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FRANK PARTNOY is the author of *The Match King* and *Fiasco* which was shortlisted for the *Financial Times* business book of the year award. He has worked as an investment banker at Morgan Stanley and as a corporate lawyer and has testified as an expert before both the United States Senate and House of Representatives. A graduate of Yale Law School, he is currently the George E. Barrett Professor of law and finance at the University of San Diego.

INFECTIOUS GREED

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HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS

FRANK PARTNOY

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For Fletch

"An infectious greed seemed to grip much of our business community. . . . It is not that humans have become any more greedy than in generations past. It is that the avenues to express greed have grown so enormously."

—Alan Greenspan, testimony before the
Senate Banking Committee, July 16, 2002

"In principle, the losses will be spread across a broader range of investors than in past debt crunches, suggesting risks have been well diversified and the financial system is secure. In practice, financial market and corporate innovation during the 1990s has meant it is impossible to be sure, a source of concern to financial regulators."

—Stephen Fidler and Vincent Boland,
Financial Times, May 31, 2002

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INFECTIOUS GREED

INTRODUCTION

Many people know the story of the 2008–2009 financial crisis, but few remember what happened just before that. This book is a financial history, a story of the dramatic changes in markets during the two decades before the subprime mortgage boom and bust. It brings together the most important characters and events of this period, connects the dots among them, and explains what happened—and why. It shows how the levels of deceit and risk grew so dramatically, so quickly, and offers suggestions about how to avoid another round.

The recent happenings in financial markets are mysterious to many investors. The names alone evoke vague memories of scandal, but few common denominators. Think not only of Lehman Brothers and Merrill Lynch, but back to WorldCom, Global Crossing, Enron, and the dot-com bubble, the panic surrounding the collapse of Long-Term Capital Management, the fall of the venerable Barings Bank, the bankruptcy of Orange County, the financial crises in Mexico and Asia, and so on. Most investors recall some of these events, but few people understand how they interconnect.

Each story is remarkable, but the headlines can seem isolated, like distinct cells within different bodies. Even when scandals pique the attention of investors, the details are evanescent, and any links to events of the recent past slip away. Investors become outraged, and the media

seize on indignities, but over time everyone seems to lose the ability to relate back—especially as markets begin going up again.

This was especially true during the 1990s, a decade of persistently rising markets—ten solid years of economic expansion, with investors pouring record amounts into stocks and pocketing double-digit returns year after year. That stock-price boom was the longest-lived bull market since World War II. Some stocks or sectors suffered periodically, but almost anyone who remained invested throughout the decade made money.

During this time, individuals came to believe in financial markets, almost as a matter of religious faith. Stocks became a part of daily conversation, and investors viewed the rapid change and creative destruction among companies as investment opportunities, not reasons for worry. In 1990, the ten largest U.S. firms—including companies such as Exxon and General Motors—were in industrial businesses or natural resources. By 2000, six of the largest ten firms were in technology, and the top two—Cisco and Microsoft—had not existed a generation before. These stocks almost always went up. Microsoft met analysts' expectations in 39 of 40 quarters, and for 51 straight quarters the earnings of General Electric—a leading industrial firm that was also heavily involved in financial markets—were higher than those of the previous year.

The decade was peppered with financial debacles, but these faded quickly from memory even as they increased in size and complexity. The billion-dollar-plus scandals included some colorful characters (Robert Citron of Orange County, Nick Leeson of Barings, and John Meriwether of Long-Term Capital Management), but even as each new scandal outdid the others in previously unimaginable ways, the markets merely hiccoughed and then started going up again. It didn't seem that anything serious was wrong, and their ability to shake off a scandal made markets seem even more under control.

When Enron collapsed in late 2001, it shattered some investors' beliefs and took a few other stocks down with it. But after a few months, many investors began yawning at Enron stories, confident that the markets had survived yet another blow. Few considered whether the problems at Enron were endemic, or whether it was possible that Enron was only the tip of the iceberg. Instead, investors shrugged off the losses, and went back to watching CNBC, checking on their other stocks.

Then, Global Crossing and WorldCom declared bankruptcy, and

dozens of corporate scandals materialized as the major stock indices lost a quarter of their value. Congress expressed outrage and mollified some investors with relatively minor accounting reforms. But most investors were perplexed. Should they wait patiently for another upward run, confident that Adam Smith's "invisible hand" would discipline the bad companies and reward the good? Or should they rush for the exits?

The conventional wisdom was that markets would remain under control, that the few bad apples would be punished, and that the financial system was not under any serious overall threat.

The recent financial crisis seems unrelated to prior scandals, and the revised, new conventional wisdom is that the collapse of 2008 was unique, a financial lightening strike. If only government can repair the damage to banks, the markets will recover and return to their prior well-functioning days.

The argument in this book is that the conventional wisdom is wrong. Instead, any appearance of control in financial markets is only an illusion, not a grounded reality. Markets came to the brink of collapse several times during the past decade, with the meltdowns related to Enron and Long-Term Capital Management being prominent examples. Today, the risk of system-wide collapse remains greater than ever before. The truth is that the markets are still spinning out of control.

The relatively simple markets that financial economists had praised during the 1980s as efficient and self-correcting are gone. Now the closing bell of the New York Stock Exchange is barely relevant, as securities trade 24 hours a day, around the world. The largest markets are private and don't touch regulated exchanges at all. Financial derivatives are as prevalent as stocks and bonds, and nearly as many assets and liabilities are off balance sheet as on. Companies' reported earnings are a fiction, and financial reports are chock-full of disclosures that would shock the average investor if she ever even glanced at them, not that anyone—including financial journalists and analysts—ever does. Trading volatilities remain sky high, with historically unrelated markets moving in lockstep, increasing the risk of systemic collapse.

During recent years, regulators have lost what limited control they had over market intermediaries, market intermediaries have lost what limited control they had over corporate managers, and corporate managers have lost what limited control they had over employees. This loss-of-control daisy chain has led to exponential risk-taking at many companies, largely

hidden from public view. Simply put, any appearance of control in financial markets has been a fiction.

If investors believe in the fiction of control, and ignore the facts, the markets will rise again. But if investors continue to question their faith, as they have more recently, the downturn will be long and hard. As investment guru James Grant recently put it, "People are not intrinsically greedy. They are only cyclically greedy."[1] The most recent cycle of greed appears to have ended, but at some point, inevitably, the next one will begin.

This book traces three major changes in financial markets during the fifteen years before the recent crisis. First, financial instruments became increasingly complex and were pushed underground, as more parties used financial engineering to manipulate earnings and to avoid regulation. Second, control and ownership of companies moved greater distances apart, as even sophisticated investors could not monitor senior managers, and even diligent senior managers could not monitor increasingly aggressive employees. Third, markets were deregulated, and prosecutors rarely punished financial malfeasance.

These changes spread through financial markets like a virus through the population. Before 1990, markets were dominated by the trading of relatively simple assets, mostly stocks and bonds. The sine qua non of the 1980s was the junk bond, a simple, fixed-income instrument no riskier than stock. The merger mania of the 1980s—driven by leveraged buyouts, in which an acquirer borrowed heavily to buy a target's stock—involved straightforward transactions in stocks and bonds.

Back then, individual investors shied away even from stocks, and most people kept their savings in the bank or in certificates of deposit, which paid more than 10 percent annual returns during most of the decade. Mutual funds became popular briefly—with stock-picking legend Peter Lynch of the Fidelity Investments' Magellan Fund attracting several billion dollars—but from 1968 through 1990, individuals sold more stock than they bought and money flowed out of the market. Few stocks traded at prices of more than twenty times their annual earnings, and stocks with no earnings were shunned.

Derivatives—the now-notorious financial instruments whose value is derived from other assets—were virtually unknown. The two basic types of derivatives, options and futures, were traded on regulated exchanges and enabled parties to reduce or refocus their risks in ways that improved the overall efficiency of the economy. Customized over-the-counter deriv-

atives markets—where derivatives were often used for less laudable purposes—were a fraction of one percent of their current size, and most complex financial instruments still had not been invented. It is telling, for example, that in *Barbarians at the Gate,* the classic book about 1980s finance, derivatives are not even listed in the index, and stock options merit only a footnote on page 364.[2]

Some companies used basic forms of derivatives during the 1980s, including so-called "plain vanilla" interest-rate swaps, where one party agrees to pay a fixed rate of interest to another party, who agrees to pay a floating rate. But the forms of structured financing and over-the-counter gizmos that later would bring hundreds of companies to their knees simply did not exist. Moreover, the exchange-traded derivatives some investors bought and sold were not especially risky; they had changed little from financial instruments the ancient Greeks created and used.

Even stock options—the derivatives that became the primary source of executive compensation during the 1990s—were relatively uncommon. A typical 1980s executive received cash salary and bonus, with perhaps a little stock, but few or no options.

The legal environment during this early period was harsh. The go-go 1980s led prosecutors to clamp down hard on securities fraud, indicting dozens of financial-market participants, nearly 100 in January 1989 alone. Looking back on the decade, the *Wall Street Journal* noted that "the word 'indictment' became almost as central to Wall Street lexicon as stock or bond."[3] The financial-market watchdogs made investors feel secure—almost smug—about financial fraud.

In several high-profile cases, judges imposed heightened duties on corporate directors, bankers, accountants, and lawyers, who came to understand that they violated the law at their peril. Regulators tightened rules against insider trading and other financial abuses. Joseph Grundfest, a commissioner of the Securities and Exchange Commission during the 1980s, opened a 1988 speech by saying, "It's a pleasure to appear before so many unindicted participants in the financial markets."[4] The decade closed with Judge Kimba Wood sentencing the infamous financier Michael Milken, of Drexel Burnham Lambert, to ten years in federal prison. By that time, prosecutors certainly had Wall Street's attention.

Top managers of large companies lived with another fear, too. Well-known corporate raiders—including Ivan Boesky, Carl Icahn, Ronald Perelman, and T. Boone Pickens—routinely bought large stakes in companies and then ousted ineffective managers to boost the value of shares.

Greed was good for these raiders (and, sometimes, for shareholders), but it wasn't good for the managers, who scrambled to create defenses against these takeovers and thus preserve their jobs. To the extent the 1980s involved complex financial dealings, they were focused on these increasingly intricate takeover defenses.

Still, most finance professionals—even highly paid investment bankers—were technologically primitive, without e-mail or the Internet. They used HP12C calculators instead of computer spreadsheets and statistical software. Few had formal finance training, and almost no one had a math or finance Ph.D. A 1980s trader would be virtually unemployable today; his HP12C would be about as useful on a trading floor as an abacus.

Individuals were technologically primitive, too. Investors placed orders to buy and sell stock by letter or over the phone, not with the click of a computer mouse. People learned how their stocks were performing at most once a day, from the financial pages of the morning newspaper, not in real time on television. Financial analysis was available through the mail at a price, not on the Internet for free.

In sum, the 1980s were a relatively primitive period on Wall Street. Life was uncomplicated, if aggressive. Participants were labeled barbarians, predators, even thieves. At the same time, the financial markets became increasingly competitive and profit margins dwindled. The stock market crash of October 19, 1987, didn't help matters. After the Dow Jones Industrial Average tumbled 508 points, or more than 22 percent, in one day, investors became skittish. As analysts struggled to explain the collapse, the investment bankers' business sputtered. The last years of the decade were likely to be lean, and the future looked grim. It was not a good time to be working on Wall Street.

All of this was about to change.

STAGE ONE

INFECTION

1

PATIENT ZERO

Andy Krieger was one of those kids who, it seemed, could do everything. He was an excellent high school student, and was admitted to the University of Pennsylvania, where he was elected to Phi Beta Kappa.[1] He was a competitive athlete and briefly played professional tennis on the European circuit.[2] He was an advocate for the poor, and was especially interested in the plight of lepers in India. As a graduate student during the late 1970s, he studied South Asian philosophy, translated obscure Sanskrit texts, and planned for a career in academia.[3] He was a vegetarian.

One day, Krieger's dissertation adviser told him that although his work had been first-rate, he would not be able to land an academic job until one of a handful of people working in his area died. Krieger wanted to help the poor, not become one of them, so he decided to trade careers. After six years of graduate study, he enrolled in business school.

Almost immediately, his life was transformed. Krieger studied finance at the Wharton School of Business, whose graduates included the infamous financiers Michael Milken and Donald Trump, men who had thrived in the relatively simple 1980s world of junk bonds and corporate takeovers. Krieger took a course in international finance, and was captivated by a new, more esoteric phenomenon: trading in foreign-currency options, the rights to buy and sell currencies at specified times and prices.

The curriculum at Wharton—which now includes dozens of specialized courses in finance—barely touched currency options when Krieger was there.[4] But J. Orlin Grabbe, a young finance professor at Wharton and a pioneer in the area,[5] became Krieger's mentor and taught him just enough to whet his appetite.[6] Krieger sought to reinvent himself as a currency options specialist; in 1984, he wrote a computer program to assess the value of currency options, and when he learned that Salomon Brothers, the New York investment bank, would be interviewing Wharton students for a position trading currency options, he submitted his résumé.

At Wharton, Krieger had learned how foreign currencies whose value had been linked to gold or to the U.S. dollar were now floating freely. Instead of requiring that their currencies be exchanged for a fixed amount of gold or dollars, various central banks—including the Federal Reserve—were permitting the value of their currencies to fluctuate in the market. Trading in these currencies was increasing exponentially, and companies had moved beyond simply exchanging U.S. dollars for Japanese yen, or German marks for British pounds, to betting on dozens of currencies in all sorts of new and fantastic ways.

During school, Krieger did a stint at O'Connor & Associates, an options trading firm in Chicago. He found that in currency trading, "you're pitted against some of the sharpest minds in the world."[7] The currency markets were intensely competitive, with hundreds of billions of dollars changing hands every day. Firms that traded the more exotic instruments—including currency options—were cleaning up. When Krieger discovered that some of these traders were making millions in bonuses, he quickly found "an inner drive to see how good I could be."[8] So much for Sanskrit.

Krieger gave up his tennis career and put his academic interests to the side. He persuaded the interviewers from Salomon that his brief experience as a trader, plus his detailed understanding of currency options, plus his knowledge of foreign languages and cultures, made him the ideal hire.[9] Salomon agreed, and Krieger began his career there after graduation.

Four years later, during early 1988, Krieger briefly was as well-known as some of the men who had come before him at Wharton. The publicity didn't last long, and few people remember Krieger today. But Krieger's story from that time is an object lesson in the risks associated with financial innovation.

• • •