlow (whose stock went from 24 to 126 at IPO): “Going public at that time is [like] raising a first or a second round of venture capital. There [are] a lot of unproven elements.... I haven’t proven that we can be profitable. I haven’t proven that I can really grow the revenue. I don’t have all of the members of the management team. The product may even still have some technology issues that we have to validate.”

Such companies, their fundamental deficiencies notwithstanding, were heavily recruited by venture capitalist firms and investment banks looking to sponsor a public offering. The venture capitalist (VC) firm helped find an investment bank, and then the company was

escorted by the bank and VC on a “road show,” a rapid tour across the US, visiting roughly a dozen major cities in as many days to pitch the company’s IPO to major mutual funds and other financial institutions.

Why the rush? Because, at least after the Netscape IPO (whose share price climbed from 28 at IPO in August 1995 to a high of 167 in January 1996), the big investment banks saw the prospect of windfall profits. So long as enough investors could be convinced to scoop up the stock, its price could be expected to soar at IPO. Hence the need for frantic promotion during the “road show.”

Before long, expectations were widespread that nearly any Internet-associated stock IPO would result in skyrocketing share prices on the first day. Investors hoping to profit quickly wanted to buy stock at the IPO price. But, for all but the insiders, this was not possible. Smaller investors, as well as many larger ones, were shut out of the IPO.

Blocks of stock were allocated only to “preferred” clients of the investment bank sponsoring the offering. These clients were able to acquire the stock at the initial asking price when the market opened. In some cases, they were even allowed to buy in at the original asking price after the market had opened and the trading price had ballooned. These insiders were virtually guaranteed a windfall profit.

The big investors sold (“flipped”) the stock after the market opened. Some waited until the end of the day or longer. Others would sell in minutes. David Siminoff, a money manager at Capital Group, which oversees the American Funds, one of the largest mutual funds in the world, noted: “In a four year period, I saw over 500 IPOs. We probably owned 200 or 250 of them for 10 minutes.... [A]t eight or ten dollars a share, you thought, OK, I can understand how this can compound to 20 percent a year if they hit their targets, but when the first print of the IPO was 95 dollars, it was very easy to sell.”

Not infrequently, in exchange for being allowed in on the IPO, clients kicked back money to the investment banks by paying commissions far in excess of going rates. In this way, the banks and clients effectively split the proceeds of the IPO.

One investment bank, Credit Suisse First Boston (CSFB), while admitting no wrongdoing, has settled a complaint brought by the US Securities and Exchange Commission along these lines for \$100 million. According to Forbes.com, there are 1,000 lawsuits being taken out by private investors involving 300 public offerings and 45 securities firms.

The PBS documentary noted that by 1999 this quid pro quo was well known in business and media circles. “But in the midst of the frenzy,” the narrator stated, “there was no one yet willing to blow a whistle. Too many people were getting rich.”

Another form of quid pro quo existed in the relation between venture capital firms and investment banks. The program cited a

glaring example. In exchange for finding companies that CSFB's leading banker, Frank Quattrone, could take public, the VC firm Technology Crossover Ventures was allocated 50,000 shares of the IPO of VA Linux (a company for which it had not raised venture capital). This was acquired for \$1.5 million. At the end of the first day's trading, the stock was worth \$12 million.

A problem remained after the IPO—how to keep the stock price up. The solution: analysts from the investment banks who had become regulars on the financial talk shows touted the stock to keep the con going. The insiders could quietly sell at a profit, some of the start-up companies' executives could cash out after their required "waiting period," and the Internet bubble could be kept growing, setting the stage for future IPOs.

On the financial news programs, the analysts presented a deceptive picture of what a given company would likely earn. Neither they nor the networks informed viewers that the analysts' employers—the investment banks—had material stakes in the IPOs and the inflation of the companies' stock prices.

The analysts rarely, if ever, issued "sell" recommendations, no matter what the state of the companies. Lise Buyer of CSFB admitted: "If your firm has done banking work for a client, it is understood that the analyst is not going to come out and say, 'Bad idea, stay away from it.'" Another analyst, Scott Ehrens of Bear Stearns, could give no answer when asked why he never issued a sell recommendation in several years of television appearances. In the end, he fumbled: "I didn't put too much thought into it."

Ehrens was hardly alone. Bear Stearns issued sell recommendations less than 1 percent of the time over the same period.

Arthur Levitt, the former SEC chairman, noted the analysts' conflicts of interest in a March 2000 speech at Boston College. He said: "A lot of analysts that we see on television recommending stocks work for firms that have business relationships with the same companies that the analysts cover. And some of these analysts' paychecks are typically tied to the performance of their employers. One can only imagine how unpopular an analyst would be who downgrades his firm's best client."

Levitt attempted in vain to pressure the networks into revealing the material interests of the analysts' companies. He told "Dot Con": "The networks in general felt that they had no responsibility in terms of monitoring the guests that appeared on their programs. And my feeling was that the analysts who came on those shows and promoted certain stocks that represented companies involving investment banking clients of their employers had a responsibility to clearly reveal that on camera. I still feel that way. I still feel that the kind of disclosure we are getting from analysts in both print and electronic media is inadequate and incomplete."

Later, when the fiction of the companies' values could no longer be maintained, their stock prices collapsed, liquidating the investments that were made by smaller investors who had been conned into buying at the inflated prices.

The ballooning stock prices were not sufficient to provide a secure financial footing for most of the start-up companies involved. The bulk of the millions generated after IPO was pocketed by Wall Street insiders and big investors.

Executives at the start-up companies were pressured to find ways to avoid or conceal the inevitable losses that accompany nearly all new firms. Not until after the IPO were the business models even defined and the most basic financial projections performed. A former top executive of Mothenature.com told "Dot Con" that it was only

months after IPO that the company carried out an analysis of revenues and costs. The study revealed that the firm was spending \$60-80 to win each new customer, but was getting back only \$10 for the lifetime of the customer. When such companies failed to generate profits, they began to collapse.

The chief strength of the "Dot Con" program was its accumulation of facts and statements by those who were involved in the IPO process, demonstrating that the fortunes made during this period were the result of fraudulent actions taken by a whole class of people—venture capitalists, investment bank analysts and executives, media personalities. They cannot simply be explained as the outcome of impersonal "market forces."

The documentary explored the suggestion that the IPO con could have been prevented by closer regulation of the financial markets by the SEC or by various technical alternatives to the present form of IPO allocation. (One idea promoted by investment banker Bill Hambrecht is called a "Dutch auction," described in detail on the program and its web site).

What the program failed to address, however, is how it was possible for rampant financial fraud to spread throughout so many areas of American business, impacting its nominal regulators, political institutions and the media. The corruption of the IPO process, far from being an isolated infection of an otherwise robust economic order, is an organic expression of more profound tendencies that, in their totality, express the degeneration of the economic system itself. Palliatives like the Dutch auction, even if they could overcome the opposition of powerful business interests, which is doubtful, could at most change the form of the disease, rather than effect a cure.

To "Dot Con"'s credit, the documentary closed on a sober note, with the narrator commenting: "But Hambrecht may be overly optimistic about Wall Street's willingness to change. The IPO explosion of recent years generated a feeding frenzy worth billions to Wall Street's banks. Very few people who work here believe the system needs fixing."

The "Dot Con" program, the transcript of an online chat with Producer Martin Smith and viewers, and related links can be found at: <http://www.pbs.org/wgbh/pages/frontline/shows/dotcon/>



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