AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

ANALYZING THE ANALYSTS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON
FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

JUNE 14; JULY 31, 2001

Printed for the use of the Committee on Financial Services

Serial No. 107–25

U.S. GOVERNMENT PRINTING OFFICE

73–368 PS WASHINGTON : 2001

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

MICHAEL G. OXLEY, Ohio, *Chairman*

JAMES A. LEACH, Iowa
MARGE ROUKEMA, New Jersey, *Vice Chair*
DOUG BEREUTER, Nebraska
RICHARD H. BAKER, Louisiana
SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
ROBERT W. NEY, Ohio
BOB BARR, Georgia
SUE W. KELLY, New York
RON PAUL, Texas
PAUL E. GILLMOR, Ohio
CHRISTOPHER COX, California
DAVE WELDON, Florida
JIM RYUN, Kansas
BOB RILEY, Alabama
STEVEN C. LATOURETTE, Ohio
DONALD A. MANZULLO, Illinois
WALTER B. JONES, North Carolina
DOUG OSE, California
JUDY BIGGERT, Illinois
MARK GREEN, Wisconsin
PATRICK J. TOOMEY, Pennsylvania
CHRISTOPHER SHAYS, Connecticut
JOHN B. SHADEGG, Arizona
VITO FOSELLA, New York
GARY G. MILLER, California
ERIC CANTOR, Virginia
FELIX J. GRUCCI, JR., New York
MELISSA A. HART, Pennsylvania
SHELLEY MOORE CAPITO, West Virginia
MIKE FERGUSON, New Jersey
MIKE ROGERS, Michigan
PATRICK J. TIBERI, Ohio

JOHN J. LAFALCE, New York
BARNEY FRANK, Massachusetts
PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
KEN BENTSEN, Texas
JAMES H. MALONEY, Connecticut
DARLENE HOOLEY, Oregon
JULIA CARSON, Indiana
BRAD SHERMAN, California
MAX SANDLIN, Texas
GREGORY W. MEEKS, New York
BARBARA LEE, California
FRANK MASCARA, Pennsylvania
JAY INSLEE, Washington
JANICE D. SCHAKOWSKY, Illinois
DENNIS MOORE, Kansas
CHARLES A. GONZALEZ, Texas
STEPHANIE TUBBS JONES, Ohio
MICHAEL E. CAPUANO, Massachusetts
HAROLD E. FORD, JR., Tennessee
RUBÉN HINOJOSA, Texas
KEN LUCAS, Kentucky
RONNIE SHOWS, Mississippi
JOSEPH CROWLEY, New York
WILLIAM LACY CLAY, Missiouri
STEVE ISRAEL, New York
MIKE ROSS, Arizona

BERNARD SANDERS, Vermont

Terry Haines, Chief Counsel and Staff Director

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

RICHARD H. BAKER, Louisiana, *Chairman*

ROBERT W. NEY, Ohio, *Vice Chairman*
CHRISTOPHER SHAYS, Connecticut
CHRISTOPHER COX, California
PAUL E. GILLMOR, Ohio
RON PAUL, Texas
SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
BOB BARR, Georgia
WALTER B. JONES, North Carolina
STEVEN C. LATOURETTE, Ohio
JOHN B. SHADEGG, Arizona
DAVE WELDON, Florida
JIM RYUN, Kansas
BOB RILEY, Alabama
VITO FOSSELLA, New York
JUDY BIGGERT, Illinois
GARY G. MILLER, California
DOUG OSE, California
PATRICK J. TOOMEY, Pennsylvania
MIKE FERGUSON, New Jersey
MELISSA A. HART, Pennsylvania
MIKE ROGERS, Michigan

PAUL E. KANJORSKI, Pennsylvania
GARY L. ACKERMAN, New York
NYDIA M. VELÁZQUEZ, New York
KEN BENTSEN, Texas
MAX SANDLIN, Texas
JAMES H. MALONEY, Connecticut
DARLENE HOOLEY, Oregon
FRANK MASCARA, Pennsylvania
STEPHANIE TUBBS JONES, Ohio
MICHAEL E. CAPUANO, Massachusetts
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
JAY INSLEE, Washington
DENNIS MOORE, Kansas
CHARLES A. GONZALEZ, Texas
HAROLD E. FORD, JR., Tennessee
RUBÉN HINOJOSA, Texas
KEN LUCAS, Kentucky
RONNIE SHOWS, Mississippi
JOSEPH CROWLEY, New York
STEVE ISRAEL, New York
MIKE ROSS, Arizona

CONTENTS

WITNESSES

Thursday, June 14, 2001

APPENDIX

WITNESSES

TUESDAY, JULY 31, 2001

APPENDIX

ADDITIONAL MATERIAL PROVIDED FOR THE RECORD

ANALYZING THE ANALYSTS

THURSDAY, JUNE 14, 2001

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 10:00 a.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker, [chairman of the subcommittee], presiding.

Present: Chairman Baker; Representatives Oxley, Ney, Shays, Paul, Castle, Royce, Barr, Weldon, Biggert, Miller, Ose, Hart, Kanjorski, Bentsen, J. Maloney of Connecticut, Hooley, Mascara, Jones, LaFalce, Capuano, Sherman, Inslee, Moore, Hinojosa, Lucas, Shows, Israel and Ross.

Chairman BAKER. I would like to call this hearing of the Capital Markets Subcommittee to order. We're starting promptly on time this morning. We like to have the ability to start trading as soon as the opening bell rings around here.

First, by prior agreement with Mr. LaFalce and Mr. Kanjorski, opening statements today will be limited to Chairman Oxley, myself, Ranking Member LaFalce, and Mr. Kanjorski, who is on his way, to expedite the proceedings of the hearing this morning.

All other Members' statements will be incorporated into the record.

I am appreciative for the courtesies extended by Mr. Kanjorski and Mr. LaFalce in facilitating this meeting this morning.

As we all know, this is an issue of some importance and volatility. There was a question on a recent magazine cover that struck me as particularly appropriate: "Can We Ever Trust Wall Street Again?"

The simple answer to that question is, we must. That is, we must find a way. It's simply not a choice. America's prosperity, as always, is intrinsically bound to the influx of capital investment that fuels business expansion, job growth and technology.

To the extent that American consumers have been temporarily shaken by the recent market downturn, our first goal today here is to begin a process of rebuilding that confidence, not only to reaffirm American consumers' faith in the fairness of the market, but actually to have their trust.

Clearly, I am a pro-market conservative legislator and I am going to be one of the last on the subcommittee, I think, to suggest Federal intervention to solve every problem.

However, the foundation of the free market system is based on the free flow of information which is straightforward and unbiased. I believe this subcommittee has a very high responsibility to safeguard this principle.

I am deeply troubled by the evidence of the apparent erosion by Wall Street of the bedrock of ethical conduct.

It's a new and continually changing marketplace. Since 1995, online trading has resulted in enormous growth of investment by working families, some 800,000 trades a day, I am told, with a typical demographic profile of a $60,000 annual income with net worth less than 50.

These individual investors rely on and believe what they think is objective, professional advice from sophisticated analysts.

There's a message here. These investors are the future of the dynamic growth of the market place. They deserve fair treatment not only for their best interests, but for the growth of the market.

Folks who work hard to pay the house money, pay their taxes, and the grocery bill don't have luxury to be able to speculatively gamble. Over the last few years, Wall Street's insiders have whispered knowingly about a grade inflation, as it's called, resulting in what I think is a very coded language in analysts' recommendations.

A goal of this hearing is to begin speaking openly about what has apparently been unspoken in the past. I'm amazed. I'm the chairman of the Capital Market Subcommittee in the United States Congress. I learned this yesterday. Strong buy does not mean buy, but actually out-perform.

It really makes you wonder what out-perform or accumulate must mean. I am concerned not only about the potential for significant losses by the unwary and misinformed individual investor, but the possibility of overall market volatility that results when a more rational view does return.

Today, we are going to inquire into disturbing media and academic reports about pervasive conflicts of interest, which appear to be compromising the integrity of current market practice.

In fact, I want to enter into the record at this time, a study from the Harvard and Wharton Business School study entitled "The Relationship Between Analysts' Forecasts of Long-Term Earnings Growth and Stock Price Performance Following Equity Offerings."

I want to quote from that report one paragraph: "Our evidence suggests that the coexistence of brokerage services and underwriting services in the same institution leads sell-side analysts to compromise their responsibility to brokerage clients in order to attract underwriting business. Investment banks claim to have Chinese walls to prevent such a conflict. Our evidence raises questions about the reliability of the Chinese walls. We document that analysts officiated with the lead underwriter of an offering tend to issue more overly optimistic growth forecasts than unaffiliated analysts. Furthermore, the magnitude of the affiliated analysts' growth forecasts is positively related to the fee basis paid to the lead underwriter. Finally, equity offerings covered only by affiliated analysts experience the greatest post-offering under performance, suggesting that these offerings are the most over-priced."

I have to say this in my own words, as I basically understand it. Maybe there hasn't been a complete erosion in the Chinese walls that traditionally shield analysts from investment banking interests. But I have to say that I believe there are some folks out there manufacturing a lot of Chinese ladders for people to climb back and forth over those walls as they deem appropriate.

A market bubble that bursts is the time when people look for someone to blame. I believe it rather should be an opportunity for all concerned in the activity to step back, take a deep breath, and reexamine their own accountability to make sure it doesn't happen again, and all parties have some shared responsibility.

Today, we focus on the analysts' conflicts. At some point, we will take a look at the investment banks and the institutional investors.

And I must say a word about the financial press. They have much greater impact than many have given them their allocation for. It is irresponsible reporting to quote unquestioningly irresponsible analysts' reports and put them on the cover of magazines and make them into rock stars.

There is some examination due in this area as well. Consequently, while I appreciate the effort of the Securities Industry Association with their best practices proposal, put forward only 2 days ago, I am not yet convinced we have a remedy to our problem.

I take the very drafting of them as a positive sign that the industry accepts that problems may exist and I am naturally going to take a very careful look at any document that, on its face, has a disclaimer, which I'm paraphrasing here, respectfully, we're going to do our best to be honest and straightforward unless of course circumstances dictate we must do something different.

Today is not the end of our discussion, but the beginning. In the next few months, we will access recommendations, converse with regulators and, at the end of the process, the subcommittee, I hope, will come to a bipartisan agreement as to the best practices standard. Make the recommendations to regulators, and only if necessary, in my view, propose legislation, particularly for the sake of the growing number of $200 investors who are out there this morning on the job, working trying to make the next dollar.

It is far more important to do this very carefully, thoroughly, rather than do it quickly. Therefore, this hearing this morning marks the beginning.

It is my intention to have several hearings over the coming months. At the suggestion of many, we will hear from regulators, we will hear from academicians, we will hear from all those concerned who have a financial interest in seeing trust become the bedrock of our financial marketplace again.

[The prepared statement of Hon. Richard Baker can be found on page 116 in the appendix.]

Mr. Kanjorski.

Mr. KANJORSKI. Thank you very much, Mr. Chairman.

We meet today to consider the issue of analyst independence, a subject of great significance to our nation's vibrant capital markets. I congratulate you on your diligence in convening this very important and well-timed hearing.

I would make, at this point, two observations, however, Mr. Chairman. As I walked down the hall, it is the first time in my memory that the line is down to the corner and around the corner, and down the other hallway. It reminds me that when I was a little boy, I read the 50 years of the *New Yorker* cartoon book, which asked a very pungent question: Where are the investors' yachts? I think today's crowd brings that cartoon back into play. Maybe that is why we are meeting here.

The second observation is one of internal process. I do want to register my great disappointment with the House leadership in convening a very important bill involving SEC revenues that is on the floor today at the precise moment we are having this hearing. As you know, Mr. Chairman, several of us on this side of the aisle are opposed to the passage of the bill in its present form, and intended to argue that position on the floor today, as well as offer amendments in accordance therewith. And, as a result of the importance of this hearing, and the conflict with that bill on the floor, we are really put in an impossible situation either to miss our opportunity here and the intelligence we can gather, or to have a bill go through without comment. I hope this scheduling was not intentional, and I hope it never happens again.

With that said, it is a well-timed hearing. I am not attempting to be facetious when I say that. Over the last several years, the perceived immortality of the U.S. economy and the emergence of the Internet have contributed to extraordinary interest and growth in our capital markets.

Investors' enhanced access to financial reporting and their newfound ability to trade electronically also helped to fuel this dynamic expansion. Unlike some other sources of investment advice, the vast majority of the general public has usually considered the research prepared by Wall Street experts as reliable and valuable. With the burst of the high tech bubble, however, came rising skepticism among investors concerning the objectivity of some analysts' overly optimistic recommendations. Many in the media have also asserted that a variety of conflicts of interest may have gradually depreciated analysts' independence during the Internet craze and affected the quality of their opinions.

We have debated the issues surrounding analysts' independence for many years. After the deregulation of trading commissions in 1975, Wall Street firms began using investment banking as a means to compensate their research departments, and within the last few years the tying of analysts' compensation to investment banking activities has become increasingly popular.

As competition among brokerage firms for IPOs, mergers and acquisitions grew, so did the potential for large compensation packages for sell-side analysts. These pay practices, however, may have also affected analyst independence.

While some brokerage houses suggest that they have erected an impenetrable Chinese wall, which you mentioned, that divides analyst research from other firm functions like investment banking and trading, the truth, as we have learned from many recent news stories, is that they must initiate a proactive effort to rebuild their imaginary walls.

The release of some startling statistics has also called into question the actual independence of analysts. A report by First Call, for example, found that less than one percent of 28,000 recommendations issued by brokerage analysts during late 1999 and most of 2000 called for investors to sell stocks in their portfolio. Within the same timeframe, the NASDAQ composite average fell dramatically. In hindsight, these recommendations appear dubious. Furthermore, First Call has determined that the ratio of buy-to-sell recommendations by brokerage analysts rose from 6-to-1 in the early 1990s, to 100-to-1 in 2000.

Many parties have consequently suggested that analysts may have become merely cheerleaders for the investment banking division of their brokerage houses. I agree. To me, it appears that we may have obsequious analysts instead of objective analysts.

Today's hearing will help us better understand the nature of this growing problem and discover what actions might restore the public's trust and investors' confidence in analysts. Like you, Mr. Chairman, I generally favor industry solving its own problems through the use of self-regulation whenever possible. But in this instance, the press, regulators, law enforcement agencies, and spurned investors have also begun their own examinations into these matters. I suspect that these parties may demand even greater reforms than those recently proposed by the Securities Industry Association, including the need for full and robust disclosure of any and all conflicts of interest. To address these concerns, the industry may eventually need to come forward with a way to audit and enforce the best practices it now proposes. If not, others may seek to impose their own solutions to resolve this problem.

We will hear today from eight distinguished witnesses representing a variety of viewpoints. I am, Mr. Chairman, particularly pleased that you invited a representative from the AFL-CIO to join in our discussions. I would have also liked to learn from the concerns of SEC and NASD, among others.

I was, however, heartened to learn yesterday that you plan to hold additional hearings on this issue in the upcoming months with the concerned parties.

As we determined last year during our lengthy deliberations over Government sponsored enterprises, a roundtable discussion is often the most appropriate forum for us to deliberate over complex issues. In the future, I urge you to convene a roundtable over the matters related to analyst independence. A roundtable discussion would force the participants to challenge each other's assumptions and assertions in an open environment. It would also provide us with greater insights than testimony that has been scrutinized and sterilized through the clearance process. A roundtable debate would further allow us to more fully educate our Members about the substantive issues involved in this debate.

In closing, Mr. Chairman, let me caution all Members of this subcommittee, and particularly Members on my side. This is an issue that evidently is somewhat sexy and popular just by evidence of the amount of television here today. To people in public office and, quote: "politicians," it may be a great temptation to be a demagogue.

I join you in urging our fellow Members and others in our society to hold back their fire and their conclusions. We have the most successful financial and capital markets in the world.

Because we are in some difficulty economically in the markets, this is not the time to grab a club and take personal advantage by playing the role of lead demagogue. We cannot afford that, and the American economy cannot afford that.

So I look forward to hearing the testimony today. I think that over the next several months, if we use more open fora, we may be able to find a solution to a problem that is self-regulation by the Association and the industry itself. I would join you in that effort and hopefully, that is the best conclusion that we could reach.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Paul Kanjorski can be found on page 120 in the appendix.]

Chairman BAKER. Thank you, Mr. Kanjorski.

Just by way of assurance, the subcommittee's hearing date was established some time ago without knowledge of the floor consideration. Your point concerning the fee reduction bill on the floor today and the subcommittee hearing simultaneously is a matter of concern, but I assure you it was not an intentioned effort to create difficulty.

I happen to have some interest in the opposite side on that matter, and would like to be there to watch you on the floor very carefully.

Mr. OXLEY. Thank you, Mr. Chairman. Let me commend you for holding this hearing.

One of my goals, as the Chairman of this new Committee, is to help investors by improving the way they get information on which they base their investment decisions. Due in large part to the advances in technology that have brought to us the Internet, we've become not only a Nation of investors, but a Nation of self-taught investors.

No longer do investors have to rely on the information they obtain from their broker to make their investment decisions. Today, there is a veritable smorgasbord of information about the marketplace available to the public through financial websites, print publications, television, and virtually every media outlet.

There is a wealth of data available to investors. I launched this subcommittee's inquiries into improving the way stock market quotes are collected and disseminated into the impact of Regulation FD with an eye toward assuring that investors have broad access to the highest quality information about the marketplace.

Today's hearing continues our work toward that goal. I commend you, Mr. Chairman, for your work on each of these issues and for holding this important hearing today. I heartily agree with the Supreme Court's characterization in the Dirks case of the importance of analysts to investors to the marketplace.

And I quote: "The value to the entire market of analysts' efforts cannot be gainsaid. Market initiatives are significantly enhanced by their efforts to carry it out and analyze information. Thus the analysts' work rebounds to the benefit of all investors."

Yet the important work of analysts is not to the marketplace or investors any good at all, if it is compromised by conflicts of interest. There has been a great deal of concern raised by the media by regulators and by market participants about the perception that analysts are not in fact providing the independent, unbiased research that investors and the marketplace rely on.

We are here today to learn whether the Chinese wall that is long cited as the separation between the research and investment banking arms of securities firms has developed a crack or is completely crumbling.

I am encouraged that Wall Street has recognized that this is not a phantom problem, and has proposed industry best practices guidelines to address these conflicts about which we will hear today.

But I must emphasize that if that Chinese wall is in need of repair, wallpaper will not suffice.

While I am a strong proponent of free market solutions, I and the subcommittee plan to examine these industry guidelines very closely to ensure that they are tough, they are fair, and they are effective.

I am distressed by the statistics that as the markets were crashing last year, less than two percent of analysts' recommendations were on the sell-side.

It is no wonder there is public outcry about analysts' independence when the statistics are so stark. But it seems to me that the problem is not simply biased analysts. The firms that employ these analysts tie their compensation to the analysts' success in bringing in investment banking business.

Then the firms are undermining the independence of their own employees' recommendations.

Similarly, companies that pressure analysts through either the carrot on the stick or of increased or decreased investment banking business in turn for favorable reports exacerbates the problem.

Likewise, institutional investors also exert pressure on analysts to issue rosy reports about the stocks those institutional investors hold in their own portfolios.

We intend to examine every angle of this issue in order to best determine how to resolve it. Our subcommittee's goal here is to improve industry practices and I call on the industry to eliminate the conflicts of interest created by compensation structures and insufficient separation of investment banking and research, and I call on them also to provide meaningful and understandable disclosure to investors that will enable investors to evaluate, for themselves, what weight they should give the recommendations of any particular analyst.

Mr. Chairman, this hearing is this subcommittee's first step in a long-term effort to ensure that the Nation's investors have the best possible information about the stocks in which they invest. Ensuring that investors could rely on the expertise of analysts, without any doubt as to their integrity or independence, could not be more fundamental to that effort.

I yield back the balance of my time.

[The prepared statement of Hon. Michael G. Oxley can be found on page 126 in the appendix.]

Chairman BAKER. Thank you, Mr. Chairman. I certainly appreciate your leadership on this issue as well.

Mr. LaFalce.

Mr. LAFALCE. Thank you very much, Chairman Baker.

Today, our subcommittee confronts the very important question of whether investors are receiving unbiased research from Wall Street securities analysts.

I don't think they are, and I commend the Chairman for holding these hearings. I'm very concerned that investors have become victims of recommendations of analysts who have apparent and direct conflicts of interest relating to their investment advice.

So I think this morning's hearing is extremely important. It is anomalous that as our subcommittee considers this extremely important hearing, the bill that was reported out of our subcommittee is on the floor of the House of Representatives either now or in a matter of moments, reducing the fees of the SEC by approximately $14 billion over the next 10 years, without regard to the capacity of the SEC to effectively enforce the laws and regulations responsible for investor independence and objectivity, responsible for accounting independence and objectivity, responsible for so many of the other problems which are probably just the tip of the iceberg of problems existing for investors in this multi-trillion marketplace that the individual citizen is participating in today in the United States in a manner unparalleled in American history.

That's very regrettable, but in any event, I'm glad for the hearing. It's clear that sell-side analysts work for firms that have business relationships with the companies they follow. Most analysts are under increased pressure to look for and attract business and to help the firm keep the business it has.

The analyst is asked to be both banker and stock counselor and these two goals often live in conflict. The individual investor is often unaware of the various economic and strategic interests that the investment bank and the analysts have that can fundamentally undermine the integrity and quality of analysts' research.

The disclosure of these conflicts is often general, inconspicuous, boiler plate, meaningless. In addition, current conflict disclosure rules do not even reach analysts touting various stocks.

For example, on CNBC or CNN, as former Chairman of the SEC, Arthur Levitt noted, I wonder how many investors realize the professional and financial pressures many analysts face to dispense recommendations that are more in a company's interest rather than the public's interest.

I believe it is precisely these pressures that moved many analysts, during the technology boom over the last several years, to recommend companies and assign valuations beyond any relationship to company fundamentals.

In a recent article, a very well-known technology analyst was quoted as responding to questions concerning the legitimacy of the valuation of a particular company, and the analyst said, we have one general response to the word "valuation" these days. Bull market. We believe we have entered a new valuation zone.

The article to which I refer, and many, many, many others like it, make the case that these conflicts may have profoundly undermined analysts' integrity and possibly misled investors. I think possibly should be almost certainly misled investors as analysts held fast to companies, as the market eroded out from under them.

The Securities Industry has suggested new guidelines to address some of the conflicts we will discuss in today's hearing. Their initiative is an important first step. I do not believe, however, that these voluntary guidelines go far enough to address the problem.

I am pleased therefore that today's hearing will begin a process whereby our subcommittee and the regulators can begin to take a hard look at these troubling questions affecting the American investing public.

I look forward to the hearings where the SEC and the NASD, amongst others, where academic analysts, where investors, attorneys, and others can testify on the question of analyst objectivity.

In my view, the Securities regulators' perspective is especially critical. We cannot fulfill our oversight responsibility if the Government and quasi-government entities, charged by Congress with the protection of investors, have not been heard.

Not only do the Securities regulators have an important perspective on the magnitude of the problem, they also have a view on how the industry is complying with current regulations on information barriers, so-called Chinese walls and the disclosure of conflicts.

In sum, I am increasingly concerned that industry self-regulation may not be sufficient to guard against the problems and abuses we are seeing, and that more disclosure of these conflicts, in itself, may not suffice to protect the individual investor.

So I hope today's hearing is only the first step in confronting these very troubling issues of securities analysts conflicts of interest that mean trillions of dollars to people in neighborhoods across America.

I thank you.

[The prepared statement of Hon. John J. LaFalce can be found on page 122 in the appendix.]

Chairman BAKER. Thank you, Mr. LaFalce.

By prior agreement, we had hoped to limit opening statements to the Members previously recognized, and I intend to do so, but I have been requested by Ms. Jones to be recognized for 30 seconds to explain her necessity for departing from the hearing this morning.

Ms. Jones.

Mr. JONES. Mr. Chairman, Mr. Ranking Member, Colleagues, I appreciate the opportunity to submit my statement for the record.

This morning, the National Institutes of Health will be naming a building after the Honorable Congressman Louis Stokes, my predecessor. I must go out there and congratulate them. Thank you very much. I submit my statement for the record.

[The prepared statement of Hon. Stephanie T. Jones can be found on page 118 in the appendix.]

Chairman BAKER. Thank you very much, Ms. Jones.

At this time, I would like to proceed with the introduction of our panelists.

Our first to participate this morning, we welcome, is Mr. David Tice, Portfolio Manager, the Prudent Bear Fund, and publisher of the institutional research service known as "Behind the Numbers."

Welcome, Mr. Tice.

For the record, all witness statements will be made part of the record. Please feel free to summarize. We will have a number of questions for the panel during the course of the morning, and we would like to maximize that time as best we can.

Please proceed, sir.

STATEMENT OF DAVID W. TICE, PORTFOLIO MANAGER, PRUDENT BEAR FUND, AND PUBLISHER OF THE INSTITUTIONAL RESEARCH SERVICE "BEHIND THE NUMBERS"

Mr. TICE. Thank you very much, Mr. Chairman. David W. Tice & Associates operates two different businesses. We publish "Behind the Numbers," an institutional research service, and serve as investment advisor to two mutual funds.

I started "Behind the Numbers" in 1988 because I realized institutional investors did not receive independent, unbiased research from their traditional brokerage firms, which almost never issued sell recommendations.

To our knowledge, there are now fewer than six other significant firms that concentrate on only sell recommendations.

We like to call ourselves "The Truth Squad" with regard to individual Wall Street recommendations. The truth is, this lack of analyst independence has been great for our business. Currently, more than 250 institutional investors purchase our service. Our 15 largest clients manage more than $2.3 trillion.

David W. Tice & Associates, Inc., is a modest-sized organization of 17 professionals, yet every 2 weeks we butt heads with the best and brightest from Wall Street's biggest firms with our assessment of company fundamentals.

Of nearly 900 sell recommendations issued between 1988 and 2001, 67 percent have under performed the market with about half declining in price in the biggest bull market in this century.

Usually our analysis makes our research clients uncomfortable as well as potential mutual fund shareholders because it differs from the Wall Street consensus.

However, our research has earned respect because of its quality and because people realize that our conclusions are free of the biases that affect traditional Wall Street research.

Our job is not to be pessimistic or optimistic, but to be realistic and to help protect clients' capital. In this spirit, and with the benefit of our insight into hundreds of U.S. companies that we analyze, the U.S. stock market and economy, we concluded that we had a bubble stock market and a bubble economy.

So we organized the "Prudent Bear Fund" in 1996, the same year that Alan Greenspan made his famous "irrational exuberance" speech.

We believe the individual investor should be warned and should have access to a vehicle to hedge himself in a market decline. Some will question our objectivity since we manage this bear's fund, and say that I'm just talking "my book."

But I believe passionately in every word of my testimony, and it's all based on fact, rigorous analysis, and solid macro-economic theory.

There is no question, Mr. Chairman, that Wall Street's research is riddled with structural conflicts of interest. Compounding this problem, according to a recent study, those who closely follow Wall Street's stock recommendations have suffered abysmal investment performance as this study showed that from 1997 through May 2001, only 4 out of 19 major Wall Street firms would have generated positive returns over the 4½ year period in the biggest bull market in this century.

In our testimony, we've provided many examples of conflicts. Generally, our perception of this situation today coincides with the Chief Investment Officer of Asset Allocation of a multi-billion dollar asset manager who said, and I quote: "Research analysts have become either touts for their firm's corporate finance departments or the distribution system for the party line of the companies they follow. The customer who follows the analysts' advice is paying the price."

Today, the power structure of most Wall Street firms is simply concentrated too much in investment banking; and even with the supposed Chinese walls, there are still multiple cases of analysts reporting to investment bankers.

This is an outrage. This conspicuous lack of objectivity in research is indicative of what we see as a general lack of responsibility on Wall Street today, one that's having a corrosive effect on the marketplace.

The main emphasis of our testimony has addressed the consequences that arise when capital markets lack integrity, stemming largely from this lack of objectivity. This problem is much larger, Mr. Chairman, than whether or not individual investors are disadvantaged or have suffered losses, or if analysts receive oversized bonuses.

What's at stake we believe is that a sound and fair marketplace is at the very foundation of capitalism. It is the functioning of the market pricing mechanism that determines which businesses and industries are allocated precious resources, and it is this very allocation process that's the critical determining factor for the long-term economic well being of our nation.

When the marketplace regresses to little more than a casino, the pricing mechanism falters and the allocation process becomes dysfunctional. When the marketplace's reward system so favors the aggressive financier and the speculator over the prudent businessman and investor, the consequences will be self-reinforcing booms and busts, a hopeless misallocation of resources, and an unbalanced economy.

We believe that in an environment of more independent analysis, it would have led to a more efficient capital allocation where we would have financed fewer internet companies less fiber optic bandwidth, and instead perhaps built more refineries in California power plants.

When credit is made readily available to the speculating community, failure to rein in the developing speculation risks ponzi-type investment schemes. Such an environment will also foster a redistribution of wealth from the unsuspecting to those most skilled in speculation.

Such an environment creates dangerous instability, what we refer to as financial and economic fragility.

The financial sector is creating enormous amounts of new debt that's often being poorly spent. Sophisticated Wall Street, with its reckless use of leverage, proliferation of derivatives, and sophisticated instruments, is funding loans that should not be made.

While such extraordinary availability of credit certainly does foster an economic boom, it must be recognized that history provides numerous examples of the precariousness of booms built on aggressive credit growth that are unsustainable and dangerous.

Goldman Sachs' Abby Joseph Cohen has used the phrase "U.S. Supertanker Economy," but the problem is Wall Street has created a ship that has run terribly off course. Wall Street's lack of independence has fostered this misdirection and camouflaged the fact that our U.S. economy is in danger because of our capital misallocation and credit excess.

This may sound ridiculous to most of you with nearly uniform optimism among traditional economists. But if you doubt me, I'll quote ex-Fed Chairman Paul Volker, who more than 2 years ago said, quote: "The fate of the world economy is now totally dependent upon the U.S. economy, which is dependent upon the stock market whose growth is dependent on about 50 stocks, half of which have never reported any earnings."

If I could go to our potential solutions. We do not pretend to be experts in the area of Securities Law and Regulation. We have presented a list of nine solutions in the spirit of general directions to take, not specific laws to change.

Not included in our list of solutions are proposals that try to tinker with analysts' compensation schemes or require some type of peer review. We believe the problems are so significant and so critically important, bold solutions, not incremental change, are required.

Tremendous political courage will be needed to effect change in this area. Those who have benefited from the current broken system have enormous financial resources.

The raw political power of those who favor the current system cannot be underestimated.

The voice of those favoring change will be faint, but well worth listening to. However, we must remember that trust in our institutions is the cornerstone of a vibrant capitalist society, and lies at the heart of a healthy democracy.

Chairman BAKER. Can you begin to wind it up, sir?

Mr. TICE. Yes. We commend the subcommittee and Chairman for tackling such a difficult and timely issues. The stakes are enormous.

Thank you for the honor of appearing before this subcommittee.

[The prepared statement of David Tice can be found on page 128 in the appendix.]

Chairman BAKER. Thank you, Mr. Tice. I appreciate your courtesy, sir.

Our next witness to appear is Mr. Gregg Hymowitz, founding partner, EnTrust Capital.

Welcome, sir.

STATEMENT OF GREGG S. HYMOWITZ, FOUNDING PARTNER, EnTRUST CAPITAL

Mr. HYMOWITZ. Mr. Chairman Baker, esteemed Members of the subcommittee, I'm Gregg Hymowitz, a founding partner in EnTrust Capital. It's a pleasure to share with you this morning my summarized thoughts and observation.

My comments today represent solely my personal views and not necessarily the views of EnTrust Capital.

Is there a conflict of interest among sell-side analysts and the companies they cover? In my opinion, the answer is yes.

But the relationship between analyst, issuer, and the investing public is a complex network of checks and balances.

Typically, the analyst works for an investment bank whose bankers are attempting to move business from the issuer, often in the form of a capital market transaction. Therefore, most analysts recognize it does not behoove their firm's self-interest to have a negative view on the issuer.

Additionally, most analysts's compensation at investment banks has historically been partially determined by the amount of high margin capital market transaction revenues for which each analyst was responsible.

The communication between analyst and issuers is symbiotic. The issuer needs the analyst's coverage to get potential investors interested in buying, and the analyst's life blood is an open communication channel to the issuer.

One can surmise that communication is easier and more open between parties when they are aligned. The pressures and conflicts on the sell-side analysts during the recent equity bubble were exaggerated by the compressed period of time the capital markets were accommodative.

Investment banks, due to the demand from the investing public, and the supply created by venture capitalists, took hundreds of companies public that, in historical terms, would never have made it out the door.

The need for new valuation metrics became apparent. Free cash flow and earnings metrics were replaced with multiples of sales, developers, and my favorite, web hits.

Now while many of these metrics have turned out to be just plain silly and will continue to remain just plain silly, we need to remember 20 years ago, a now widely recognized metric called EBITDA was created to analyze certain profitless companies.

Investment banks have been recommending stocks to their clients roughly since the 1792 Buttonwood Agreement. Historically, however, the Morning Call was the province of the institutional money manager, who understood where this information was coming from and was able to evaluate its relative importance.

With the rise of the Internet, Wall Street calls are everywhere, rich with a frenzy day trading analyst calls took on exaggerated importance. Often the trading public seized upon these calls and stocks would move significantly. Remember, there was little or no public uproar over analysts' rosy coverage in 1999, when many investors were making in the market hand-over-fist.

For years, the institutional money manager understood from where the sell-side research held, and as it became more dispersed, the individual investor has now caught on.

In this age of information overload, the individual has the responsibility to perform his or her own due diligence. For decades now, the institutional investor has been ranking equity analysts, and today there are dozens and dozens of free websites, which rank analysts.

These resources are doing an excellent job of informing those investors who are willing to invest the time on doing due diligence, and which analysts to follow.

But for the individual who merely sees the stock market as a craps table, without doing any of his or her own research on either the issuer or the analyst, does so at one's own peril.

One idea that may coerce analysts to be more thoughtful in their recommendation is for investment banks to actually urge analysts to own the stocks they suggest, with proper internal safeguards to prevent such things as front running in addition to appropriate disclosure, analysts actually owning the stocks they recommend actually may help ameliorate the biases that exist.

The old Wall Street adage to analysts is, don't tell me what you like, tell me what you own. Many individuals want to find a causal relationship between the market's crash and the lack of sell recommendations among sell-side analysts.

I believe no causal relationship exists. While there have been many buy ratings on the steel, food, and retail stocks, with little if any sell recommendations, they did not experience the meteoric rise many tech stocks had over the past couple of years, incorrectly many believe that there are few sell recommendations on Wall Street.

There are, however, numerous firms, including Mr. Tice's, that specialize in providing only sell recommendations. Unfortunately, much of this research is not widely circulated to the individual investor because, quite frankly, it is very costly. There are also many countervailing pressures on analysts that work toward providing a balanced view, first and foremost. On Wall Street, reputation and record mean everything.

The analysts over time who are the most thoughtful, responsible and correct earn the respect of the investment community. This institutional pressure for analysts to be correct is the largest force compelling unbiased work.

Another clear way of holding analysts accountable is for the investment bank to publish each analyst's performance record. This will provide more information to the investors and aid those who are superior stock pickers.

Investment bankers should improve the materiality of disclosure statements. It is more important from a potential conflict standpoint to know if the bank is currently engaged by the issuer or is pitching the firm new business, rather than the typical historical disclosures.

The disclosure statement should consist of whether the analyst personally owns the security. Equity ownership by analysts is a positive occurrence, not something to be shunned.

I will sum up. The new information age, combined with Regulation FD, Fair Disclosure, is impacting the role of the analyst, with companies now severely limited to what they can say to analysts.

Prior to generally released news, the importance and edge that analysts have over the investing public has significantly diminished. Unfortunately often, and I know this from personal experience, the only way to learn this business is from mistakes. That costs money.

Investors have learned a hard lesson. With huge rewards come equally huge risks, the bubble has burst. There will be other manias with new and probably evermore fanciful evaluation metrics in our future.

Investors should not believe everything they read, hear, or see. In the new Regulation FD Internet age, the playing field has been leveled, possibly lowered. And therefore the responsibility accordingly must be shared.

Thank you, Mr. Chairman.

I'd be honored to attempt to answer any questions the subcommittee may have.

[The prepared statement of Gregg S. Hymowitz can be found on page 160 in the appendix.]

Chairman BAKER. Thank you very much.

Just by way of notice to Members, we have a 15-minute vote on the floor pending, followed by two 5-minutes. It would be my intention to recognize Mr. Glassman for his opening statement, and then recess the subcommittee at that moment to proceed to the votes. We'll be out for about 15 minutes. We will try to get back as quickly as possible.

Mr. LAFALCE. Parliamentary inquiry, Mr. Chairman.

I understand what you just articulated. I wonder if we might consider—I suppose this depends upon the schedule of the witnesses of panel one and panel two. The bill that we are considering deals with the SEC and the fees that are being charged. Section 31, Section 6, Section 13, Section 14, peg to parity capacity of SEC for enforcement, and so forth.

I'm wondering if we couldn't recess until completion of debate and passage of that bill, and then return. I suspect it would be about 2:00 o'clock. But I don't know what the schedule of the witnesses is.

Right now, we have two responsibilities; one here and one there. We can't bi-locate, so either we have to give short shrift to one of our responsibilities and they are both great.

Chairman BAKER. I understand the gentleman's point. Ordinarily, if we had prior notice to try to make arrangements, we would have just convened at a later hour today, but given the witnesses' traveling arrangements, I respectfully suggest we proceed as announced with a brief recess, come back, and we will do all we can to accommodate appropriate consideration.

I intend to be in the subcommittee most of the day and will miss most of the debate on the floor myself, which I deeply regret. But I think in deference to the eight people who've made arrangements to be here, we need to proceed as we scheduled.

At this time, I'd like to recognize Mr. James Glassman, no stranger to the subcommittee, who is a Resident Fellow at American Enterprise Institute and Host of TechCentralStation.com.

Welcome, Mr. Glassman.

STATEMENT OF JAMES K. GLASSMAN, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE, AND HOST WWW.TECHCENTRALSTATION.COM

Mr. GLASSMAN. Thank you, Mr. Chairman, Members of the subcommittee.

My name is James K. Glassman. I'm a resident fellow at the American Enterprise Institute, author of financial books and an investing columnist for many years. I've devoted much of my professional life to educating small investors.

This hearing sheds light on an important subject, but I urge restraint in two ways. First, analysts should not be seen as scapegoats for the recent market decline.

Second, this subcommittee should resist the urge to pass legislation in this area.

Analysts and firms have enormous incentives to do their jobs well. The marketplace weeds out the bad from the good as long as the public has the information. That is the function of a hearing like this, and I commend you for holding it.

Many analysts were caught off guard by the recent decline of the stock market, which represented the first bear market in a decade. Some of them were accused of allowing personal financial interests and a desire to cater to the investment banking side of their firms to distort their judgments.

Let me make three comments about this criticism.

First, conflicts of interest pervade the securities industry because they pervade life. You Members, yourselves, cope with conflicts all the time. You have allegiances to family, to donors, to party, but you try to surmount them.

Or consider journalists. Surveys show that most journalists lean to the left of the political spectrum. For example, a study by the Roper Center of 139 Washington bureau chiefs and correspondents found that in 1992, 89 percent of them voted for Bill Clinton, 7 percent for George Bush, yet every journalist to whom I've ever spoken claims that his professionalism overrides these conflicting political leanings.

Does it?

Well, the answer is that we can judge for ourselves by reading the articles that they write or the TV segments in which they appear.

A similar situation prevails for stock analysts, except that their judgments are clear and more easily accessed by the public.

The essential problem with a conflict of interest of any sort is that it leads to poor decisions. In the case of journalists, bias may suddenly color reporting and be difficult to discern.

In the case of stock analysts, it could mean that a company with poor fundamentals is given a high recommendation.

In this case, however, the analysts' judgment is assessed quickly by the public. An analyst who consistently gives bad advice will be rejected as not useful, either to investors or ultimately to the firm that employs her. An analyst cannot hide for very long.

Second, I favor voluntary and extensive disclosure by analysts of personal holdings and other affiliations that might color decisions. But don't exaggerate the benefits of disclosure. What, for example, should an investor make of the disclosure that an analyst owns shares of stock that he recommends?

Is it that the stock may not be all that good, but the analyst is pushing it for personal gain?

Or is it the opposite. That the stock is particularly good because the analyst owns it?

I am not really sure that disclosure is all that helpful. Yet, I do favor it, and I do it myself.

Third, the essential critique is that analysts biased by conflicts have made poor recommendations. Now we can test that theory by looking at the actual performance of analysts.

How well do they do? This question has been examined at length in a study published in the April 2001 issue of the Journal of Finance, a highly regarded publication for scholars.

In the article, the articles, Brad Barber of the University of California at Davis and three of his colleagues found that analysts' recommendations were in fact prescient and profitable. This research reinforces earlier studies that have found that professional securities forecasters have acted rationally, that is, with proper judgment.

The authors of the new study looked at a database of 360,000 pieces of advice from 269 brokerage houses and 4,340 analysts from 1986 to 1996. They found that investors buying portfolios of the highest rated stocks by these analysts achieved average annual returns of 18.8 percent to compare with a stock market benchmark return over this period of 14.5 percent.

The lowest rated stocks by analysts achieved a return of only 5.8 percent.

These results are truly exceptional. Rare, for example, is the mutual fund that can beat the Standard & Poor's 500 Stock Index by four points over 10 years. In fact, the benchmark has beaten the majority of funds over the past two decades.

I should add that Mr. Tice likes to criticize analysts, but his own fund, the Prudent Bear Fund, has, according to *Morningstar*, produced a total return of minus 47 percent from its inception in 1996 through April 30th, 2001.

The S&P 500, the benchmark, produced a return of positive 120 percent.

The results of the Barber study suggest that analysts are truly able to pick winners.

Now last month, the researchers published an unpublished follow-up for 1997 to 2000. In the first three of those years, the results were even better than they had been in the previous 10 years. But in the final year, 2000, the results were terrible. The most highly recommended stocks fell sharply while the least favored stocks did the best.

Those results of course are at variance with the previous 13 years and certainly we should watch analysts closely, but the longer term results show that, on the whole, analysts do a good job for their clients.

Finally, I worry that this hearing could send three wrong messages to investors, to small investors. The first is that bad stock picks are the result of corruption and bias. In the vast majority of cases, they are not.

Poor picks usually happen because the market in the short term is impossible to predict. No one is right all the time or even much better than half the time.

The second wrong message is that short-term stock recommendations are all that important to investors. Again, they are not. The best advice to investors always is to own a diversified portfolio for the long term.

Concentrating on the day-to-day judgment of analysts is not a profitable pastime for small investors, whether those analysts are pulled by conflicts of interest or not.

And the third wrong message is that the paucity of sell recommendations is a scandal. To the contrary, smart investors buy stocks and they keep them; they don't sell.

Despite the past year, as I said earlier, the benchmark is up 120 percent in 5 years. Investing is a long-term endeavor; done best, it is boring. If I could change anything that analysts do, it would be to encourage them to tell us the best stocks to own unchangingly for the next 5 to 10 years, not the next 5 to 10 weeks.

However, I congratulate this subcommittee for airing such an important issue.

Thank you.

[The prepared statement of James K. Glassman can be found on page 166 in the appendix.]

Chairman BAKER. Thank you, Mr. Glassman.

We stand in recess for approximately 15 minutes.

Thank you.

[Recess.]

Chairman BAKER. I'd like to begin the effort to reconvene our hearing. The good news is we only had two votes instead of three and Members are on their way back. I expect them to be coming in as we proceed.

In order to facilitate the progress in the hearing, I'd like to go ahead and recognize our next witness. It's my expectation that we will have at least another hour before we get interrupted again unless of course things change.

With that caveat, I would like to, at this time, recognize Mr. Marc Lackritz, President of the Securities Industries Association.

Welcome, Mr. Lackritz.

STATEMENT OF MARC E. LACKRITZ, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr. LACKRITZ. Thank you, Mr. Chairman. Mr. Chairman, I'm really pleased to be here this morning to have this opportunity to meet with you and the subcommittee.

The subject of today's hearing concerns how this industry fulfills its obligations to its customers, to the nearly 80 million Americans who directly or indirectly own shares of stock.

Our most important goal as an industry is to foster the trust and confidence of America's shareholders in what we do and how we do it.

And we succeed as an industry only when we put investors' interests first, period.

I will refer you to my written testimony for a detailed description of who analysts are and how they help investors and our markets. The value added by securities analysts has been widely appreciated.

For example, both the Supreme Court and SEC have said in the Dirks case, as Chairman Oxley indicated earlier, that the value to the entire market of analysts' efforts cannot be gainsaid.

Market efficiency and pricing is significantly enhanced by their initiatives to ferret out and analyze information. Thus, the analysts' work redounds to the benefit of all investors.

How good a job you can ask do securities analysts do? As a group, they do a pretty good job. As my colleague, Mr. Glassman, said earlier, the recent academic paper that he cited reviewed approximately 500,000 analysts' recommendations from 1986 to 2000, and concluded that the consensus recommendations that analysts make on specific stocks prove both prescient and profitable.

The authors found "sell-side analysts' stock recommendations to have significant value." Aside from this comprehensive study, it's quite notable that 71 percent of recommendations listed in First Call are buys or strong buys.

This seems appropriate, considering that the 12 years from 1988 through 1999 saw the Dow Jones Industrial Average and the Standard & Poor's 500 Index both post an average gain of 16 percent a year.

Critics of analysts were much less vocal then. To be sure, in the past year or so as the market declined and the Internet bubble burst, it seems that securities analysts have a few bloody noses. They certainly do and they are not alone. Just about everyone working, reporting on, and commenting about securities recently has tripped at least a few times.

The question before this subcommittee is whether these analysts can be subjected to direct or subtle pressure to skirt objectivity and shade their conclusions one way or another.

It's a very legitimate question. The answer is, yes, they can. We in the industry, as well as those who regulate us, long have been aware of this. For this reason, there are strong legal mandates in the Securities Exchange Act of 1934. And similar regulations and laws are on the books to ensure research integrity and objectivity.

These are tough regulations as are the internal safeguards, yet is clear that some doubts may now be clouding the perception of how securities analysts operate. That's why we're meeting today, just to banish these clouds.

The Securities Industries Association has formalized and bolstered the safeguards by endorsing and releasing earlier this week, these best practices for research. In these, we articulate clearly the means to protect the independence and objectivity of securities research and the securities analysts.

We reaffirm that the securities analyst serves only one master, the investor, not the issuer nor the potential issuer.

Let me offer some examples from its main points:

One. The integrity of research should be fostered and respected throughout a securities firm. Each firm should have a written statement affirming the commitment to the integrity of research.

Two. The firm research management, analysts and investment bankers, and other relevant constituencies should together ensure the integrity of research in both practice and appearance. Research should not report to investment banking. The recommendation should be transparent and consistent. A formal rating system should have clear definitions that are published in every report or otherwise readily available, and management should support use of the full rating spectrum.

Three. An analyst should not submit research to investment banking nor to corporate management for approval of his or her recommendations or opinions, nor should business producers promise or propose specific ratings to current or prospective clients while pursuing business.

Four. A research analyst's pay should not be linked to specific investment transactions.

Five. Research should clearly communicate the relevant parameters and practical limits of every investment recommendation. Analysts should be independent observers of the industries they follow. Their opinions should be their own, not determined by those of other business constituencies.

Six. Disclosure should be legible, straightforward and written in plain English. Disclaimers should include all material factors that are likely to effect the independence of specific security recommendations.

Seven. Personal trading and investments should avoid conflicts of interest and should be disclosed whenever relevant. Personal trading should be consistent with investment recommendations.

There are a number of other important points to best practices, copies of which have been submitted to the subcommittee.

In addition to these best practices, Mr. Chairman, we will also continue and renew our efforts to educate investors on the risks and rewards inherent in the market, as well as basic investment precepts.

We have a number of publications that we've put out over the last couple of years. They are available on our website, and we're renewing our efforts to distribute them through our own members to investors directly.

Successful investing is a partnership between securities professionals and the investor. Therefore, just as the securities industry is renewing its commitment to do its part, we ask investors to be educated, informed, and prudent in their investment decisions.

The long-term interests of investors, the securities analysts and the securities firms for which they work are best served by analysts using their most skilled powers of research and best judgment.

The market is a very powerful and unforgiving enforcer. Flawed projections lose customers.

All of us in this industry know only too well the truth of the adage that it takes months to win a customer, but only seconds to lose one.

No securities firm wants to give advice that will hurt a client. Firms that offer bad investment guidance penalize themselves.

We believe the best practices endorsed by so many major firms and continuing throughout our Association demonstrate a vigorous renewed commitment to the investor. We hope they will go a long way toward ensuring that the public maintains and increases its trust and confidence in our markets and our industry.

Thank you very much, Mr. Chairman.

[The prepared statement of Mark E. Lackritz can be found on page 172 in the appendix.]

Chairman BAKER. Thank you, Mr. Lackritz.

I'll start my questions with you and the recitation of the best practice summary you just concluded. One element of that that I believe I understand, and want to clarify, that the compensation for an analyst should not be tied to a specific transaction, so that a recommendation that leads to a client is an example of something, a favorable recommendation would not be compensated by bringing that client into the bank.

However, I believe this to be accurate, and this is the reason for the question. Either on a quarterly or on an annual basis, the bank may declare bonuses for all affected parties and therefore reimburse or reward the analyst for the year-long effort, as opposed to the specific transactional activity.

That is correct, is it not?

Mr. LACKRITZ. Yes. But the specific best practice says that competition is not to be directly tied to any specific banking transaction or trading revenue or sales practice, but should be based on the overall performance of the analyst including the quality of the recommendations that the analyst has made.

So the notion is to make it a merit-based compensation system. Of course, if the firm does better, everybody is going to get some of the rewards from that.

Chairman BAKER. I understand that. I'm just reading it critically from a legislative perspective.

I would seem to me that rather than Fed-Exing the reward, we're going to send it by bus. That's my problem. There still is a correlation between the recommendations and bringing business in, as opposed to doing pure analytical work.

I'm merely making that point to say that the best practices are indeed an appreciated step and I want to acknowledge that.

As I told you and others, when it was presented, one of the elements that I believe is missing that we need to figure out how to resolve is the way to confirm or audit the compliance. It's one thing to have a nice book and put it on a shelf; it's another thing for it to actually be utilized.

I think what you have presented there represents the absolute minimum standard for reasonable professional conduct.

I also understand my criticism about the disclaimer. I've been provided with information in the interim that was intended to preclude potential civil cause of action for someone finding that a particular standard was not complied with and therefore creating unwarranted legal liability.

I respect that, but I have to honestly say I don't believe that disclaimer would get you where you want to be. I think in fact there would be very creative efforts to say that that means nothing.

If we are going to go that route, I'm simply offering this today as a matter for later discussion that really would have to be the subject of legislation to provide for a safe harbor from civil liability in the event that's where we think we need to go in order to get the quality of conduct that we think is required.

Do you have any comment?

Mr. LACKRITZ. Maybe I could discuss that from two perspectives. One, your concerned about attracting long-term business to the firm because of these recommendations, and second with respect to the footnote.

The goal of these best practices is to raise the quality of research throughout the industry, not to create a sub-structure of lots of different rules and regulations, but clear standards of behavior for what we can control.

In the long run, firms are going to succeed by the quality of their advice. They will attract business because of the quality of their advice.

Chairman BAKER. I think that's true at a modest growth or certainly in an environment where people are worried about losing money. But in a bull market we've just come through, people are going to throw money without regard.

They're going to watch the evening commentators figure out who the hot guys are. I mean, I've watched it. I've had yahoo finance web page and I watch and I say, this is going to be a real comer.

You can see almost instantaneously the level of volatility that comes as a result of that guy's hip-shooting, and I can't say that that's appropriate for the investor to do it, but I'm saying that's what's happening.

And people don't want to miss out on the opportunity to see their wealth increase. It's just logic.

So we look to this analyst group to be the guys who really make sure that we're not being led in the wrong direction.

Mr. LACKRITZ. I think that's a very good point, and it's part of the reason we're renewing our efforts toward investor education, because that's so very important to advise investors to get a second opinion, to do the research, to not just immediately buy something.

Chairman BAKER. Let me jump, because I've got a couple of other things I want to try to cover before I run out of my own time.

I just can't fathom going through the list you read, which is outstanding, that there would be a circumstance in which any of those minimal requirements would not always be applicable. In other words, what circumstances would I not do this, applying the Louisiana Real Estate Code to my practice?

In all honesty, we've got a way to go here to catch up to that.

Mr. Glassman, let me address your comment about journalism and matters in political office and their ethical conflicts. If you are suggesting that the measure of congressional ethics ought to be the standard, which I think would shock most people in America, let me quickly add, we have to disclose every nickel of public income, every nickel of outside income, which is also limited. We have to disclose what boards we serve on if we choose to serve on boards. We have to disclose what charitable contributions are made to our credit by third parties. We have to report what trips we take if we're not on our own time, where we go. Then we are precluded from eating anything unless we're standing up.

The political contributions, we're limited in what we do. If you're suggesting we should subject the analyst community to the same standards of disclosure as the Congressman, I'm on.

Mr. GLASSMAN. In fact, as you may know, Congressman, first of all, I lived in Louisiana for many years myself, and I know what you're talking about.

Chairman BAKER. Ethics is always the number one concern in Louisiana. I'm sure you know that.

Mr. GLASSMAN. When I was editor of Roll Call, the newspaper that so diligently covers Congress, I editorialized many, many times against these nitpicking kinds of disclosure rules to which Congress is now subjected.

I think at least there's a certain consistency in my view. The only thing I can say is that there are many other conflicts. They have to do with family, and in some cases they have to do with donors, that really are not covered by any rules. And the fact is, you surmount them day after day.

For example, it's no secret, and it's not necessarily terrible that Members of Congress who have Members of their own families who are suffering from a specific disease will advocate more research money for that disease.

Chairman BAKER. Sure, but that's only subject to getting 219 votes to make it happen.

Mr. GLASSMAN. Exactly right. These conflicts are surmounted I think in most cases by you, because you have to publicly vote. And if you take a vote, and people say, oh, well, he did this because of this donation or because of this conflict or that conflict, it's out on the table.

That's the analogy that I wanted to draw.

I think with journalists, it's the same thing, but basically in spades. The journalists lean to the left based on studies. I think it would be hard to argue with that. And yet every journalist says that he or she is a professional who surmounts those conflicts.

Chairman BAKER. But if the journalists was writing about a stock in which he had a financial interest and put it in the paper, that would be grounds of dismissal, would it not?

Mr. GLASSMAN. It depends on the publication, frankly. I think that journalists should disclose their holdings, but I think that's really up to them and to the publication. I don't think the Congress should pass a law that says that every journalist must disclose holdings.

When I worked for the *The Washington Post*, I was not even allowed to own stocks, and I thought that was a good rule.

Chairman BAKER. My point is that you don't have to have a public disclosure. There is a professional standard which says, you don't play in this game, period.

Second, if you do play in the game and you write about what you own, which is self-serving, you're gone. I don't think that needs to be subject of a rule or regulation. I think that's professional standards, which is what we are trying to pursue here today.

And I'm way over my time. I assure you I'm going to be back.

One caveat that I think, in fairness, I should make an announcement. After discussion with Mr. LaFalce, Mr. Kanjorski, and Chairman Oxley, what we do intend to do with the Fair Practices Standard, not to make a political determination here today, is to, between now and the next hearing, circulate the Best Practices Standard for review and comment by regulators, NASD, the SEC, academic review, to get professional response to us from appropriate interested parties.

Convene a second hearing, at which time we will receive those comments, and a second panel. I spoke last night with Ron Ehsara concerning media concerns was on the air, and he wanted to know if anybody in the media had been invited, and I said, yes, we hadn't had anybody take us up, and he wants to come down.

So we will have a media panel to get their involvement in this. We cannot shoot specific minnows in the barrel. There are a number of people who are in the tank who have shared responsibility.

Before we're done, we're going to look at everybody, and I just wanted to make that announcement for the subcommittee as well.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. Thank you all for being here. I apologize for missing some of the testimony.

This is an interesting hearing, but I can't think of a time and I would ask the panel when there was a time that you had a run up in the market and then you had a correction, that the fingers didn't start being pointed at one another.

Particularly, it's one thing with retail investors and I think you have to differentiate between retail and institutional investors. But I happen to think of institutional investors as so-called "big boys" as being ones who theoretically and under the law are considered as being sophisticated and know what they are getting into.

And yet I can't think of an instance where there's a correction and sophisticated investors don't turn around and say, why didn't you tell us this? We weren't aware of this.

And yet, there is, under the law, a least in some practice, there's a great deal of disclosure. I guess from my perspective, I'm kind of shocked to find out that stock analysts or equity analysts might well be giving subjective advice as opposed to objective advice.

I would bet that the retail public would be equally shocked to find out that somehow that analysts who work for brokerage houses may well be interested in helping promote some of the stocks or bonds that are being sold by those houses.

You know, I understand if there is an issue that relates to manipulation, but on the other hand, I think we might be erring a little bit in trying to think that analysts employed by firms which are underwriting stocks and bonds are somehow supposed to be auditors and not people who give a subjective viewpoint, and that we don't take this with a grain of salt.

But I would ask anybody, is there a period of time that there hasn't been a correction where people haven't come back and said, things were not done fairly.

Mr. Hymowitz raised the issue of EBITDA went on after the crash of the job market, and people were saying that there wasn't appropriate disclosure, that these deals were oversold, and yet you had some very sophisticated investors who were involved in buying those deals.

Mr. HYMOWITZ. Unfortunately, I've had the finger pointed at me by my clients when I lost their money, so your point is well-taken. Obviously, when the market starts going down, people start loosing money, you learn very quickly that people take their money very, very seriously.

This is not a perfect business. In a sense, investing is not a science. David does an excellent job and we subscribe to his research, but quite frankly all of our records are mixed. It is not a science.

I will say one thing to a previous question, Mr. Chairman, that you asked. We all have to understand that in the underwriting process, the analyst is extremely important in that process as it relates to the investment banks decision whether or not to proceed with taking a particular company public. It is crucial for the investment banker to get the input of the firm's supposed expert in a particular industry sector or, to use a term of art now, space.

If you want to see a public uproar, divorce the analyst from that role, then have the investment bank take the company public. Then, after the quiet period, have the analyst issue a sell recommendation on that stock, and you will see a public uproar.

It's impossible. I've been in meetings at my previous firm where the analyst with a private company decided, based upon the qualities of a particular company, that it would be unwise to take that company public.

The fact of the matter is, during the most recent bubble, the pressure on banks, the pressure on investment banks to meet the demand of the investor for paper of Internet companies was extreme. That is why, unfortunately, a lot of companies that should never have made it out the door, went out the door and in many respects, as I say in my written testimony, the public equity markets became second-stage venture capital.

And if anyone's ever looked at the venture capital markets, the risk involved is enormous. And that, in many respects I believe, is what happened and what ultimately caused the market correction that we have, besides a whole host of monetary issues also.

Mr. GLASSMAN. Can I respond to your question, Congressman Bentsen?

I think we are telling the American public the wrong thing if the idea they get from this hearing is that the reason that stocks have gone down, or their own accounts have declined, is because of some sort of manipulation that's been going on by analysts.

That's not it at all. The truth is that markets go up and they go down. And in the history of the stock market, one out of every 3 or 4 years, the markets go down.

This is an important lesson for people to learn. In fact, this has not been a particularly rough bear market. The Dow was down, which I think is a very good reflection of the market as a whole. The Dow-Jones Industrial Average was down five percent last year; it's up a little bit this year.

That doesn't mean there's not a lot of pain out there. There is, and I think a lot of people unfortunately have learned a tough lesson, and there may well have been and I know there were some people who exaggerated and led them down the wrong path.

That's why this hearing is good. But investors have got to understand that markets go up and markets go down and the way to smooth them out is by holding diversified portfolios for the long term.

Mr. BENTSEN. My time is up. But investors, I think, also need to understand that analysts who work for investment firms are not independent auditors and were never intentioned to be independent auditors.

And I think Mr. Hymowitz makes a very important point, that there is another role that applies that analysts play within the firms for credit concerns, underwriting concerns that affect the ability of the firm to function in the future and the risks that it may take.

And I think that all of this needs to be taken into consideration.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Bentsen.

Let me make just one comment.

Mr. Hymowitz, I want to acknowledge your comment. I will get back to that subject at a later time.

Mr. Paul.

Mr. PAUL. Thank you, Mr. Chairman

I want to direct my comments and questions to Mr. Tice and follow up on his testimony.

This is, to me, a very important subject, but for some reason I think we are really missing the whole point, because we are dwelling on the analysts and the advisors.

That's very important, but I think there's a much bigger problem than the best analysts may be giving the bad advice. But if you added up all the advice of the analysts and the advisors last year, I guess they gave pretty good advice. They told somebody to sell, so I guess more people were selling than buying. Somebody was giving the correct advice.

But, I'm surprised that people are surprised at what's been happening for the past year. Free market economists who understand the business cycle and understand monetary policy knew this stock market correction was coming and anticipated: and they anticipate even more problems down the road.

I see this as more of an attempt to scapegoat, find out who's been causing this problem because people lost some money.

If we had not had a stock market crash, we wouldn't be here. If the bubble kept growing, you know, we would have been blissfully nonchalant about what was happening.

But what we don't ask is, why did we have the bubble? Where did that come from? Was it the analysts that caused the bubble? They were a participant, but they don't cause bubbles; analysts can say a lot of things, but credit causes a bubble, excessive credit, not analysts.

Where does credit come from? Do we go to the bank and borrow money that someone loaned to the bank? No. Nobody saves any money. Credit comes out of thin air from the Federal Reserve System, and we need to concentrate on that.

When the Fed does this, the Fed artificially lowers interest rates and this causes people to do dumb things. It causes people who used to save money not to save. It causes consumers to borrow more money than they should. They cause investors to invest irrationally. And then all of a sudden, we have this bubble.

And then, on top of this, this has been around for a long time, this is nothing new, everybody knows about this, but this time around, of course, it was different. It was unique, because we had a "new era" economy, just like Japan had in 1980, and just like we had in the 1920s, a "new era," a new paradigm. And therefore all the rules were thrown out.

And who pumped this up? Who really said the new paradigm was here? The central bank, the same central bank that created all the credit. The Fed creates the credit, it created all the distortion, and then it says, "Oh, there's so much productivity increase that it's going to solve all our problems."

Therefore, the analysts become the victims. They're victims of bad information and not good judgment, but they're not the cause. They are the symptom of the problem.

So my question is, is this not what you were alluding to? Should we not pay more attention to monetary policy? And is it not true that just regulating analysts is not the answer, because they're doing what they see in their own rational self-interest, under the circumstances. Yes, for 10 years, they made a lot of money, and they made a lot of money for other people.

It's just when the bubble burst that it happened. But it seems to me that regulating analysts is not the answer; it is paying more attention to how we regulate and rein in the power of the Fed to create money and credit excessively out of thin air that we should be dealing with.

Mr. Tice.

Mr. TICE. Thank you, Mr. Paul. I agree with you completely. However, I also do believe that there is a Wall Street problem. I believe that Wall Street has been a cheerleader for the bubble.

I share your view that our economy is where it is today due to excessive credit growth. If you look at the telecom and Internet mania that occurred, that was really the first stage of excessive credit growth.

We essentially have financed a number of businesses that should not have been financed, as I talk about in my written testimony.

We kept the cost of capital too low. I'm a believer of the Austrian school of economics, as you are, Dr. Paul, and I believe that the interest rate has been kept too low and that we essentially financed a number of CLEC and Internet companies. We essentially misallocated capital in the Nation that will have a tragic cost to the country.

Currently, we are over-financing the financial sector. We are growing MZM at nearly a 20 percent rate over the last 6 months in an attempt to keep the bubble going. We believe that this bubble is not yet over.

There've been a number of comments as though the bubble has burst, the decline is over, we can get back to fun and games again. We don't believe that. The NASDAQ is still selling at nine times sales. The S&P 500 is still selling at 30 times earnings.

Mr. Glassman will of course disagree with me. He has a book out talking about the Dow 36,000. You know, we think that's absurd. Nobody will pay 100 times earnings for a company like Bank of America, as he's talked about in his book by assuming that the discount rate is going to be five-and-a-half percent.

We believe that there's still a great deal of danger in the economy going forward. It is due to excessive credit growth. If you look at some of the numbers recently, asset-backed securities growth is growing at 42 percent. Credit card securitization is growing at 70 percent. Home equity loans growing at 63 percent.

So I think it's important to understand that Wall Street is complicit in this credit growth and essentially seeking out asset inflation. And they sought out Internet companies and telecom companies in the first stage.

Now it's the financial companies, but we have an asset bubble and unfortunately there's more pain ahead.

Chairman BAKER. Mr. Paul, your time has expired. We'll come back for another round.

Mr. Capuano, why don't you be next by time of arrival, sir?

Mr. CAPUANO. Thank you, Mr. Chairman.

I too want to congratulate you for conducting this hearing. I think it takes a fair deal of courage to raise these issues in a public forum.

I'm not a big time investor. I don't really understand some of the things, the details of how all this works. But I try to draw analogies.

The analogy I draw is, I don't think there's a big conspiracy on the part of Wall Street to somehow control the world. There is certainly not one that I'm aware of in the Congress to over-regulate anybody. I don't do any of those things.

All I'm interested in really is transparency. We talk about it all the time when it comes to financial issues. We did it last year in the banking bill. We do it on international issues all the time.

Transparency is honesty and honesty is if you're making analysis of anything, tell them who you're working for, and then a reasonable person can make a decision.

Fair enough. I guess, though, I didn't get a chance to look it up, but a few months ago, I read a pretty interesting story about a young teenage boy who was dealing on the Internet on penny stocks, basically giving an analysis of the penny stocks to lots of people. They would drive up the market, and he would all of a sudden buy or sell or do whatever he was doing, and made billions of dollars as a young teenager.

He got caught. He got a slap on the wrist, but it was a lack of transparency. It has nothing to do with a teenage kid dealing with penny stocks who cares; that's good. But that's what I think is missing so far is all this concern about what's going on. I want honesty, that's all I want, so that investors can make honest decisions.

I guess I was going through a whole litany of examples, and I just wonder, what's the difference between what's going on and the old payola scandals of the radio days when people, allegedly independent DJs would be on the payroll of a record company, and all of a sudden, out of nowhere, this record was going to number one with a rocket. Why? Who knows why? Gee, it just so happens they're on the payroll of the record company.

What's the difference between this and the S&L scandal? Don't worry, this company, this investment is stable, it's got good credit, trust me. Oops. I didn't want to tell you that we have an investment in that. I didn't want to tell you that my cousin is the owner.

What's the difference between this and Michael Milken's situation? Trust me, we don't have any inside information, no one on Wall Street does that, that is wrong. What's the difference?

What's the difference between this and the cable oligopolies who tell me, as a consumer, don't worry, everybody wants the 14 history channels, and in order to do that, we have to raise everybody's rates a buck-and-a-half. What's the difference. And gee, we didn't bother to tell you that we own all 14 of the history channels.

What's the difference between that and what's going on right now with our energy oligopolies? I'm not quite sure what they're doing just yet, but I know one thing. All of a sudden it is costing us a lot more money and it seems like it's all going to one group of people who keep telling me that there is only one problem; that they need to be able to drill.

All I see is a complete and utter—not by everybody—but, a significant lack of honesty and transparency. If someone is an analyst who works for somebody who pays them, and then there is money to be made, so be it. Just tell me what's so hard about that? What is so difficult about that? Why can't Wall Street just do it, as opposed to simply coming up with, and again I've only just gotten them today, but, you know, the best practices.

They sound awfully nice, but I don't see teeth in them, and I'm sure we'll have further discussions. I do want to talk to the SEC to see what's going on with it.

I don't believe there is any conspiracy, I really don't, but I do believe one thing; money makes people do crazy things. And I'm no different; we all do it.

And if there's money on the table to be made by someone who holds themselves out, either publicly or by innuendo, as an independent analyst, simply tell us the truth. Are they independent or are they not. And I would like to know what the difference is in any of your minds between any of the analogies that I just drew and what apparently is going on as apparently a relatively accepted practice on Wall Street that it's OK to try to burn both ends.

Mr. TICE. I'd like to respond, Congressman.

I agree with you completely that the system is broken. I do not see that much difference between what goes on commonplace on Wall Street versus what happened with this Internet 15-year-old boy. There's been a lot of discussion so far, as if we can fix this around the edges.

We think we have a broken system, and I would like to read you a couple of quotes from our written testimony. This is from a former research director at Lehman Brothers. He said an analyst is just a broker who writes reports.

Another gentleman, who was an analyst, said he explained his reasons for recommending a company. I put a buy on it because they paid for it. We launched coverage on this company because they bought it fair and square with two offerings.

Another case, an analyst at Morgan Stanley, who followed Cisco Systems, analyzed his rationale——

Chairman BAKER. Excuse me, Mr. Tice. I would like to have everybody have an opportunity and my time is running out. I apologize for interrupting.

Mr. HYMOWITZ. Congressman, I would add that disclosure is everything. You are absolutely correct. I think the problem, one of the problems with current disclosure today is often the disclosure statements are longer than the actual research pieces.

You get an early morning note from an investment bank, it'll be a paragraph long, and the disclosure statement is three pages long. Disclosure statements need to be, as I guess the SEC has tried to make prospectuses more in plain English, disclosure statements need to be more in plain English.

Furthermore, I think that if you really examine this issue, where the crux lies is that many investment banks, as is the nature of the business, are constantly trying to get more investment banking business. So people have grown skeptical of whether or not the analysts are trying to aid the investment bank in getting that business.

So one suggestion I have is possibly, as long as it doesn't interfere with the commercial practicabilities of the industries, for the investment banks, for issuer to disclose whether or not they are currently engaging in any publishing investment banks on them, or whether or not there is the potential that they are seeking investment banks.

Then you'll know really whether or not—or at least as to your point—the public will then be informed that possibly if Investment Bank X is issuing a positive report on Company Y, well maybe it's due to the fact that there is a beauty contest going on for capital markets transactions.

The disclosure needs to be more relevant, shorter, more succinct, and in plain English.

Mr. GLASSMAN. Congressman, I'm definitely in favor of transparency. I think the question is the role that this Congress should play. It seems to me that all industries, all businesses have a tremendous incentive to tell customers what they're doing, because customers will shun businesses that are either dishonest with them or opaque.

I also just want to say that I do take exception to a number of the things you said about energy oligopoly and some of your comments about Michael Miliken, but in general, I would also say that the S&L crisis had definitely presented a role for the Federal Government to play because of insurance.

This area I don't think there's a role for you to play except to have hearings like this and air these issues publicly. That's very important.

In general, I want to associate myself with your comments about the importance of transparency.

Mr. LACKRITZ. Congressman, I would also associate myself with those comments and with your comments about transparency. We have always favored transparency. That's at the crux of the securities laws in this country.

Where I take issue is when you compare the situation to a number of other scandals in the past. I think if you take a longer perspective of what the securities industry has done over the last decade, the securities industry raised more capital in 10 years to build plants, to build schools, to create new jobs, to create new products and services than in the entire 200 years before that combined.

So we are very proud of what we've accomplished and the opportunities that we have created for millions and millions of investors who, if you look at over time, have done extremely well.

Last year, we had a terrible year. And we could have either said, well, it was just a bad year and we're going to get back on track, or we could say, look, let's see if we can fix some behavior here and assure that going forward, there will be no questions whatsoever about the independence and objectivity of analysis.

And that's what we've done with these best practices and transparency really is at the core of these best practices.

Chairman BAKER. Your time has expired, Mr. Capuano.

Mr. Castle, you'd be next.

Mr. CASTLE. Thank you, Mr. Chairman.

Let me thank you for holding these hearings. Let me encourage you, although I don't think you need encouragement, to continue this. This is big time business we're talking about. It's covered by a lot of national magazines, by national television every night, by a lot of financially focused magazines.

It involves the assets of most of America today, and these questions should be asked and we should get some answers. I'm not sure that we should legislate in this area, and I'm all for best practices, I think that's great.

I don't know how much good disclosures do unless somehow you all are regulating that. I started to get my privacy notices in the mail recently. I don't even understand what the heck they mean half the time. And I'm not convinced at all that either we, as average investors—and that's what I consider myself to be—would really, truly understand all disclosures anyhow.

And I would be the first to tell you that stocks are unpredictable and always will be. And when you get into the timing of the stock market, it becomes even more unpredictable, and when you get into the timing of particular sectors, such as the high tech sector, it becomes even less predictable yet.

Having said that, I am absolutely, totally convinced there are conflicts out there. I think anyone who dismisses that out of hand is off base and I do agree with something Mr. Tice said, something along the lines of Wall Street has been the cheerleader for the bubble, and I think that is essentially correct. And I think it really needs to be looked at. I honestly believe it needs to be looked at, and hopefully you will all look at yourselves and tell us something so that we don't have to do something here.

I've been here for most of this hearing and I don't think I heard this; maybe I did. But I think Mr. Hymowitz, you said something to this effect, maybe you or Mr. Glassman can help me with this.

But you stated that many believe there are few sell recommendations on Wall Street. Maybe you question this fact, but how do you reconcile that statement with a study by First Call indicating that the ratio of buy-to-sell recommendations by brokerage analysts rose from 6-to-1 in the early 1990s to 100-to-1 in the year 2000.

I don't even know what half these expressions mean. Out-perform, strong buy. I've never seen a sell recommendation on anything frankly. All I see are these recommendations of a buy nature, which is part of being the cheerleader for the bubble, as far as I'm concerned.

I'd be interested in your views on that. I think we have a problem out there and I think we need to admit that and determine how we're going to fix it.

But I get the idea that you don't necessarily agree that there is a problem; maybe you disagree with those facts or don't think it's relevant or something. I would like to hear from the two of you on that.

Mr. HYMOWITZ. Congressman, to answer your question, I'm not familiar with the First Call Survey. But we utilize First Call in my firm, and typically First Call covers mainly the well-known broker/dealers. That's only if, I believe, those companies submit their research and their analysts' estimates to First Call.

When I said there's plenty of sell recommendations——

Mr. CASTLE. I don't mean to interrupt you, I'm sorry, but let me go on. Maybe that's important. If Merrill Lynch is giving bad recommendations, if Dean Witter's giving bad recommendations, instead saying out of 100 securities firms, which are also analyzing stocks, so many of them gave us bad recommendations, I think we need to look at the number of people they are impacting and the total number of dollars they're impacting.

We might dismiss this on the basis of some three-man shop doing it incorrectly, but the big boys aren't.

Mr. HYMOWITZ. I understand that.

My point about the fact that there are as many sell recommendations on Wall Street as there are is the way I define Wall Street. As an institutional money manager, we have the resources due to the fact that we do commission business all over the street.

To get private research, meaning companies like Mr. Tice's here and others who specialize in providing a counterbalance to the sell side research. There are different types of analysts on Wall Street.

In my written testimony, I define them. One is what we have mainly been talking about today, the sell side analyst that's mainly related to a large investment bank.

But there are numerous other kinds of analysts on what I call Wall Street, and many of them work at research houses only. And those analysts also provide buy recommendations and sell recommendations.

Although there has been the creation of a niche business recently where specifically research analysts look at accounting issues and sometimes just fundamental business issues, and recognize that certain companies are possibly candidates for shorting. So many of the institutional money managers who subscribe to these services, they tend to be very costly, you know. I think in the range of some of them cost roughly $100,000 a year.

And we subscribe to these services and we use these services to counterbalance the sell side research. Just let me add one other thing, and I said this in my written testimony. The most important thing, though, is for the investor to do their own research.

How many people do we know that spend more time with the Consumer Reports magazine trying to determine what DVD player to buy. Then they do in time on due diligence of what stock they should buy, and ultimately——

Mr. CASTLE. Let me cut you off, because my time is running out. I don't know what you expect some of us, as investors, to do. I imagine most people you're dealing with have other jobs, have a heck of a lot to do and are dependent upon people who are supposed to be professionally trained in that job to do it, which are these analysts. If they're not getting good advice, they're in a degree of difficulty, and I don't disagree with you.

I wish I had the time to do it. I wouldn't probably be such a loser on the stock market.

Mr. HYMOWITZ. Could I touch on that one last point?

You have to remember the analysts are not buying the securities. You're right. Many of the individuals do not have the time to manage money. That is why I'm in business. Without the fact that you all don't have enough time, I'd be out of business. So that's why people are very wise to give money to mutual funds, money managers, hedge funds, index funds. That's why this business exists, because many people don't have the time, nor should they spend the time because you're right.

There are professional money managers out there who understand what sell-side research is all about.

Mr. CASTLE. Hopefully, individual investors could depend on those people who have the expertise, without conflict, to have their good advice.

Mr. Glassman.

Mr. GLASSMAN. I just wanted to comment on selling. There are 7,000 listed stocks in general. Analysts follow stocks that have good prospects, because it doesn't make a lot of sense for them to spend a lot of time on the others, and there are specialty firms that follow some of these other stocks if they think there might be a chance to short them.

I just also want to say that the idea that individual investors should be preoccupying themselves with selling, which is basically market timing that you talked about earlier I think is a mistake.

Generally, the way to be a good investor is to buy good companies and hold onto them for a long time. The paucity of sell recommendations, as I said earlier, is a reflection, in part, of what companies' analysts are following, and also the market itself, which, despite the year 2000, has gone from, if we just look at the Dow, from 777 in August 1982 to over 10,000 today.

So if you're spending a lot of your time selling, you weren't doing very well.

Mr. CASTLE. My final statement, Mr. Chairman, if I may. I don't disagree with what you've just stated and I don't mind buy-and-hold as a theory of investing, which I think makes a lot of sense.

But if you're getting a preponderance of buy recommendations, the ratio of 99 to one, and a lot of these are going down as much as 50-, 60-, 70-, or 80 percent of the course of a year or two, that's a problem as well for the poor devil who's trying to buy and hold it in that circumstance.

It's not just looking for sell recommendations, it's knowing what not to buy. And I don't think the average investor knows, looking at these reports, in many cases what not to buy.

You cited figures earlier. We can't go into them. I'm just not as optimistic about all those figures.

Chairman BAKER. Mr. Castle, if you will, it looks like we'll be able to do another round and we'll come back to you.

Mr. Kanjorski.

Mr. KANJORSKI. Thank you very much, Mr. Chairman.

I think the issue boils down to the fact of whether any of the alleged conflicts of interest are in real existence, and if they are, to what percentage they are.

I am sort of disappointed, looking at the analysts' problem, at a time when the stock market has not reacted well. Sometimes we get bad law out of responding in times like these. And, we ruin reputations and injure a lot of people who have been paid to make estimations that have not got any basis, other than a lot of their own intuitive senses, once they study a situation.

But I do think, from my own experience, something I would like to posit to the panel. Would any of you like to play on a professional football team where the referees' salaries were dependent on which team won the game? I think we would have a tendency to wonder whether every call of the referee was sound.

I will give you an example in Pennsylvania. Up until about 30 years ago, when we reformed our Constitution, the lowest judicial court in Pennsylvania was the Magistrate's Court. We saved a lot of money in Pennsylvania because we never paid magistrates. The way they got paid was by collecting the fees on the convictions.

It was amazing how many convictions there were in Magistrate Court, somewhere around 90 percent. When we changed the Constitution and directly paid Magistrates a set salary without a fee attachment, suddenly convictions fell precipitously.

I think in my analysis of this situation, it is somewhat similar to what happened in the late 1920s and the early 1930s in the boiler room operations.

There were a lot of people who said, "No, you do not have to pass the SEC legislation, we can self-regulate ourselves. I particularly look at the analysts that appear on the network or cable programs that are prognosticating 24 hours a day of how to get instantaneously wealthy.

Investors are 50 percent of the American population, and I think probably 95 percent of which do not have an MBA from Harvard or Wharton. So, in a way, they are responding to this guy in the Brooks Brothers suit, who looks smart, talks smart and works for a very prestigious named investment house. And they are relying that these analysts are honest people.

A I mentioned in my opening remarks, the point I want to make is that we should find whether or not there is any evidence of actual problems out there.

I would say if we do find literal abuse of position to gain personally, it is going to be in the smallest percentage of instances. I think in most instances, the failure to predict accurately what to do is the exuberance of the market. Who wants to call contrary to the trends of the market? That is probably what most analysts did.

This is not necessarily a bad time to raise this problem. I guess the question I would like to have answered concerning the best practices as put out by the industry, which are nice, but are they not a little late and probably fortuitous in timing, because the hearing was coming up? That is my impression anyway.

But without any enforcement, do you four witnesses, any one or all of you, feel that the industry and the private sector itself cannot only put out standards and have best practices, but also develop an enforcing mechanism and a mechanism of disqualification, fines, penalties, and so forth, that will really work and take the unethical behavior out of the business, or is that beyond the private industry to do? Does this matter instead require SEC regulation or acts of Congress to accomplish that?

Mr. LACKRITZ. Could I address that first, Congressman? I think that these best practices that we've come up with are going to be very effective, and are going to work extremely well.

The reason for that is because they've been endorsed not only by the 14 largest firms representing 95 percent of the underwriting business, but all the CEOs of those firms down through the directors of research.

In addition, you've got an incredibly powerful and unforgiving enforcer in the marketplace. These practices are designed to help improve the quality of research.

To the extent that the quality of research doesn't improve for clients, they go other places. To the extent that competitors see that their competitors may not be following some of these rules, they're going to be quite aggressive.

Already you see a fair amount of competition in the marketplace.

Mr. KANJORSKI. Wait a second. I love the marketplace. I think it has a lot of regulation to it that is imposed by the natural forces, but I think to make the argument that the marketplace itself is going to take care of things is quite optimistic.

Let me give you an example. Just recently in a fraud case involving GSEs, as a matter of fact——

Chairman BAKER. I am shocked.

Mr. KANJORSKI. ——Perhaps thousands of mortgages were improperly sold at an inflated value. And, when you look at it, it is alleged that the perpetrators of the fraud were really two appraisers who were going in and appraising these homes over their real value.

And in the preliminary investigation, after identifying something has been maybe millions of dollars of potential fraud, these two appraisers were fined just $10,000. Woowhee, big deal.

I mean, if you guys are going to self-regulate by fining somebody or slapping them on the wrist, and shuffling them off to Buffalo, if you will, we will not receive any real reform. I have just met with the State regulators and they tell me that there are brokers selling intrastate that have been fined and convicted in three and four and five other states and the State regulators have no capacity to find out who these people are. They are just moving around the country, one State by one State, knocking it off.

And honestly, with the industry coming forward now and saying, wow, we have got to find a way to make sure this information gets out to all the regulators so that these investors are warned that there are these bad actors out there, it seems questionable.

Look, when you can make millions of dollars by perpetuating frauds like this one, and you only lose your license, or you get a penalty of $10,000 on a multi-million dollar fraud, I do not know any con artists that are going to turn down that deal. That is a pretty good deal.

Mr. LACKRITZ. Congressman, I would take issue with that. Industry has no tolerance for bad actors. We want to do everything we can to get fraudsters out of the industry.

Mr. KANJORSKI. Why, under best practices, do you not have transparency, enforcement, and penalties that are just like the Bar Association?

If you have a bad lawyer, you can disbar him and throw him out.

Mr. LACKRITZ. We have transparency in these recommendations. There's mandatory clear language and mandatory disclosure of holdings of conflicts that go beyond these best practices, Congressman, go beyond the regulations that are on the books now.

They take the regulations on the books now and go beyond that. In fact, part of the reason it took us a while to come to relesae these was because it was a long process of negotiating among the firms.

The firms took it quite seriously because they realized in some cases they might have to change the way they did business in order to comply with this They took it extremely seriously.

As a result, that's what held this process up a little bit, but from the standpoint of their effectiveness, I'm quite confident that they are going to be effective and I think time is going to be the test. The proof is going to be in the pudding.

Chairman BAKER. Mr. Lackritz, and Members, if I can, we would like to recognize Mr. Inslee for these questions. We are nearing the end of debate time on the next vote. I would like to get him in and perhaps conclude this panel before the vote starts. You probably would like that idea.

Mr. Inslee.

Mr. INSLEE. Thank you, Mr. Chair.

We don't have a rule that we just shoot the analysts here when the market goes down, if that's any relief to you, but I'm intrigued by a thought that Mr. Cole, who was an author, I assume you are familiar with, who has been critical of the industry in various ways.

Basically as I understand his approach, he believes that there's been such a radical change in the structure of the industry toward an investment banking oriented part of the industry that it's changed dramatically the problems that analysts have internally in their own structure.

For instance, he quotes a statistic. I don't know if it's accurate or not, that says that 60 percent of industry revenues before 1975 were trading commissions. Today, that's less than 16 percent.

As I understand his argument, he's basically saying that analysts now have this much greater incentive, if you will, to deal on the investment side, and that's what skewed judgments perhaps or at least created a concern in the public about that.

And I just want to read—and he's going to testify later—I want to read something I want to get your comments on, if I can.

He said, where the role of analysts has changed dramatically in the last 25 years, the regulatory environment has little changed from 1975 or even 1945.

Analysts have safe harbor under the law, even to the extent that they can tell their larger clients that a stock is really a dog, while keeping the buy signal on for the public. That is entirely legal.

It is even legal for an analyst to tell their trading departments that a buy signal will be out on the morrow. If the analyst is influential, the trading department can bulk up on the stock and then sell it to retail demand then generated by the buy signal all legal.

Brokerages call this, quote: "building inventory to satisfy demand, just serving our customers."

Others might call it a license to print money.

I read in your best practices. As I read it, it sounds like your best practices were designed somewhat to address some of the issues that he's raising here.

But I guess what I'd like you to do is if you could respond to his argument that the dominance of the investment side of the industry has become such that we now need to take another cut at looking at the regulatory aspects on analysts, particularly some of the issues that he raised.

I'll leave this open to any of you.

Mr. LACKRITZ. I would just say, first of all, I disagree completely with some of the things that you read that he's written.

Clearly, an analyst that's giving some recommendations to one side of clients and not to others, that's not currently appropriate and obviously that's not a good business practice.

Second, the business is changing dramaticaly, but I suggest that it's changing from a transaction-based business that it's been historically, to an information and advisory business more and more and more. This means that the quality of our information is the most important product that we're offering.

The quality of our advice is the most important product that we're offering, which is why we put forward these best practices. We think these will help to continue to improve the quality of the advice that we are offering and in the long run, that's what's going to be successful for the business.

Mr. HYMOWITZ. Congressman, I would also add I would not be that concerned about the shift in fees investment banks earned from commissions to advisory fees. I will tell you things have changed once again back. One would have to wonder what investment bankers are doing these days. Even the fact that the capital markets are effectively shut down, there hasn't been, other than the Kraft IPO yesterday, I don't remember the last IPO.

It's a natural cycle in the business. When the markets are going up, the investors are looking for companies to take public. Therefore, the percentage of revenues in the investment banking department goes higher, the commission and manaegment fees goes lower. But the cycle changes.

And today, if you took a snapshot of any investment bank, I'm sure commissions, asset management fees are gaining in the preponderance that they represent in the total revenues of the companies. And in investment banking fees, you can see it by Wall Street. Look at the layoffs that are occurring. They're not laying off asset managers, they're laying off investment bankers, because that portion of he business is suffering due to hte fact that the capital markets are shut down.

Mr. GLASSMAN. Congressman, I'd like to respond to this issue of best practices and what the SIA has done. Also, this addresses something that Congressman Kanjorski asked.

I'm not so sanguine about it, because I think the way to solve this problem is by individual firms stepping up to the plate and saying that, at our firm, we have a real Chinese wall, and if we find anyone breaching it, that person is out. That's our rules at this firm.

Now another firm will then compete and say "No, no, we can top that." We can have even more objectivity among analysts. There are good things about industry groups, but one of the problems is that they all get together and decide what the rule is going to be.

That's also the problem, by the way, with legislation. It takes away the competition, which really ends up giving you the best kind of rules and the best protections for consumers. That's what I worry about.

Mr. INSLEE. Let me tell you abuot a concern I have. Obviously what it sounds like, your best practices are designed to build a Chinese wall. My concern, however, is if you build a Chinese wall, but you leave it under the control of the Chinese about where the gates are going to be and how high the wall is going to be, I'm not sure it gives enough confidence to the people in this regard.

So let me just ask you this. In contrast to the legal profession or the accountancy profession, or the physicians' profession, is there any reason to have Americans trust the industry to be self-regulatory on this issue as to analysts where Americans demand some independent source, to some degree, to control the behavior of lawyers and doctors and accountants.

Mr. LACKRITZ. Can I address that?

I think, first of all, the quality of our professionals has never been higher. We in the securities industry have a mandatory continuing professional education requirement, as I understand that no other profession even has.

We have to have mandatory retesting your fifth year and tenth year after receiving a license. So that, in and of itself, makes it different and the quality has gone up considerably.

I also think that it is fairly easy for customers to see, because they get their statements every month how they are doing.

With other professions, sometimes it's not as clear; it's a much more subjective kind of judgment.

So we have a real bottom line I think that really serves as a very effective accuntability mechanism, which is one of the reasons that the quality of the research is so important. Which is why our firms have an incentive to give out the best quality advice they possibly can to their investors.

Mr. TICE. Congressman, if I could just add that I do believe that you hit a hot button issue as far as the magnitude of dollars that are involved in the investment banking. And the fact is that people are people and money motivates people. And the structure of these firms is that the investment bankers are still too powerful within these firms, because that's where money is made.

Now as Gregg said, the IPO and the investment banking revenues are down currently. However, paying 6 cents a share or 4 cents a share, which is what institutions are paying for research today, the profitability is much greater in investment banking, and therefore investment banking drives it.

We don't believe the industry can regulate this from within. The dollars are just too big.

Another problem is, the industry, in my opinion, has not even admitted that there's much of a problem. There's talk about there's a perception of a problem, rather than admitting that there is a problem.

Mr. HYMOWITZ. You're not arguing for higher commissions, are you?

Mr. TICE. I would pay higher commissions, sure.

Mr. INSLEE. Thank you, gentlemen.

Chairman BAKER. Your time has expired, Mr. Inslee. Thank you very much.

I want to pick up with a point that I failed to make accurately perhaps.

Mr. Hymowitz, in your answer to a prior question, talking about the demand in the market to get paper out, and that as a result perhaps some of the dot coms move to public offerings that weren't, in all circumstances, mature for that position. That is extremely troubling to me.

What is the role of the analyst? Maybe that's where there's a miscommunication. I want to take you to the days of LTC, and I'm not making a parallel, I'm not making accusations, merely to understand my level of concern.

We had 3 years of back-to-back trading without 2 days of concurrent loss. There were extraordinary levels of profitability. You had bankers, you had folks in the international community, literally throwing money at them.

You were told a million dollar minimum, 3 years. Don't pick up your phone and call me. I'll let you know what's happening. Extraordinary types of information, lack of exchange.

Now what drove that was the desire by the individual to get a piece of the action and make a quick buck. I understand that.

In my view of market responsibility, the single person who should have been in that room when the credit was being extended by the bank was the credit risk analyst. The little guy sitting in the corner with the glasses, reading the complicated sheets. Who says, wait a minute, guys, there may be something wrong here.

If the management overrides him, I understand, but it's that analyst who should be the one to have the professional standard to stand in that door and say, no.

What you're telling me is, because the investor's demand to get in on the run up of the market, it was almost embarassing to go to a cocktail party or a birthday party, or you're in the back row of the church, and people saying, man, have you seen my 401K lately, and if you weren't in it, there was something wrong with you.

So the public pressure was to get a piece of it, and within the firm, deciding what they were going to market and what they would not, because of the demand for paper.

Because the community was asking for it, the investor lowered his bar and said, let's put this out, because we've got to get something for people to buy and keep this moving.

Am I wrong?

Is it not the analysts' obligation to reach a professional opinion and express it, notwithstanding market conditions and consumer demand?

Isn't it a professional responsibility to say, no, now is not the time? People can disagree, but the board can override. But somewhere in the record, that analyst's view should be noted. Is that wrong?

Mr. HYMOWITZ. I don't think it's wrong, but I think the answer is very complicated. I'm sure we don't have enough time for it, but let me just make a couple of comments.

The capital markets changed dramatically when companies like Netscape and Yahoo were able to be taken public without profits.

Investment bankers realized, unlike years past, the investor was willing to take the chance, and risk, and look, that's what investing is about.

Chairman BAKER. But on that point, I hate to interrupt, but it's so critical and pivotal to the understanding.

The investor was willing to take the risk because the analyst was telling him it was a good risk to take. You're telling me the analyst was saying, don't invest in this? I didn't hear that.

Mr. HYMOWITZ. I didn't say the analysts, I'm not saying that. But I think it's more complicated than that. A company is taken public. We all recognize that the Internet was, a few years back, something completely new.

Let's remember, I see many Congressmen using their Blackberries. You weren't doing this 3 or 4 years ago. Without the capital markets financing these companies, we wouldn't be able to do it.

So there's lots of tremendous positives that have come from this, thousands and thousands and hundreds of thousands.

Chairman BAKER. I agree with you. I think that's great.

What I'm saying to you is, the huge capital flows that appeared since' 95 to the current day, come from less-than-sophisticated pension fund managers in some cases, you now, some school teachers' retirement fund, they are under critical pressure from their owners of that fund.

Wait a minute. Everybody else is getting 18, 21 percent, why aren't you? He goes further out on the risk profile. He is listening to his analyst.

My point, I want to be focused on, I'm not disputing that the capital markets don't perform a wonderful function. I am not a regulator. I don't think the Federal Government is the answer.

But I am suggesting very strongly in terms that I hope are clearly understood, I believe the sentiment's been expressed in this subcommittee today, if we don't get this fixed, probably some session of Congress is going to fix it in a manner the market won't like.

That's what we are about here, is trying to not have that occur. And if you're telling me the role of the analyst is not to be direct and forthright, and to tell people what they don't want to hear in an environment when it's not popular to say it, that's a very disturbing thing. We've got to find a way to fix that.

And I want to say to Mr. Lackritz and the SIA, I appreciate what you have done, but we have now recognized we have a problem. We have entered the 12-step process. We are step one, maybe two. We are all getting in a room together and comforting one another. We haven't really decided where we're going to wind up in a few weeks.

We're shaking it a little bit and we are a little bit worried, but there is a problem. And in my view, although I fault the media for hyping the stuff, I fault the investment bank for pushing the analysts, I fault the investor for not doing the due diligence that they ought to do.

At the end of the day when I get my call from a broker saying, boy, you don't want to miss this train, it's a sure bet, who am I to disagree?

I rely on their professional judgment to tell me when it's advisable. Should they be right a hundred percent of the time? Heck, no. I'd like them to be, you now, 51/49, but at some point we have to realize the standard of conduct which a reasonable man should expect from the Street has not been utilized, and the formulation of the best practice standard I think is evidence there was a recognition of a problem. And we're now about addressing it.

I don't think we need to skirt around it anymore. I think we've got to figure out what do we do. That's the last piece. I don't see a lot of recommendations beyond the best practice standard.

Mr. Tice, you had a few?

Mr. TICE. Yes. If I could respond briefly to Mr. Hymowitz' point, I don't think it is that complicated and you're exactly on target that the analysts should be objective. He should not be looking at what the customers demand for a product or an investment service.

That's the problem. The analyst most often serves as a sales person. He's looking at the customers out there and saying, what can I sell to them; therefore how can I promote this stock so that he will want to buy it, rather than being independent and saying, is this good for the customer.

That truly is the problem today.

Chairman BAKER. Let me give Mr. Hymowitz equal time, because we have a couple of more Members who want to come back with another question.

Mr. HYMOWITZ. First, I would say if the whole problem was just analysts had a lot of buy recommendations on stocks, and that was it then the railroad stocks would have gone to the moon, the drug stocks would have gone to the moon, the food stocks would have gone to the moon. That's not what happened.

What happened is the public at large, and I don't know who is to blame, and I'm not smart enough to figure it out, the public at large had a very short period of time, 12 months, maybe 18 months where they got completely enthused with the Internet and anything dot.com, and that's it.

You know what? Ultimately a lot of these companies will be good companies. Many companies will employ hundreds of thousands of people years from now.

The fact is, as I said earlier, for a moment, and I'm not necessarily saying this is a good thing or a bad thing, but for a moment, a short period of time, the capital markets that historically were mature markets, were funding what I have called and many other people have called "second stage venture capital businesses."

Chairman BAKER. I agree with you.

Mr. HYMOWITZ. There's nothing wrong with that.

Chairman BAKER. We don't have a dispute about that. My point is that there was no public discussion that we were into venture capital as opposed to long-term investments. When a dot.com only lost 6 cents instead of seven, they were rewarded. And when a brick and mortar, who has a 50-year history of profitability, made 6 cents instead of 7 cents, they were hammered.

I can't explain that either.

My point is that the rational, calm voice in the midst of turmoil should be the analyst.

Mr. HYMOWITZ. Mr. Chairman, could I just comment on that last thing.

I actually respectfully disagree with you that we weren't warned. We were of course warned. Any investor should have just picked up the prospectus and read it, and all you had to do is look at the financial statements of these companies, and you would have seen the warnings.

You would have seen that these companies were profitless. There were plenty of warnings out there that these companies that were being funded were immature, often very young companies.

Chairman BAKER. I respectfully understand your disclaimer, but it would take someone fairly committed and fairly clever to read through the 86 pages of disclaimer. It's the only thing that I've seen that's more complicated than the first mortgage loan closing document package. That is not a reasonable man standard.

What I'm saying to you is the reasonable man, the working family was providing the capital for all this wonderful activity. The analysts comfort him and say, yes, I think in the long haul, you know, don't buy for today, buy for the long haul. It will be a wise investment. They did.

And when things go south, understandably, the investor is disturbed.

But if the analysts had done the job at the outset in saying, look, this is a ten percent shot. If you want to do it, I'll be happy to service your account, but I would strongly recommend you get over here with this long record. It'll be slower growth, it'll be more stable growth, less risk. And I don't think a lot of those conversations were held is my concern.

Mr. Castle, I'm sorry I've taken so much time.

Mr. CASTLE. I'll try to be brief too.

If this was asked, somebody cut me off because I had to be out of the room for a little bit.

But, Mr. Tice, you apparently in your testimony, according to our staff, cited the tremendous competitive disadvantages that independent research firms actually face.

I think a few of them, such as where is the revenue coming from and whatever, and I can think of a few of them.* But if people who are investors believe that Wall Street firms are not giving good advice, then why don't the market forces send more people to the outside. Why don't the market forces sort of rise up and say, you're not giving us good advice. We have to look someplace else for it. And give the independent firms greater strength than they presently have. What's the marketing problem there. I don't follow the dynamics of all that.

Mr. TICE. One of the issues there, Congressman, is the fact that we believe that Wall Street research should be priced. Currently, Wall Street research is essentially being given away in order that the big investment managers could have access to their trading, to their IPOs, and so forth.

Therefore, it's very difficult for a small, independent firm, such as mine, to be able to garner fees and commissions in order to get paid. It's very easy to continue to get the First Boston, the Goldman Sachs, and Merrill Lynch research, because it's essentially free.

What we would like to see occur, and we've pointed this out in our solution to a very complicated issue that I can't get into today, is to have Wall Street price their research.

Mr. HYMOWITZ. Can I just make one comment?

Wall Street research is priced. You do not get Wall Street research if you're a client or an institutional money manager unless you have some relationship with the bank in the form of commissioned business. There's a price you pay for it.

Mr. CASTLE. Just a final comment. We are sitting here talking about analysts and Wall Street firms, and securities firms, and whatever. But the average person out there is usually dealing with a broker who is then handing them that information. They don't know who the analyst is. They don't even know if the firm that's handing them the information is the one who did the analysis or whatever it is.

There's sort of a disconnect here between what happens in public and what we're discussing.

Mr. GLASSMAN. Not only that, Congressman, they are dealing in many cases with mutual funds. Forty percent of Americans own mutual funds. Three trillion dollars are in equity funds, and these are professionals who are getting advice from lots of sources.

I don't think we need to have laws passed to protect these professionals.

And also let me just say, I really think it's important to put in perspective what has happened in the markets over the last few years.

Over the last 5 years, the stock market as a whole has gone up 120 percent despite what happened in the year 2000. The NASDAQ, which is the high tech index, has just about tripled over the last 10 years.

So the idea of passing legislation, which in fact, if it's the wrong kind of legislation, will have a devastating effect on the market itself, because of a problem that has occurred in stock prices over the last year, I think that may be going a little bit too far to say the very least.

Mr. CASTLE. I'll close with this. I don't disagree with you perhaps, at least at this point, in passing any kind of regulatory legislation or anything of that nature with respect to Wall Street research or whatever, but I remain adamantly convinced that you have not made the case that we have unbiased research on Wall Street.

I think a lot of the conflicts and problems that have been mentioned at this hearing do exist, and I think it is up to you all, meaning the broad securities industry as a whole, to really take a good look at this.

I think factually that can be demonstrated and I believe something has to be done, maybe away from Congress, but something should be done.

I yield back.

Chairman BAKER. Thank you, Mr. Castle.

For the record, Mr. Glassman, I don't think anyone today is suggesting further legislation on the matter. This is an opportunity to share thoughts and hopefully see some positive results without legislation.

Mr. Kanjorski.

Mr. KANJORSKI. Mr. Hymowitz, you made some interesting comments about reading the prospectus, the profit-and-loss statement, and the balance sheet of some of these corporations. You suggest that people are able to ascertain and make a judgment on their own.

Unlike Congressmen, you probably spend more time at the club than you do at the gas station. We are about to decide a public policy on whether or not Social Security should be invested in the stock market. The proposal would allow people to have the voluntary election to do that.

There are about 150 to 160 million workers covered by Social Security. If you know something about the statistics on level of education, I think it is more than 20 percent of the American population that is functionally illiterate. That would be 35-, 40-million adult Americans that cannot even read and understand what would be in a business prospectus.

I hope therefore, people are listening to this broadcast that are going to be deciding whether or not we should open up Social Security money to go into private accounts managed by private individuals for investments. In part of your testimony, I was under the impression that we were going to have a very high standard of professionalism. You should have taken into account one out of four people's total incapacity to understand and comprehend these things. Without the professionals of Wall Street, they would not have to.

But you are telling me, you are saying to all Americans now: It is up to you to understand these things, to read these statements, and to comprehend these statements. So the Congress, under that argument, should say look, we know there is more than 20 percent of the population that is functionally illiterate, who cannot even read and fill out an employment form, much less read a prospectus.

Should we not protect them and say that is the craziest issue in the world? Are you not one of the greatest witnesses against privatizing Social Security?

Mr. HYMOWITZ. Congressman, let me answer the question. What I was responding to was Chairman Baker's question about why wasn't the public informed when the capital markets switched, in some respects, to start funding secondary venture capital companies, young, immature enterprises.

And my answer was that prospectuses that this Government requires companies to file hopefully are meant to be read. And the individual who does not want to spend time and the effort to read the prospectus then should do what millions and millions of Americans do every day, and that is give their hard-earned investments to mutual fund companies to index funds, to brokers, to money managers to hedge funds.

Look, I don't know anything about automobiles, so if I go in and I attempt to figure out what car to buy, I'm going to get some expert advice on what kind of car I should buy.

Mr. KANJORSKI. The average American does not do that. He does not hire an engineer to evaluate an automobile. I do not know where the heck you are living, but you are not going to the gas station to which I go to pump my gas. I talk with people every day.

I want to give you an anecdote. In a coffee shop 2 weeks ago, I saw a friend of mine, injured seriously on his job, and who settled out his Workman's Compensation case at $250,000 about 3 years ago. He got caught up in the hysteria of the stock market, and made some investments in early IPOs. These stocks really ran up at first.

He thought Christmas had now arrived 365 days a year. That $250,000 is, however, now worth less than $19,000. When he told me what he was doing, I could not believe it. I recommended against it. I said, "Don't you ever play this game with this money. This is your livelihood." But he could not resist that temptation. Everybody else was doing it.

Mr. Baker made the point. Having all my 401(k) in Government securities, I have to say over these last 5 years, sometimes I have kicked myself when I look at that bottom line, and I look at my neighbor's bottom line. But knowing that I neither have the time nor the expertise, I just cannot. I may also have a conflict of interest, so I just stay out of it.

But there are an awful lot of American people who are not capable of doing that. We try to open up hope and opportunity to everyone, and there is not any question, as I said in my opening statement, that the American capital markets are the envy of the world. We are not trying to cast aspersions on all analysts, even the majority of analysts, and certainly not on all investments.

I know these people. They are mostly exceptionally talented, bright, and highly ethical. Do they police everything or are mistakes made? Yes. But our problem is that we have to respond and try to protect in some way, even the foolish and the functionally illiterate. What I think we are asking this panel to do, and the industry to do, is put your heads together and come up internally within your industry with standards that are acceptable, and enforcement that is acceptable. We need standards that leave us with the belief that the markets are being handled by people that are credible with integrity, and not to the disadvantage of the average person.

And if we cannot do that, I agree with my colleagues: there will be a time when either the regulator, or this Congress, will act precipitously if conditions continue.

Chairman BAKER. Thank you, Mr. Kanjorski.

If no other Member wishes to ask a question of this panel.

Congressman Shays.

Mr. SHAYS. Mr. Chairman, I consider this a very important hearing and I was chairing the National Securities Subcommittee and I just apologize for missing what I was told was an outstanding dialogue with this panel and the Members and I look forward to the next panel.

Thank you.

Chairman BAKER. Thank you, Congressman Shays.

I want to thank each of you for your perspectives. I assure you, the subcommittee will move very slowly. We are, hopefully, not being viewed as demagoguing an important issue. We want to understand it. We want to know how markets function, the role of the analyst and all participants.

We would welcome your further comment pursuant to your appearance here today. If you have answers responsive to any Members' questions, we would welcome them.

I specifically would like further analysis on if we are to proceed with the best practices model, in whatever form that finally is contemplated, I feel it appropriate to have some confirmation of compliance, whether that is by the Congress, the regulator or some other activity by contract. But we need to have some assurances that the standards that are being held up, as in all other professions, there's some level of accountability for assuring those practices are being followed.

I don't sense, from the Members of the subcommittee here today, that we feel like we're near resolution, but that we can reach an understanding with professional leadership from the investment community that I think can be acceptable to all parties, and most importantly, we all fully understand that the huge growth in our economic ability and our quality of life in America has been very positively effected by the activities over this past decade.

We wish to do nothing to impair the efficient flow of capital markets, but we also have a new political responsibility. People who are working families that had no access to the markets to speak of are now on-line, as we hold this hearing, making investments because they want to have part of this dynamic growth and that is creating a new level of responsibility.

As I quoted earlier in the week, I said it may be one thing for one shark to eat another; it is quite a different matter for the shark to eat the minnows, and we're about making sure that everyone who's in the tank has equal access to opportunity, a free flow of information that's unbiased, that will result in the restoration of unquestioned truth and faith in our capital market system.

That really is our purpose and I really do appreciate your participation. It was not easy to get folks to come and talk about this and frankly it wasn't easy to call the hearing, but I think we served an important purpose and I thank you for it.

At this time, I'd like to call our second panel, please. I'm told, just as an update, we're getting to a point in debate on the floor where we're expecting a vote within a few minutes. I'd like to go ahead and proceed. If need be, we will temporarily suspend. I think it may be only one vote and I can run over quickly and be back just to give you an advisory.

We will start first with welcoming Mr. Benjamin Mark Cole, Financial Journalist, author of the "Pied Pipers of Wall Street: How Analysts Sell You Down the River."

Thank you, Mr. Cole.

STATEMENT OF BENJAMIN M. COLE, FINANCIAL JOURNALIST

Mr. COLE. Thank you, Mr. Chairman, for receiving my testimony today. With the NASDAQ cut in half from 2000 and Internet stocks trading for pennies on the dollar, many Americans are asking themselves what happened.

How come no major securities house predicted you might lose half your dough on the NASDAQ in less than a year, or lose almost all your money on an E-toys price line, or an I-Village.

It reminds me of that old joke of the 1970s, made fresh again by recent events. “How do you end up with a million bucks on Wall Street? Start off with two million.”

What the public doesn’t realize yet, though it is catching on, is that Wall Street research has become hopelessly corrupt. Today’s so-called analysts are more akin to lawyers in court. They regard their job as one of advocacy to make the best case why a stock is a terrific buy.

Ask an analyst if what they are doing is dishonest, and they will answer that you don’t understand their job description.

What happened to analysis? Why does a sell signal make up less than one percent of analysts’ recommendations?

The answer lies in the way Wall Street makes money today compared with 1975. Twenty-five years ago, Wall Street made money in ordinary retail trading commissions which were fixed by regulation. That environment, something of a cross between Shangri-La and Fat City, made Wall Street a clubby place of almost assured profits. The prized customer was a wealthy individual or family that liked to trade stocks and the prized employee was a stockbroker with a good book of business.

But the SEC erased fixed trading rates in 1975, an action then fought tooth and nail by the industry, which wanted no part of free enterprise and competition.

In the years since, if inflation is taken into account, retail trading commissions have fallen to a penny on the dollar.

If you look at a thrifty investor using a discount on long brokerage for securities firms, the downward plummet of trading rates raised a serious problem.

How do we make lots of money like we all came to Wall Street for?

Wall Street, after 1975, had to come up with a new way to make lots of money and they found it, happily for them in their own corporate finance departments, also known as investment banking.

Investment banking is the business of underwriting initial public offerings of stock, secondary offerings, bond underwriting, or advising companies on mergers and acquisitions.

Increasingly, brokerages have moved upstream in the financing cycle of companies, often providing private equity, also called venture capital, to a company before they take it public.

This activity can be extremely lucrative. CIBC Oppenheimer, now CIBC World Markets, invested $30 million in private equity into Global Crossing Limited, the Telecom giant. After the company went public and the stock surged, that stake became worth $4.3 billion.

Goldman Sachs invested $36 million private equity or stock in Storage Networks, Inc., pre IPO. That stock became worth $1.6 billion after Goldman took Storage Networks public.

Some quick numbers illustrate the changed nature of Wall Street. In 1974, the U.S. securities industry underwrote $42 billion worth of stocks and bonds. In 1999, the industry underwrote $2.24 trillion of stocks and bonds, more than 50 times the pre–1975 level.

Trading commissions today made up 60 percent of industry revenues before 1975, but today make up less than 16 percent.

The simple story is this: Wall Street makes its money on investment banking, not retail trading commissions. With this change, came a change in who held power within the brokerage.

In days of yore, as quaint as it may seem today, the stockbroker with his book of business was the power employee within the brokerage. Sometimes they were referred to as customers' men.

When an analyst wrote a report, he looked over his shoulder at the customers' men who would hold him accountable.

Today, things have changed. Today, analysts look over their shoulders at investment banking and trading departments, the new profit centers.

The results of this switch in loyalty are obvious to all within the industry, so much so that brokerage analysts are referred to often dismissively as sell-side analysts. Perhaps not surprisingly, numerous industry and academic studies have found that analysts' recommendations as a group under perform the market.

Investors would be better off tossing darts at the *Wall Street Journal* than following analysts' recommendations.

Although the role of analysts has changed dramatically in the last 25 years, their regulatory environment is little changed from 1975 or even 1945. Analysts have safe harbor under the law even to the extent that they can tell their larger clients that a stock is really a dog while keeping the buy signal on for the public. That is entirely legal.

It is even legal for analysts to tell their trading departments that a buy signal will be out on the morrow. If the analyst is influential, the trading department can bulk up on the stock, and then sell into the retail demand generated by the buy signal, all legal.

Brokerages call this "building inventory to satisfy demand." Just servicing our customers. Others might call that a license to print money.

What is disturbing in the last 25 years is to see that many practices once limited to regional and one-branch brokerage shops, the so-called schlock shops have become commonplace in Wall Street proper.

In particular, when a brokerage finances a company before an IPO and then has an analyst issue a buy recommendation, it is mimicking practice commonplace off Wall Street for generations.

Some quick stabs at solutions here.

One, I would increase the budget of the SEC for enforcement actions and beef up the U.S. Attorneys Office for securities industry prosecutions.

Two. I would require the brokerages to create a uniform standard for rating the accuracy of analysts' recommendations and that analysts' batting averages, if you will, be constantly published on an industry website maintained by the National Association of Securities Dealers.

As an aside, I find it somewhat amusing that we know Marc McGuire's batting average day-by-day, how many home runs he's hit, but we don't know what the analysts' batting average is day-by-day, yet we are investing based upon their recommendations.

In the 1930s, the SEC examined whether brokerages should even have underwriting and retailing operations under one roof. It may be time to reexamine that situation.

In care and feeding of short traders, in a nut shell, allow short traders to have contracts specifying terms for returning borrowed shares. Short traders can be a tonic on the market.

Lastly, better mandatory disclosure of analysts' conflicts of interest in both broadcast and print media.

Thank you very much, Mr. Chairman.

[the prepared statement of Benjamin M. Cole can be found on page 181 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Cole.

The next witness is Mr. Scott Cleland, Chief Executive Officer of the Precursor Group.

Welcome, Mr. Cleland.

STATEMENT OF SCOTT C. CLELAND, CHAIRMAN AND CEO, PRECURSOR GROUP

Mr. CLELAND. Thank you, Mr. Chairman, for the honor of testifying. I'm Scott Cleland, Founder and CEO of the Precursor Group.

We provide investment research to institutional investors. We've aligned our business interests solely with investor interests so we've avoided the common financial conflicts of interest. We do no investment banking. We don't manage money. We trade stocks but we never own them.

And all Precursor researchers may not own individual stocks. We are a pure research firm because we believe that a company cannot serve two masters well at the same time. You can't serve investors and companies together.

We think conflicts undermine research. We think independence improves research.

We saw a real market opportunity to be a pure research company.

Our interest in testifying is clear. We are worried that the powerful investment banking and trading interests that have suffocated independence within a firm are at work within the industry at large, and can suffocate the independent research views at large.

That's because the firms that have conflicts control well over 90 percent of the market for research commissions, according to our best estimate.

So what we're calling for is more competition to conflicted research, not less. The less regulation of pure research and more disclosure and regulatory oversight of conflicts of interest, the freest and the most competitive flow of information is what best serves investors and helps the markets operate efficiently.

A system that's 90 percent or more dominated by companies that have inherent conflicts of interest profoundly distorts the type of information that the market receives. We think that more competitive research is the answer.

Recently, American shareholders and pension plan beneficiaries lost over $4 trillion when the NASDAQ fell, and at that time, there were only one percent of analysts recommending a sell.

I'm not saying that the problem is the analysts. I think they are being made the scapegoat.

The problem is the regulatory system that is favoring companies over investors. The analysts and the firms work primarily for companies, so it's unrealistic to expect that they are going to bite the hand that feeds them.

So what are our recommendations for you? We have four.

The first recommendation is, encourage fuller and more practical useful disclosures of financial conflicts of interest. Who does a researcher work for? Is it the companies or is it the investor.

My second recommendation is encourage the alignment of interests, encourage research that is aligned with investment and with investor interests.

Let me tell you a little fable in a sense. This is a classic case of the fox in the hen house. Today, the investment research assumes that the investor hens will be just fine in the same hen house with the investment banking fox as long as the regulator, the farmer, makes sure there's enough chicken wire to keep the fox away from the hens.

My question to you is: Why not encourage more hens seeking out hens and why does the system always encourage that a hen must deal with a fox? It makes no sense, but that's what the system encourages.

It encourages the hens to live right next to the fox all the time.

Now what's my third recommendation? Reduce regulatory barriers to people who want to do pure investment research like we do. Do you realize that in order to become an independent research broker/dealer, we had to be licensed and regulated and audited to do investment banking and all the trading.

There are over 900 pages of regulations that we are subjected to and only ten apply to research. We essentially in the regulatory system, why you have so little independent research is the regulatory system powerfully discourages it. We have to take a regulatory exam called a Series 24. We took it and we passed it.

However, it was a very difficult exam. We spent over 150 hours studying for that in order to pass it. And there were very few questions, a very small percent that applied to what we are trying to do in our business, which is to provide investment research to improve investors' performance.So we think you can do a little bit of deregulating. The last recommendation I have is ensure a full and diverse competition for ideas and information in the marketplace.

More specifically, watch the institutional commission lists, because right now the folks that have 90 percent share of those research commission lists are trying to get 100 percent. That's the reason why we're testifying here today. If you want to have more independent research, if you want to fix the solution, allow the marketplace to compete with conflicted research.

Thank you for the opportunity to testify today.

[The prepared statement of Scott C. Cleland can be found on page 184 in the appendix.]

Chairman BAKER. Thank you very much, sir. We appreciate your appearance.

Our next witness is Mr. Thomas Bowman, CFA, President, Chief Executive Officer, Association for Investment Management and Research. Welcome, Mr. Bowman.

STATEMENT OF THOMAS A. BOWMAN, CFA, PRESIDENT AND CEO, THE ASSOCIATION FOR INVESTMENT MANAGEMENT AND RESEARCH

Mr. BOWMAN. Good afternoon, Mr. Chairman, and other Members of your subcommittee. My name is Thomas Bowman, President and Chief Executive Officer of the Association for Investment Management and Research, a non-profit organization with the mission of advancing the interests of the global investment community by establishing and maintaining the highest standards of professional excellence and integrity.

Thank you for the opportunity to and privilege to speak on behalf of more than 150,000 investment professionals worldwide who are members of AIMR or who are candidates for AIMR's Chartered Financial Analyst designation.

For more than 30 years, CFA charterholders, candidates and other individuals who are AIMR members have adhered to a standard of practice that requires them, among other things, to achieve and maintain independence and objectivity in making investment recommendations and to always place their clients' interests before their own.

Although AIMR members are individuals, not firms, AIMR has succeeded in developing other ethical and professional standards that require firmwide compliance and have been globally adopted. Based on our experience, ethical and professional standards are most effective when voluntarily embraced rather than externally imposed.

To provide analysts with an environment free of undue or excessive pressures to bias their work, we must understand that these pressures come from many sources, not simply investment banking activities, and not all of them internal to their firms. None of these pressures is new, but their impact has escalated in an environment where penny changes in earnings per share forecasts make dramatic short-term changes in share price, where profits from investment banking activities outpace profits from brokerage and research, and where investment research and recommendations are now prime time news, or as some would say, entertainment.

Let me elaborate a bit on some of these pressures. Analysts need to work with their investment banking colleagues to evaluate prospective clients. Although we do not believe that this relationship is inherently unethical, firms must have procedures in place that minimize, effectively manage and adequately disclose the conflicts to investors.

Firms should foster a corporate culture that supports independence and objectivity.

They should establish or enforce separate and distinct reporting structures so that investment banking can never influence a research report or investment recommendations.

They should have clear policies for analysts' personal investment and trading.

They should implement compensation arrangements that do not link analysts' compensation to work on investment banking assignments; and

Make prominent and specific, rather than marginal and boilerplate, disclosure of conflicts.

Analysts also have been pressured by companies to issue favorable recommendations. Companies have been known to take punitive action against analysts and their firms for negative coverage.

Some institutional clients also support ratings inflation. Portfolio managers' compensation may be adversely affected by a rating downgrade of a security in their portfolio. Consequently, they may retaliate by shifting brokerage to another firm.

These and other conflicts are discussed at length in a position paper that AIMR will soon issue for public comment. This paper will form the basis for the development of AIMR's Research Objectivity Standards, which will be specific and measurable practices addressing each conflict.

Finally, we must address how research recommendations are communicated. Increasingly, private investors get research recommendations through brokers, the media and the Internet. Typical research reports are lengthy, but are often condensed to earnings forecasts or buy, hold or sell recommendations when communicated to the investing public. This makes a good sound bite, but investors should know that headline ratings do not provide sufficient information for buying or selling a security.

Investors or their investment managers should study the entire research report to assess the suitability of the investment to their own situation, their own investment objectives, and their constraints.

Although the analysts we are addressing are a small fraction of AIMR members, and the investment profession at large for that matter, I would like to impress upon the subcommittee that AIMR and its members appreciate the seriousness and also the complexity of this problem. We recognize that the reputation of the entire investment profession has been called into question. But a precipitous solution is not the answer.

AIMR is committed to work with the profession to develop effective, long-term solutions. I'll be happy to answer any questions you may have. And again, Mr. Chair, thank you very much.

[The prepared statement of Thomas A. Bowman can be found on page 195 in the appendix.]

Chairman BAKER. Thank you, Mr. Bowman.

Our final witness today is Mr. Damon Silvers, Associate General Counsel, AFL-CIO. Welcome, Mr. Silvers.

STATEMENT OF DAMON A. SILVERS, ASSOCIATE GENERAL COUNSEL, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS (AFL-CIO)

Mr. SILVERS. Thank you, Mr. Chairman. The AFL-CIO and its member unions—there are 13 million members—believes today's hearings on investment analyst independence is of vital importance to working families and their pension funds.

We would like to thank the Subcommittee for its efforts in this area. In particular, Mr. Chairman, let me express our appreciation to you for your concern for the interests of working families as investors.

Defined benefit pension funds that provide benefits to the AFL-CIO's 13 million members have approximately $5 trillion in assets. Through 401[k] plans, ESOPs, and union members' personal savings accounts, there are further extensive investments in equity markets by America's working families and union members.

Most of our members and the trustees of our pension funds rely on a variety of professionals for their information about the equity markets. America's working families have an enormous stake in the accuracy of this investment analysis.

In addition, many of the largest pension funds, whose beneficiaries account for hundreds of thousands of working families, have placed the majority of their equity investments in index funds. This decision is driven by index funds' lower fees and the difficulty of obtaining consistent above-market returns in active trading.

However, the funds who invest in indexes are placing their trust in the transparency and honesty of our markets and have no defense against systematic distortions such as those created by conflicted analysis.

In that context, what are we to make of the data that's been cited here frequently today that in December of 2000, 71 percent of all analysts' recommendations were buys and only 2.1 percent were sell?

In the remainder of my testimony, I would like to suggest that what has happened here is the collapse of what used to be called the Chinese Wall between investment banking and analysis, and that only regulatory action can rebuild it.

There is substantial statistical evidence that analysts' decisions whether or not to recommend that investors buy a stock are influenced by whether their firm is an underwriter for that issuer or considering becoming one.

CFO Magazine reported last year that analysts who worked for full service investment banks have 6 percent higher earnings forecasts and close to 25 percent more buy recommendations than analysts at firms without such ties.

And in the last few months, analysts have been quoted by name in the financial press saying such things as, quote: "a hold does not mean it's OK to hold the stock". And, quote: "the day you put a sell on a stock is the day you become a pariah."

This data is not surprising given the relationships that have developed between analysts and the investment banking side of the full service securities firms. It has become a common practice for analysts to accompany teams from their corporate finance departments on underwriting roadshows, and most importantly, analyst compensation has become tied at many firms to analyst's effectiveness at drawing underwriting business.

In addition, the consolidation of the financial services industry puts issuers in a position to withhold business from the firms of critical analysts across a wide array of markets, including commercial loans and commercial banking services, pension fund and Treasury money management and insurance contracts.

For example, the same CFO Magazine article reported last year that First Union cut off all bond trading business with Bear Stearns in response to negative comments by Bear Stearns' analyst, and Bear Stearns then ordered the analyst to be more positive.

Just yesterday morning there was an account of how an analyst report critical of the Kraft offering that was mentioned here today was effectively suppressed by Goldman Sachs. They had their reasons, they reported in the press. The fact is, the report was suppressed.

On the eve of this hearing, the Securities Industry Association announced a voluntary set of principles governing analysts at their member firms. We would urge the subcommittee to look closely at this code to see if it leaves room for continued linkage of analyst compensation to investment banking activity or continued participation by analysts in marketing securities underwritten by the analysts' firms.

The problem of conflicted analysts is driven by extremely powerful financial pressures, and it will not be halted or reversed by either general statements of a desire to be honest or subtly crafted principles that on closer examination leave room for a continuation of business as usual.

Rather, we think Congress ought to assist the Securities and Exchange Commission, the NASD and the national exchanges in continuing the course toward greater market transparency and integrity promoted by the SEC's recent regulatory initiatives.

Already in Regulation FD on selective disclosure, the subcommittee has taken an important step toward combatting conflicting analysts' reports. The disclosure targeted by Reg FD gave issuers power to punish and reward analysts with information that warped the behavior of those analysts who actually got the selective disclosure.

Unfortunately, despite the improvements wrought by FD, we believe that there is a need amply demonstrated by this morning's hearing for this Subcommittee to work with the regulatory agencies, including the industry itself, in the NASD and the SROs to develop new regulatory approaches.

Some measures this subcommittee ought to consider and raise with the Commission should include bars on any form of linkage between analyst compensation and investment banking performance. And in addition, bars on analyst participation in marketing activities by their firms, most importantly, underwriting roadshows.

The subcommittee should also consider whether in view of the pressures at work here a more comprehensive ban on analysts from issuing reports to the public on companies which their firms are underwriters for should be appropriate. One thing that has not come out in this discussion very much this morning is that analysts and broker-dealers are fiduciaries for their clients here. And they owe a duty to those people under law currently. Unfortunately, it seems to be somewhat unenforceable.

Working with the Commission on these new initiatives, however, will take time. In the meantime, we think this subcommittee would do a great deal to protect investors and the analyst community if at a minimum it used its influence with the SEC to protect Regulation FD and ensure it continues in its place in current form.

In conclusion, the AFL-CIO believes the question of analyst independence is vital for the retirement security of America's working families. We thank this subcommittee for its work in this area, and we look forward to working with you in the future.

[The prepared statement of Damon A. Silvers can be found on page 199 in the appendix.]

Chairman BAKER. Thank you, Mr. Silvers.

Mr. Bowman, I'd like to start my questions with you, sir. In your capacity representing AIMR and secondarily as to the content of your statement, I found it most helpful. You centered on a number of concerns that I have had, and I express my great interest in the release of the paper, which I assume will address all of those issues raised.

Have you had occasion to review yet the Best Practices standard of the SIA?

Mr. BOWMAN. Very briefly, sir. I think they came out earlier this week. And I had not had any advance—I had not discussed that with the SIA prior to their coming out with it. So I'm vaguely familiar with them, but I have not read them in depth.

Chairman BAKER. And you're not in a position to make a comment today?

Mr. BOWMAN. Well, I found one thing very interesting. As I read through those, in fact I had an e-mail from one of our members who had seen it, and if you read through those Best Practices, while we agree with them all, it's very interesting to see that most of what was included in that report has been in our Standards of Practice handbook for 35 years—analyst independence, clients first, you know, conflicts.

Chairman BAKER. I was expecting that looking at that manual for 35 years of practice it would appear to me on first blush from a distance of about 40 feet, it contains a bit more than the Best Practices Standard recommended by the SIA. Is that a fact?

Mr. BOWMAN. Well, in fairness it does, but there's case studies in here too. So this is not all the standards.

Chairman BAKER. Are there significant elements of its content which you would deem advisable for the subcommittee to consider in the application to the Best Practices of the SIA?

Mr. BOWMAN. Very much, sir.

Chairman BAKER. What I will suggest, since I have a suspicion this will get inordinately complex very quickly, is to request—and I'll follow up in writing—your organization's review of those Best Practices as recommended, and particularly a contrast between your Manual of Best Practice and that which is proposed to help the subcommittee better understand where deficiencies might exist or where we find something of value in the SIA's proposal.

At least my view, and I think the view of most Members of the subcommittee is there is not a desire to legislate in this matter, but we certainly want to encourage the best possible standard to be self-implemented, but to view the best way to confirm, as Mr. Silvers had pointed out, a way to ensure that the conformity with the standards is in place. Is there such an audit or enforcement provision with regard to the AIMR standards?

Mr. BOWMAN. Again, sir, as I mentioned in my testimony, we are an organization of individual professionals. We do not have corporate membership, and therefore no authority over some of the firms that we're talking about here this morning.

So we do have enforcement mechanisms over our members.

Chairman BAKER. Right. In other words, if you find somebody not complying with your rules, they're out?

Mr. BOWMAN. They're out.

Chairman BAKER. But my point is that there's accountability at least within the organization, and where there is evidence of inappropriate conduct, there are consequences?

Mr. BOWMAN. Absolutely.

Chairman BAKER. Well, see, that's something that's lacking I think in the SIA proposal. There's not even the beginning suggestion of a consequence for your failure to act appropriately.

Mr. Cleland, did you want to jump in there?

Mr. CLELAND. Yes, if I could. It's always important to put things into context. And the SIA Best Practices, everyone should support. I just would like to put it into context that there's nothing really new here; that this is boilerplate.

If you look at the National Association of Security Dealers self-regulatory manual that was first published in the 1950s, this language would be very similar to what the preamble was there.

Chairman BAKER. So you would characterize this as not a particularly bold step, in other words?

Mr. CLELAND. This is probably a needed refresher course. But it's been the standard for 45 years.

Chairman BAKER. And by the way, just for the record, it was stated earlier that perhaps the organization was one of the few that had continuing education. I can confirm from my own personal experience there. Annual education requirements for most professional affiliations with annual testing. And I can speak to that from only the real estate perspective. But it is not an abnormal activity for a professional organization to require continuing education and examination, and I think that's highly appropriate.

Did you wish to jump in, Mr. Silvers?

Mr. SILVERS. Yes, Mr. Chairman. I think that you have a way of avoiding the dichotomy that I think you wish to avoid between purely voluntary self-policing of the sort that the SIA code suggests, and legislation. Congress is fortunate that in its wisdom it created the structures of the self-regulatory organizations and the NASD, which are industry structures, controlled by the leaders of the securities industry who have the authority to enact structures of accountability in this area.

It's our view that the proper role for this subcommittee here is to work with those bodies and encourage them to use the authority they have to address this problem and create the kinds of accountability, Mr. Chairman, that you are concerned about.

Chairman BAKER. Thank you. I'm going to jump to Mr. Bentsen. I don't know how soon we'll get to a vote, but I'd like to try to at least get Mr. Bentsen and Mr. Shays' questions in before then. Mr. Bentsen?

Mr. BENTSEN. Thank you, Mr. Chairman. let me just restate and make sure it's clear what my opinion is on this so no one is confused. I think there is some move here to try and treat financial analysts in the same way that we treat auditors and to link their positions. And I just continue to believe that those are two different professions and we ought to be cautious in our approach.

And in a couple of the testimonies that were given, there seems to be an extrapolation of not just fiduciary responsibility—and I agree that analysts, because they have contact with investors, are required to take their Series 7 and I don't know whatever series tests they have to take through the SROs.

But no one yet has shown me in the law where analysts' reports fall under the same guidelines that offering documents for securities do in terms of providing objective disclosure. And second of all, no one has yet fully provided for me some widespread pattern of manipulation of the market on the part of the analyst corps that creates some real and present problem that needs to be addressed through regulation or legislative action.

Now at the same time, as I said to the earlier panel, and maybe I'll try and be less subtle, that it comes as no great surprise to me that analysts who work for investment banking firms or brokerage firms may well be, particularly on the sell side, may well be trying to add in the pitch of the sale. And I think there is a risk to the brokerage firms that they be cautious in how subjective they want to be, because they are trading ultimately on trust. And then if they cross that line into what is manipulation through false disclosure, even though they are not under the Security Act or other disclosure laws.

I mean, can anybody here give me a pattern that has occurred? And the other thing I would just add, and I'd ask Mr. Cole, you talk about the fact that the NASDAQ has been cut in half from 2000, but this is not the first time we've seen market corrections in the 20th century. I mean, you had in 1900, in the 1920s, in the 1950s. You had a brief correction in the 1980s.

And if there's a correlation between analysts saying sell versus hold versus buy, is it to say—I mean, how did you get that 50 percent correction in the first place? Had they all said "sell," would it have been a 100 percent correction in the market? Or does the market move on information other than what analysts provide to them?

And finally, I'd just say, in many respects I think there is a herd mentality that occurs in the market, and I think the excess capacity of media outlets amplifying what analysts are saying, which heretofore used to be a subscription-type business sort of amplifies what their real worth is.

But basically, I'd like to know where is the pattern? Where is the empirical evidence? Because I don't think that case has been made today.

Mr. CLELAND. If I could jump in, I wouldn't necessarily say that—I wouldn't try and answer it that way. What I would say is the entire structure, the economics, the structure, the regulation, the compensation structures, are all mutually reinforcing that put company interests ahead of investor interests.

The SIA's Best Practices said the investor interest comes first. Well, if you look through the regulation, the structure, the economics of the industry and the compensation, it all rewards companies over investors.

Mr. BENTSEN. Now Mr. Cleland, do you support Reg FD?

Mr. CLELAND. I think that Reg FD is OK. I think what it means is that most research has to happen in a stadium, and that generally isn't how research is done. Research is done day by day, tough, you know, digging and getting different nuggets at different times.

Mr. BENTSEN. But wouldn't it, if we had a Reg FD, isn't there a school—I think there's a school of thought if we had Reg FD that when a company tells an analyst that they have a cozy relationship with they also have to disclose to the rest of the world. I mean, isn't that what you want to see happen?

Mr. CLELAND. I have no problem with that.

Mr. BENTSEN. Isn't that what we're saying in part here today?

Mr. CLELAND. Yes. And I don't think there's any—I'm not quibbling with FD.

Mr. BENTSEN. We had a hearing a week ago, or 2 weeks ago, where some were trashing Reg FD and saying that it was going to lead to less disclosure and contort the market and all other sorts of things.

Mr. CLELAND. And I'm not quibbling with FD. I'm trying to tell you that there is a systemic bias toward representing company interests over investor interests throughout the system. And you will get biased research, because that's what the system is geared to do.

Mr. BENTSEN. In the laws governing offering documents, I mean, issues you raise about companies taking positions, the brokerage houses taking positions in companies that they're also writing research for, when they are actually pitching a stock through an offering document is a material item that has to be disclosed in the document.

And I think what you are arguing is perhaps we need to apply disclosure standards, legal disclosure standards to research, which is a pretty far step to take.

Mr. CLELAND. No, I'm not saying that. I think the rules as I know them that research reports are classified as sales material. So at least that's what the current rules do say. They treat research as—they call it sales material.

Chairman BAKER. If I can, Mr. Bentsen, I'm going to jump to Mr. Shays, and hopefully we can release our witness panel. Mr. Shays?

Mr. SHAYS. Thank you. I'm intrigued with all your testimony. Mr. Cole, you start out very clearly and say Wall Street has become hopelessly corrupt. And I'm interested in you trying to give me the two or three best examples of why you think it's hopelessly corrupt, and then I'd like a response by the rest of the panel.

Mr. COLE. Well, when you look at a Planet Hollywood underwriting or Playboy secondary offering and you see the quality of research which was released in either of those companies. Planet Hollywood went bankrupt shortly after it went public. Or if you consider the role of analysts at a brokerage where the brokerage actually provides venture capital to a company, helps create the company, then takes it to an initial public offering and the company does go public, the brokerage itself has a stake in the company worth from hundreds of millions to billions of dollars.

What analyst is going to come out with a sell recommendation when the brokerage itself owns billions of dollars of stock in that company? If the analyst's sell recommendation only knocked 10 percent off the value of that stock, it could hurt the brokerage to the tune of hundreds of millions of dollars.

Mr. SHAYS. I'm struck by the fact, though, I don't know how a brokerage firm does well if its analysts are constantly telling people to do something that's not in their best interest. I see the built-in bias, but in the end, it seems to me that analysts——

Mr. COLE. The day of reckoning may come, as I said in my statement. I think the public is catching on. And if you want to be a little bit dramatic, what happens when the public does catch on and loses faith in Wall Street?

Mr. SHAYS. What about all the other analysts who work for other companies who will express an opinion about a particular area where one company has a vested interest in? In other words, doesn't the fact there are so many analysts out there ultimately modify, provide additional information? So one brokerage firm says buy and another one says sell.

Mr. COLE. I wish that it did modify it, but it seems to magnify it since as we've heard, 99 percent of recommendations are buy, it seems to have a reinforcing effect rather than a moderating effect.

Mr. SHAYS. I guess my question is, other firms that don't have a vested interest in it. Therefore, I don't see where their bias is.

Mr. COLE. They may seek business in the future. They may be owned by a commercial bank which has a commercial banking relationship with the company in question. It never pays to make enemies.

Mr. SHAYS. Let me just hear the response of others. Mr. Cleland, I want to just say, the way you organize your statement tells me it's based on your training as an analyst. I'd love to show my staff how clearly you organize your statement. It's intriguing.

Mr. CLELAND. Thank you.

Mr. SHAYS. But I'd love you all to just respond to Mr. Cole's comments.

Mr. CLELAND. Well, I think I wouldn't use the word "corrupt". I would use the word "conflicted". I mean, there's nothing wrong with representing companies. The problem in the system is, is people think the system represents investors. And the structure, the economics, the compensation and the regulation is all biased toward helping company interests subordinate investor interests. That's the system. That's the problem is that it's not transparent that the system is so skewed.

Mr. SHAYS. Mr. Bowman?

Mr. BOWMAN. With all due respect, I categorically disagree with Mr. Cole's statement. As I think Mr. Glassman and the earlier panel indicated, life has conflicts, as does any business.

As I mentioned, I represent an organization of 150,000 investment professionals and I deal with thousands of investment professionals every day, and I can tell you that in 99.99 percent of the cases, all they want is for the investing public and for us to be able to demonstrate that these people are honest, forthright and are putting their clients first.

In fact, since this whole issue arose several months ago, I have probably never been inundated with e-mail, mail and fax from members about the concern that they have and the black eye that they're receiving over what is really an isolated set of conflicts. And that is a relatively few number of sell-side firms who have these potential conflicts.

So I can tell you that over 30 years of investment practice, all the investment professionals that I've ever run into and at least those who are members of our organization, are honest, forthright and only interested in serving their clients.

Mr. SHAYS. Thank you.

Chairman BAKER. Thank you, Mr. Shays.

Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman. I missed a little bit of the testimony here, because the Investor and Capital Market Relief Act is on the floor and I was speaking to that bill. But I caught some of the earlier testimony.

And I have yesterday's *Wall Street Journal* with me here. And I just want to read for the panel here a comment made in yesterday's *Journal*: "Investors increasingly are blaming analysts for helping to pump up the dot.com bubble by issuing favorable research reports in recent years on companies handing out fat investment banking fees and not warning investors of the problems at these companies until long after the bubble burst."

And what the Journal does is just give a short example here, which I'd like you to comment on. It says: "A week ago Credit Suisse First Boston was appointed lead underwriter on a new stock deal for GoTo.com, a Pasadena, California Internet search engine. And Credit Suisse First Boston beat out Merrill Lynch and Company for the lucrative position. A few hours later, Merrill's high profile technology stock analyst, Henry Blodgett, who had been bullish on GoTo.com shares, did a turnaround on the stock. He downgraded the stock to a neutral from accumulate." And the *Wall Street Journal* asks the question, a coincidence? And that's the question I want to ask you. Is that a coincidence?

Chairman BAKER. If I may suggest, gentlemen, respond very quickly, and here's the incentive. If we get through this round of questions in time, we will adjourn our hearing. If not, we'll come back. It's your choice.

[Laughter.]

Mr. ROYCE. Those types of examples. Are they a coincidence?

Mr. SILVERS. Congressman, I think that if you look at the academic studies in this area which were cited extensively in my written testimony, you'll see that not only is that not a coincidence, but that it preceded the bubble. That those people at the leading business schools of this country who have taken a look at the relationship between whether or not an analyst's firm has an investment banking relationship with the company that analyst is looking at has an effect on their reports, the answer time and time again has been yes in the 1990s.

It's a matter I think of statistical proof. And in addition to the academic studies that were done all through the 1990s that are in my testimony, the Journal had reports yesterday on a study that showed someone who followed the recommendations of conflicted analysts would have had a 50 percent grater loss than one who did not. And furthermore, there was a study in CFO Magazine that I mentioned earlier. And there is to my knowledge no contradicting studies.

I think that there is ample data for the proposition that you're asserting here and that regulators' inaction, frankly, at this point is inexplicable to me.

Chairman BAKER. If I may suggest, we're down to probably a couple of minutes left, Mr. Royce on the vote.

Mr. ROYCE. Thank you, Mr. Chairman.

Chairman BAKER. Thank you very much. I would enter into the record, Mr. Silvers, the document you were referring to is the Investars.com study in which 53.34 percent—investors lost an average of 53.34 percent when they followed analysts employed by firms as opposed to independent analysts lost 4.24. Now both were losing. I mean, there's nothing to brag about in this message. But the point is that it seems to have been exacerbated by the affiliation.

To that end, I think the testimony given here today has been very helpful.

I'm sorry, Mr. Bentsen. Very quickly.

Mr. BENTSEN. If I could clarify very quickly, on a point Mr. Cleland made, talking to counsel, the 33 Act for disclosure purposes does not cover analysts' reports. And I think we're again being very confused here that analysts' reports are not offering documents. And at the end of the day, people who are buying stocks and bonds should read the offering document where the disclosure is in and we are now extrapolating that, expanding that to cover analysts reports. And I think we need to think long and hard before we make that assumption.

Chairman BAKER. We're down to a minute, Mr. Bentsen. And I don't dispute your point. Investors should have some responsibility. But this complicated matter, I hate to close our hearing in this fashion, but I must. We will address the remaining issues in hearings that are yet to come. I would welcome your written comments and suggestions, and certainly Mr. Bowman, I eagerly await the findings of the paper and look forward to working with each of you toward appropriate resolution.

Our hearing is adjourned.

[Whereupon, at 1:25 p.m., the hearing was adjourned.]

ANALYZING THE ANALYSTS

TUESDAY, JULY 31, 2001

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 2:05 p.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker, [chairman of the subcommittee], presiding.

Present: Chairman Baker; Representatives Castle, Royce, Oxley, Fossella, Toomey, Kanjorski, Bentsen, J. Maloney of Connecticut, LaFalce, Sherman, Inslee, Moore, Gonzalez, Ford, Hinojosa, Lucas, Shows, Crowley, Israel.

Chairman BAKER. I'd like to call this hearing of the Capital Markets Subcommittee to order. I'm advised Members are on their way to the subcommittee, but to try and keep our proceedings on a timely basis, I will open our hearing.

This is the second in a series, and I expect a long series of hearings over the concerns of market practice and the free flow of unbiased information to investors.

Many people have expressed concern over the under-performance of the market over the last few weeks, and individual investors have seen portfolios shrink rather dramatically. That is not the basis on which the subcommittee conducts its review today.

As always, investors have the ultimate responsibility to make their own determinations based on their own best judgment. However, it has become increasingly clear that market practices are not what they used to be, and, in fact, there will be today, I believe, testimony to indicate that the scope of concerns the subcommittee has had are fully warranted and, in fact, may be more pervasive than originally contemplated.

The purpose of the hearing will be to determine the breadth of those problems and to begin the initial process of assessing the appropriate steps that are responsive to the problems that are identified. As everyone is aware, we have appointed a peer review committee which now has under advisement the best practices standards as issued by the Securities Investment Association, (SIA).

It is our hope that with the information provided in the hearing today, that we can properly assess the effectiveness of those rules and determine what enforcement mechanisms may be appropriate in light of the difficulties that have been determined to date.

I'm particularly grateful for those who are participating on today's panels. There's pretty clear agreement among all the witnesses as to the fact that a problem exists. I suspect there may be some differing opinion as to the remedies that might be appropriate, but I very carefully reviewed all the witnesses' testimony and think the hearing today will be very helpful for the subcommittee in understanding what will be an appropriate remedy to our concerns.

To put a fine point on that process, the subcommittee will conduct a hearing in the fall, after the August recess. We will develop recommendations for the industry to consider, and we will develop a mechanism by which those recommendations can be verified as to the level of compliance.

However, I should make it fairly straightforward, at least in my opinion, that should there not be an appropriate or adequate response by the industry to the identified public policy concerns, I am not turning my back on the question of providing a legislative remedy should we fall short of achieving the desired goal.

With that, I would like to recognize Mr. Kanjorski, the Ranking Member, for his opening statement.

[The prepared statement of Hon. Richard H. Baker can be found on page 209 in the appendix.]

Mr. KANJORSKI. Thank you, Mr. Chairman.

We meet today for the second time to consider the issue of analyst independence, a subject of great significance to our Nation's capital markets. Increasing the transparency of analysts' work should make it easier to detect faulty research and should enable investors to more easily evaluate the differing views of analysts who cover a particular stock.

Increased transparency should also help restore confidence in Wall Street's research. Since we last met on this subject in June, a number of developments directly affecting the subject of analyst independence have occurred.

Therefore, I will summarize some of these events before we begin today's hearing. First, the National Association of Securities Dealers (NASD) recently proposed changes to its disclosure rules. These amendments propose, among other things, to include common stock as a financial interest that firms and analysts must disclose.

More importantly, the proposal would also require abbreviated disclosures during public appearances on radio and television shows. When implemented, these changes should help retail investors to better understand analyst conflicts.

Officials with the NASD have also personally assured me that this rulemaking is not the last step that their organization will take to enhance analysts' capabilities. A number of securities firms have additionally announced revisions of their existing policies to manage analysts' conflicts. These changes exceed the recommendations for best practices announced by the SIA at their last hearing.

For example, Merrill Lynch, Edward Jones, and Credit Suisse First Boston have announced plans in July to prohibit their analysts from owning securities in companies they cover in their research. In the coming weeks, I expect other firms will follow the lead of these companies by announcing changes in their own policies and practices designed to increase the independence of research.

Furthermore, the Nation's largest brokerage firm announced that it has agreed to pay $400,000 to a pediatrician in Queens, New York. This doctor claimed that he lost more than one-half million dollars following the advice of his broker who regularly cited the bullish research of a prominent Wall Street analyst.

Although this settlement establishes no legal precedent by itself, it does raise important ramifications for the brokerage business, especially if other investors, in the weeks and months ahead, pursue similar cases.

I predict that just one or two more settlements of this type will create an incentive for the investment banks to take further action to improve the quality and trustworthiness of their research. Although each of these actions demonstrates that the marketplace has begun to self-regulate on the issue of analyst objectivity, we must still do more.

Mr. Chairman, in the week since our last hearing, the debate has intensified about whether we should privatize Social Security. Social Security presently covers about 160 million persons. Because more than 20 percent of the adult American population is functionally illiterate, we can estimate that about 35 to 40 million Americans cannot read or understand a business prospectus. Yet, we would be asking these very same individuals to make decisions about their retirement funds under Social Security privatization schemes. If they cannot read and comprehend a business plan or an accounting statement, it seems likely that many of these individuals would become reliant on the advice of Wall Street researchers when making their investment decisions.

Therefore, industry has an obligation and a responsibility to comprehensively address the issue of analyst conflicts and resolve all related concerns before we begin any public policy debate on the future of Social Security.

With that said, Mr. Chairman, today's hearing will further our understanding of the nature of this growing problem and help us to discover other actions that might restore the public's trust in analysts.

As you know, I generally favor industry solving its own problems through the use of self-regulation whenever possible. And I was pleased to join you in recent weeks in creating a review board to assess the adequacy of the industry's reform proposals. I will also listen carefully to today's testimony and continue to encourage our subcommittee to move deliberately on these matters in the months ahead.

As I advised at our last hearing, we should not demagogue on the issue of analyst objectivity to score political points. Only cautious action on this subject will help to ensure that our capital markets remain strong and vibrant.

In closing, analyst independence is an issue of the utmost importance for maintaining the efficiency of and fairness in our Nation's capital markets.

Thank you, Mr. Chairman, for having this hearing today and raising these concerns.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 217 in the appendix.]

Chairman BAKER. Thank you, Mr. Kanjorski.

Chairman Oxley.

Mr. OXLEY. Thank you, Mr. Chairman. I commend you for holding this important hearing, part of a series of hearings on issues of Wall Street research practices. These practices have come under fire in the past year for some good reason. As we learned at our first hearing on analysts last month, and as even the trade group for analysts acknowledged, conflicts of interest do pervade Wall Street's research machine and taint the recommendations of equity analysts.

There's one reason institutional investors pay little attention to sell side analysts, relying on their own research professionals instead.

Robert Sanborn, a former portfolio manager of the Oakmark Fund says that anyone who follows a recommendation from a sell side analyst is an absolute fool. Most investment advisors caution investors to consider analysts' recommendations not as definitive in any way, but rather as a single factor in making a buy or sell decision. That is good advice, but even as a single factor in an investment decision, an analyst's recommendation should, at the very least, be free from the taint of bias.

The financial media has played an important role in elevating the profile of Wall Street analysts. Mary Meeker and Henry Blodgett are now familiar names to a large number of American investors. Many have criticized the news media for its failure to hold analysts accountable for wildly wrong predictions. I would urge the news media to require sources to disclose whether they hold any interest in stock, long or short, and whether their firms have business relationships with the company. Then let investors weigh that information. Some news media already take these steps, but it should be universal.

Having said all that, as a free market Republican, I am loathe to legislate in this area. My preference is for industry to clean up its own mess. I'm encouraged by steps that some companies have taken to address the issue. I will continue to work with the industry to make sure sufficient steps are being taken to resolve the problems and to restore confidence in Wall Street research practices.

This subcommittee has established a peer review board of industry practitioners, money managers, academics, and regulators to comment on the industry's proposals for reform. That group will present its findings to the subcommittee at a hearing this fall.

I look forward to our distinguished witnesses today who will provide new perspectives on the issue including Commissioner Laura Unger, the Acting Chairman, who has done considerable work on this matter as Acting Chairman of the Commission, and on our second panel, a variety of esteemed experts in research and investment banking, and the financial media.

Welcome, Ms. Unger, it's good to have you back before the subcommittee.

Mr. Chairman, I yield back the balance of my time.

[The prepared statement of Hon. Michael G. Oxley can be found on page 225 in the appendix.]

Chairman BAKER. Thank you, Mr. Chairman.

Mr. LaFalce.

Mr. LAFALCE. Thank you very much, Mr. Chairman. And thank you, Mr. Kanjorski, for the fine work the two of you have been doing in the hearings you've had thus far on these very, very important securities issues. They, along with the many meetings that I've had with market participants and regulators and academics have increasingly convinced me that analyst conflicts have seriously eroded confidence not only in the capital formation process, but in the way stocks are evaluated by investors who seek objective advice in a very complex marketplace.

It's also become clear to me that the analysts have a role in boosting and supporting the stock price of certain companies. That is but one piece in a series of activities that contributed to the market exuberance of the late 1990s and the early months of this century. We must redress these practices.

The centrality of the market, as both the measure of a company's success and a fundamental source of wealth creation for insiders especially, has tilted companies' attention toward their stock price and away from the fundamentals of their business.

Executive compensation is now most often intertwined deeply with the performance of a company's stock. The stock price, in turn, is very much affected by the expectation of the securities analysts and the investor community. Companies live and die by meeting analysts' predictions each and every quarter. Missing the estimates by as little as a penny can send a company's stock price plummeting, even when there has been no substantive change in the firm's condition or prospects.

Since the last hearings, the SIA, in an effort to stem the public and vocal tide of criticism, released its voluntary guidelines, and shortly after its release much of the industry claimed they were already following these guidelines.

In response, Ms. Unger was quoted in the press as saying that this would, quote: "Suggest that perhaps the guidelines need to be enforced more stringently." Perhaps so, if you can enforce guidelines.

In any event, shortly following those remarks, in a very positive but telling step, Merrill Lynch, Credit Suisse First Boston, amongst others, barred their analysts from owning the stocks that they cover. Now I think that was a clear indication that something was very wrong. I also think it's a clear indication that the wrong can be righted. As a result, I've communicated with Ms. Unger, and the NASD on two occasions to call for a rulemaking that goes beyond the enhanced disclosure recently proposed by the NASD to amend Rule 2210.

We know that the role of the analyst is both a mechanism to win business and a voice to speak objectively about the business fundamentals of the companies they cover. This advice is relied upon by small investors and by large investors alike.

What is at risk is often a person's entire future, a person's retirement, a person's financial security, a person's fortune. Conflicts are not simply facts to be disclosed. Conflicts of interest undermine the objectivity of the analyst and the efficacy of the work that they do.

Like any profession that requires trust by the public, conflicts need to be minimized or eliminated, not simply disclosed. Therefore, I have suggested to Ms. Unger, and I invite her to respond today, if not on behalf of the Securities and Exchange Commission (SEC), on behalf of Laura Unger personally, to the following recommendations.

First, to affirm through regulation the actions of companies such as Merrill Lynch and Credit Suisse by banning securities analysts from owing or having an interest in the stocks that they cover.

Second, to engage the academic community, the NASD and market participants to arrive at a workable construct that will alter the present compensation structure of analysts to separate analysts' compensation from their investment banking function, and reward them based on the quality of their research.

Third, to require securities firms to disclose on each research report or recommendation, how many issuers they cover, and an aggregate breakdown by category of the ratings assigned to these issuers. For example, xyz investment firm covers 200 public companies. Of these companies, 50 are strong buys, 100 are buys, 49 are holds, and one is a sell or two are sells or three or four or whatever it may be. But that might put the recommendation in perspective.

I made additional suggestions to the Commission in late June following this subcommittee's first hearing. Without objection, I would ask that they also be made a part of the record.

Chairman BAKER. Mr. LaFalce, without objection, but I hate to ask if you could begin to close.

Mr. LAFALCE. Yes, I do support many of the modest changes supported by the NASD in its proposed rulemaking. But I'm increasingly concerned that industry self-regulation may not be sufficient and that more disclosure of these conflicts in itself will not suffice to protect the American investor.

So I urge the regulators to act quickly to eliminate these conflicts, because if the regulators do not, Congress must.

[The prepared statement of Hon. John J. LaFalce can be found on page 219 in the appendix.]

Chairman BAKER. Thank you, Mr. LaFalce.

I go next to Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Ms. Unger, it's good to have you and the rest of our panel. Mr. Chairman, I appreciate that you are having the second round of hearings on this important issue, and I think the panel that you have today, Ms. Unger from the SEC, and our other, broader panel will be very helpful for both the Congress as well as the public, who is watching this, to get a better understanding of both how the process of research analyst works as well as what, if any, the response from the Federal Government should be.

However, I would caution my colleagues, and I would caution the Securities and Exchange Commission to be careful in our attempt to, as we look for a culprit for the collapse—or I don't want to use the word collapse—but the rapid decline in the value of certain markets, that we shouldn't try and go and pin it, in this instance, on the case of the research analyst and try and sterilize the research business.

I would remind my colleagues that on the books we have existing securities laws, existing disclosure laws which, whether or not people are actually looking at what is being disclosed, is something that we should not ignore.

Second of all, I think we have to be realistic and understand that this is a problem that the industry not only has a responsibility to the general public, but has a responsibility to their own shareholders and their own partners to fix. I think that any firm which gains a reputation of irrational research will soon find that reflected in their bottom line.

So I would hope that we gather as much information as we can, but that we proceed very cautiously in this approach, and that we do not try to equate the research business in the same way as we might equate the auditing business. Because, in this Member's opinion, those are two very, very different things.

I thank the Chairman for calling this hearing.

Chairman BAKER. Thank you, Mr. Bentsen.

Mr. Fossella.

Mr. FOSSELLA. Thank you, Mr. Chairman.

To follow up on my colleague, Mr. Bentsen, it's a great thing that more Americans have become investors. I think it's a healthy thing. I think what is important, as well, is to remind all Americans who want to become investors that it's in their interest to become educated for their own good.

We acknowledge the critical role I think that research analysts play in developing the markets and maintaining the integrity of the markets, and ultimately providing a service not only to their companies and firms, but to ordinary investors across this country.

I think that what's happened in the last several weeks is a positive thing, that is, the industry, I think, has identified that there seems to be a problem. While the vast majority of individuals who work for these firms I think are of the utmost integrity, they have to comply with their own firms' standards, and deal with the SEC, among other regulatory entities, to comply with the law, there seems to be a strong belief that something needs to change.

Some firms I think initially have thought that the best practices in events recommended by the SIA are necessary. It is healthy and good that some firms have said, no, I think we need to make some changes and modifications to our practices.

What's left to be asked, however, is how much time should the industry have in order to change the way they go about these practices. There are different firms. Each firm has a different standard. How is it that the SEC is going to look upon the implementation of these best practices to ensure that as many firms as possible, if at all, are going to comply? You look at a Merrill Lynch, it has a different standard than a First Boston and a different standard than Salomon.

I think over time it's up to the SEC to put a timeframe on those, is it 3 months?; is it 6 months?; is it after bonuses are given in December, to see if these things are working?

I share Mr. Bentsen's views, and I believe my other colleagues who have said let's not jump to legislative remedies for this, because ultimately it's up to the investor to beware. But there is a degree, and a large degree of questions at stake with those few research analysts who compromise not only themselves, but their firm's integrity, as well as that of the individual investor.

There are going to be conflicts always. There's no question about it. You have the responsibility, and I think you would do well to ensure that those conflicts and compromises are kept at a minimum. As the market decreases, it did so rapidly in less than a year, people are going to start pointing fingers and looking for someone to blame.

I don't think that's the right thing to do in the long term. The right thing to do in the long term is to bring all these firms as close as possible to the best practices as recommended by the SIA and try to take another snapshot, in say 6 months' time to see what's happened. But the rush to judgment may just be a big mistake.

I yield back.

Chairman BAKER. Thank you, Mr. Fossella.

Does any other Member have an opening statement?

[No response.]

Chairman BAKER. If not, it would be my intention to recess pending the floor, Ms. Unger. I'll come back very quickly. My best guess is that that will take me about 10 to 12 minutes, and then we'll get started.

Thank you very much.

[Recess.]

Chairman BAKER. I'd like to reconvene our hearing. We had two votes instead of one so we were detained a little. The other Members will be returning as soon as possible.

I'd like at this time to recognize our first witness for today's hearing, The Honorable Laura Unger, Acting Chairman of the Securities and Exchange Commission, certainly no stranger to the subcommittee.

Welcome, Ms. Unger.

STATEMENT OF HON. LAURA S. UNGER, ACTING CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

Ms. UNGER. Thank you very much, Chairman Baker, and others who may be returning to the hearing. A lot of what was said really resonated with me, and I think you'll find that what I say today will resonate with you.

I thank you for the opportunity to address the subcommittee today concerning analysts' conflict of interest. The Commission commends the subcommittee for its continued attention to this important issue. I thought I would spend my time this afternoon addressing three issues.

The first is, what conflicts affect analysts and why do these conflicts exist? The second is, what have we observed about analyst conflicts as a result of our staff's recent exams of brokerage firms? The third is, what is being done to address these conflicts?

Before I turn to these particular questions, I think a preliminary remark is in order. It is fair to say, as others have said today, that it has not been a banner year for analysts. The profession has been the subject of intense public scrutiny. In many respects, analysts are a victim of their own success. The longstanding bull market and the record number of Initial Public Offerings (IPOs) made research—and the positive impact on stock price that research could have—a basis on which investment banking firms competed for underwriting business.

But I think it's important for us not to lose sight of the important role that analysts play in our securities markets. As the Commission recently stated, in adopting Regulation Fair Disclosure (FD), analysts provide a valuable service in sifting through and extracting information, the significance of which might not otherwise be apparent to the ordinary investor.

We should also not forget that the overriding majority of analysts operate on the highest ethical plane. In other words, the issue of analysts' conflicts is largely structural and not personal.

With that preface, I will begin by identifying a few of the more acute conflicts. Most stem from the blurring of the lines between research and investment banking that I just alluded to. This blurring can be seen in a number of ways. First, an analyst's salary and bonus may be linked to the profitability of the firm's investment banking business, motivating analysts to produce favorable research that will attract and retain investment banking clients for the firm.

Second, at some firms, analysts are accountable to investment banking for their ratings. Third, analysts sometimes own a piece of a company that they cover, mostly through pre-IPO share acquisitions.

SEC staff has conducted on-site examinations of several full service brokerage firms, focusing on analysts' conflicts of interest. The staff, in its examinations, selected nine firms that underwrote significant numbers of IPOs, particularly internet and technology-related IPOs. These examinations focused on the three areas that I just mentioned: compensation arrangements; analysts' accountability to investment banking; and analysts' financial interest in companies they cover.

Today, I will share with you some of the preliminary observations. The first is that the line between research and investment banking, has indeed blurred. Seven of the nine firms inspected reported that investment banking had input into analysts' bonuses and the analyst hiring process. In at least one of those firms, 90 percent of the analyst's bonus is based on investment banking revenue.

The staff inspections found that the investment banking department does not formally supervise the research department, but that analysts assist investment banking by consulting on IPOs, mergers and acquisitions, participating in pre-IPO road shows, and initiating research of prospective investment banking clients.

Second, interviews with former analysts revealed that it was well understood that they were not permitted to issue negative opinions about investment banking clients.

Third, about one-quarter of the analysts inspected owned securities in companies they covered.

The staff found that 16 of 57 analysts reviewed made 39 investments in a company they later covered. All of the investments were pre-IPO. Moreover, the examiners found that three of these analysts traded contrary to their research report recommendations. Examiners also found that in 26 of 97 lockups reviewed, research analysts may have issued "booster shot" research reports. These reports reiterated buy recommendations shortly before or just after the expiration of the lockup period.

As you know, a lockup is the time period during which insiders and others who have obtained pre-IPO shares are prohibited from selling those shares. In each of these instances, the firms underwrote the IPO of the company in which the firm's analysts owned stock. So, you may ask what is being done to address these conflicts?

As has been noted today, the industry, the Self Regulatory Organizations (SROs), and the Commission have taken action to improve the objectivity and independence of research analysts. Both the SIA and the Association for Investment Management and Research recently issued a set of best practices in this area. These best practices provide a basis or foundation for on-going discussions about managing conflicts.

Firms are reviewing their internal policies and procedures. Several securities firms have already taken some initiatives to revise their existing policies and procedures to manage conflicts. As reported in the press, at least three securities firms have recently adopted policies that prohibit analysts from owning securities in companies they cover.

The NASD recently proposed for member comment changes to enhance and harmonize its conflict disclosure rule. The Commission has two roles in managing analyst conflicts. The first is making sure that disclosure is adequate and effective. The second is educating investors.

So far, we have worked with the SROs to improve and more diligently enforce the disclosure of conflicts of interest. Our Office of Investor Education and Assistance has also issued an Investor Alert to explain to investors exactly what conflicts analysts may face and how investors should interpret disclosures about these conflicts.

I believe investor education is particularly vital to managing analyst risk. I say this because we can really only manage the conflicts. Some conflicts will always exist, such as pressure from institutional investor clients protecting their portfolio value, and pressure from issuers who put analysts in the dog house for downgrading their stock.

It is my hope that with a little help from the regulators, the industry will resolve these issues. The recent industry initiatives are a step in the right direction. But I would be remiss, especially as a former enforcement attorney, if I did not emphasize that the industry and the SRO initiatives will only succeed with vigorous enforcement.

The SEC staff inspections revealed that firms had policies on the books that were virtually ignored and rarely enforced in practice. For example, one firm approved an analyst's pre-IPO investment 3 years after the fact. In another example, only one firm could identify accurately all pre-IPO investments by analysts. This situation cannot continue. The firms, the SROs, and the SEC must work together to ensure that we have information with integrity out in the marketplace.

I look forward to continuing this partnership. Thank you, Mr. Chairman. I will now be happy to answer any questions.

[The prepared statement of Hon. Laura S. Unger can be found on page 227 in the appendix.]

Chairman BAKER. Thank you very much. I was optimistic that your testimony would satisfy all the concerns of the subcommittee and I think you've done an outstanding job of energizing the subcommittee's concerns.

Ms. UNGER. Thank you.

Chairman BAKER. There is considerable content to your testimony that I would like to question you about, but I'm going to focus on two or three things that I think are particularly disturbing.

Examiners found that three analysts executed trades for their personal accounts which were contrary to the recommendations in their research report. That's from page 6, footnote 8. It goes on to say, and this is what really got me concerned, that the analysts' profits generated by acting in what I think is at least unethical if not a violation of some rule somewhere, between $100,000 and $3.5 million for each transaction by selling their shares while continuing to maintain buy recommendations. One analyst sold securities short while maintaining a buy recommendation on the subject company.

What was the scope time-wise of your inquiry in the market? How recent are these examinations that led you to this discovery?

Ms. UNGER. The examinations occurred in 1999 and 2000. What we saw as far as the scenario you just mentioned in terms of analysts deriving significant profits from selling activity contrary to their recommendations is something that we are taking a very close look at. And in fact, in those cases, it's possible that the analysts violated not only firm policies, but also the Federal Securities laws.

Chairman BAKER. That really was my next question. Was there a regulation, a professional standard of conduct, or a statute, and if not, I would welcome, once your review is finished, advising the subcommittee as to what, if needed, any steps might be taken. I find it frankly appalling that someone could tell me to buy while they're selling in the back room profiting from my investment.

If that's not a bedrock of necessity to correct, there is nothing in this marketplace that we can correct. I just found that very troubling.

The staff found instances in which the analysts' ownership in stock of the covered company was not disclosed in the research at all. Now I have trouble with the boilerplate that says we may have an interest, but to not say it at all is not a violation of current practice or regulation or is there any rule that says you have to disclose at least that the firm may have an interest?

Ms. UNGER. Well, this is part of the problem. The New York Stock Exchange has rules, as does the NASD. There is a disparity between what each of the SROs require in terms of disclosure. For example, one SRO requires that the firm disclose the common stock position, and the other doesn't. One SRO requires that there be a disclosure of the investment banking relationship that's more detailed than another.

And so what we really need to do as a first step is harmonize the existing SRO rules to make it easier for firms to comply with those rules.

Chairman BAKER. I think the subcommittee would be interested. Again, one of the footnotes, page 8, footnote ten, despite the language of the rule, the NASD has stated that it does not interpret the disclosure requirement to apply to media appearances by analysts. So the SRO doesn't see anything wrong with someone getting on the television set saying what a great investment opportunity this is and there are no consequences. In fact, it doesn't violate the code of conduct.

Again, I commend you for great testimony, but you've just increased our workload here for the considerable future. If we don't now have rules sufficient to govern practice from the SRO, I think we have a long struggle to get the industry to get where I believe you think they ought to be without significant encouragement.

Ms. UNGER. Well, the Commission, as you know, has been engaged in a dialogue over at least the last year with the NASD about their interpretation of what disclosures must be made by analysts in media appearances.

Chairman BAKER. Well, for what it's worth, I'd like to see a Surgeon General's warning that says, "Warning. I have an interest in this thing I'm talking about," kind of flashes on the screen.

Ms. UNGER. Well, we have taken the position that the disclosure requirement applies irrespective of the media.

Chairman BAKER. Absolutely. Just because you whisper it instead of standing up and saying it in public is no different, you still have to disclose.

Ms. UNGER. I think the NASD is coming around to that viewpoint.

Chairman BAKER. Well, for what it's worth, I hope we can encourage them.

I have one more point I want to make, but my time's coming to an end, and so I'll do it real quickly. This is a what-if, and you may not be comfortable to comment today. But let's assume we had a standard of conduct which we all would prescribe as being good, and that we were able to get the industry to voluntarily implement that standard. We don't have it and we're not there yet. But assume for the moment we had it.

The other point of your testimony was many of the organizations have very well written, very well thought out codes of conduct, but they're also ignored. So we have pretty books sitting on the shelf that nobody reads.

What we need, no matter what the standard may look like, is someone to determine compliance and a consequence for not having compliance. It seems to me there is a great deal of non-compliance and there's no consequence. For example, the fellows who are trading against their public position.

What would be the effect of having just a grading system, A, B, C, for example, real simple. A you comply with everything, B you're pretty close, but you're not there, and C you better really get your stuff together or bad things are going to happen.

Now I don't know whether that would be the role of the SEC, the NASD, the SRO, but there has to be some measure of performance of your conduct, because without that, the market can't act and bring about the discipline we all want.

Can you comment generally on the idea?

Ms. UNGER. You are correct. I would like to see the SROs first make the disclosure requirements crystal clear and consistent. I would next like to see the firms adopt policies across the board that would make disclosure with the requirements an everyday practice, and then I think we need to ensure a way for firms to enforce those rules.

And what you've described is certainly one way and a powerful incentive, I'm sure, for the firms to comply with their own internal policies which in turn comply with the existing SRO rules, or soon to be existing SRO rules.

I'm not sure what the extent of the SEC's involvement would be in something like that. I would prefer the Agency not to have any type of merit review, because we are traditionally not involved in merit review, and this would be something like that. I think we could be helpful in the process of developing standards and certainly we'd like to be engaged in the dialogue.

Chairman BAKER. But do you see merit in the public disclosure of outcomes? That's really my point, that today there are—although we all wish for self-discipline in the market—there is are consequence if you do not, and you can't make an informed judgment as an investor unless you know how the company functions. And it appears to be a very difficult determination to make today.

Ms. UNGER. The Commission often uses disclosure as a means of discipline.

Chairman BAKER. Thank you. I've exhausted my time.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Ms. Unger, let me ask you this at the outset, because of how this is being portrayed and I want to make sure that I don't dig myself in too deep in the situation, because I'm a little worried that we're on a little bit of a witch hunt here.

But do you believe that given the current situation and the concerns about conflicts of interests with analysts, that this is something akin to—there was a movie called "Game Show" about the 1950s and the hearings in Congress, long before you and I were born.

Ms. UNGER. Yes, I know what you're talking about.

Mr. BENTSEN. But it was sort of a rigged market. Is that your perception?

Ms. UNGER. No. And I think maybe you missed my opening comment where I said that, in fact, analysts perform a critical role in today's market, and in large part, they are victims of their own success.

I think what's happened is that the market was so strong for so long and with the huge influx of IPO activity, firms looked for ways to compete to get that IPO business. Part of the way they began competing was to include analysts in the mix. The ability to provide favorable analyst coverage became part of the mix of services the investment banking firm offered clients.

Mr. BENTSEN. Let me ask you this. I mean, hasn't the analyst position always been part of the mix of investment banking and the mix of the trading and underwriting? I mean, haven't brokerage houses always relied, at least for internal purposes, for their own internal credit risk purposes, on the work of their research analysts?

Ms. UNGER. Well, I hate to do this, because it always seems like we point to the deregulation of commissions as the pivotal point for changes in the industry, but I do think that had some impact on the underwriting business. Commissions were where most of the money was being made by Wall Street at that time, and deregulation changed the focus of that business and how that business was conducted, and what made it profitable.

I think analysts have probably always been involved in the deals, but not to the extent that they are now, and not to the extent that they have become so idolized in some respects.

Mr. BENTSEN. Well, they have become the masters of the universe, I guess, of the 1990s, as opposed to the investment bankers of the 1980s, at least in the media's eyes.

Let me ask you this. Is there anything under the existing securities laws that subjects analysts' documents, analysts' reports or whatever, to the same disclosure requirements that are required of offering documents. And if not, should there be?

And furthermore, didn't the Commission, just a few years ago, pass—I can't remember what the colloquial term was for this—but a plain English approach to the writing of offering documents so that they would be more easily understandable and possibly used by the public?

Ms. UNGER. Well, it's interesting, because you raise, I think, a critical point in the discussion which is not only have the dynamics of the marketplace changed the role of analysts, but the role of research reports themselves and the extent of their availability have also changed. Investors can now access research reports that they were not able to before, as a result of the internet.

So what does this mean in terms of how the Commission needs to educate investors about the conflicts, and what investors need to know in using these research reports? Yes, there are the offering documents; yes, they are subject to review by the Commission, but we don't have the resources, nor would we want to be engaged in merit review with respect to the contents of a research report.

Mr. BENTSEN. Well then, in fact, the law doesn't cover the research documents in the same way, I don't think, as it does the offering documents.

Let me ask you one more question.

Ms. UNGER. Well it's slightly different, because Section 11 is strict liability for what is contained in a registration statement.

Mr. BENTSEN. Right.

Ms. UNGER. Section 10(b), the anti-fraud provision, applies to everything.

Mr. BENTSEN. Let me ask you this, because my time is up, but I want to ask you this. Can you be concerned about conflicts of interest between analysts and companies and be opposed to Reg FD, and be consistent?

Ms. UNGER. I'm sorry, can you repeat that?

Mr. BENTSEN. Can you be concerned about potential conflicts of interest between research analysts and the companies that they review and the relationship with the investment banks, and also be opposed to Reg FD and be consistent?

Ms. UNGER. Me personally?

Mr. BENTSEN. In general.

Ms. UNGER. Yes, I think you can, because I think you can note that the conflicts exist, but I believe that Regulation FD does not cure the conflicts. Reg FD goes to communications between an issuer and an analyst and not to insider trading, which was purported to be the original objective or reasoning for Reg FD's adoption.

So it depends how far you want to go with the conflicts. The conflicts are the underpinnings of the discussion on both Regulation FD and today's hearing, but in a very different way.

Mr. BENTSEN. Thank you. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Bentsen.

Mr. Castle.

Mr. CASTLE. Thank you, Mr. Chairman. I have an opening statement which I would like to submit for the record.

Chairman BAKER. Without objection.

Mr. CASTLE. Thank you.

Ms. Unger, I have some questions. I've got to tell you that this whole practice bothers me a tremendous amount. And I, in my opening statement that I've just submitted, state that I don't think we should legislate in this area. But I'm just not sure anymore. I mean, I'm becoming more and increasingly concerned. I mean, there could be anything from just bad analysis which of course should not be punishable by anything to the classification situation, to the so-called "hold" business, which apparently is a red flag to sell which most of us never understood, except for the analysts owning the stock, to the firm for which the analyst works owning the stock and the retirement accounts or otherwise, or other individuals just having big placements in that particular stock that the analyst is recommending or the investment banking side of the firm owning it, or the analysts' compensation being tied to overall profits of the firm for which the analyst works, or the analyst being involved in the early IPOs at a lower price than the IPO is going to come out, and then huckstering it in some way or another, either verbally or in writing some way or another.

Are there any situations such as that where the SEC does step in now?

Ms. UNGER. Step in and do what?

Mr. CASTLE. Step in and enforce, do something about it?

Ms. UNGER. There are instances——

Mr. CASTLE. Are any of those things violations of laws or regulations at this point?

Ms. UNGER. I wish you had asked me that before you enumerated them. None of them jumped out at me as violations of the law, but I will say that the Commission looks very closely at what's disclosed, whether there was material information that was not disclosed by an analyst and the firm's involvement in recommending and selling. But sometimes you can't just look at one particular activity—you need to look at the whole picture to really get a sense of whether it's an area for an enforcement action or not.

But yes, we brought cases involving analysts.

Mr. CASTLE. You have brought cases that just involve the analyst side of it, is that?

Ms. UNGER. Well, we've brought cases where an analyst was making reckless statements——

Mr. CASTLE. Are these penny stock-type cases or are these major firms that may have these conflicts in which you've brought the cases?

Ms. UNGER. There's a handful of cases that I could get you more information about if you're interested.

Mr. CASTLE. I mean my judgment is there have been billions of dollars put on the table as a result of a lot of these practices and which probably occasion losses of a tremendous amount. Do you trust the industry itself to be able to do this as a self-regulatory matter, or does the SEC have to get tougher with its enforcement in order to back that up? Or should we be passing laws up here which frankly I'm loathe to do, but is that something we should be considering?

Ms. UNGER. Well, I think there are three prongs. One is compensation, one is the accountability of analysts to investment banking, and the third is the stock ownership. And I think you need to look at each one of those individually in determining whether or not there are issues that need to be addressed.

I think there are disclosures that apply in each of these areas and there are existing rules that, as I said earlier, need to be harmonized and clarified and followed. And I think we need to do a better job, the industry and the SROs need to do a better job in inspecting firms to make sure that they comply with rules that are on the books and rules that are about to be improved that will be on the books.

I also think that the firms need to do a better job of ensuring compliance with their existing internal policies and procedures, most of which exist at the firms that were inspected, most of which are not being enforced adequately today.

Mr. CASTLE. Well, and you're right. I mean, there's a whole level of enforcement in various ways. But do you believe that the SEC should change its rules and regulations or specifically its enforcement mechanisms to address some of the problems which you have spoken to in your opening statement, which we've had another hearing, which I'm sure you're familiar with, and which is going to be continued later today by another panel involving a number of the different situations that I have set forth, all of which you're familiar with in terms of different practices that are at least questionable.

Or do you think the SEC is fine the way it is?

Ms. UNGER. The SEC has broad antifraud authority. We have ample authority to bring cases involving fraud and violations of Section 10(b) and Rule 10(b)(5). The first line of defense in this whole discussion about managing analyst conflicts really are the SROs whose rules deal with this more directly than the Commission.

Again, I think we all need to do a better job. I think of course the Commission is doing a great job, but we need to do more in our oversight of the SROs in making sure that they conduct the inspections and examinations that are needed to determine whether the firms have the appropriate policies and whether the policies are being followed.

I think that's really the first step that we need to take in this discussion which I think is why the Chairman of this subcommittee is asking about ways to improve enforcement efforts and make the firms accountable to the public in terms of what they're doing internally.

Mr. CASTLE. Well, my time is up, but I mean, this won't be a question but, you know, I think it's our job to worry about the consumer out there. I can't worry about the big firms, I can't worry about the practice of the SEC, but I think a consumer should be able to look at an analyst's recommendation on a stock and it could be wrong, but at least it should be done with integrity and honesty and they get a pretty good idea of what they're dealing with.

Until we've gotten to that point, it seems to me we all haven't done our job. And I yield back the balance of my time.

Chairman BAKER. Mr. Castle, just to finish up on your point, in earlier questions to Ms. Unger, I've made reference to her footnotes of her own document. In just one transaction, the fellow profited $3.5 million by selling his interest while publicly telling his clients to buy. On its face, unless it's the gentleman's estate—that's the only reason I could see it would be OK—that in itself is a serious problem, and yet that is under advisement at the moment for determination as to whether action is appropriate or not. That is a very large concern. Your point is right on target.

Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman.

I wanted to follow up. Did I hear you respond to Mr. Bentsen that you don't have the resources to do some of the things you'd like to do?

Ms. UNGER. We would always like to have more resources, but I don't think that merit review of analyst research reports is something that's appropriate for the agency, given our mandate as it exists today.

Mr. KANJORSKI. So in order to have you do something, we would have to enact statutory law to give you greater authority or direction to do that?

Ms. UNGER. I guess you would, but I also don't think it's a good idea. With all due deference to this subcommittee, I think the problem is in managing the conflicts. Whether the Commission reviews the substance of the research or not, you still have the issue of the conflicts and managing those conflicts.

Mr. KANJORSKI. Let me direct ourselves to some of those conflicts. The Chairman and I were talking when we went over to the vote, particularly about these transactions that you mention in your testimony. One example is that of pools of analysts that were investing and giving advice to buy when, in fact, they were selling, and, in fact, they were making single transactions in the range of $100,000 to $3.5 million.

I think the Chairman made the observation that if this activity happened in Louisiana real estate, there'd be somebody in jail.

Chairman BAKER. That's a pretty bad comment too. You know, when you think about it, when we put anybody in jail in Louisiana, they've got to really be out of it.

Mr. KANJORSKI. And I tend to agree with him. Doesn't that constitute fraud? Forgetting conflicts, isn't that just out and out fraud?

Ms. UNGER. I did say we were reviewing these particular transactions.

Mr. KANJORSKI. How long ago did these transactions happen, Ms. Unger?

Ms. UNGER. 1999 and 2000.

Mr. KANJORSKI. So they are almost 2 years old and we're still reviewing those transactions? The reason I asked you how long is because I recall from law school that most of the court decisions on bills and notes were around 1934, 1935 and 1936. It seems to happen that we want to find somebody at fault or responsible when the market crashes.

What I am wondering is why these transactions were going on when the market was pretty healthy in 1999 and 2000. Are you intending that we realize that you didn't know at that time? Did you just found out recently? Or did you know in 1999 and 2000 before the market crashed?

Ms. UNGER. Well, no, we did just find out last month, and in fact, I think it would be highly unlikely that anyone would be making that kind of money in today's market.

Mr. KANJORSKI. OK, but when did you find out about it, I said?

Ms. UNGER. Pardon me?

Mr. KANJORSKI. When did you find out?

Ms. UNGER. We have just been conducting these reviews about analyst conflicts.

Mr. KANJORSKI. So there isn't any reporting or any way that you could pick that up without doing these reviews?

Ms. UNGER. No. There are inconsistent requirements that exist currently, SRO requirements, about the firms' disclosure of stock ownership.

Mr. KANJORSKI. Did they make the proper disclosures in a timely manner?

Ms. UNGER. This is what I'm trying to explain to you. Of the firms we inspected, which were nine firms that account for the majority of the IPO and technology underwritings, only one of the firms was able to give us a list of employees who invested pre-IPO in a company that the firm had as a client.

So in fact, the internal controls at the firms apparently did not require this information.

Mr. KANJORSKI. And you have no regulations that require that internal information?

Ms. UNGER. They are required to make the disclosure.

Mr. KANJORSKI. Under your regulations they're required to make it?

Ms. UNGER. No, under the SRO regulations, they're required to disclose in the research report, depending on which regulation you're looking at, the firm is required to disclose certain ownership positions.

Mr. KANJORSKI. I understand that. I have limited time, and I'm trying to rush you along.

What I understand is they didn't make the disclosure, and they may not have had the internal controls to do that. However, neither do you have the internal controls to know that they weren't doing that.

Somebody here is responsible at the end to know whether or not these SROs are doing what they are supposed to do, or whether or not you have a requirement to find that out in a reasonable time: I think 2 years is beyond a reasonable time.

And then for you to tell me you're reviewing these things; these guys may retire or die before you get all done with those reviews. And I think the Governor made a good point. You know, we're not worried about the big, the conflict, quote: "that may exist between the analyst and his own company." I don't know if there is a clear conflict with those ten million people who are watching nightly television and listen to this guy saying, "Oh, this is a great buy." And I watch them every night. And I have yet to hear anybody telling me to sell. And they're still doing it. And every now and then they do say, "Oh, our company does have stock in them or represent them in some stock offering." I don't understand it.

I want to get to the point. What I'm indicating to you is, if you don't have the authority to test whether the SROs have internal controls and are properly reporting or having transparency back to the SEC, then you should be up here asking us for that authority.

But second, I'm worried about another thing that I brought up in my opening statement. You're sitting back here and there is a public policy decision that's going to be made probably in the next 6 months or a year, but certainly within the next 18 months, to privatize Social Security. We're going to throw 160 million consumers into the marketplace, 25 to 30 percent of which are functionally illiterate. That 25 to 30 percent are going to be guiding their own accounts.

Has the SEC started to enlarge its structure and anticipate what is about to happen, which could cause massive fraud and conflict of interest if all these billions of dollars and millions of people come into the marketplace? Or are you just going to wait around and have this happen and then come in and say—2-3 years after the fact, that you have a problem?

Aren't you anticipating that if we, as a matter of public policy, decide to privatize Social Security, then we are putting at least another 80 to 100 million people into the market that have never been there before? And aren't a good portion of these people not qualified to read financial statements and understand this information? Many certainly are not qualified in "newspeak," and I think that is what we are talking about here. We're in 1984. These people are using terms that are not standardized. The language that sometimes is only understood within their own house or within a limited number of houses, but certainly not by the general public.

And it just seems to me that the SEC ought to be proactive in anticipating what is about to occur, what may occur. Looking back at these experiences that you have been reviewing for the last 2 years and anticipating how they will be compounded if we put another 50 or 80 million people into the marketplace.

Instead, 2 years after we do that, we are going to have a hearing within the halls of Congress filled with a lot of middle-aged and older people that will claim that we led them down the primrose path. They will say we drove them to take their 2 percent of Social Security and invest in these horrendous start-up entities that weren't regulated, weren't controlled, and didn't have transparency: and they will claim "people were telling us to buy and we bought, and then some people who were telling us to buy were selling and cleaning up and making $3 million per transaction.''

What is your response to that?

Ms. UNGER. Are we talking about Social Security or analysts' conflicts now?

Mr. KANJORSKI. I'm talking about looking at what we've already seen in a hyper market in 1999 and 2000.

Ms. UNGER. Just the market generally?

Mr. KANJORSKI. With analysts and anticipating what may happen if we enlarge this market by 80 million more customers?

Ms. UNGER. Well, as part of my testimony, I said I thought the SEC's role in analyst conflicts was disclosure and educating investors. We have put out a very comprehensive and well-received ''Investor Alert'' about analysts' conflicts so that investors would understand exactly what we're talking about and to highlight for them what analysts' conflicts are and how they should approach interpreting a research report.

I would never counsel, and I think many people have said that no investor should rely exclusively on an analyst research report or recommendation in making an investment decision. The Commission generally is very proactive in terms of investor education.

I presume that if Social Security were privatized and there were special needs presented to the marketplace and to the Commission, we would attempt to fulfill those special needs by outreach in further investor education.

With respect to the analysts' conflicts we're talking about today, it was the SROs' responsibility to supervise and monitor and inspect for the private investments by the analysts and the firms at which the analysts work.

Mr. KANJORSKI. I love the terminology education and I do appreciate it and I hope you're very successful in educating all the people that are in the marketplace today. However, I doubt that you are going to give them the equivalency of a working understanding of the marketplace and terminology, but I'm not talking about those people. I'm talking about knowledge that there are 20 to 25 percent of the American people that are functionally illiterate. They cannot even fill out an application form, let alone read a profit and loss statement or a balance sheet.

Are you suggesting to me that you're going to put together an investor educational program that are going to take 25 percent of the American population's functional illiterate and have them understand what they need to understand to be privatized and investors in the marketplace and not have to rely on analysts or security house recommendations?

Ms. UNGER. Well, if they are functionally illiterate, they're not reading research reports either, are they?

Mr. KANJORSKI. No, I doubt it. That's why I'm suggesting that.

Ms. UNGER. Just checking.

Mr. KANJORSKI. Well, that's the next question. Have you been asked for, or have you been given by either the Commission or this Administration, recommendations as to whether or not we should privatize Social Security and put 160 million more Americans in the stock market? And are they qualified by basic learning and education to manage their accounts, or are we setting them up for a tremendous let-down?

Ms. UNGER. Commissioner Carey, who recently passed away, was the Commission's expert on Social Security privatization and he did a lot of work on that. And I commend him for that work. He, however, is no longer with us, and we have not yet determined who will take on that responsibility at the Commission.

Mr. KANJORSKI. Are you prepared though to make a recommendation to the Congress?

Ms. UNGER. We have not adopted a Commission position yet on Social Security privatization. There've been numerous different permutations of how that could occur. We would be happy to participate in any discussions about Social Security privatization.

Mr. KANJORSKI. Could you succinctly tell me, though, have you made a recommendation, positive or negative, on that particular issue? Are we prepared to see 40 million functionally illiterate Americans put into the market?

Ms. UNGER. We have not adopted a Commission position.

Chairman BAKER. We'll have to move on.

Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman.

Chairman Unger, one of the things I was going to ask about is the interviews that we have with people who are analysts, the information that we've received indicate that one of the things that's changed on Wall Street is the business model. One of the things that used to drive profitability was revenues from research and trading, and as that began to decrease, it was supplanted instead by enormous revenue gains from initial public stock offerings. As you saw a 15-fold increase over a decade in the fees coming into the firms, then the business models changed.

And the allegation here is that included in that change was a change in the way the analysts were compensated. In the past, bonuses were given to analysts based on research quality, or on the brokerage arm's profitability.

Now it is common for those bonuses instead, and typically this would be the bulk of their annual compensation at most of the firms, to be tied to the amount of banking business that they generate for the firm. And that change in business model could explain a lot. It certainly could explain the disparity between positive and negative recommendations. Could it be that analysts are fearful of offending their banking colleagues and fearful of those existing underwriting clients or potential underwriting clients? I mean, why would it be that only two percent of the stocks covered would have that sell rating? I mean, that's one of the things I wanted to ask you.

Another question that I had, we have a witness coming on to the next panel and he submitted his testimony in advance, Chris Byron. And he calls this an outrageous situation. He says IPOs are offered to investment bank clients at cheap pre-market prices even as the bank's analysts engage in non-stop commentary designed to pump up demand for the stock in the after-market.

And I wanted to ask you also what is your view of that practice, OK?

Ms. UNGER. OK. I will try to address those questions in totality.

Mr. ROYCE. Thank you.

Ms. UNGER. I agree that there has been a change in the business model which has led to a lot of what we're talking about today. It's not just the investment banking client that applies the pressure though; it's also the institutional investors who don't want their investments downgraded. Firms are competing for underwriting business, and favorable analyst coverage is part of the package.

No investment banking firm will take a company public that its analysts couldn't issue favorable research about. Why would they? Nor would a company want to have an underwriter like that. So, in a sense, they become intertwined at the very beginning, which accounts for why you see a large number of favorable research recommendations. The business itself demands that, and it makes sense. Many firms do not bring many deals for that reason.

Mr. ROYCE. Should we then rename them from analysts to salesmen?

Ms. UNGER. Well, that's sort of the gatekeeper function of the firms and the analysts that have become part of that. Once the company goes public, the analyst issues a report, which we know is going to be favorable, 25 days later. Then the firm begins putting its clients into that stock, a lot of which are the institutional investors with sizable portfolios.

As you can imagine, the research is favorable, there may come a point when the analyst says, "Gee, this company's not doing as well as I thought it was going to, I'd like to change the rating." Well, consider all of the pressure that's applied by the company with the investment banking relationship, the institutional investors where the firm has a stake in its commissions and with its relationship, and perhaps stock ownership on the part of the firm or the analyst.

I don't know that you can ever eliminate these conflicts and I'm sure there is some good in all of it in terms of understanding the company and the dynamics and everything else.

What I do think you can do is manage the conflicts, and the way I think you can manage the conflicts is to have the investment banking firm disclose the analyst's involvement in the deal, and to have disclosure if the analyst owns stock in a particular company that it's issuing research reports about, and have that all be very clear to the investors, so that the investor understands any potential conflicts and can take that into account.

I think we're not even seeing that threshold disclosure at this particular point. I think we're seeing that stock ownership exists, that the pre-IPO share allocations exist, and that there's considerable influence exerted over the analyst by the investment banking part of the firm, but we are not managing all of that very well right now, in terms of disclosure.

Mr. ROYCE. And I guess for the SEC and for us, one of the critical questions is, how is that disclosed in a way that the small investor really comprehends, really sees that disclosure, as opposed to the institutional investors? How do we do this in a way that the market really understands?

Ms. UNGER. And that question really takes us full circle, because the reason that this is a discussion that many people are having now is because of the broad dissemination of research reports and the fact that they are reaching the individual investor who may not be as experienced in interpreting the documents and knowing what the conflicts are.

So that is the challenge of the SEC in terms of educating investors, and that's what we try to address in our Investor Alert that we released last month.

Mr. ROYCE. We have a long way to go.

I thank you, Chairman.

Chairman BAKER. Thank you, Mr. Royce.

Mr. Toomey, you're up.

Mr. TOOMEY. Thank you, Mr. Chairman.

I'd like to first follow up briefly on a line of questioning that my good friend and colleague from Pennsylvania made earlier about Social Security accounts and his concern that 25 percent of the American public is insufficiently literate to accumulate savings in personal accounts.

I would point out that most of these people have jobs, they buy homes, they raise their children, they do lots of things in life, and I think if we suggest that they are not competent to invest their savings, we may not be giving them the credit they deserve.

Furthermore, I would observe that any mechanism by which investments would be made in personal accounts within Social Security has yet to be defined. It's entirely possible that it would consist of choosing from a range of funds in which the individual investor would never have the occasion to actually attempt individual stocks. So I, for one, hope that you won't suggest any major new policies and initiatives in anticipation of what I do hope will be a significant move to allow personal accounts within a reformed Social Security.

But my first question for you, I'd like to harken back to an example that's been referred to several times and the suggestion that an analyst who sells a stock, while recommending a buy, has prima facie committed fraud and that this is outrageous. Now I'm not defending any particular individual or circumstances that I'm not familiar with. But perhaps you could comment. It seems to me that one could recommend a buy on a stock while selling it into one's personal account, and that there might not be anything wrong with that whatsoever.

There are a lot of reasons a person might choose to sell stock. It could be the individual simply needs to raise cash for any number of reasons. It could be that the person's portfolio is too concentrated in a particular industry or too concentrated in that particular company. It could be a function of the profit that's been accumulating in a particular holding, and the person's own personal investment criteria.

But would you agree that selling a stock while recommending a buy in that stock is not necessarily evidence prima facie of fraud or even any nefarious activity on the part of the analyst by itself?

Ms. UNGER. And I'm glad you raised that point, because I would hate for this subcommittee to walk away today thinking that it is prima facie evidence of wrongdoing. We would need to conduct a very fact-intensive review of exactly why the analyst was acting contrary to the recommendation. There are firm policies that have very specific times and circumstances under which an analyst can buy or sell contrary to a recommendation.

I'm not sure that in this case, or these couple of cases that we're talking about, that was done. If it was so clear and it was prima facie, we would have brought those cases. So that I'm sure we are assessing exactly what you are describing and that is whether there other reasons for the selling in the account.

I have heard anecdotally that firms have very strict procedures in terms of looking at the overall portfolio. I'm confident that firms are able to make and develop internal policies to make sure that it happens under the proper and appropriate circumstances.

Mr. TOOMEY. Thank you. Perhaps you could comment on this idea, that there are no consequences for firms which would engage in inappropriate compensation or creating incentives for analysts that they ought not to have.

I disagree with that. First of all, I think there's a very competitive marketplace out there. There are a lot of alternatives for any investor, and we've seen the industry take many steps already. The securities industry has put forward an industry best practices guideline, there are rating agencies that assess the performance of analysts' recommendations, individual firms disclose their underwritings, and it is public information what kind of underwritings are going on.

As you pointed out, the SEC has done an alert which strikes me as the obvious, that investors should not rely solely on the advice of a particular analyst. And when I look at all this in a cumulative sense, it strikes me that certainly most investors, the overwhelming majority, it's going to occur to them that they ought to have a certain amount of skepticism about what an analyst recommends, and that that should be one of various factors that they would include.

But there are alternatives for investors. There are consequences imposed by the marketplace and we ought not go too far in trying to impose regulations on this.

Ms. UNGER. I think you're right, we ought not go too far, but I think all we're talking about today or all I'm recommending today is that we follow the existing rules and actually improve the existing rules to make clear what the disclosure obligations are of the firm and the analyst and to follow those rules. For firms to either follow the best practices or their own internal procedures that they've already established and to actually enforce those.

And I think that's the first area that we need to focus on in terms of managing the conflicts.

Mr. TOOMEY. Thank you. I yield the balance of my time.

Chairman BAKER. Thank you. Just for the record's sake on whether or not folks trade inappropriately, I think I recall you making the comment that of the firms you surveyed, only one could tell you all the positions of every analyst. It would make it rather difficult, I think, to make the judgment that the firms are therefore making appropriate disclosure over these matters when they don't know what the investments are. That's my point.

And second, the statement that there are perhaps adequate rules in place, but I believe, in accordance with your own observation, that they are not being followed, is the core of the problem. And if we don't bring enough attention and focus on it, practices are not likely to change.

I do appreciate your appearance here. There are a number of questions that I would like to follow up with. For my own sake, and for any of the subcommittee, we'd like to hold the record open for a few days and perhaps submit additional inquiries for the record. And we do very much appreciate your courteous participation today. Thank you, Ms. Unger.

Ms. UNGER. Thank you very much.

Chairman BAKER. We'd like to have our second panel come forward, please.

Welcome. I'd like to get started with our panel. I regret we have so much territory to cover and such a distinguished panel of witnesses here today. Without further ado, I'd first like to call Mr. Ron Glantz, former Managing Director, Tiger Management, former Director of Research and Chief Investment Officer of Paine Webber. Incidentally, in light of your written testimony, I think I need to say you're rated by Institutional Investor for seven consecutive years as the top investor. So I particularly appreciate your willingness to appear here today, sir. Welcome.

STATEMENT OF RONALD GLANTZ, FORMER MANAGING DIRECTOR, TIGER MANAGEMENT, FORMER DIRECTOR OF RESEARCH AND CHIEF INVESTMENT OFFICER, PAINE WEBBER

Mr. GLANTZ. Chairman Oxley, Chairman Baker, Ranking Members LaFalce and Kanjorski, and Members of the subcommittee, thank you for inviting me to testify on Wall Street's research practices.

My name is Ronald Glantz. I was in the investment business for 32 years before retiring last year. I began my career on Wall Street as an equity research analyst. Money managers polled by Institutional Investor Magazine selected me the top analyst in my field for seven consecutive years. I then became Director of Research, Chief Investment Officer, Director of Economics and Financial Markets and a member of the Management Board of Paine Webber, one of the largest brokerage firms in the United States.

I ended my career as a Managing Director of Tiger Management, one of the largest hedge funds in the world. This has given me a good perspective on how the role of analysts has changed over the last three decades.

When I began in the business, the top-rated equity research firm was named Laird. Within 5 years it failed. So did most of the other top-rated firms. What happened? When I began, the average commission was over 40 cents a share. A few years later, institutional commissions became negotiated, almost immediately falling to less than six cents a share. The only way for research firms to survive was to merge with someone that could spread research costs over a larger base, usually brokerage firms whose main clients were individual investors.

Retail commissions had remained fixed and retail brokerage firms discovered that good research helped them gain retail clients and stockbrokers. By the end of the 1970s, the largest number of top analysts were at Paine Webber, which had bought the top-rated research firm, and Merrill Lynch, which hired talent from failing research firms.

Meanwhile, as analysts became more influential, companies increasingly pressured analysts to recommend their stocks, since a higher price means fewer shares have to be issued when raising new funds or acquiring another company, they are less vulnerable to being taken over, executives make more money when they cash in their options, and shareholders are pleased.

It is easy to reward favored analysts. They are given more access to management, "helped" in making earnings estimates. They'll even call you up and tell you that your estimates are too high or too low, and invite you to resorts for "briefings." And most important, their firm receives lucrative investment banking business.

Companies penalize analysts who aren't sufficiently enthusiastic. Let me give you a personal example. When I was a brokerage firm analyst, I downgraded a stock. The company's chief financial officer called my firm's president to say that unless I recommended his stock, he would cease doing investment banking business with my firm, and would order the bank which managed his company's pension fund to stop doing any business whatsoever with my firm.

I have seen top analysts removed from company mailing lists, their telephone calls left unreturned, and even physically barred from company presentations. Once I was doing a reference check on an analyst I was considering hiring. A chief financial officer told me that the analyst was disliked so much that he was deliberately given misleading information.

In 1980, top analysts made just over $100,000 a year. Today, top analysts make up to $20 million a year. How is this possible, considering that institutional commissions have fallen even further and brokerage firms now discount retail commissions to avoid losing customers to such firms as Schwab and e-Trade?

What happened is that brokerage firms discovered that highly rated research helped them gain investment banking clients. Soon the largest number of top analysts were at investment banking goliaths such as Morgan Stanley and Goldman Sachs. They could pay considerably more because investment banking transactions were much more lucrative than trading stocks. The institutional commission on trading $300 million worth of stock was only $300,000, of which less than $25,000 would go to the research department. This barely paid for printing and mailing research reports on that company. However, underwriting a similar dollar value of a new issue would bring in at least $10 million, and bankers thought nothing of giving a million dollar fee to the analyst responsible for the business. A merger or acquisition could bring in even more. Soon, firms were including anticipated investment banking fees in the contracts they offered analysts. The huge fees earned by investment banking gives them the ability to influence and, in some cases, even control the equity research department. As we all know, whoever "pays the piper" names the tune.

Analysts used to view retail customers and investment managers as their clients. My first boss told me "widows and orphans depend upon you to give good advice." Now the job of analysts is to bring in investment banking clients, not provide good investment advice. This began in the mid-1980s. The prostitution of security analysts was completed during the high tech mania of the last few years. For example, in 1997 a major investment banking firm offered to triple my pay if I would join them. They had no interest in the quality of my recommendations. I was shown a list with 15 names and asked, "How quickly can you issue buy recommendations on these potential clients?"

Let me pause here to assure you most analysts still want to give good advice. Not only is it the right thing to do, it helps their reputation, which brings in investment banking business. Nevertheless, the pressures are enormous.

When I was Director of Research, analyst compensation was based upon the performance of his or her recommendations, commissions generated, and ratings by institutional clients and the retail system. Today, name analysts are given guaranteed contracts, whether or not their recommendations are any good. Every year, *The Wall Street Journal* lists the analysts who have provided the best investment advice. These analysts are rarely the best paid in their field.

Why is that? Investment banking. It is an open secret that "strong buy" now means "buy," "buy" means "hold," "hold" means that the company isn't an investment banking client, and "sell" means that the company is no longer an investment banking client.

[Laughter.]

Mr. GLANTZ. Less than one percent of all recommendations are "sell." Some analysts call their best clients and tell them that their real opinion differs from their published opinion, even though this is illegal.

But what about the individual investor? No one told my 86-year-old widowed aunt that the internet stocks she was buying in 1999 had no hope of ever earning any money, or that the analyst recommending purchase was being paid by investment banking.

Investment banking now dominates equity research. Bankers often suggest and are usually asked to approve hiring analysts from other brokerage firms. Investment banking provides the bulk of proven analysts' pay package. Some analysts report directly to investment banking. Analysts routinely send reports to the companies and to bankers for comment before they are issued.

Three years ago, Tiger was able to hire the top-rated analyst in his field from a Wall Street firm. This analyst had consistently been negative on one company, a major source of investment banking fees, because of its many acquisitions. Then his firm hired an investment banking team from another brokerage firm. As reported in the *Wall Street Journal*, the analyst was fired so that a more "compliant" analyst could be hired, one who would recommend potential investment banking clients. Disillusioned, this analyst moved over to money management where the quality of recommendations was still more important than the quality of relationships with potential buyers of investment banking services.

To give one of many personal examples, 4 years ago I came up with some extremely negative information on a company, including bribery, defective product, accounting irregularities, and serious pollution problems. I called the three most visible analysts recommending the stock, one of them the top-rated analyst in his field, and gave them my evidence. Every one of them continued to recommend the stock. Why? This company was an investment banking client. Incidentally, within a year, every member of top management was thrown out and, of course, the stock plummeted.

The genie has been let out of the bottle. As long as investment banking is the most profitable part of the firm, then investment bankers will find a way to pay analysts who bring in business. Money managers can hire their own analysts. But my elderly aunt will never know whether the advice she is receiving is unbiased or not. That's not only bad for the average investor, it undermines one of the primary reasons for having a stock market—the efficient allocation of investment dollars.

My proposals can only address part of the problem. At the least, brokerage firms should list in large type on the first page of all buy recommendations any investment banking business they have had with the company over the last 3 years and any equity ownership by the analyst, members of his or her immediate family, or the firm.

Second, no buy recommendation should be permitted if the analyst, members of his or her immediately family, or the brokerage firm purchased stock or options for their own account in the month preceding the report, nor should they be permitted to sell stock until 3 days after a sell recommendation is issued.

Third, any shares purchased of a new issue by the analyst, members of his or her immediate family, or a money management arm of a brokerage firm should be held for a minimum of 1 year.

Thank you, I would be happy to answer any questions.

[The prepared statement of Ronald Glantz can be found on page 241 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Glantz.

Our next participant is Mr. Christopher Byron, Syndicated Radio Commentator, Columnist for MSNBC.com.

Welcome Mr. Byron.

STATEMENT OF CHRISTOPHER BYRON, SYNDICATED RADIO COMMENTATOR, COLUMNIST, MSNBC.COM

Mr. BYRON. Thank you very much, Chairman Baker, distinguished Members of the subcommittee.

Chairman BAKER. I should make a special notation. As our MSNBC.com and also our *Bloomberg News* participant, you are our first media-related types willing to stand in front of the subcommittee in a public forum. I welcome you for that reason.

Mr. BYRON. Before I go any further, I want to thank the subcommittee enormously for inviting me to appear before it and give me this opportunity to do just that. It's an enormous personal honor and a pleasure to be able to appear before you and give testimony on a subject that I've written about in one form or another for a number of years now in various publications that I write for.

You've asked me for some brief biographical information about myself, and I'll give you that very quickly. I'm a magazine, newspaper, and internet columnist and radio commentator. My columns appear weekly in the *New York Observer* newspaper, on MSNBC.com interactive on the internet, where I host a daily webcast radio show called "High Noon On Wall Street." I also do a radio show called "Wall Street Wake Up with Chris Byron" that's syndicated on 40 AM radio stations around the country, and I write a monthly column for *Red Herring* magazine as well.

Over the years, I've written for a great number of newspapers and magazines. They are listed in my submitted testimony. I won't bother you with them now.

The subject that we are about here today is enormously important to me personally, because it affects what I do for a living. The changing role of financial analysis and journalism on Wall Street is a very important topic for a whole variety of reasons.

I have a long perspective on this subject. When I came to Wall Street as a reporter in 1968, the beginning of 1969 was at the tail end of the go-go 1960s bull market. Three decades later, I'm still here covering essentially the same material that I covered then. A lot of the money and equity markets of America, now the world, a lot has changed in that time. When I came to Wall Street as a reporter in 1969, not a single person I knew, including myself, owned a computer. I had never seen a computer. Today, I know of no one who doesn't work with a computer.

When I came to Wall Street as a reporter, it took days, sometimes a week or more, to get my hands on the most single valuable asset that any writer in this subject area, any investor, any financial analyst or reporter can have, and that's an audited financial statement from a company.

Today, that information is instantly available to anybody with a desktop computer, a telephone connection, and a dial-up service on the internet. There's also been an enormous explosion in the public's interest about financial information itself. When I began covering financial markets at the end of the 1960s, The *Wall Street Journal* was generally viewed by people in my profession as kind of a second tier publication. There was no CNBC, no CNFM, there was no internet. Now *The Wall Street Journal* is regarded as one of the world's premier newspapers. Electronic media likes CNBC, MSNBC.com on the internet all have global audiences on every continent.

I'll give you one personal illustration of this, and I think it is sort of revealing about the kind of thing that we're talking about here. I do, as I said before, a daily noon time webcast radio program called High Noon On Wall Street With Chris Byron. It's carried from my home office in Connecticut via a distribution system provided by Microsoft in Redland, Washington to 24 time zones around the world simultaneously. I must tell you, it is pretty daunting to sit in my den at noon every day and start to offer opinions and commentary on whatever happened in the market in the last 3 hours, and instantly receive back from every continent on the earth, emails from people listening to what I'm saying and saying "Byron, that's a great point," or "You're an idiot, you don't know what you're talking about."

It's really a very, very large audience that reacts instantly to financial information all over the world.

There's one thing, however, that hasn't changed in the 30 years that I've been doing this job, and that is fundamentally Wall Street remains what it has always been: the place you go to get the money. That's where the money is.

You may hear discussions from time to time about socially responsible investing and phrases like that. But the reality is people go to Wall Street to get the money and the promotion of concepts like socially responsible investing, and phrases like that are simply another way to enable them to get the money.

The financial markets of Wall Street are, in my personal opinion, the single most successful self-regulatory arena the United States has had, at least in my life time. I think that's because people are, generally speaking, honest by nature and we have the oversight capacity of the Securities and Exchange Commission hovering in the wings over the self-regulatory bodies that we've been talking about this afternoon.

But there's something different now. There's a huge, huge amplification of voices provided by the digital age. This is creating what I think are really important new difficult challenges for the self-regulators and for the SEC. I think you can make a convincing case that this entire tech sector bubble that we saw begin in the mid-1990s, swell over the following 4 years, the last two of which the NASDAQ composite index nearly tripled in value, and then popped like a champagne bubble and just disappeared in the glass, was caused by, and I think the responsibility lies directly at the feet of the amplifying megaphones of the digital age, the internet, the world of cable television, and the access to them that financial analysts and compliant journalists have which reaches investors all over the earth.

This has huge and obvious policy ramifications for Congress, in my opinion, because the collapse of the market, the NASDAQ national market is in collapse and we would be remiss to call it anything other than that. It has lost over 75 percent of its value from its stock. Some of it's come back, but it is still way, way off.

This has brought an end to the longest running bull market we've known in this country's history. It now threatens to tip the entire economy into recession. No one has any clear idea what to do with it. Trillions of dollars have vanished from the economy by the implosion of what Federal Reserve Chairman Alan Greenspan referred to as the "wealth effect" created by this bubble and the dot.com stocks that were in effect the miner's canary of that bubble.

The Bush Administration and the Federal Reserve are now engaged in efforts to replace it with a combination of tax rebates, lowered short term interest rates. No one is entirely clear whether this is going to work or not. But if prices hadn't been pumped up to the levels they reached in the first place, they wouldn't have fallen as far as they have, and we wouldn't now be groping for a way to pump them back up again.

This bubble was financed largely by individual investors. And it is the Wall Street analysts and the media voices that helped turn the analysts into pseudo-celebrities whom I believe now have to bear the consequences for their actions, the responsibility for their actions. In some cases, we've seen what I thought I would never see in my life time in this business which is the spectacle of professional investors, who simultaneously wear a hat purporting to be an analyst, an investor and a journalist simultaneously.

I think is just a circle. You can't square and you can't put any kind fine line, fancy talk around it. Those three things don't go together. For nearly 4 years from the Yahoo IPO in 1996 to the deluge of IPOs that spread across Wall Street in the first 3 months of 2000, the analyst community, Wall Street, and the media organizations that covered them engaged in what I would call nothing less than a massive, shameless, totally irresponsible free-for-all riot in the pursuit of money.

I have included with this testimony a collection of stories and columns I wrote during this period that attempted to call the public's attention to the colossal pocket picking that they were being subjected to. Most particularly, I wrote repeatedly about the outrageous situation in which IPOs would be offered to investment bank clients at cheap, pre-market prices, even as the bank's analysts and the firms engaged in non-stop public commentary designed to pump up demand for the stock among individual investors in the after-market.

There are dozens of billion dollar examples of this in the public record before us today. Then when the stock would come public, the insiders would instantly dump their shares into the waiting and outstretched arms of individual, after-market investors at four, five and sometimes ten times the price they paid for them, often within hours.

You can call that what you want, but I call it fraud. You may review the trading histories of dozens of tech sector IPOs and dot com IPOs during this period and find precisely this pattern repeating itself over and over again. To that end, I would thus respectfully call the subcommittee's attention to the following IPOs which are simply illustrative of the process I've described.

VA Linux Systems, Inc. The insider price in this deal was $30, the first price to an after-market investor in the public market, $320.

TheGlobe.com, Inc., a deal that failed the first time around and couldn't even be gotten off, because the underwriter couldn't even find a market for it. The second time around at a mark-down, Cy Sims' basic sale price of nine bucks. This deal got off at $9. First sale to individuals in the after-market, $97.

WebMethods, Inc., sale price to the insiders, $35; first sale to the after-market individual investors—everyday citizens, $336.

All these stocks have since collapsed. There are dozens more like that. These stocks and countless more were pumped to wildly supportable prices by impossibly grand claims from analysts regarding their potential as businesses. We all knew, as journalists, that these claims were absurd, and we would constantly talk with each other about that. Not often did our private opinions about what we were seeing make it into public print. The fact that these claims echoed through the megaphones of TV and the internet to reach individual investors from every corner of the globe simply underscores how much capital can be raised on Wall Street now that the whole world is watching.

And this is only the first instance of this in which this unexpected alliance of analysts and the electronic media has come to bear on the marketplace. Unless efforts are undertaken to prevent this recurrence, I think we can look for even more disruptive recurrences of this in the future.

To that end, I would respectfully suggest the following:

Without going into the specific Sections of the 33 and 34 Act, because I'm not entirely certain, in the amount of time that I had to prepare this testimony, I have the correct references in my written submission.

Chairman BAKER. To that end, please feel free on reflection to forward that information in writing at a later time. That will help you in your presentation.

Mr. BYRON. I would simply say Section 17(b) of the Securities and Exchange Act of 1933, which I understand it in laymen's terms, requires anyone who is paid by an issuer to circulate, publish, or otherwise disseminate stock recommendations, be augmented to require, as a matter of law, that anyone publishing or disseminating that information disclose on that document in which the dissemination takes place, any financial interest, either direct or indirect, he or she holds in the stock in question, and I would wholly endorse the vivid image that the Chairman offered before of I want to see the surgeon general's warning stamped across the front of these things. It says "Caution! Investing in This Deal May Be Hazardous To Your Financial Health" in big red letters.

In this particular area, I think that volunteerism just hasn't worked. And I don't think that the' 33 Act, I live by the First Amendment. I say things that anger lots of people so the First Amendment is very important to me, and I don't feel that the 1933 Act, as it's written now, violates my First Amendment rights, and I don't think that the augmentation in the way I'm saying, you might want to consider augmenting it, would violate them either.

Second, I think that Section 10(b) of the 1934 Act, which deals with the general concept of fraud of the market, could be aggressively enforced by the SEC Enforcement Division. For example, the black letter law we all know well in my line of work, the Foster Wynans case. This is a case that the *Wall Street Journal* reporter ran afoul of the act by using information that he had obtained in the course of his work to trade on stocks before putting it in the paper, in violation of his agreement that he signed with the *Wall Street Journal* not to do that.

I think the essential holding in that case boils down to this: He promised not to do something that he went ahead and did anyway. While I think the basic principle there can be expanded to find an implied covenant, not just with your publisher, but with the whole world of your consumers, particularly when you're disseminating financial information that is offered to the public under the color of impartiality.

Nobody is going to believe what you write if it comes stamped all over it and says "I make a buck so long as I get your money," but if it's stamped on the front of it, if it comes representing itself to be this is unbiased material, in that case I think when you don't deliver unbiased material, you ought to be held to account with a sanction that hurts.

I think we shouldn't be looking at the minimum amount of disclosure necessary to find adequate disclosure, but the maximum possible disclosure to protect the individual investor, a completely different orientation.

I've probably run over my time. I thank you for your patience.

[The prepared statement of Christopher Byron can be found on page 245 in the appendix.]

Chairman BAKER. Thank you very much, sir. We appreciate your remarks.

Our next witness is Mr. Charles Hill, Director of Research at Thomson Financial/First Call. Welcome.

STATEMENT OF CHARLES L. HILL, DIRECTOR OF FINANCIAL RESEARCH, THOMSON FINANCIAL/FIRST CALL

Mr. HILL. Thank you. Good afternoon, Chairman Baker. I would like to thank you and the Members of the subcommittee for the opportunity to espouse my views on this important subject. Let me first mention the usual disclaimers. The views expressed here today are my personal ones, and are not necessarily those of my employer, Thomson Financial/First Call, where I'm Director of Financial Research, or those of the Boston Society of Securities Analysts, where I'm a Vice President and a Director.

I'm a chartered financial analyst and proud of it. My only aim today is to uphold and improve on the quality and integrity of my profession.

The problems we are talking about today are not new. They tend to wax and wane with each stockmarket cycle. The only difference this time is that some of the problems may be worse than in past cycles. There does to be some secular trend underway that may have been exacerbated by the cyclical swing in the market and that needs to be corrected.

Any prolonged corrections in stock prices tend to wring out some of the excesses we're talking about today. Nevertheless, some of the underlying secular trends are disturbing and it may take more than just a market correction to remedy the situation.

Let me point out that in this market downturn, as in past ones, investors always look for scapegoats. The broker/analysts are an easy target. There is no doubt some basis for this, but it is most probably over done. Let the record show that at the time of the market's frothiest peaks, there were many broker/analysts doing very thorough and objective research.

The problem was that there were not enough in this category. There were too many whose work was shoddy and/or biased because of naivete, laziness or outside pressures.

But let's not paint all the analysts with the same brush. As a former sell side analyst for 18 years, I shudder at the thought of returning to that field and having to compete with some of the top analysts today with all the technology tools available. There is no question in my mind that today's stock research for the top sell side analysts is better than from the top analysts of 25 years ago.

What we need to improve is the quality and objectivity of the work from the rest of today's sell side analysts that are not currently doing their job as well as they should. Before we turn to the causes of deteriorating stock research quality, it is worth looking at how the problems of quality and bias can manifest themselves. There are four data items by which analysts can distort an investor's perceptions of a company's stock or leave the investor confused.

The first is recommendations, the second is target prices, third is earnings estimates, and fourth is earnings basis. On recommendations, this subcommittee has previously raised this issue and has cited bar data, first calls data. The rough rule of thumb is that about one-third of all broker recommendations are in the positive category, strong buy, or whatever the broker's equivalent term is.

About one-third are in the second most positive category buy or whatever the broker's equivalent term is. About one-third are in the third most positive category, hold or the equivalent, with only about one percent in the two bottom categories, sell and strong sell or their equivalents.

The individual investor needs a decoder that would put all the brokers' various terminology for their recommendations on a common scale. The brokers are doing a better job of putting in each research report a definition of what their recommendation terminology means, making it easier for investors to compare one broker's recommendation with another. However, not all are doing this. A better answer might be if the brokers could agree on a common scale with common terminology.

Let me digress from my printed text for a minute to refer to something Congressman Kanjorski was talking about. When you mentioned about the confusion of the terminology, let me just read you the different terms that the brokers used for the third category. We've gone to all the brokers and said, you fit whatever your scale of terminology is to a common scale from one to five where one's a strong buy, two's a buy, three is a hold, and so forth.

Here are the terms that are used in category three: Accumulate, attractive, hold, average, hold/neutral, long-term accumulate, long-term attractive, maintain, market average, market perform, neutral, neutral/hold, no action, out perform, perform in line, speculative buy, trading buy, market out perform, stock pick.

Now what is the individual investor to do without this decoder?

But let me go on. Unfortunately, the investor needs a second level in their decoder to adjust for the over-optimism of the broker analyst recommendations. Since the better companies get more analyst coverage than do the weaker companies, there is a justification for somewhat of a positive bias to the recommendations. As of the end of July, yesterday, this data was run. 27.6 percent were in the strong buy category, 36.9 in the buy, only 1.1 percent were sells and 0.4 percent were strong sells. That means the number of buys of all kinds were 47 times the number of sells of all kinds. That much of a positive bias is hard to justify.

Last year when the market was at peak levels, the spring of 2000, and many stocks were substantially overvalued, the ratio was even worse. On 1 March, it was 92-to-1. As the market crept up to a bigger peak on May 1st, it was 100-to-1. As the market began falling, the ratio was still a very high one, 99-to-1 on the first of August. By October it was 78-to-1. Today, as I mentioned, it's 47-to-1. It's a bid harder to understand why the recommendations were even more positively biased than normal at the market peak.

Second issue, target prices. Target prices are another area where the analysts have the opportunity to put their naivete or biases to work. Target prices became the rage of the 1990s, but their popularity seems to have abated slightly. Many were unrealistic, but many of the analysts that were providing those target prices have lost considerable credibility.

Earnings estimates. Most analysts, most of the time, tend to start out too high with their estimates at the earnings report time. On average, the analysts start out too high ahead of the reporting period. They bring the estimates down, but take them down too far at the end of the period. More than half of the companies in the S&P 500 beat the final estimates every quarter.

Whether the analysts have been misled by the company's guidance or whether they knowingly went along with that guidance is debatable, but there does seem to be too regular a pattern of companies beating the estimates, particularly at some companies.

Now Regulation FD hopefully will diminish that problem. Now the fourth one is earnings basis. One of the problem areas that is mushrooming, but is often overlooked is the determination of the earnings basis used to value the stock. The SEC requires companies to report earnings on the basis of Generally Accepted Accounting Principles, (GAAP). Most everyone would agree that those numbers often need to be adjusted to exclude non-recurring and/or non-operating earnings.

The problem is that what one person considers non-recurring or non-operating, another may not. There is no right answer. It is all in the eyes of the beholder. A big part of the analysts' job is to determine the appropriate basis for earnings as used in the price earnings ratio or other earnings-based valuation yardsticks.

A company's earnings can often be enhanced by excluding items that normally would not be excluded or by including items that normally would be excluded. The excesses in this area have been most common in the technology sector where the use of the cash earnings or pro forma earnings have taken on a wide variety of special meanings that have greatly enhanced some companies' earnings.

Chairman BAKER. Mr. Hill, if you can begin to wrap up, I want to get all of our panelists in before we get interrupted by a vote. I hate to do it.

Mr. HILL. OK. There's a growing trend for companies to put out releases that emphasize an earnings number that has been adjusted to a basis the company espouses, sometimes to the almost total exclusion of the GAAP results. What this is amounting to is a way for companies to gild the lily on their earnings reports, and it's an issue that Lynn Turner did bring up before his leaving the SEC.

But, let me just quickly say that the four ways that the analysts are being pressured is first, themselves, in that the analysts have fallen in love with the industries they cover, or they'd be covering some other industry. So they start out with what I call an honest bias, come to the table looking through rose colored glasses. Second is the investment banking issue that we've talked quite a bit about today. The third is the public companies, the companies themselves putting pressure on the analysts or they'll be cut off communications-wise.

Last, the institutional shareholders who also can pressure the analysts not to put out a sell when they own the stock.

[The prepared statement of Charles L. Hill can be found on page 248 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Hill. Your testimony and all the witnesses' testimony will be made a part of the record in full, and I'm sure—I know I do—we'll have further questions in writing as well. Pleased don't feel dispossessed if you don't get through your entire prepared text.

Our next witness to appear is Mr. Matt Winkler, Editor-In-Chief of *Bloomberg News*.

Welcome, Mr. Winkler.

STATEMENT OF MATT WINKLER, EDITOR-IN-CHIEF, BLOOMBERG NEWS

Mr. WINKLER. Thank you very much, Mr. Chairman. I'm delighted to appear before the subcommittee as part of your continuing discussion of analyzing the analysts. My name is Matthew Winkler. I am the Editor-In-Chief of Bloomberg News, a global news service with 1100 reporters and editors and 80 bureaus in 50 countries.

Bloomberg News produces more than 4,000 stories daily on the economy, companies, governments, financial and commodity markets, as well as sports, politics, and policy. Many of these stories are published in more than 350 newspapers including the *New York Times*, *The Washington Post*, *Los Angeles Times*, *Le Monde*, and the *Daily Yomiuri*.

Since its inception in 1990, *Bloomberg News* has received more than 50 awards and citations for the quality of its journalism, including awards from the Overseas Press Club, the Gerald Loeb Foundation, the Society of Professional Journalists and the Society of Professional Business Editors and Writers. *Bloomberg News* is the main content provider for Bloomberg print and broadcast media. These include several magazines, a New York-based radio station and network, and a 24-hour television network operating in the U.S. and in a dozen languages in countries in Europe, Asia, and South America.

Financial stories are both complex and critically important. As someone who is passionate about providing the public with the context and analysis necessary to make sound decisions, I want to salute this subcommittee for its extraordinary commitment to ensuring that investors have broad access to the highest quality information about the marketplace. When this subcommittee greets with skepticism efforts to create a property right in stock market quotes, or highlights the question of whether investors are getting unbiased research from Wall Street, you are taking a step toward ensuring public access to information. In the information age, that is no small accomplishment.

It may take a bear market for investors to realize that many stock analysts have never been anything more than fancy pitch men for the firms that sell securities. As long as shares went up, as they did in the 1990s, analysts rarely had to say "sell." In their lingo, the stocks were never "fully priced." Now that the NASDAQ composite, the symbol of the greatest bull market ever, is down about 50 percent from a year ago, it is easy to attack the analysts because the few occasions when they might have said sell came long after the damage was done.

Analysts always will have a conflict of interest as long as the firms that employ them participate in initial public offerings, arrange stock and bond sales, and use analysts' research to help win new business. In such circumstances, it's hard to find any analyst on Wall Street who met a stock he or she didn't like. Analysts are part of the sales team.

Analyst conflicts of interest are a symptom of something much more sinister. Until the Securities and Exchange Commission late last year approved Regulation FD, public companies routinely invited analysts and some of their shareholders to private meetings as they discussed sales, profits and losses. Until adoption of Regulation FD, analysts were protected under law from insider trading liability and liability for "tipping" if they did not have a special relationship with the corporate officials that fed them insider information—a monetary or other quid pro quo.

That protection was designed to shield analysts from unlimited risks of liability for attempting to ferret out information. It quickly became perverted, however, as issuers figured out they could punish analysts that did not give them good ratings. The punishment came in the form of exclusion from the inside information gravy train which was provided to their competitors. Inside information was thus joined with analysts' recommendations in a troubling form of barter. It was as if a student could punish the teacher for giving him or her a bad grade by withholding the teacher's pay.

In short, this practice of selective disclosure increasingly made the stock market a financial "Animal Farm" in which some shareholders were more equal than others. The sloped playing field created by selective disclosure during the 1990s was so common that many analysts and publicly-traded companies assumed it was the price of capitalism. Analysts equipped with inside information, they argued, were needed to grease the wheels of the market, even if they could trade on that information before Aunt Betsy and the rest of the company's shareholders.

The SEC disagreed because in too many instances, trading in a company's shares turned out to be rigged, undermining the integrity of the stock market. I believe the SEC got it right. What precisely does Regulation FD have to do with analyst conflicts of interest? Everything. Conflicts and bias breed in the dark. The more information that is available to the public the greater our collective ability to assess independently whether the analysis we are receiving is potentially biased.

Does Regulation FD solve the problem of analyst conflicts? Of course not. I repeat, as long as firms employ them to participate in initial public offerings, arrange stock and bond sales, and use analyst research to help win new business, analysts will always have a potential conflict of interest. Initiatives that enhance broad dissemination of information to the public will have a salutary impact.

Justice Brandeis is remembered for observing “publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants. Electric light, the most efficient policeman.” Like seeing a policeman in the rear view mirror or knowing a Congressional Oversight Committee is looking over your shoulder, the availability of information enhances accountability. That serves as a catalyst that sometimes prods better behavior, and that is very much in the public interest. Again, I commend you for your willingness to explore this important issue.

Thank you very much.

[The prepared statement of Matt Winkler can be found on page 253 in the appendix.]

Chairman BAKER. Thank you very much for your remarks.

With apologies, Mr. Kianpoor, Chief Executive Officer for Investarts.com, also a media panelist of sorts, I have been informed that I have overlooked as well TheStreet.com also being an internet site. Thanks to both you gentleman for your willingness to appear today.

STATEMENT OF KEI KIANPOOR, CHIEF EXECUTIVE OFFICER, INVESTARS.COM

Mr. KIANPOOR. Speaking on behalf of the Investars.com team and our co-founder, John Eagleton, I’m honored to have the opportunity to contribute to these hearings. Investars.com was founded in October 1999 to give investors tools to better interpret stock recommendations made by Wall Street Analysts. With the huge growth in the number of individual investors in the mid-1990s, Investars.com sought to measure the track records of Wall Street’s research providers, thus giving investors the tools that would allow them to sift through dozens of stock recommendations made daily. Investars.com degree of success system calculates the hypothetical return an investor would have made if he or she had traded based on each brokerage’s recommendations.

Investars currently ranks more than 200 research firms, based on their overall hypothetical returns for every stock since January 1997. Hindsight has made it clear that the boom and bust of the past 4 years did not leave lasting benefits for anyone. Investors have suffered, businesses built on unrealistic have collapsed, and the brand equity of many brokers whose businesses depend on public trust is being eroded as we speak.

We must join forces to implement common sense reforms that will benefit all parties. Respectfully, we’d like to propose three basic reforms.

One, to make historical recommendation and earnings estimate data public; two, to encourage disclosure of investment banks relationships with covered companies; three push for a common recommendation language.

In the interest of saving time I’ve pared down some of my testimony on subjects that have been mentioned before. I would like to focus on some of the more important things. Historical Wall Street recommendations and earnings data is not available only to institutional investors. Individual investors suffered in the recent boom and bust cycle, because they lacked these key facts. They lacked these facts, because there’s a virtual monopoly on the distribution of analysts' historical data, namely, financial data distributors who agree with investment banks not to make historical ratings information available to the public.

This is the single most important, most absurd, and least addressed issue affecting the individual investor today, that investment banks can prevent the release of their historical recommendations data to the public. Historical recommendations and earnings estimate data must be made available to all investors and preserved in the public venue, such as the SEC database.

Please refer to the statements made by other analysts ranking sites, such as Validea.com and MarketPerform.com in our written testimony.

The second issue is the disclosure of investment banking relationships. Our IPO bias feature compares the track records of investment banks based on their recommendations for companies that they underwrote to their track records in companies that they did not.

Overall, since 1997, the returns in the first case are approximately 50 percentage points lower than the returns on the second. Due to the lack of availability of historical information, the possibility of conflict of interest was not previously quantifiable for investors.

As their second reform, Investars proposes that investment banks disclose to an SEC database their historical underwriting relationship with any company which they cover. I believe that's been brought up before. Disclosure is not an end in itself. We call on the media on-line brokers, financial advisors, research firms, and sites such as Investars, to educate and protect the people. By placing this information in context with current technology, we can explore investment banks' track records and conduct a detailed peer group analysis, and the media should avail itself of these new tools. If it proves impossible to obtain full disclosure, the media should emphasize the implications of its absence.

The third issue we need to address is Wall Street's language. Again, that has been mentioned before. We need a common scale. It's just common sense. In that case, our conclusion is that we cannot lose sight of the average investor who must be equipped to assess the quality and integrity of market analysts.

It is common sense when you buy a car, you check consumer reports. When you buy a house, you have it inspected. To make such assessment possible, we need to establish a standard language and break the investment banks' control over factual historical recommendation data. Investars also suggests that the media start to delve into more detail when reporting on analysts' recommendations to the public.

We now possess the technology to refer to analysts' batting averages and provide play-by-play commentary on their ratings. We can publicize the good and transparent and underscore the deficient, heighten investor awareness that will self-enforce industry compliance with higher standards.

I'd like to end my testimony with a statement. There's a greater fool theory in the market. It states that no matter what a stock is worth, investors buy it, because they believe there will be a greater fool willing to buy the stock from them at a higher price. As long as brokers and financial data providers can block the distribution of factually historical data to the public, the average investor will ever remain as a greater fool in the market. That's just common sense.

I'm grateful for this opportunity to share our views with you today.

[The prepared statement of Kei Kianpoor can be found on page 261 in the appendix.]

Chairman BAKER. Thank you very much, sir. I appreciate your willingness to appear.

Our final witness today is Mr. Adam Lashinsky, a Silicon Valley columnist, and employed by TheStreet.com.

STATEMENT OF ADAM LASHINSKY, SILICON VALLEY COLUMNIST, THESTREET.COM

Mr. LASHINSKY. Thank you very much, Mr. Baker. I had the privilege of interviewing you recently for an article that I was writing, so turn about seems fair play. I'm happy to give you my thoughts today.

When I first started out as a business reporter, I was handed a large book called the Nelson's Director of Investment Research. I was told there are lists of analysts in this book. Call them if you need comments for the stories you're writing on public companies.

I knew nothing about what the individual analysts did, the importance of their firms, whether some were better than others. All I knew was that the ones who returned my phone calls were more valuable than the ones who didn't return my phone calls. If they said something germane on the record, they were even more valuable because they could go into my articles.

I think that as we entered the bull market, the individual investor found him or herself in a similar position. They were told in either the newspaper article or on television that an analyst had something good to say about a stock. They had no ability to judge whether or not that analyst was good or bad. They knew that an expert was speaking and that information was good enough.

The news media plays a role in this, and I'd like to address that. The point is that professional investors have understood the games that have been played on Wall Street all along. The individual investor didn't understand what the conflicts were, came into the game cold, if you will, just as if having been handed a big book.

One thing, Congressman Baker, that I think hasn't been addressed in the hearings yet is who is entitled to the information that we're discussing and how they should be using it. There's been discussion today of research reports being entered into historical records or indeed being regulated like a securities offering.

The fact remains that at least for now, these are not public documents, these are proprietary pieces of research for which investors pay. So Fidelity understands that it is a client of Goldman, Sachs, to choose one example.

To the person watching on CNBC, it's not typically a client of Goldman, Sachs. It they act on the research that Goldman, Sachs has produced, in a sense, they're taking a shot there on their own; they're not the client, they didn't pay for it. But what is the media role here?

TheStreet.com has had a policy since its founding in late 1996 of always stating a conflict of interest that an analyst has. So if we quoted an analyst whose firm was the underwriter of the IPO of the company that we're discussing, we simply say so. It doesn't mean that the analyst is good or bad, it means that we're cluing our readers in that there's a potential conflict here.

I would point out that sometimes those analysts are the best informed because they spend more time with the companies, but an investor has to have his or her eyes open to the fact that there may be a conflict here. Thus, Street.com is not immune from some of the criticism that the financial news media deserves.

Over the past few years, we had, for example, something called the "Red Hot Index" where we participated fully in the momentum of the era. However, I'm proud of what TheStreet.com has done in terms of outlining analysts' conflicts. I don't think the rest of the media has lived up to the same standard, in particular the broadcast media has been particularly harmful in putting analysts or putting fund managers on television without explaining to the overage viewer at home what the full story is behind the recommendations that they're making.

I would offer to you several solutions that you're addressing, not all of which I necessarily endorse, but I offer them as food for thought.

One, you could write legislation to split investment banks from brokerages. This would solve the problem. It would be very painful. It would fly in the face of the last 10 years of consolidation in the financial services industry, and of course brokerages wouldn't be able to make much money in that scenario, because trading is not a particularly profitable endeavor, but it would solve your problem. Then you could allow fixed rate minimum commissions again, so that brokerages could run a profitable business. That flies in the face of Congress' concerns about price fixing.

You could require, and you are discussing requiring greater disclosure as the industry itself is discussing. My personal opinion is that these are palliatives. They will have little impact on the conflicts. They simply will make people more aware of what the conflicts are and perhaps make people feel better.

Lastly, you can rigorously support Regulation FD. There is an undercurrent that isn't stated loudly that there are elements with in the SEC and certainly on the Commission and certainly in the securities industry to diminish the effects of Regulation FD, because it makes the industry uncomfortable, and it is requiring the industry, in my opinion, to work harder.

In my reporting, it's my opinion that Regulation FD is one of the best things that has happened for individual investors in recent history, and Congress can do its part by standing firmly behind Regulation FD and not give in to some of the demands that it be weakened.

Thank you, sir.

[The prepared statement of Adam Lashinsky can be found on page 266 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Lashinsky.

Let me say to the whole panel, thank you very much. This has been again very informative, but also very troubling. From the first hearing, when there were some observing, wow, Congress is looking at the conflicts of interest on Wall Street, isn't that news?

Obviously we all know that there are conflicts and firms have assured us of their ability to manage those conflicts. But the further we have gone in looking at the divergent list of individuals who have unique perspectives of market actions, there is no doubt that the character and nature of the market has changed over the last decade.

Unfortunately, I think there is reason for most investors to have great concern about the independence of the information flow when they make such significant investment decisions coupled with the advent of online trading, and now what many of us in political life call the working moms and pops investing on line and, to some extent, using media appearances. Look at what's happening here in this sector today, the type of analysis in order to make all those small individual transactions in the aggregate responsible for the huge inflows of capital to the market. We have a very volatile circumstance.

In speaking with most members, we are all reticent to act legislatively. But it would be my intention, based on the support of the subcommittee, that we would move forward from this point with some recommendations through the fall and winter and perhaps come back with the assistance of the NASD, the SROs and the SEC, and determine whether our actions and recommendations have not only been implemented, but there is actual day-to-day practice and consistent following of the recommendations that appear to be warranted.

Let me make a couple of statements and then kind of get the consensus, yes or noes. My view is everybody thinks there's a problem. You all may not see the same problem, but generally there's a problem that we need to fix. Nobody objects to that?

Second, that it would be better, if possible, for the industry, itself, to craft the remedy, but have that remedy be subject to the light of day. For example, additional committee hearings, SRO insight, that's maybe in the middle of the pack.

Are there those who agree with that sort of general context that we ought to do something, look to the industry, and then verify.

The next question is much more difficult. Let's assume we've gotten through those first two steps. We've prepared a list, we've gotten the industry to look at it, but there's still not consistent uniformity in compliance. What should be the enforcement mechanism? Is it sufficient, as I suggested to Ms. Unger earlier, to have just a rating mechanism; a, you're complying with all the rules; b, you're trying, but you're not quite there; c, you've got a problem. Will the publication of you being on the c list have a consequence in the market? Is that a point of discussion?

Yes, sir?

Mr. WINKLER. Mr. Chairman, I think the greatest impact on the market is disclosure and the more disclosure there is, just as you yourself said earlier today, a warning on a package of cigarettes is a very powerful way of letting people know that they are about to use something that's possibly fatal. Reg FD goes a long way toward that kind of goal.

And I do think that if this subcommittee were active in doing everything it can to promote and enforce Reg FD, that would be very helpful.

Chairman BAKER. Thank you for that. I do have some concerns about Reg FD, but not from the perspective of the industry having a difficult time complying. I just want to make sure it functions in the intended fashion. And further to the point, it would have no implication on an analyst making a recommendation to buy when he's selling his own interest.

I think we have to get not only at the flow of information but the personal conduct issue of the individuals. For whatever reason, it makes no difference; are they being pressured by the firm or is it the opportunity to make four or five million dollars on a deal. If they do it, it's wrong. That's where we have to have, I think, significantly more involvement by the SROs than we have today.

For example, it troubles me greatly that, at least according to Ms. Unger, the NASD does not look at an analyst or require disclosure, if he makes a television appearance, if he's got an interest in the stock which he's talking about. I find that unfathomable from a regulator's perspective.

Mr. Lashinsky, did you have a comment?

Mr. LASHINSKY. Yes, sir. I was going to say that in every instance I know, the compliance department of any firm would not allow the type of department that Ms. Unger described earlier. Without being a lawyer, that strikes me as fraudulent behavior and bad ethics, so there's a break down in how the SROs are regulating the compliance departments of their own members.

Chairman BAKER. Ms. Unger also stated that in the short-term audit they conducted, there was only one firm that could give her an accurate reporting of all the analysts' interests within the firm. How could you possibly have any capacity to govern analysts' practice if you don't know what they own?

There's a fundamental structural problem here that is going to take more than one hearing and one simple piece of legislation to fix. To that end, we will get back to each of you with additional questions and insights for you to give us your educated opinion on.

But we would very much welcome, over the course of the August recess, your best thinking along the idea of here are the elements we think would be important as we have a peer review group now looking at the SIA's best practices.

By the way, just a show of hands, how many of you think the SIA's best practices recommendations are sufficient?

[No response.]

Chairman BAKER. That's what I thought.

Over the August recess, if you'll give me your insights into those, as well as additional steps from your various perspectives, it would be very helpful to us in trying to construct very carefully a package for us to suggest to the SROs that they review, and our process would be very slow. We're not going to rush to judgment. But to take the fall and winter and come back next spring and make an assessment about the effect and consequences and recommendations that the subcommittee may make this fall. It's just by way of process.

I don't want to go on at length because Mr. Kanjorski and Mr. Crowley have been very patient sitting here.

Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Kianpoor, you made an observation that the value of a stock will be whatever the next idiot will pay.

Mr. KIANPOOR. That's right. It shouldn't, but it did for the last 2 years.

Mr. KANJORSKI. And after the excellent testimony of the entire panel, each one of you added a great deal of insight into some of the problems in analysis on Wall Street.

I don't think any of you are my age, but I'm going to relate a story. You may remember my favorite program when I was a young man in the late forties, was Captain Midnight. Captain Midnight was sponsored by Ovaltine, you'll remember.

I was just about able to read, write, and figure out how to do things, and I was pressed at 5:00 o'clock every day to listen to Captain Midnight. And Captain Midnight started this process of the secret code and secret information, and every day you would write down the numbers. They were useless to you if you didn't have a decoding device, but Captain Midnight offered a decoding ring with ten bottle labels of Ovaltine and a dollar.

And as a dutiful follower of Captain Midnight, I bugged the hell out of my mother to get those ten bottles of Ovaltine. By hook or crook, I got that dollar and I wrote in, and at that time, nothing was instantaneous like the internet; thus, with bated breath every day, when I'd come home from school, I'd look for my package from Captain Midnight. It wasn't there. It took weeks. But every day at that program at 5:00 o'clock, I copied down all those numbers so that when my ring came, I'd know what Captain Midnight was saying to me.

Finally, the day arrived and it came, and I remember it very well. I tore that box open. I immediately ran in and I couldn't wait for the program to be over when the message would be given, and finally it was given. And I took my ring and I decoded the message. It was probably the best lesson I ever learned in my life, because the message was——

Mr. HILL. Congressman, that was the information for my reference. I had my Captain Midnight Decoder.

Mr. KANJORSKI. Do you remember what the decoded message was? "Buy Ovaltine."

[Laughter.]

Mr. KANJORSKI. Well, it taught me a lesson. We can't encourage Americans to necessarily buy decoder rings when they're not available. Somebody's got to do something with this decoding. We have to move out of the Orwellian world. I think the Chairman and I both agree we would least like to do it by Government action. But clearly, I was disappointed. I listened to the testimony of the SEC today. And I got the feeling that it's not our fault, it's somebody else's responsibility if they are not doing something.

It didn't strike me that the proper attention was paid, but then I thought about listening to all of you six gentlemen here. I want to compliment you. You are all competent and very successful in your field, but you have to answer this question for me.

Why wasn't there anyone that did investigative work in 1998 and 1999 and 2000 to tell the American people and most of us about these terrible analysts when the market was going up?

Yes?

Mr. KIANPOOR. As I said before, the data was not being made available to individual investors. That means to do this investigative work, you need to get the historical data for what these analysts and investment banks have been recommending for the past 10 years.

Mr. KANJORSKI. You mean that there is nobody?

Mr. KIANPOOR. The data is being provided by investment banks to certain financial data providers which will not allow——

Mr. KANJORSKI. Then, we are going then through a fog, is that it?

Mr. LASHINSKY. Mr. Kanjorski, there were plenty of people during that period who did research and said repeatedly "this is madness, this stock is not worth what you say it's worth. There are ways to fundamentally value this stock, and it's highly over-valued." And those people were laughed at for roughly 3 years because the stock kept going up and kept going up and kept going up. That was the period we just came through.

Mr. KANJORSKI. Would it have made any difference if we had the historical knowledge?

Mr. KIANPOOR. It would have, Mr. Kanjorski, and it will in about 4 or 5 years. As early as now, people are looking at our site and finding out what people's track records are instead of having a Surgeon General's warning on TV coming up, you could have the person's track record and see either the guy is a complete crook or a complete idiot. It's far more effective.

Mr. KANJORSKI. It strikes me as something like Monday morning football reporting, how well we played the game that was played on Saturday. We are the greatest analyzers of why Al Gore lost the election. But I don't think anybody could have told you that or would have told you that beforehand.

And I'm just wondering, are we chasing a phantom?

Chairman BAKER. Let me jump in too, because I think Mr. Byron wanted to make a comment in response to that question.

Mr. BYRON. Yes. I would simply say, Congressman Kanjorski, that the data on which you can base informed judgments with respect to the value of a stock, given that no one can foresee the future, at least makes some reasonable guess about the likely course of a stock's value. It's available to everybody, whereas 20 years ago, it wasn't. And I mean by that, the instant access to audited financial statements, balance sheets, income statements, cash flow statements, shareholder equity statements from publicly traded companies via the filing system of the SEC. That stuff is all available and usable by anyone.

Most people have neither the time nor the expertise to dig into that stuff and understand it. That's where the role of the media is critically important, because in my respects, we're the unelected, self-anointed proxies for public understanding of what these documents are.

Mr. KANJORSKI. How am I going to know, though, if I'm listening to you on the radio, and you're paid for by Exxon or American Express? How do I know whether or not that's influencing what you're saying to me?

Mr. BYRON. There is an inherent problem in that with everything in the capitalist system obviously. At some point, we all need to pay the rent.

The question that I want to get at is when the conflict becomes gratuitous, particularly in the media, when media voices begin to have a demonstrable self-interest in the outcome of their own opinions and their own reporting at the same time the entire system tends to break down, because there's no place left for the public to go unless a investor wants to take the time to learn how to read a 10K statement from the SEC. Most people don't want to do that.

So in my opinion, a very important part of this equation has to be the role of the media and financial journalists. When we start thinking of ourselves as superstars in the same way that the analysts do, we have a really serious problem on our hands, because who stands to inform the public when you have a situation like that?

Chairman BAKER. If I can recognize Mr. Crowley, do you have a comment or question, sir?

Ms. CROWLEY. I do, Mr. Chairman. Thank you very much.

It's funny. If I close my eyes, I think I'm listening to election reforms sometimes, some of the comments that are made. I appreciate that, because there are some analogies I think you can draw between the two in terms of the sharing of information by electoral analysts or financial analysts in terms of expertise dealing with election results or, in this case, maybe before the bell rings, what they hope would be the market results for a particular product.

Mr. Glantz, I have a couple of questions, and first of all, let me thank you for being here. It's good to have, from a retired analyst, insider information basically on how some of this may work.

The Henry Blodgett case put the analysts into the forefront for millions of small investors. While this case was before the SEC and Mr. Kanjilal—I hope I'm pronouncing that right—of Queens, my hometown, went to arbitration, and it first looked like that was going to be the road we were going to be going down.

This event brought to light a serious issue that when small time investors, who are the bulk of the American public, set up a brokered deal, many of these firms require that that individual agree to arbitration as opposed to going to the courts to address any wrongdoings down the road.

In your view, do you think the current law should be overturned or reviewed so that private plaintiffs are provided with the right of action against analysts?

And with respect to the current arbitration system, do you believe that the arbiters should be outside the securities industry and that they rather be from the American Arbitration Association or some other outside firm to oversee the arbitration?

Mr. GLANTZ. Yes. I agree that investors should be able to sue in courts. I believe that any arbitration should be done by people outside of the system.

If I can also add a response to a previous question. One of the problems with the rating systems is that the greatest excesses are made by people who have no track record. Whoever heard of Henry

Bodgett before the internet stocks went up? It would have taken until the stocks fell that you would know that he had been over-enthusiastic. I think the basic problem is not the analyst, but the pressure on investment banking.

If you tell the investment bankers, "Gee, I think this is a terrible company," you get fired. If you don't support the stock, you get fired.

Ms. CROWLEY. Today, but not in the past.

Mr. GLANTZ. Right.

Mr. HILL. Back in the days when I was an analyst, I could put a sell, as I did on investment banking clients, and I did not hear anything from the investment banking side of the firms I worked for or from the companies involved. But that's changed today.

Mr. KIANPOOR. Mr. Crowley, that's why we are looking for historical information on investment bank recommendations. We don't go by analysts, because we believe that going by analysts would be like saying that the tail is wagging the dog. We go by Merrill's recommendations or CFSB's recommendations. Every time they make one, they put their equity at stake, and the public should know what their track record in different stocks and different sectors is when they're making those decisions. That's a market-based solution to the problem.

Ms. CROWLEY. In the interest of time, I yield back, but before I do, I thank the Chairman. I believe this is the second hearing on this and there are going to be more hearings. I look forward to it because this is a very interesting issue. The whole concept of an analyst being rewarded for information that he or she gives over the mass media is troubling to me. It's substantial dollars. We're talking in the range of $100,000 plus dollars for every time they give a bump to a product over the media, the mass media. That's troubling, because it affects my constituents, the general public that is more involved and more interested in the market than ever before, those are the people that we have to look out for.

And that seriously troubles me. So I thank you all for your testimony today.

Chairman BAKER. Thank you, Mr. Crowley, and yes this is only the second, but it really is the beginning of this subcommittee's jurisdictional responsibility. I don't see even the passage of legislation as the end of our responsibility. If there's anything I've learned from pass excesses, the Long-Term Capital Management and others, there has to be outside constant review of business practice in order for the system to work without distortion.

Ms. CROWLEY. I agree with you, Mr. Chairman. In fact, I think the hearings you're holding are doing in many respects just that.

Chairman BAKER. Thank you, sir.

I believe that it's an important responsibility in light of the way the market has changed, technology has opened up the world to the small dollar investor, they may even, despite FD, be flooded by information they can't even understand. So I don't know that folks today have the confidence that the people they pay for information are necessarily giving them the unvarnished truth.

That's what this is all about. I would like to return to the remedy aspect. I don't think it's that difficult. I think it's difficult because it may change business practices in certain areas and cause difficulty in securing the IPO client for the investment bank. But if you have the research department not reporting to the investment bank, where their compensation package may be based on the quality of their work, is it facetious to be believe that, as a research analyst, that if you do your work, and go out and say this is a dog and say this one is so-so, and this one is where we want to put our money, and based on those recommendations at year end, if you did identify the dog, you did tell them where to put their money properly, isn't that a mechanism which could work with reasonable support from professional management?

Mr. Hill.

Mr. HILL. It could work if the compensation system was changed. It did work in the past, but the problem is, and this is where the buy side institutions have to look in the mirror. They have been one of the big complainers about the deterioration and the objectivity of quality of sell side research, but they've driven commissions down to extremely low rates. There's more of a premium today on trading execution so it's difficult to get paid the way the brokers used to be able to for their research.

When I was an analyst, I was incentivized monetarily to do good fundamental research. Once a quarter, the institution sent a letter in saying, we did X amount of commissioned business directed to your firm in return for research services provided by the following analysts.

If my name appeared on more of those letters than my compatriots did, I got a bigger share of the research department bonus pool. In those days, the research department generated enough commission business to have a bonus pool. If I did something for investment banking along the way, there may be a little sweetener in there for that, but it was the frosting on the cake.

The problem today is it's the cake, because they can't get paid for research and they've had to return to investment banking to compensate the analysts.

Chairman BAKER. Let's take that point. Let's assume for a moment that business practice has changed. We can't undo it and it's a fact of life. The conflict of interest will continue. Is merely the disclosure of the relationship somehow doing something about the IPO problem that was referenced, I believe, by Mr. Glantz in your testimony. Is that going to be sufficient along with Reg FD-like disclosure requirements sufficient to bring back or to establish credibility in analysts' work with the average investor.

If we can't unwrap the investment bank research problem, where do we go from there?

Mr. GLANTZ. You have asked two question. One question that you asked earlier, if I have an investment banker who is making the firm hundreds of millions of dollars, I don't care what the formal relationship is, he runs research. The second is to restore investor credibility. Unfortunately, the investors who are hurt the most are not paying for the research, they're trading on AmeriTrade.

Chairman BAKER. A network.

Mr. GLANTZ. They're trading on the internet. Every once in a while I used to go into one of these chat rooms to find out what people were saying. I was amazed at the illiteracy, the lack of knowledge, "So-and-so's stock is going to go to a hundred," and that's not the analysts' fault.

The criticism I make of analysts is conflict of interest and I think that should be on the first page. But is that going to cure the problem of the reputation of analysts? No.

Chairman BAKER. Any other comment on the next step?

Mr. LASHINSKY. I would just disagree with one thing that Chuck Hill said to get to Ron Glantz's point. Typically, the buy side is not particularly upset with the situation. They see it as an unfortunate situation, but they know that they can't rely on the sell side for buy and sell recommendations. So they take the sell side for what it's worth. It's expertise, it's knowledge, it's analysis, not its recommendations on the stocks. They have their own research teams for that.

Chairman BAKER. Would you like another round, Paul?

Mr. KANJORSKI. I was going to confess something. I gave up holding equities when I got elected to Congress. But I have to tell you, I gave up going to cocktail parties about 5 years ago, because I just couldn't stand to go to them and listen to all my friends making 30 and 40 and 50 percent return on their investments knowing I'm in Government bonds.

Now I appear absolutely brilliant, but I want to make the point that what some of you were talking about here goes to the question of ethics and business. These investment banking houses are very substantial houses employing very substantial people. It seems to me they are prostituting, as I think the word was used, their analysts to help that side of the business.

Am I to believe that Wall Street is so much different than say the journalistic area where Katherine Graham stood behind her investigative reporters even against the President of the United States. Have we lost that standard of ethics in the business field? Has capitalism gotten to the level that money and money alone is the determining level of what ethics exist in the business?

Mr. BYRON. Congressman Kanjorski, I would simply say that we're at the end, or we were in March of the year 2000, to the longest sustained bull market in the Nation's history. We saw levels of premium value attached to stocks that really turned people's heads around.

I think that it's really possible to lose your moorings when you can go from $30,000-a-year to $2- or $3-million dollars a year in 2 years in a job. So, yes, I think that the correction that you're now seeing in the market is likely to correct a lot of that.

Nobody was complaining. Nobody ever complains about the stock market when it goes up. It's only when it stops going up that people start wondering, well, why didn't you tell me before. So the ethical question I think is likely to disappear as values return to their historical norms.

Mr. KANJORSKI. With the market coming down, everybody's going to get ethics and morals?

Mr. BYRON. You'll find ethics returning to their mean, yes.

Mr. KANJORSKI. I had the one question that I brought up in my opening statement. Maybe if you could just individually respond if you have a comment on it. I have a great fear on the public policy question of privatizing Social Security and turning those millions of investors and billions and trillions of dollars over to what you describe as an "unethical, ethical or egoistic omen market."

What are your feelings on this as individuals? Are we prepared to do that?

Mr. Glantz.

Mr. GLANTZ. I think this has to be extremely well thought out or we're going to have a repetition of the S&L problem. With your constituents saying, "I just lost half my money, make me whole."

Mr. LASHINSKY. I work for a website that is committed to informing the individual investor and I think your concerns are extremely valid.

Mr. KANJORSKI. I just want to congratulate you two. Are you the last two existing dot com companies?

Mr. LASHINSKY. I'm not sure how to respond to that.

Mr. KANJORSKI. Going back to what I said before, when I was growing up in a rather conservative investor home, we used to think of real estate investments the way you figure out the value of property was ten times earnings rentals: That was a pretty good mix of whether the profit was going to be there and the real estate investment, a maximum of 12 to 20 percent profits or earnings to price.

Then, of course, I went to these cocktail parties 5 years ago and I heard 100-to-1. You didn't worry about companies even making earnings. It was what do we call it, a new market, a new economy?

Chairman BAKER. Stupidity, I think is what it was.

Mr. KANJORSKI. We do not want to go into overkill. I, for one, would like to see more Americans have the capacity to participate in equities. I think that is a major positive feature of America today and the world today, but we cannot allow unrestrained exposure of the fox in the hen house, and I'm even worried about H.R. 10.

Now we have allowed these securities companies to become part of huge banks and huge insurance companies. If they are willing to pollute and prostitute any measure including the media, maybe we have some fear out there. Unfortunately, maybe we need Government restraint, even though so many of us would like to have less regulation. Maybe we are starting down a trail that we have created our own monster.

How is H.R. 10 treating this? I talked to a banker the other day and he expects the world to have six multi-trillion dollar banks in the next 10 to 20 years and that will be it. The rest will be little mom and pop operations out there. That's an awful lot of economic power to put in the hands of single people. The questions are what will they do with it, and what will the people that work for them do with it, and how willing will they be to surrender their ethical standards or morality?

Anyway, Mr. Chairman, again, great panel, great discussion. I think we can take back to our membership a great transcript. Thank you.

Chairman BAKER. Thank you very much, Mr. Kanjorski. I too, like Ranking Member Kanjorski, don't have any investments in the market. Given my responsibilities, I don't think that's appropriate. But my son asked me some time ago, "Dad, when should I get out of the market?", and I told him "About 3½ years ago." This thing can't last. He just started speaking to me a couple of weeks ago now that things have gone in a different direction.

There is no doubt that the individual investor shares a great deal of responsibility in the current market circumstance. People don't make you put your money in the market, you have to make a conscious decision to write the check, to add the debit to your account. But I think our concern, properly focused, is when you make that decision that the information you are receiving is unbiased, accurate, and any interest in the party that is giving you the information material to your investment decision should be made clear.

There's nothing wrong, and I've used it numerous times in prior hearings, in Louisiana real estate law, if I'm going to represent buyer and seller, I must have a written disclosure by both that that is OK, and then I am not allowed by law to give any information about the buyer to the seller or conversely that would prejudice the ability of the other to get full market value, or for the seller to get the best price.

I become basically a letter carrier at that point, and can no longer espouse a particular party's interest in that transaction. We have got to get our standards and the consequential effects for violating the standards in a position where I can have the same confidence in the analysts that my constituents are utilizing that I think my constituents can have in a Louisiana realtor.

I don't think that is a standard that's too high to achieve. So from my perspective, with your good help over the coming months, we hope to be able to encourage the private market to see the advisability of this effort to be cooperative and to perhaps lead us in the right direction.

But, as some have indicated, if we are not successful and the problems do not appear to be remedied, then I certainly would not at this time rule out the possible further actions of this subcommittee, given the Members' interest expressed here today.

With that, I thank you for your courteous and lengthy participation and we look forward to hearing from you further.

Our hearing is adjourned.

[Whereupon, at 5:15 p.m., the hearing was adjourned.]

APPENDIX

June 14, 2001

Opening Statement
The Honorable Richard H. Baker, Chairman
House Financial Services Committee Subcommittee on
Capital Markets, Insurance and Government Sponsored Enterprises
Hearing, June 14, 2001
"Analyzing the analysts: Are investors getting unbiased research from Wall Street"

To the question raised on a recent magazine cover - "Can we ever trust Wall Street Again?" - the simple answer is: we must. That is, we must find a way. It's not a choice. America's prosperity, as always, is intrinsically bound to the influx of capital investments that fuel business expansion, job growth, and technological advancement.

To the extent that America's faith has been temporarily shaken by the recent market downturn, our first goal here today is to begin a process of rebuilding confidence in the market. Not only to help reaffirm the American people's faith in the fairness of the market, but to earn their trust.

As a free-market conservative, I am the last person interested in government putting the market on trial or contributing unnecessary barriers against a market recovery that keeps expanding opportunities for all Americans. However, the foundation of the free-market system is the free-flow of straightforward, unbiased information. This subcommittee has a responsibility to safeguard this principle. And I must say I am deeply troubled by evidence of Wall Street's erosion of the bedrock of ethical conduct.

It's a new and continually changing market. Since 1995, online trading has resulted in enormous growth of investment by working families - some 800,000 trades a day by typical investors with $60,000 incomes and net worth of less than $50,000. These small, individual investors rely on what they believe to be objective, professional advice from sophisticated analysts.

Message to Wall Street: these small investors are the future of the market. They deserve fair treatment. Folks who work hard to pay the house note, taxes, and the grocery bill don't have the funds to speculatively gamble.

Over the last few years Wall Street's insiders have whispered knowingly about a kind of "grade inflation" and "coded language" in analyst recommendations, issued with a self-serving bias to solicit a client or to earn enhanced fees. A goal of this hearing is also to begin speaking openly about the unspoken, and to inform the public. I'm amazed to have learned just yesterday that "strong buy" really doesn't mean "buy" but actually means "outperform." Makes you wonder what an "outperform" recommendation really means. I am concerned about not only the potential for significant losses by the unwary, misinformed individual investor, but also the possibility of overall market volatility when a "rational" view returns.

Today we inquire into disturbing media and academic reports about blatant and pervasive conflicts-of-interest compromising the integrity of current market practices. In fact, I will now enter into the record a Harvard and Wharton Business School study entitled "The Relationship Between Analysts' Forecasts of Long-Term Earnings Growth and Stock Price Performance Following Equity Offerings."

I now quote from the conclusion of that study:

> "Our evidence suggests that the coexistence of brokerage services and underwriting services in the same institution leads sell-side analysts to compromise their responsibility to brokerage clients in order to attract underwriting business. Investment banks claim to have 'Chinese Walls' to prevent such conflicts of interest. Our evidence raises questions about the reliability of the 'Chinese Walls.' We document that analysts affiliated with the lead underwriter of an offering tend to issue more overly optimistic growth forecasts than unaffiliated analysts. Furthermore, the magnitude of the affiliated analysts' growth forecast is positively related to the fee basis paid to the lead underwriter. Finally, equity offerings covered only by affiliated analysts experience the greatest post-offering underperformance, suggesting that these offerings are the most overpriced."

Let me say this in my own way. Maybe there hasn't been complete erosion in the Chinese Walls that traditionally shielded analysts from investment banking interests. Or maybe somebody's just been handing out a whole lot of Chinese Ladders for people to climb back and forth as they please.

A market bubble that bursts is a time when some people look for someone to blame. Instead, I believe it should be an opportunity for all concerned to step back, take a deep breath, and re-examine their own accountability to make sure it doesn't happen again. All parties have to share responsibility.

If today we focus our gaze on analysts' conflict of interest, then at some point we will focus on the investment banks that encourage the conflict of interest, the institutional investors who expect it, and even the financial press that glosses it over and thereby amplifies its harmful consequences.

Let me say a word about the financial media, whose impact in this may be greater than we now realize. It is irresponsible reporting to quote unquestioningly irresponsible analysts and place them on magazine covers and turn them into rock stars.

Consequently, while I appreciate the "Best Practices" proposals put forward by the industry, I am not convinced they go far enough to insure accountability and enforcement. I take the very drafting of them as a positive sign that the industry admits and accepts that problems exist. But I'm naturally skeptical of a document that contains a disclaimer, which, to me, essentially says "We promise to be honest ... unless of course circumstances warrant that we can't be."

Today is not the end of our discussion but a beginning. In the next few months we will assess these recommendations and converse with regulators. At the end of the process, the committee will either help develop a "Best Practices" standard, make recommendations to regulators, or propose legislation if warranted.

Particularly for the sake of the growing number of $200-at-time investors planning for a family, an education, or a secure retirement, it is far more important to do this carefully than it is to do this quickly. And we will continue this effort until we reach an appropriate conclusion.

Statement of
Congresswoman Stephanie Tubbs Jones
Committee on Financial Services
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprise

Mr. Chairman and Ranking Member Kanjorski:

Thank you for holding this hearing on the importance of maintaining ethical practices between Wall Street analysts and the consumers or clients to whom they provide their research and guidance. It is certainly troubling that many in the financial sector are calling attention to the possibility of biased or inaccurate advice that comes down to investors from analysts in firms who are also involved in investment banking.

Certainly, individual investors must be protected from such bias by disclosure and competence on the part of analysts. I applaud the Securities Industry Association for their recent release of the "Best Practices for Research" and the guidelines it provides for disclosure, integrity in analyst research, and the goal for directing that compensation stem from analyst performance and not directly from their firm's investment banking profits.

I hope that we can gain the perspective of analysts from this panel today, and if we should discuss this issue further maybe we can bring forth more analysts to testify. These are individuals who do provide information and advice to their clients, and certainly they would all be out of business if Americans thought Wall Street research was worthless.

As we see a stock market where prices are crashing, it would be unfair and illogical to point to industry analysts as the scapegoat for the economic downturn. In recent years, our economy has shown great growth and prosperity, and this was in part tied to the growing technological industry. It seems that part of this outcry over possible analyst bias stems from the downfall of tech stocks and the current downturn of the market. There are many factors that should be considered here, and they may suggest that analysts were not necessarily cheating their clients. E-commerce is a relatively new player in the market and I hope that we can analyze whether some of the downfalls of this industry stem from treating e-businesses like the traditional mortar and stone companies.

Again, it is important for this committee to examine the current state of self-regulation. I hope that the witnesses here today can provide insight and their expertise as they comment on the current state of the analyst-client relationship and the government's role in protecting investors.

OPENING STATEMENT OF RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON ANALYZING THE ANALYSTS: ARE INVESTORS GETTING UNBIASED RESEARCH FROM WALL STREET?

THURSDAY, JUNE 14, 2001

Mr. Chairman, we meet today to consider the issue of analyst independence, a subject of great significance to our Nation's vibrant capital markets. I congratulate you for your diligence in convening this very important and well-timed hearing.

Over the last several years the perceived immortality of the U.S. economy and the emergence of the Internet have contributed to extraordinary interest and growth in our capital markets. Investors' enhanced access to financial reporting and their newfound ability to trade electronically also helped to fuel this dramatic expansion. Unlike some other sources of investment advice, the vast majority of the general public has usually considered the research prepared by Wall Street experts as reliable and valuable. With the burst of the high-tech bubble, however, came rising skepticism among investors concerning the objectivity of some analysts' overly optimistic recommendations. Many in the media have also asserted that a variety of conflicts of interest may have gradually depreciated analyst independence during the Internet craze and affected the quality of their opinions.

We have debated the issues surrounding analyst independence for many years. After the deregulation of trading commissions in 1975, Wall Street firms began using investment banking as a means to compensate their research departments, and within the last few years the tying of analyst compensation to investment banking activities has become increasingly popular. As competition among brokerage firms for IPOs, mergers, and acquisitions grew, so did the potential for large compensation packages for sell-side analysts. These pay practices, however, may have also affected analyst independence. While some brokerage houses suggest that they have executed an impenetrable "Chinese wall" that divides analyst research from other firm functions like investment banking and trading, the truth, as we have learned from many recent news stories, is that they must initiate a proactive effort to rebuild their imaginary walls.

The release of some startling statistics has also called into question the actual independence of analysts. A report by First Call, for example, found that less than one percent of 28,000 recommendations issued by brokerage analysts during late 1999 and most of 2000 called for investors to sell stocks in their portfolios. Within the very same timeframe, the NASDAQ composite average fell dramatically. In hindsight, these recommendations appear dubious. Furthermore, First Call has determined that the ratio of buy-to-sell recommendations by brokerage analysts rose from 6:1 in the early 1990s to 100:1 in 2000. Many parties have consequently suggested that analysts may have become merely cheerleaders for the investment banking division in their brokerage houses. I agree. To me, it appears that we may have obsequious analysts instead of objective analysts.

Today's hearing will help us to better understand the nature of this growing problem and discover what actions might restore the public's trust and investors' confidence in analysts. Like you, Mr. Chairman, I generally favor industry solving its own problems through the use of self-regulation whenever possible. But in this instance, the press, regulators, law enforcement agencies, and spurned investors have also begun their own examinations into these matters. I suspect that these parties may demand even greater reforms than those recently proposed by the Securities Industry Association, including the need for full and robust disclosure of any and all conflicts of interest. To address these concerns, the industry may eventually need to come forward with a way to audit and enforce the best practices it now proposes. If not, others may seek to impose their own solutions to resolve this problem.

We will hear today from eight distinguished witnesses representing a variety of viewpoints. I am, Mr. Chairman, particularly pleased that you invited a representative from the AFL-CIO to join in our discussions. I would have also liked to learn about the concerns of the SEC and NASD, among others. I was, however, heartened to learn yesterday that you plan to hold additional hearings on this issue in the upcoming months with the concerned parties.

As we determined last year during our lengthy deliberations over government-sponsored enterprises, a roundtable discussion is often the most appropriate forum for us to deliberate over complex issues. In the future, I urge you to convene a roundtable over the matters related to analyst independence. A roundtable discussion would force the participants to challenge each other's assumptions and assertions in an open environment. It would also provide us with greater insights than testimony that has been scrutinized and sterilized through the clearance process. A roundtable debate would further allow us to more fully educate our Members about the substantive issues involved in this debate.

In closing, Mr. Chairman, I will listen carefully to today's testimony and encourage our Committee to move deliberately and cautiously on these matters in the months ahead. Analyst independence is an issue of the utmost importance for maintaining the efficiency of and fairness in our Nation's capital markets. Finally, given the complex nature of this subject and the controversy surrounding it, I believe that our Committee's deliberations would greatly profit from a roundtable discussion.

Statement of Rep. John J. LaFalce
Ranking Member, Committee on Financial Services
Hearing on Analyst Objectivity
June 14, 2001

Today the Subcommittee confronts the very important question of whether investors are receiving unbiased research from Wall Street securities analysts. I commend the Chairman for holding these hearings, for I am very concerned that investors have become victims of recommendations of analysts who have apparent and direct conflicts of interest relating to their investment advice.

It is clear that sell-side analysts work for firms that have business relationships with the companies they follow. Most analysts are under increased pressure to look for and attract business and to help the firm keep the business it has. The analyst is asked to be both banker and stock counselor. These two goals often live in conflict.

The individual investor is often unaware of the various economic and strategic interests that the investment bank and the analyst have that can fundamentally undermine the integrity and quality of analysts' research. The disclosure of these conflicts is often general, inconspicious and boiler-plate. In addition, current conflict disclosure rules do not even reach analysts touting various stocks on CNBC or CNN. As former Chairman of the SEC Arthur Levitt noted, " I wonder how many investors realize the professional and financial pressures many analysts face to dispense recommendations that are more in a company's interest rather than the public's interest."

I believe that it is precisely these pressures that moved many analysts during the technology boom over the last several years to recommend companies and assign valuations beyond any relationship to company fundamentals. In a recent article, a well-know technology analyst was quoted as responding to questions concerning the legitimacy of the valuation of a particular company. The analyst said, "**We have one general response to the word 'valuation' these days: 'Bull market' . . . We believe we have entered a new valuation zone.**" The article to which I referred and many others make the case that these conflicts may have profoundly undermined analyst integrity, and possibly even misled investors, as analysts held fast to companies as the market eroded out from under them.

The securities industry has suggested new guidelines to address some of the conflicts we will discuss in today's hearing. This initiative is an important first step. I do not believe, however, that these voluntary guidelines go far enough to address the problem.

I am hopeful that the hearings this Thursday will begin a process whereby Congress and the regulators can begin to take a hard look at that these troubling questions affecting the American investing public. I also look forward to additional hearings where the SEC and NASD, amongst others, can testify on this question of analyst objectivity. In my view, the securities regulators' perspective is critical to the question at hand. We cannot fulfill our oversight responsibility if the government and quasi-government entities charged by Congress with the protection of investors have not been heard. Not only do the securities regulators have an important perspective on the magnitude of the problem, they also have a view on how the industry is complying with current regulations on information barriers, so-called Chinese walls, and the disclosure of conflicts.

I am increasingly concerned that industry self regulation may not be sufficient to guard against the problems and abuses we are seeing, and that more disclosure of these conflicts, in itself may not suffice to protect the individual investor. I hope today's hearing is only the first step in confronting the troubling issues of securities analysts' conflicts of interest.

BOB NEY
18TH DISTRICT, OHIO
1024 LONGWORTH H.O.B.
WASHINGTON, DC 20515
(202) 225-6265
(202) 225-3394 FAX
E-MAIL: bobney@mail.house.gov

COMMITTEES:
BANKING AND FINANCIAL SERVICES
TRANSPORTATION AND INFRASTRUCTURE
HOUSE ADMINISTRATION
DEPUTY WHIP

Congress of the United States
House of Representatives
Washington, DC 20515–3518

Opening Statement of Congressman Bob Ney
Vice Chairman of Capital Markets Subcommittee
June 14, 2001 Hearing Analyzing the Analysts

Mr. Chairman, Ranking Member Kanjorski thank you for calling this important hearing on the independence of securities analysts. I know that this hearing is important in exercising this subcommittee's important role in overseeing securities markets and protecting American investors.

We all watched as stock markets lost 60 percent of their value last year, seeing trillions of dollars of wealth wiped out in the matter of a few months. However, 99 percent of market analyst recommendations during this time were buy, strong buy or hold. Only 1 percent of these recommendations were for sell or strong sell, even though the markets were losing 60 percent of their value. This "strange coincidence" has raised questions about the independence and integrity of Wall Street analysts. Analysts at securities firms are supposed to make objective recommendations on companies for which their firm is underwriting the IPO, or their firm's investment banking division has a stake in. However recent evidence indicates that the wall that is supposed to ensure the integrity and independence of securities analysts may be crumbling. Anything less than real independence only invites fraud.

We are here today to determine whether analyst recommendations have been subordinated to the needs of their investment banks and IPO underwriters, or if there is another reason for the inflation of stock recommendations in recent years. We also seek a clear explanation of how 99 percent of recommendations are buy or strong buy in a declining market.

We must look at what is behind these recommendations, and whether or not they are based on truly independent research. For example, it has come to light that in some firms analysts have been part of the investment banking division, stock recommendations have been reviewed by the investment bankers and companies being rated, and analyst pay has been tied to the profits of the company's investment bank. This cannot be independent research.

I believe that positive actions must be taken to restore the confidence of investors in the recommendation of securities analysts. I was encouraged to see that a group of securities companies recently came forward with a proposed best practices policy that would ensure the independence of analysts, eliminate the inflation of recommendations, and restore the confidence of investors in stock recommendations. Some of these recommendations include limiting the ties between analysts and investment bankers, changing the compensation

DISTRICT OFFICES:

3201 BELMONT STREET
ROOM 604
BELLAIRE, OH 43906
(740) 676-1960
(740) 676-1983 FAX

HILTON-FAIRFIELD BUILDING
152 2ND STREET, NE, #200
NEW PHILADELPHIA, OH 44663
(330) 364-6380
(330) 364-7675 FAX

MASONIC TEMPLE BUILDING
38 NORTH 4TH STREET
ROOM 502
ZANESVILLE, OH 43701
(740) 452-7023
(740) 452-7191 FAX

PRINTED ON RECYCLED PAPER

structure for analysts, limiting the amount of material that can be reviewed by security firm investment bankers, and standardizing recommendations.

The industry must institute a sound policy to guarantee that analysts are making fair, and unbiased recommendations for stocks. We must ensure that these proposed best practices guidelines policy have the enforcement mechanisms necessary to ensure proper implementation, and they must guarantee that investors can trust the recommendations of securities analysts.

This committee will continue its oversight in this matter, and I look forward to returning to this issue to see if efforts by the securities industry to institute a best practices initiative have had the results necessary to achieve true analyst independence and consumer protection.

Again, thank Mr. Chairman for holding this important hearing, I appreciate you bringing this important issue before our committee.

For more information contact:

Jim Forbes
Director of Communications
Committee on House Administration
Congressman Bob Ney of Ohio
Direct Phone: 202-225-1350
Fax: 202-225-3394
E-mail: jim.forbes@mail.house.gov

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises

"Analyzing the Analysts: Are Investors Getting Unbiased Research from Wall Street"
June 14, 2001

One of my goals as Chairman of this new Committee is to help investors by improving the way they get information on which they base their investment decisions. Due in large part to the advances in technology that have brought us the Internet, we have become not only a nation of investors, but a nation of self-taught investors.

No longer do investors have to rely on the information they obtain from their broker to make their investment decisions – today there is a veritable smorgasbord of information about the marketplace available to the public. Through financial web sites, print publications, television, and virtually every media outlet, there is a wealth of data available to investors.

I launched this Committee's inquiries into improving the way stock market quotes are collected and disseminated, and into the impact of Regulation FD, with an eye toward ensuring investors have broad access to the highest-quality information about the marketplace. Today's hearing continues our work toward that goal. I commend Subcommittee Chairman Baker for his work on each of those issues, and for holding this important hearing today.

I heartily agree with the Supreme Court's characterization, in the Dirks case, of the importance of analysts to investors and the marketplace:

> "The value to the entire market of [analysts'] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors."

Yet the important work of analysts does not do the marketplace, or investors, any good at all if it is compromised by conflicts of interest. There has been a great deal of concern raised by the media, by regulators, and by market participants about the perception that analysts are not, in fact, providing the independent, unbiased research that investors, and the marketplace, rely on them for.

We are here today to learn whether the "Chinese wall" that has long been cited as the separation between the research and investment banking arms of securities firms has developed a crack or has completely crumbled.

I am encouraged that Wall Street has recognized that this is not a phantom problem, and has proposed industry best practices guidelines to address these conflicts, about which we will hear today.

But I must emphasize that, if that Chinese wall is in need of repair, wallpaper will not suffice. While I am a strong proponent of free-market solutions, I, and this Committee, plan to examine these industry guidelines very closely to ensure that they are tough, they are fair, and they are effective.

I am distressed by the statistic that, as the markets were crashing last year, less than two percent of analyst recommendations were to sell. It is no wonder there is public outcry about analyst independence when the statistics are so stark.

But it seems to me that the problem is not simply biased analysts. If the firms that employ those analysts tie their compensation to the analysts' success in bringing in investment banking business, then the firms are undermining the independence of their own employees' recommendations.

Similarly, companies that pressure analysts through either the carrot or the stick of increased or decreased investment banking business in return for favorable reports exacerbate the problem. Likewise, institutional investors also exert pressure on analysts to issue rosy reports about the stocks those institutional investors hold in their portfolios. We intend to examine every angle of this issue in order to best determine how to resolve it.

Our goal here is to improve industry practices. I call on the industry to eliminate the conflicts of interest created by compensation structures and insufficient separation of investment banking and research. I call on them also to provide meaningful and understandable disclosure to investors that will enable investors to evaluate, for themselves, what weight they should give the recommendations of any particular analyst.

This hearing is this Committee's first step in a long-term effort to ensure that the nation's investors have the best possible information about the stocks in which they invest. Ensuring that investors can rely on the expertise of analysts without any doubt as to their integrity or independence could not be more fundamental to that effort.

###

Committee on Financial Services

Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee

"Analyzing the Analysts: Are Investors Getting Unbiased Research from Wall Street"

June 14, 2001

Testimony of

David W. Tice

David W. Tice & Associates, Inc.

Prepared by:

Marshall Auerback
Jeff Dalton
Tim Heitman
Chad Hudson, CFA
Gregg Jahnke, CFA
Albert Meyer, CFA, CA
Jeff Middleswart
Doug Noland
Rob Peebles, CFA
David Tice, CFA , CPA

Table of Contents

Executive Summary

David W. Tice and Associates, Inc. is a company built around the idea that the most important resource an investor can have is independent analysis. Often our analysis makes our research clients and mutual fund shareholders uneasy because it differs significantly from the consensus on Wall Street. However, we believe we have their respect because they realize that our conclusions are free of the biases that affect other investment research. The BACKGROUND section discusses the organization of both our research and mutual fund management business.

We believe there is no question that Wall Street's research is riddled with conflicts of interest. The conspicuous lack of objectivity in research is indicative of what we see as a general lack of responsibility on Wall Street today that is having a corrosive effect on the marketplace. The section titled WALL STREET'S LACK OF OBJECTIVE RESEARCH HAS DIMINISHED MARKET INTEGRITY gives many examples of these conflicts from a variety of sources.

The main emphasis of our testimony will address the consequences that arise when capital markets lack integrity. This problem is much larger than whether or not individual investors are disadvantaged or suffer losses, or if analysts receive over-sized bonuses. When the market pricing mechanism that determines which industries are allocated precious resources is dysfunctional, the foundation of capitalism is threatened. When the marketplace's reward system favors the aggressive financier and speculator over the prudent businessman and investor, the consequences will be self-reinforcing speculative booms and busts, a hopeless misallocation of resources, and an imbalanced economy. Such an environment fosters a redistribution of wealth from the unsuspecting to those most skilled at this game of speculation. Our section on CONSEQUENCES addresses these issues.

In our opinion, reckless financial behavior fostered by Wall Street analysts has already caused capital misallocation throughout the high tech sector, particularly the Internet and telecommunications industries. We believe a similar misallocation is being directed toward the financial services area. Capital has been recklessly deployed to hundreds of businesses with rapid revenue growth, but with flawed business models at the expense of other viable, more important projects. A dangerous "credit bubble" has been created that threatens our financial system.

We do not claim to have the optimal solutions to these problems. In our section on POTENTIAL SOLUTIONS we suggest proposals that might help solve some of these conflicts. Being fervent advocates of the free market we are loath to advocate new regulations and more regulators to enforce them. However, we believe that the problems are so critical that something must be done. We leave the matter of specific laws and regulations to those wiser than us on these matters.

Tremendous political courage will be needed to effect change in this area. Those who have benefited from the current broken system have enormous financial resources. The raw political power of those who favor the current system cannot be underestimated. The voices of those favoring change will be faint, but well worth listening to. However, we must remember that trust in our institutions is the cornerstone of a vibrant capitalistic society, and lies at the heart of a healthy democracy.

We commend the Chairman and this Committee for tackling such a difficult and timely issue. The stakes are enormous. We are always willing to discuss the ideas presented here with any member or staff at their convenience. Thank you for the honor to appear before this committee.

Background

David W. Tice & Associates, Inc. (DWTA) operates two different businesses. The firm is publisher of *Behind the Numbers* (BTN), an institutional research service, and is investment advisor to two mutual funds. The bio and resume of David W. Tice can be found in Appendix A.

We started BTN because we were aware that institutional investors did not receive independent research from their traditional brokerage firm relationships. Certainly, Wall Street firms were not advising their clients when to "sell." In fact, while there are many independent research firms that supply services from economic consulting to technical analysis, we believe there are fewer than six other significant firms that concentrate on sell recommendations. We began issuing our own "sell recommendations" in 1988 in a research publication we call *Behind the Numbers*. Today more than 250 institutional investors purchase this product. Our 15 largest clients manage more than $2.3 trillion in assets. DWTA employs a staff of 12 analysts, 5 professionals and 10 support personnel. Of the 896 sell recommendations issued between 1988 and 2000, 598 (67%) have underperformed the market averages. As of June 1, 2001 we have 160 "warnings" outstanding. For an overview of our analytical process please see "BTN's Indicators of Weakness" in Appendix B. Actual BTN reports can be found in the Appendix C (Paging Network, Sunbeam, and Rhythms).

Since 1996 DWTA has managed the Prudent Bear Fund (BEARX). The fund currently has assets of $130 million. Prudent Bear was founded to provide individual investors with an investment vehicle to hedge their existing long exposure to equities, allowing them to profit from a stock market decline. While many funds now have the ability to sell stocks short, we believe only a handful are actually more short than long. As the market approaches more reasonable valuation levels we expect the fund to take a more balanced approach using both long and short positions. At the current time BEARX holds short positions with 67% of its assets, and put options with 4% of its assets. The remaining assets are invested in long precious metal stocks and a few development-stage companies. For more information on the Prudent Bear Fund see the "Investment Guide" in Appendix N.

It is crucial to understand that David Tice has not always had a bearish outlook on the U.S. equity market. Although he has been bearish through the later stages of this bull market, he was quite bullish on equities though the 1980's and part of the early 1990's. While working for a small investment manager in the 1980's, David was instrumental in transferring wealthy individuals' assets from real estate and energy investments into the equity markets. DWTA also manages the Prudent Safe Harbor Fund (PSAFX) which started in 2000. The fund invests primarily in non-dollar short-term, high-quality debt securities, and also invests in precious metal equities. The fund plans to benefit from a decline in the value of the U.S dollar vs. other currencies. The fund has current assets of $13 million.

In September 1999, DWTA hosted a New York symposium, "The Credit Bubble and its Aftermath" to alert the media, investors and policy makers about the risks created by the historic expansion of credit. Press coverage of the conference included a front page article in the *Wall Street Journal* and stories in *Barron's*, *Business Week* and other news media.

DWTA also hosts a popular web site, www.prudentbear.com, which includes commentaries by some of our analysts. The site also collects important news stories and commentaries on economic and financial events.

Wall Street's Lack of Objective Research Has Diminished Market Integrity

We believe the evidence that Wall Street's research lacks objectivity is overwhelming. Excerpts from news reports on conflicts of interest are presented below along with some conclusions of academic research on this matter. To illustrate how Wall Street research can ignore negative fundamentals, we provide examples of our own research and compare our conclusions to those of major brokerage firms. Additionally, in Appendix I we have supplied a table that illustrates the predominance of "Buy" vs. "Hold"and "Sell" recommendations for the NASDAQ 100.

Wall Street conflicts becoming more apparent

No one can deny that criticism of Wall Street's research is increasing. While it is true that some of those critical of Wall Street research quoted below are former analysts who may have an ax to grind, there is increasing criticism coming from such divergent groups as buy-side investment firms, government regulators and academics. When taken as a whole, it is reasonable to conclude that the current analyst/investment banker/company relationship is fraught with harmful and real (not imagined or potential) conflicts of interest. Current safeguards, such as the long-touted "Chinese Walls," are ineffective.

Two recent news articles highlight the problems with Wall Street research. Gretchen Morgenson of the *New York Times* published an exceptionally insightful article on December of 2000, titled "How Did So Many Get It So Wrong?" Her story (included in the Appendix O) provides an excellent primer for Congress on analysts' objectivity. The article includes examples of high profile analysts maintaining buy recommendations on companies that their firm had underwritten in the face of plunging share prices and overwhelming evidence of rapidly deteriorating businesses. Morgenson, for example, reports that Mary Meeker (of Morgan Stanley) maintained "outperform" ratings on 11 stocks that were down 83 percent on average. Morgan Stanley had underwritten eight of those eleven companies. According to Morgenson, high profile analyst Jack Grubman of Salomon Smith Barney (who was praised in an earlier *Business Week* article for being the telecom industry "power broker") downgraded his ratings on 11 small telecom stocks, all of which had been underwritten by Salomon, only after they had declined by 77 percent.

How could such highly regarded analysts be so wrong on the performance of the companies they followed? In Morgenson's article, Stephen Abrams, chief investment officer for asset allocation at the Trust Company of the West, suggests that the analysts are beholden to their firm's underwriting business. Trust Company of the West is a highly respected institutional investment management firm with $80 billion in assets under management. According to Abrams, "research analysts have become either touts for their firm's corporate finance departments or the distribution system for the party line of the companies they follow. Not only are they not doing the research, they have totally lost track of equity values. And the customer who followed the analyst's advice is paying the price."

Morgenson quotes Mitch Zacks of Zacks Investment Research as suggesting that the "way an analyst can get fired is to damage an existing investment banking relationship with a company or sour a future investment banking relationship. The way you do that as an analyst is coming out and telling people to sell a stock." Note that these damaging accusations are made by industry insiders who understand how the game is played.

In a July 2000 *Bloomberg* magazine article titled "Bad Advice," Faith Keenan presents numerous examples of analysts (again including Ms. Meeker and Mr. Grubman) refusing to lower ratings on stocks where they had a banking relationship until the stocks plummeted. Some former analysts certainly think something is amiss. Ms. Keenan quotes Stephen Balog, the former research director at Lehman Brothers and Furman Selz , "an analyst is just a banker who writes reports. No one makes a pretense that it's independent." Sean Ryan, a former banking analyst at Bear Stearns Co. explained his reasons for recommending NetBank like this: "I put a buy on it because they paid for it." Ryan said he told clients that "we just launched coverage on NetBank because they bought it fair and square with two offerings." The *Bloomberg* article is included in Appendix P.

Down with the Wall

If there was ever a "Chinese Wall" at JP Morgan, it seems to have been dismantled earlier this year. According to *The London Times* (3/21/01), JP Morgan's head of equity research circulated a memo explaining that analysts must seek comments from the relevant JP Morgan investment banker before changing a stock recommendation. Furthermore, the analyst must seek comments from the company in question, and if the company "requests changes to the research note, the analyst has a responsibility," according to the article, "to incorporate the changes requested or communicate clearly why the changes cannot be made." This article is included in Appendix Q.

One manifestation of the lack of objectivity by Wall Street analysts was the practice of ratcheting so-called target prices ever higher. In the "Heard on the Street" column in the April 12, 2000 *Wall Street Journal*, George Kelly, an analyst at Morgan Stanley who followed Cisco Systems, explained his rationale for increasing his target price this way: "We have to accept the facts of life. If investors want to be in these high-growth companies, we are just trying to take what they are willing to pay and translate it into a target price and therefore a stock recommendation." Unfortunately, this example of what we would consider negligence is not an isolated case. David Eidelman, the former head of research for two regional brokerage firms in the 1970's, suggested in the Morgenson *New York Times* article that, "analysts no longer focus on tangible factors, such as discounted cash flows, that make a stock worth what it is worth. For instance, analysts have valued Internet retailers based on how many customers they had. This may have nothing to do with earnings, they justify it with some valuation method they invented."

We are surprised that the above widely published anecdotes have not been met with more outrage in the investment community. These comments go to the heart of the problem. Wall Street is clearly not even close to being objective in the research it publishes. Several academic studies over the years have come to the same conclusion.

Academic research

One of the more important studies on analysts and conflicts of interest was published in February of 1999 by Michaely and Womack, titled "Conflict of Interest and the Credibility of Underwriter Analyst Recommendations." We have included a sample of this study in Appendix R. The entire study can be found on the Internet at:
http://mba.tuck.dartmouth.edu/pages/faculty/kent.womack/workingpapers/boost.pdfa

In our view, important findings of the study include:

1. "In the month after the quiet period lead underwriter analysts issue 50 percent more buy recommendations on the IPO than do analysts from other brokerage firms."

2. "Stock prices of firms recommended by lead underwriters fall, on average, in the 30 days before a recommendation is issued, while prices of those recommended by non-underwriters rose."

3. "Long-run post-recommendation performance of firms that are recommended by their underwriters is significantly worse than the performance of firms recommended by other brokerage houses. The difference in mean and median size-adjusted buy and hold returns between the underwriter and non-underwriter groups is more than 50 percent for a two year period beginning on the IPO day."

4. "The mean long-run return of buy recommendations made on non-clients is more positive than those made on clients for 12 out of 14 brokerage firms. In other words, it is not the difference in the investment banks' ability to analyze firms that drives our results, but a bias directly related to whether the recommending broker is the underwriter of the IPO."

This last point flies in the face of claims that no conflict of interest exists between the analyst and the investment banker. In addition, the authors surveyed investment management firms and investment banking firms to determine what, in their opinion, caused the apparent bias in the research. The survey found that 13 out of 13 investment management firms and 10 out of 13 investment banking firms believed the bias in recommendations made by analysts whose firms had underwritten a stock was the result of "a strategic conflict of interest."

Several other studies have reached similar conclusions regarding conflicts of interest. The Fall 2000 issue of the *Journal of Managerial Issues* published a study by Jane Cote, Associate Professor of Accounting at Washington State University titled, "Analyst credibility: the Investor's Perspective." The paper revealed that "most frequently analysts are pressured to offer favorable recommendations or at least temper negative opinions. No fewer than 61 percent of analysts responding to a survey reported personal experience with management threatening reduced future access to the company, severing business ties to the investment firm, lawsuits and even having the analyst terminated." The study also found that, "in essence, pressures on analysts to issue favorable reports create a short-term benefit to certain constituents in exchange for a long-term cost for all stakeholders."

Certainly the SEC has recognized a problem. Arthur Levitt, former Chairman of the SEC, stated in a December 21, 2000 *USA Today* article that analysts "have lost significant credibility" because they "operate in an area of potential, perceived and sometimes actual conflicts, their recommendations are viewed with increasing skepticism." In her April 19, 2001 speech at the Northwestern University School of Law, Acting SEC Chairman Laura Unger noted that, "the natural incentive (as a result of the analyst working on the investment banking team), therefore, is to avoid releasing an unfavorable report that might alienate the company and impact its future investment banking business. This is not an irrational fear, either. In a recent survey of 300 CFOs, *one out of five CFOs acknowledged that they have withheld business from brokerage firms whose analysts issued unfavorable research on the company* (our emphasis)."

In May 2000, *Investment Dealer's Digest* published the results of an analysis of a random sampling of 20 IPOs where the stock had fallen substantially since the offering. The results revealed that the Wall Street underwriters of these stocks were still recommending 80% of those companies. In nine cases, the lead or co-manager were the only ones recommending the stock.

Maureen McNichols, a professor of Public and Private Management at Stanford published a study that concluded that analysts "bow to pressure from investment bankers or clients and issue more favorable reports than warranted." The report also found that analysts for underwriting firms had more favorable recommendations and long-term growth forecasts than analysts that were unaffiliated with an underwriting deal.

Buy-side managers, who can suffer from this lack of objectivity by Wall Street analysts, are becoming increasingly vocal on this subject. Scott Black, a well-respected investor and the President of Delphi Management, was quoted in the February 12, 2001 edition of *American Prospect* as saying, "most analysts are simply putting out promotional literature. They're there to sell stocks and drum up other business." Robert Sanborn, the former manager of the Oakmark fund was quoted in a *USA Today* article condemning Wall Street research. He said, "When a sell-side analyst like Henry Blodget says Amazon is worth $400 (a share) and then they bail at $30 (a share) I think it says that anyone that relies on sell-side research is an absolute fool." Tweedy, Browne Company in their May letter to shareholders lamented that "if you pardon our cynicism, many of these analysts also work for investment banking houses that are collecting generous fees for bringing Internet and Internet-related companies public. In a more rational world, this would be called a conflict of interest." Finally, Avinash Persaud, head of global research at State Street Global Markets said, "over the past five years, the quality of research has deteriorated to such an extent that many investors now view most of it as not worth the glossy paper it is written on."

IPO Mania

Actual or perceived conflicts surrounding underwriting practices during the IPO boom evidently have prompted investigations of the largest Wall Street firms, including Credit Suisse First Boston, Goldman Sachs and Morgan Stanley. Those investigating possible wrongdoing include the SEC, the regulatory arm of the NASD and federal prosecutors in Manhattan. In addition, hundreds of class-action lawsuits have been filed regarding possible wrongdoing in the underwriting process. The focus of many of these investigations is whether investment banks demanded inflated commissions in exchange for IPO shares, and whether the banks pressured large investors who were allocated IPO shares to buy more at higher prices in an effort to drive up the price of the shares in the after market.

The amount of money involved in the underwriting business is huge. The *Economist* magazine quotes Jay Ritter, economist at the University of Florida, as putting the official underwriting revenues on Wall Street for the period 1999-2000 at $7.3 billion. However, Mr. Ritter also noted that the "instant profits available for clients allocated shares in an IPO that soared on the first day of trading," totaled $66 billion or nearly ten times the amount of revenue generated by the underwriting process itself.

Recent news reports, including a story in *USA Today* (May 25, 2001) titled "Officials suspect IPO manipulation. Agencies scrutinize some investment banks," describe how Wall Street was potentially able to take advantage of the frothy IPO environment. One employee of Credit Suisse First Boston described the frenzied environment as one of "rape and pillage." Another employee said that he saw commissions as high as $1 a share cross his desk when five cents per share was more usual. "You could chart our commissions like a bell curve," he said. If these statements are true, they lend credence to the investigations mentioned above. Such activities would indicate buyers (typically institutions) were in fact rebating huge IPO gains by paying excessive commissions.

Michael Sola, portfolio manager for T. Rowe Price's Developing Technology Fund, explained *to USA Today* how the game was played. He said that "people know the higher they say they are willing to buy the stock (in the after market), the bigger the allocation they are going to get."

But why should we care that these practices go on? Aren't institutions making money for their clients? Yes, but they are doing so at the expense of individual investors and at the risk of corrupting the capital allocation system as we'll illustrate in subsequent sections. In fact, the IPO game in effect transferred wealth from individual investors to large institutions, management of the companies going public, and the venture capitalists who got out before the game ended. According to *Value Line*, individual investors own 75% of the shares in Internet companies. In contrast, individuals only own 44% of the shares of General Motors. While some institutions were selling stocks on the first day of trading, and other institutions and insiders reduced positions as the speculation continued, individuals were often left holding the bag. They had been led to believe these stocks were to be held for the long term.

In the uniformly bullish environment to which we repeatedly refer, few brokers were advising their clients to sell these speculative stocks, no matter the price. We all know the subsequent results.

This IPO mania was largely possible because of limited supply and breathtaking demand. Only a small number of shares outstanding were available in the public float since most of the newly issued shares remained initially in the hands of insiders.

The game continued, often with secondary offerings allowing insiders to get out while encouraging more small investors to come in. Thus the game continued until the bubble burst. Despite questionable fundamentals, soaring stocks in this potentially rigged game fostered a speculative environment. We are now left with the consequences of a boom turned bust.

Uniform bullishness and persistent buy recommendations with little negative commentary could very well have led to an over-allocation of individual portfolios to equities. It is certainly impossible to prove this with any available data. All we have is a mountain of anecdotal evidence. Many in our office have commented that they cannot listen to local investment shows on the radio. When our analysts hear the bullish hosts recommend people near retirement hold 80% of their investments in equities, they have a tendency to drive off the road. We do know that investors have lost more than $4 trillion, and it is our belief that the stock market decline is not yet complete. Typically, stock bubbles lead to reversals that take stocks to much lower levels. Unfortunately, the individual investor is typically late to the game, and ultimately suffers the largest losses.

Current structure puts pressure on analysts

Analysts face enormous pressure from their corporate finance investment banking teams and company managements to write positive reports on the companies they follow. As the SEC Acting Chairman pointed out earlier, one in five corporate CFOs acknowledged withholding business from firms with unfavorable reports on their companies. Since a substantial portion of an analyst's compensation is tied to corporate banking transactions, there is tremendous pressure to work closely with their firm's investment bankers to achieve harmony with the banking client. According to CNBC reporter David Faber ("Analyzing the Analysts: Taking a Look at How Analysts are Sometimes Pressured into Making Bullish Calls), analysts who write negatively about a company "get treated badly by their own bankers, by people internally." In addition, these analysts run the risk of losing their jobs.

Consider the fate of two former Wall Street bank industry analysts, Tom Brown and Charles Peabody and one current bank industry analyst, Mike Mayo. All three highly ranked analysts were fired from their positions. The reasons given for the dismissals by their former firms usually relate to mergers between investment firms. However, these three men were widely known for their strong negative calls on numerous banks during a time of frenetic merger activity in the banking industry. Clearly it would be difficult for their firms to solicit investment banking business from banks that were rated "sell" by these analysts. While numerous industry publications have speculated as to the true motives of those who did the firing, the message sent is clear. If an analyst is negative on current or potential investment clients, they should find work elsewhere. We believe that firing such high-profile, well-respected analysts has kept other analysts from making similar, useful, public calls for their clients.

Summary of conflicts

SEC Acting Chairman Unger summed up the current situation in her address to the Northwestern University School of Law, "As the Supreme Court has stated analysts should play a crucial rôle by providing investors with objective and independent analysis of a company's prospects. Our markets will remain strong and vibrant only as long as investors have confidence in them. Thus, it can only follow that the integrity of our markets relies fundamentally on the integrity of market information available to investors. To the extent that firms can ameliorate analysts' conflicts and better ensure objectivity and independence, all of the investing community will be better served." The text of this speech may be found in Appendix X.

Examples of independent vs. Wall Street research

To illustrate some of the shortcomings of Wall Street research, we present three of our *Behind the Numbers'* reports, and compare them to three Wall Street reports. Our reports on Paging Network, Sunbeam and Rhythms are included in Appendix C. The Wall Street reports on the same companies are in Appendices S,T, and U.

To dramatize the lack of objectivity in some Wall Street research, we have focused on two companies that eventually went bankrupt, Paging Network and Sunbeam. The point of this exercise is to show that even though there was ample evidence of these firms' financial difficulties, Wall Street either minimized, dismissed or ignored such information in their reports. As a result, investors who purchased equity or debt in these companies lost billions of dollars.

When examining the research produced by a major brokerage house on **Paging Network (PAGE)** in 1995, it is evident that routine financial analysis was set aside. The analyst upgraded PAGE to a "Buy," urging investors to take advantage of the company's solid underlying fundamentals. But as *Behind the Numbers* pointed out in a report written six months prior, the company's fundamentals appear anything but solid to the critical eye. Our *Behind the Numbers* report noted that "Wall Street has ignored traditionally important details such as net losses, heavy borrowing, and low interest coverage; and has instead focused attention on gross cash flow and revenues, two items that are almost meaningless when viewed in isolation."

The Wall Street research "justified" its position on PAGE by listing "positives and negatives" associated with the stock. While they touted PAGE for its large customer growth, its net losses and heavy borrowing were ignored and capital spending was treated like a non-recurring item. This allowed Wall Street to plug gross cash flow as a way to value the company, as if all of that cash flow was available to shareholders. But as *Behind the Numbers* points out, Wall Street's focus on gross cash flow ignores maintenance capital spending, which when taken into account, shows that PAGE is not self-supporting, but needs external funds to grow. When factoring in the capital expenditures and the changes in working capital, the net (as opposed to gross) cash flow of PAGE is routinely negative. Net cash flow shows that PAGE cannot even afford to pay its interest expense when taking into account its regular expenses. Capital expenditures for this company were in fact so high that the average customer cost the company more in terms of cash outflow than the customer brought in. So, as the company recruited more customers, it had to borrow more, which only compounded the problem.

This is only one example of how Wall Street downplays or ignores potential problems. This major brokerage house favored a company with no equity, no earnings, and that was borrowing to pay interest expense as long-term debt accumulated exponentially. The only mention of the significant leverage in the 17-page report was a single sentence, followed by another assuring investors that the leverage will benefit the company long-term. But there is no mention of the free cash flow problem. The details BTN provided are by no means the result of intense study of the company's financials by auditors, but rather common-sense observations of the balance sheet and financial status of the company by experienced financial analysts using publicly-available information. In fact, this experience shouldn't differ too much from that of the Wall Street analysts in whom investors place their trust.

Overall, it could be argued that Wall Street never questioned the increasing debt-levels or the free cash flow problem because PAGE was a voracious consumer of external funds, hence a major investment banking client. When this problem became so severe it could no longer be ignored, the company lost access to the public markets and filed bankruptcy.

Sunbeam Corp (SOC) is another example of how Wall Street was touting a stock that exhibited obvious problems when its financials were examined. SOC manufactured blenders and grills, and after a series of problems, a new chairman, Al Dunlap, was brought in to restructure. The stock reacted positively in late 1997 and early 1998 as Wall Street reassured investors that Sunbeam would emerge as a consumer durables powerhouse once Dunlap worked his magic. Large brokerage houses jumped on the Sunbeam bandwagon, blaming past problems on the old management, and claiming that selling blenders and toasters could be a high growth business.

But as time would tell, the turnaround was an illusion produced by aggressive accounting. At the time, SOC had acquired three companies, which, according to Wall Street, would allow for cost savings. In reality, Dunlap came in and took massive charge-offs. Inventory was written off in one year and sold in the next, booking no costs, while performing a series of questionable maneuvers that mismatched revenues with expenses. The result was one horrible year followed by what appeared to be the amazing turnaround Wall Street predicted. However, Sunbeam's businesses were not growing, a fact masked by the charges and other accounting gimmicks. Wall Street research was euphoric about the restructuring, predicting rapid growth for this notoriously slow-growth business. The Street did acknowledge that the consumer durables business was inherently risky, but the primary focus was on Al Dunlap and the efficiencies that were to develop from the synergies.

Again, it seemed as if analysts were taking cues from management on how to value the company and assess the growth rates. When adjusting for the charges, Sunbeam's growth was non-existent. Wall Street neglected to share this fact with investors in a 20-page report, evidently deeming the charges unimportant. In the meantime, SOC continued to take charges, in effect hiding the lack of actual growth.

Behind the Numbers was quick to depict in May of 1998 that Sunbeam's growth was in fact an illusion. Also, the goals set out during the restructuring were not achieved, as the cost savings, debt-reduction, and actual sales growth never occurred. Eventually, the short-term tricks ran out. SOC was forced to admit that its dramatic "turnaround" and earnings recovery were the result of aggressive accounting procedures; procedures that should not have gone unnoticed by research analysts on Wall Street. Sunbeam, an over-leveraged company with little growth prospects, was eventually overwhelmed by its debt.

Finally, to use a more recent example and to illustrate the gross misallocation of capital that has occurred over the last several years, we would like to discuss the rise and fall of **Rhythms NetConnections (RTHM).** Rhythms was founded in 1997 as a Competitive Local Exchange Carrier that focused on providing DSL services to business. Rhythms was started as a direct result of the Telecom Act of 1996, and Wall Street had high hopes for its success in competing against the Bell operating companies. As incredible as it sounds, the company went from being founded in 1997, to a public offering and market capitalization of almost $9 billion in 1999, to being de-listed from the NASDAQ exchange in 2001. We cannot recall another instance in the past 30 years where a company with losses of $36 million on revenues of only $500,000 was able to reach such an incredible valuation and then virtually disappear in the span of only four years. We would offer this as a textbook example of a malfunctioning capital allocation process.

Gretchen Morgenson pointed out in her previously mentioned article, "How Did So Many Get It So Wrong?" that analysts at two firms that were lead underwriters for Rhythms' equity offerings (and had received up to $3.8 million in fees) continued to recommend the stock until the share price fell below $3 (down from an all-time high of $111.50). One of those firms reinstated coverage with a "buy" recommendation in May of 2000 when the stock was at $18 with a target price of $46. The 20-page reported titled "We've Got Rhythm" devoted only a page and a half to the risks involved with the company, and devoted only two sentences in the "risks" section to the fact that Rhythms required almost $3 billion in additional funding to survive. *Behind the Numbers* wrote a report in August of 1999 that heavily criticized the company's poor financial condition. Bondholders were so skeptical of Rhythms' future that they demanded that the company hold back one-third of the proceeds from an offering to ensure that it had the resources to make the first six interest payments on the bonds. BTN's conclusion was clear, "the company's weak financial position, combined with tremendous competition going forward that could place substantial pricing pressure on its services, made Rhythms NetConnections a highly speculative investment. Unfortunately for the company's stockholders, they were unable to force the company to set aside one-third of the IPO proceeds to give them some of the same protection its bondholders received."

Demonstrating how far Wall Street was forced to reach to justify the valuation, BTN included in an update published in August 2000 this explanation of a price target by an analyst at another Wall Street firm:

> "Our rationale for establishing this new price target is based at least partially on the hard reset of the financial markets during the last two quarters. Prior to this, our 10-year DCF analysis did not enable us to reach price targets above the company's trading levels, which in fact might have been a harbinger of things to come across the broader markets." The prior price target of $80 was reached by "company comparable analysis and 18.0X our revised 2003 revenue estimate (*must have used revenue estimate because company does not expect to be EBITDA breakeven until 2004*, our comment included) discounted at 30% to reflect a high beta relative to the S&P 500."

Here was an analyst admitting that he could not justify Rhythms' valuation using traditional methods, but instead of admitting such in the reports, resorted to a convoluted methodology invented to justify the price. This behavior echoes that of the previously mentioned Mr. Kelly and his admitted actions on Cisco's price targets.

The objectivity of Wall Street analysis certainly comes into question when examining the research produced by some of the largest brokerage houses. In many cases, the analysts have become a "megaphone" for the management of the companies they follow. That is they focus on the issues and variables that management deems appropriate. While these issues may in fact be appropriate for comparative analysis, there are often important attributes that are ignored or "played down" – information that the average investor would more than likely want to know, including potential threats to the ongoing operations of a business.

Euphoria for NASDAQ 100 Stocks & Overall Market Continues on Wall Street despite imploding fundamentals

A testimony to the uniform bullish sentiment is the lofty valuation of the NASDAQ 100, the capitalization-weighted index that represents the 100 largest non-financial companies across major industry groups of the NASDAQ Stock Market. This index includes giants Microsoft, Cisco, Oracle, and Intel. To demonstrate how much risk is involved by investing in this index, we have applied some fundamental analysis to produce some valuation data.

For purposes of our analysis we excluded 11 of the 100 companies in the index that have never had earnings, and perhaps never will. The remaining 89 companies were weighted according to their market value as of June 1, 2001. Using traditional ratio analysis, we found that the average stock sold for an extraordinary 8.5 times book value and a sky-high 9 times sales. However, we found it difficult to produce a meaningful price to earnings figure, as out of the 89 companies in the group, 26 of them had losses for the trailing 12-month period! This made it virtually impossible to derive an aggregate P/E based on the methodology used for the P/B and P/S figures.

Given that in bear markets it is not unusual for the aggregate market to sell for 6 times distressed earnings (*not sales*), these stocks remain at historically high valuations – especially considering that more than one-third of the companies are unprofitable. Yet Wall Street buy recommendations account for 70% of all the recommendations on NASDAQ 100.

The table in Appendix I lists Wall Street's recommendations on the NASDAQ 100 stocks. Note how the "buy" recommendations far outnumber the "sells." Below is summary of these recommendations.

Average number of buy recommendations on each stock = 15.8
Average number of holds = 6.3
Average number of sells = 0.6

NASDAQ 100 stocks with no sells = 72
NASDAQ 100 stocks with one sell = 21
NASDAQ 100 stocks with more than one sell = 7

NASDAQ 100 stocks with more 20 buys = 31
NASDAQ 100 stocks with fewer than 5 buys = 3

Stocks of particular interest:

Check Point Software	35 buys 0 sells
Cisco Systems	32 buys 3 sells
I2 Technologies	32 buys 0 sells
LM Ericsson Telephone	26 buys 19 sells
Microsoft	25 buys 0 sells
Nextel	22 buys 0 sells

Ericsson is a stock that has already disappointed investors, and has declined from $24 to $6. The number of sell recommendations on the company (32% of *all* NASDAQ 100 sells) reflects coverage by a number of non-U.S. firms that actually issue sell recommendations.

The Nextel story is noteworthy. The company has never earned a profit yet there are 25 buy recommendations on the stock, no sells, and it trades for 4.5x sales. Meanwhile, Nextel bonds yield 12-15%, a level consistent with junk bond status. Curiously, bond investors are much more skeptical about the company's future than any of the equity analysts.

Is universal optimism justified?
Those who believe that the previous "Irrational Exuberance" has now been corrected, and they will be quick to dismiss our concerns regarding universally bullish reports and high stock valuations. Yet, despite a tempering of the historic manic excesses that engulfed the technology sector over the past 18 months, we see few reasons to hold a sanguine view of the marketplace. Most of Wall Street and the business media have been too anxious to declare a market bottom and now optimistically call for earnings rebound during the second half of the year. We see no fundamental justification for these rosy forecasts that are little more than cheerleading from Wall Street. Profit growth is in the midst of a virtual collapse, yet analysts predict a strong recovery.

In our view, Wall Street is ignoring the deep structural problems facing the U.S. stock market. Technology analysts, in particular, have repeated disregarded fundamental industry deterioration, with talk of short term "inventory corrections" and "company specific" disappointments. Repeatedly, analysts have made unjustified forecasts of imminent recovery, including a call last year to PC sales would boom due to a post-Y2K corporate buying binge and a new upgrade led by a mass Windows 2000 implementations. Telecom analysts predicted that cell phone sales would hit 650 million units in 2001. Network equipment analysts projected shortages of optical equipment for years hence. Semiconductor sales were supposed to surge a further 30%, led by DRAMS, which were expected to be in acute shortage by the final quarter of 2000.

The reality has been somewhat different. The semiconductor book-to-bill ratio is at a 10-year low. DRAM prices have plunged some 70 per cent during the last 6 months due to a massive supply glut, semiconductor sales are dropping by double-digit percentage rates, cell phone sales estimates have been dramatically downgraded to 450 million units, the optical equipment networking equipment sector is mired in a horrible glut and PC sales growth is declining Dramatically. Indeed, the rate of the decline for such PC sales growth is declining dramatically.

Against this backdrop, objective analysis makes it difficult to find compelling value in the stock market, even after significant declines in technology stocks. It is worth noting that the value of all stocks remains at a historically high 140% of GDP. This measure is down from its 2000 peak, but egregiously more expensive than the mean average since 1924 (55%), and well above the previous all-time peak of 87%, set in the autumn of 1929. The S&P 500 stands at approximately 28 times trailing earnings, the sort of valuation that one normally sees at the peak of bull markets, rather than the trough of a bear market where single digit price/earnings ratios, high dividend yields, and low price/book multiples are the norm. The valuation case becomes more suspect when analyzing specific stocks. Even after falling some 93% from its peak, Yahoo! sells at a lofty 9 times trailing revenues following a 50% sequential decline in quarterly revenues. Intel's stock has plunged, but its earnings have fallen even faster. At nearly 50 times this year's earnings, the stock is more expensive than ever.

This is hardly an environment that inspires uniformly bullish forecasts. Yet virtually every strategist and economist on Wall Street is calling for the end of the bear market. A few, including Stephen Roach and Barton Biggs speak in guarded tones about the future, but virtually every other Wall Street strategist and economist is bullish and speaking about the second half recovery. Is there a chance that strategists and economists might somehow be influenced by their employers? You bet there is! Wall Street firms make more money in bull markets than bear markets. Underwriting profits, derivative income and trading commissions are all much higher in a bull market.

We all like bull markets, but can they last forever, without creating excesses and imbalances? We don't think they can, and super bull markets turn into bubbles that must eventually pop, hurting our society. Our analysis indicates that the risk of a secular bear market has never been greater, but it concerns us that Wall Street is urging all investors to keep most of their assets in the stock market as if the risk of being out of the market is the greatest of all risks.

Just like analysts, bearish Wall Street strategists can find themselves looking for a new job or effectively demoted. We have watched several of the most experienced strategists in the business suffer this fate. It is understandable that brokerage firms would like investors to remain optimistic, but we question whether strategists should be making such bullish statements publicly as if they were stating objective opinions. This is a critical issue for millions of individual investors who are listening carefully in hopes of making sound investment and retirement decisions.

For more of our views on this stock market, see the Welling@Weeden interview with David Tice in Appendix J.

<u>**Consequences**</u>

With ample evidence that a problem exists, our testimony will emphasize the consequences of Wall Street's lack of objectivity. We will discuss five such consequences in this testimony.

1. The small investor has been financially injured
2. Fostering a culture of corporate irresponsibility
3. Capital misallocation
4. Enhanced credibility for loose or "creative" accounting practices
5. Safe haven for aggressive fund managers

However, before we begin to discuss the specific consequences listed above, we believe it is critically important to take a giant step back, and ask the questions: What is at stake here? What happens when the capital markets lack integrity and become dysfunctional?

What's at Stake

A sound and fair marketplace is at the very foundation of capitalism. It is the functioning of the market pricing mechanism that determines which businesses and industries are allocated precious resources, and it is this very allocation process that is a critical determining factor for the long-term economic well-being of our nation. When the marketplace regresses to little more than a casino, the pricing mechanism falters and the allocation process becomes dysfunctional, as we have witnessed with the recent spectacular Internet and telecommunications bubble and unfolding energy crisis. When the marketplace's reward system so favors the aggressive financier and speculator over the prudent businessman and investor, the consequences will be self-reinforcing speculative booms and busts, a hopeless misallocation of resources, and unbalanced economy. When credit is made readily available to the speculating community, failure to rein in the developing speculation risks a breakdown of the market pricing mechanism. Such an environment will also foster a redistribution of wealth from the unsuspecting to those most skilled at this game of speculation. Hopefully it is obvious that such an environment creates dangerous instability, what we refer to as financial and economic fragility.

Japan is now in its second decade of stagnation, what we view as largely the unavoidable consequence of its financial and economic bubble. Certainly not irrationally, many Japanese have sworn off the stock market for the rest of their lives. It is also worth noting that the Great Depression followed the wild excesses of the "Roaring 20's." After the crash and the revelations of the financial misdealings of the 1920s, it took decades for the American public to fully regain trust in the marketplace and its institutions. Not only is this trust a cornerstone of a vibrant capitalistic society, it is at the very heart of a healthy democracy. In our view we have begun sliding down a slippery slope. During this protracted and historic boom, Wall Street has come to possess tremendous power and influence over both the nation's financial system and economy. Clearly, this affords a tremendous responsibility on a few institutions and a relatively small number of individuals. The conspicuous lack of objectivity in research is indicative of what we see as a general lack of responsibility on Wall Street today, one that has is having an increasingly corrosive effect on the marketplace.

1. The small investor has been financially injured

There is no doubt that small individual investors have been and will continue to be injured by Wall Street's lack of objectivity, although estimating to what degree is impossible. In the early 1990's, we asked the Chairman of the Association for Investment Management and Research how the quality of Wall Street's research could be improved. He said "Most institutional investors realize that Wall Street's recommendations are based on investment banking ties and other considerations. They just wink at the conclusions on these reports and read whatever useful information might be in the report."

This attitude was somewhat reasonable before the widespread use of the Internet and proliferation of financial television programs. Prior to the mid-1990's, individual investors had little exposure to Wall Street analyst research, including buy recommendations. Now that information is only three mouse clicks away. The majority of those who use this information are at best unsophisticated, actually believing that a "buy" means the stock offers compelling value at current prices. In truth, these investors have no way of knowing that in many cases the recommendation is based on little more than expectations of future investment banking business. Twenty-four hours a day, seven days a week, individual investors are bombarded with what we view as little more than bullish propaganda.

The problem is equally pernicious for the individual investor who uses a stock broker. When a broker recommends a stock to a retail client that is not rated "buy" by his firm, he does so at great risk. If the investment turns out to be poor, he runs a considerable personal risk of loss if the client brings an arbitration case against the firm and wins. In this situation the individual broker might have to pay part or all of the loss. However, if the broker sticks to the buy list of his firm, then it is the firm, not the broker, who has the risk. The result is that very few brokers stray from the buy list. The entire world of investments not on the buy list gets no consideration. Once again these lightly regarded buy recommendations have unintended consequences.

Performance of Wall Street's recommendations has been abysmal

We have always questioned how profitable Wall Street analyst recommendations have been for real world clients. Well, finally, results have been presented at a web site called investars.com. This group has used a carefully devised methodology to calculate the actual returns that might have been earned by an investor who followed Wall Street recommendations. This type of calculation has, necessarily, a large number of assumptions about how an actual portfolio might have been managed, but the methodology appears reasonable.

Using the period January 1, 1997 until May 29, 2001, the analysis demonstrated how only 4 of the 19 largest U.S. brokerage firms produced a positive return in a period where the S&P 500 was up 58% and the NASDAQ more than doubled. The highest total 4-year return generated by the 19 firms was a paltry 7.6%. How is this possible? Obviously, too many recommendations were made with stocks trading at unsustainable high levels. To us, it is an outrage that a system with so many conflicts of interest while can generate such dismal performance for investor clients during one of history's greatest bull market of the century.

Clearly, Americans' willingness to own stocks is a boon to our capitalistic system. However, when investors place their funds in the marketplace with little understanding of the risks involved in an environment dominated by bullish hype, disappointment can quickly turn to disillusionment. After the unfolding bear market runs its course, it will be a long time before the individual investor returns to the market, and the system we hold so dear will suffer as a consequence.

2. Fostering a culture of corporate irresponsibility

In our opinion, one the most serious consequences of excessive bullishness is the incorrect signal sent to corporate managements. When your stock is selling for a very high price-earnings multiple and you've profited from stock options while 20 of 24 analysts are recommending your stock, the message is clear:

> "You're doing a great job, but you must maintain this rapid growth or the party comes to an end."

The message encourages aggressive behavior, providing management with every incentive to pursue large acquisitions, risky new businesses, and grow at any cost. Some may view this reckless spending as just "good old American risk-taking" We disagree. A school of economic thinking known as the Austrian School has a perfect word for the spending that occurs during the speculative phase of the economic cycle - MALINVESTMENT. Remember this word. Investment involves a careful consideration of cash flows and a firm's cost of capital. Malinvestment includes sinking money into anything investment bankers can bring public in the next six months. After you consider all the testimony about what has occurred in the U.S equity market in the past few years, you decide how to label the spending that has occurred, either investment or malinvestment.

While this may sound extreme, we have analyzed thousands of companies over the last 20 years, and never have we seen such a pattern of corporate recklessness as that of the last few years. Wall Street's lack of independence has contributed to this behavior in our opinion. How else to explain the many companies operating unprofitably for so long, while continuing to raise capital at will? Hundreds of companies have bought back stock at very high prices and taken on massive debt loads even while their business prospects deteriorate. Institutions entrusted with the task of raising needed capital for corporations traditionally have helped to restrain over-ambitious executives with uneconomic business plans. But we seem to be in environment where corporate recklessness is accepted or even encouraged. After all, mistakes are simply manifested in a multi-billion dollar accounting entry. How else can you explain the movie theatre business where six out of the nine leading companies have filed bankruptcy, with two others in dire straits.

We have already seen enormous misallocation of capital towards Internet and related companies, and we are now experiencing the slow-motion destruction of many of the telecom stocks. What's next?

The next bubble to burst
Our greatest fear is that this culture of growth with no regard to risk has permeated another critical part of the stock market and the economy -- financial stocks. Here again, Wall Street is virtually unanimous in their enthusiasm for the major players in this industry:

	# of buys	# of sells
Bank of America	18	2
JP Morgan Chase	21	1
Citigroup	22	1
Wells Fargo	21	1
Fannie Mae	19	0
Fed Home Loan	17	0
Goldman Sachs	9	0
Morgan Stanley DW	13	0
Merrill Lynch	13	0
MBNA	17	1
Capital One	21	4
Providian Fin	18	0

We are especially concerned about the financial companies because problems in this sector can ripple through out the entire economy. In fact, the rapid growth of companies in this industry, while often lifting the price of individual stocks, has created a historic credit bubble that threatens the economy. In September 1999, David W. Tice and Associates held a symposium entitled "The Credit Bubble and Its Aftermath" to express such concerns. Speakers included Lawrence Lindsey, Marc Faber, and Henry

Kaufman (Dr. Kaufman's presentation is included in Appendix D.) Since David Tice & Associates began managing, mutual fund money in 1996, we have extended our analysis from simply focusing on individual companies. We now have three analysts that look "*Behind the Numbers*" at global financial conditions, with a special emphasis on the imbalances created by rapid credit growth. Below is our summary of the current situation that, in our view, has been nourished by a climate of universal bullishness and aggressive expansion.

The U.S. Credit Bubble

It is our view that the U.S. is in the midst of an historic financial and economic bubble. Actually, evidence supporting this contention is unmistakable in data accumulated and disseminated by the Federal Reserve Board. After beginning the 1990's at less than $13 trillion, total outstanding credit market debt now approaches $28 trillion. Non-financial debt has expanded from $10.9 trillion to $18.4 trillion, while financial sector debt has surged from $2.6 trillion to $8.4 trillion. Most unfortunately, the greatest accumulation of debt in history runs unabated, with the first quarter experiencing record issuance of new debt securities. Concomitant with this credit bubble, the value of the U.S. equity market has surged by over $10 trillion to about $15 trillion. Combined, the value of outstanding equity and credit market instruments is approximately 400% of GDP. More than at any time in history, including the 1920s, it is very much a case of the financial markets driving the U.S. economy instead of the economy driving the markets.

This extraordinary period (1990 to present) has been marked by momentous changes in the financial system, both in the type and variety of institutions extending credit, as well as the myriad of securities and sophisticated instruments and vehicles available. This period has been marked by the rising dominance of Wall Street "structured finance," and any discussion of the integrity of equity analyst recommendations must be placed in the context of the analyst's role in supporting investment banking and security issuance. It is worth noting that of the more than $15 trillion increase in outstanding credit market debt over the past 11 years, less than $3 trillion has accumulated on the balance sheets of our nation's commercial banks. The tradition of the prudent banker extending loans to sound businesses, expecting to live with these lending decisions until maturity, is increasingly a thing of the past. It is critical to understand this development. The lender is today is now a security issuer with less concern about repayment. As a result, the hallmark of contemporary finance is the explosion of borrowing through the securities markets, and a proliferation of non-traditional financial institutions providing readily available credit for virtually any purpose. Too often, it is now left to the whims of the marketplace to determine what companies and industries are allocated financing.

Consumer finance

Nowhere has this momentous transformation of the financial architecture been so apparent – and credit made so readily available - as in real estate and consumer finance. Outstanding mortgage-backed securities have jumped almost 200% to $1.8 trillion. Asset-backed securities (credit card and auto receivables, home-equity loans, equipment leases, etc.) have increased almost four-fold to $1.8 trillion. It is simply not possible to overstate the dominant role Wall Street has come to possess in our nation's financial system, both in the enormous creation of securities and instruments and in managing what has been the corresponding ballooning of investor financial assets. Assets under mutual fund management have skyrocketed from about $600 billion at the beginning of 1990 to today's estimated $4.5 trillion. Money market funds have seen assets jump from $425 billion to over $2 trillion. Total assets held on the balance sheets of the securities broker/dealer community have increased from $262 billion to over $1.2 trillion.

Notably, Wall Street's expanding influence has been matched by the unprecedented lending and market (and political) power attained by the Washington-based Government Sponsored Enterprises (GSEs). Since 1990, total GSE assets have increased over 300% to $2 trillion. Fannie Mae began the 1990's with assets of about $125 billion and ended this year's first quarter with total assets of $701 billion. During this period, Freddie Mac assets increased from about $35 billion to almost $500 billion. In 11 years, outstanding agency securities (mortgage-backed securities and GSE company debt) increased more than 230% to $4.3 trillion, with much of this growth coming over the past three years. This stunning – and we would argue reckless - growth runs unabated, with Fannie Mae and Freddie Mac currently expanding lending at better than 20% annualized rates.

Since the global financial crisis that came to a head in the U.S. during the second half of 1998 (Long-Term Capital Management collapse), Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System have increased asset holdings by an astounding $766 billion. This unprecedented credit creation, in combination with extreme accommodation from the Federal Reserve, "reliquefied" the imbalanced and acutely vulnerable U.S. financial system. But it should be recognized that such aggressive market interventions come at a considerable cost, both emboldening the speculating community and creating the liquidity to fuel the next bubble. In the case of the 1998 intervention, the massive liquidity created by the GSEs played a critical role in fueling the Internet/telecommunications bubble. The bursting of this bubble is now quite problematic for the U.S. financial system. We may never know the costs associated with this most recent round of aggressive GSE "reliquefication" that began about nine months ago. At the minimum, this aggressive action is further inflating the dangerous real estate and consumer debt bubbles.

Market dynamics

While the bullish consensus would certainly disagree, the fact that the U.S. financial sector is now firmly locked in credit bubble dynamics is seemingly conspicuous in both the data and in market dynamics. Crisis leads only to another bout of Fed accommodation, wild credit and speculative excess, culminating in the next more problematic period of financial tumult. But then again, there is simply no way of curing the damaging consequences of credit and speculative excess with additional debt, and it should be clear that such a process only becomes more dangerous over time; we would actually argue that risk actually grows exponentially. Until this cycle is broken, there remains a clear and present danger of processes escalating uncontrollably to the point of potential financial collapse. The bottom line is that past borrowings were of unprecedented proportion, and at the same time were spent unwisely. We discuss this further in the CAPITAL MISALLOCATION section. Despite Wall Street propaganda espousing the "New Economy," please recognize that there is no historical precedent for an economy borrowing and consuming its way to sustained prosperity. The key to economic success is sound investment financed by savings. Unfortunately, past credit excesses fostered an environment of incredible profligacy where too many unprofitable (and hopelessly uneconomic) ventures received financing. It should be obvious that perpetuating such an environment poses great risk to both the U.S. economy and financial system.

An explosion of money and credit is, by definition, highly inflationary. After all, the excessive creation of new financial claims – or new credit – fuels over-spending and what should be recognized for its unmistakable inflationary effects. And while conventional analysis is fixated on consumer prices, we subscribe to a view of inflation posited by the "Austrian" school of economics. This view holds that credit excess creates inflationary manifestations through several distinct channels, with varying effects depending on particular circumstances. Obviously, additional credit-induced buying power may increase the prices of consumer goods and services – this is precisely what most contemporary observers recognize as "inflation." We would argue that while traditional inflation has not been overly problematic up to this point, surging energy prices provide strong warning of heightened general inflationary pressures not atypical for this late stage of a business cycle.

Financial inflation

Importantly, however, there are several other forms of destabilizing inflation that go unappreciated, despite the fact that they continue to be the major inflationary manifestations associated with this extraordinary boom. Excessive credit growth has created enormous additional purchasing power that has fueled an investment boom, with both over-investment and endemic malinvestment particularly prevalent throughout the Internet and telecommunications industries. The consequences are a misallocation of resources, wasted assets, a redistribution of wealth, and impaired financial assets. Furthermore, huge additional purchasing power has been directed at asset markets, fueling what should be appreciated as an historic asset bubble. Most now accept that NASDAQ developed into a bubble, but we would today argue that a much greater and more problematic bubble continues to inflate in real estate markets. And finally, additional credit-induced purchasing power can be directed at imported goods and lead to escalating trade deficits and a dangerous accumulation of foreign liabilities. Certainly, additional perceived wealth arising from the stock market and real estate bubbles have played an instrumental role in the consumer borrowing and spending binge. The collapse of household savings from what at the time was considered an insufficient rate of 8% during the first half of the 1990s to the recent dip into negative territory is an imbalance that must eventually be corrected. It has been quite a party, but accumulated debts must be serviced and eventually repaid. Importantly, in all cases credit excess fosters over-spending with detrimental effects to both the financial system and economy.

Ironically, consumer goods inflation is the least dangerous, as it is both conspicuous and easily rectified by aggressive action by the Federal Reserve. At the same time, asset inflation, distortions in the saving and investment process, and trade deficits are a much different story, with no constituency ready to support the difficult decision to fight these injurious but often surreptitious processes. It is, however, these very inflationary manifestations that are the most dangerous consequences of the current Wall Street and GSE-led financial bubble. Investment distortions, as are becoming increasingly conspicuous throughout the technology sector, can destroy profitability and create financial and economic instability. Trade deficits have significant negative economic effects, as well as creating problematic financial imbalances – as is clearly evident presently with current account deficits ballooning to about $450 billion annually. At the current rate of growth, the deficit could reach $800 billion by 2003. Such deficits are unsustainable, and this unprecedented accumulation of liabilities to foreigners is a bill that will someday come due.

For purposes of this testimony, it is worth highlighting asset inflation, a subject at the very heart of current financial sector vulnerability. First, it is important to appreciate that asset inflation is especially problematic for several reasons, including that it is incredibly seductive. Many incorrectly refer to rising equity and home prices as "wealth creation." Yet, true economic wealth is not created by additional credit entries on the electronic ledger that comprises the contemporary monetary system. Policymakers can also be seduced by asset inflation and the resulting surge in tax revenues and campaign contributions. Such inflation spawns dreams of perpetual government surpluses. As such, politicians and special interests are likely opposed to any central bank intervention aimed at the stock market. And can you imagine the Federal Reserve coming out and stating that they are aggressively raising rates to squelch rising home or stock prices? Obviously, that's not going to happen.

So it is vital that central banks nip asset inflation in the bud, because once it takes hold it's strictly "off limits." But central banks, as we have witnessed with the Federal Reserve, are quite prone to ignoring initial asset inflation, perhaps because they don't recognize it. Often, even top central bankers fall prey to manic notions of New Eras, New Paradigms and economic "miracles." And the longer asset inflation is accommodated – allowing asset inflation to forge a bubble economy - the greater is the structural impairment to the economy and financial system, and the more dangerous and difficult asset inflation is to control – as we've seen. Indeed, the Federal Reserve spent years attempting to determine if the U.S. was experiencing an asset bubble before Chairman Greenspan seemingly ended the debate by stating that it is impossible to know until after the fact. This is most unfortunate analysis.

Wildcat finance
The critical point today is to appreciate that Wall Street and the U.S. financial system have been left to their own devices, with the outcome being truly unprecedented credit and speculative excess – a historic period of "wildcat" finance. We will present specific examples of this reckless finance throughout this testimony. It is the proliferation of these excesses that have placed the economy in jeopardy. Credit excess begets only more excess, and financial bubble begets a precarious bubble economy. Especially with the collapse of the technology bubble, extreme accommodation by the Federal Reserve and liquidity from the GSEs are today only exacerbating an already dangerous bubble that has developed throughout real estate and consumer finance, as well as fostering general imbalances throughout the financial sector and U.S. economy. Over the past twelve months broad money supply has expanded by an unprecedented $840 billion, or 13%. The Bank of International Settlements recently reported that over-the-counter derivative positions now surpass $95 trillion. These and other extraordinary data are indicative of extreme financial distortions that we urge be addressed before it's too late. The unfolding California energy crisis and collapsing profits throughout the U.S. manufacturing sector are indicative of the severe structural distortions that have taken root throughout the U.S. economy. Most unfortunately, Wall Street and much of the U.S. financial sector continue to work aggressively to perpetuate this bubble, imparting only greater damage to the U.S. financial system and economy, as well as tremendous risk to its citizens.

For more on the Credit Bubble
For further discussion of the credit bubble we suggest readers consider the presentations made at our September 21, 1999 symposium "The Credit Bubble and Its Aftermath." Several audio clips are available on our web site at http://www.prudentbear.com/bearlibrary.htm. Also included in Appendix D is a transcript of the keynote address by Dr. Henry Kaufman (who has experience at the Federal Reserve and on Wall Street). He presents 12 brilliant ideas in his speech entitled "Lessons We Should Have Learned."

Lesson #8 was: "Investors cannot rely on the sell-side analysts to alert them to bad news. They also cannot rely on government, the IMF, or the World Bank staff either."

The other 11 lessons are well worth reading as well.

For more in-depth consideration of the credit bubble and its ramifications, we suggest reading two outstanding narratives written by Doug Noland, the Prudent Bear Fund market strategist. The first is a speech given at a Washington conference called "Toil and Trouble - Evaluating Quality of Earnings - and Risk - In the Financial Services Sector." The speech, "How Could Irving Fisher Have Been So Wrong?" is attached in Appendix F includes a discussion of the risks of derivatives. For a further discussion of the role played by the Government Sponsored Enterprises, please read Doug's article from "The International Economy," titled "The Great Experiment" found in Appendix G.

3. Capital misallocation

Do you wonder why our country does not have enough power plants and oil refineries, yet we have a reported 80-90% over capacity in fiber optic cable? There is a consequence to keeping stock prices artificially high for extended periods while extending credit recklessly in the midst of a mania. The overpriced sectors suck capital away from other vital areas of the economy. For years refinery stocks sold at low multiples of earnings and book value, and received comparatively little coverage for companies of their size. It is not surprising that companies in this industry were unable to increase capacity. As a nation, we are about to pay for this crucial misallocation of capital.

Fed Chairman Paul Volcker summed up this tragic misallocation best:

"The fate of the world economy is now totally dependent on the growth of the U.S. economy, which is dependent on the stock market, whose growth is dependent on about 50 stocks, half of which never reported any earnings"

While investing fads are to be expected in free markets, the coddling of companies by analysts fueled a massive over-investment in technology. This infatuation with all things high tech diverted capital from other sectors of the economy. In other words, while a mania for Internet and telecom stocks may have been inevitable, it should have been tempered by sober Wall Street research which would have included a cautionary word and a "sell" recommendation or two.

In a more discerning environment, we suspect that fewer companies could have transformed a flimsy business plan into an Initial Public Offering. Certainly IPOs have always been fraught with risk, but until the late '90s companies were typically viable, profit making enterprises by the time they went public. In fact, Amazon.com in 1997 was one of the of first companies with large losses to complete an IPO.

Instead, a uniformly bullish climate enabled investment bankers to bring 214 Internet companies public, raising $16.9 billion in 1999 alone (according to IPO Monitor), and along with that, an estimated $1 billion in underwriting fees.

With all these new Internet companies, individual investors were looking to Wall Street for help in identifying the winners. This need for guidance combined with the proliferation of business news programs seeking comments on individual stocks elevated the image and power of the Wall Street analyst. *Fortune* magazine (3/20/00) quotes Keith Benjamin, an ex-Internet analyst who said, "The analyst has now grown in stature from providing advice to institutions to being a beacon for *Fortune* or CNBC. It's dangerous because it's impossible to give the same amount of detail in context or tone to retail investors."

That is, institutional investors have learned to live with Wall Street's lack of objectivity, playing the game with a nod and a wink. And because money mangers had the ability to speak to analysts directly they could learn about risks that were not revealed in a published report. Retail investors, however, were left with a sea of buy recommendations and a series of 30-second interviews. Unfortunately, the naïve retail investor thought these analysts had their best interests in mind, not understanding that actual or potential investment banking relationships governed Wall Street recommendations.

Investors fed on this uniformly bullish environment. The voracious demand for IPOs in the secondary market further stimulated the IPO market, which in turn fed the venture capital market. Typically, venture capitalists make a number of long-term bets on the financial viability of innovative companies. But the Internet mania changed the role of the venture capitalist to a "cash out" specialist. Upstart companies no longer need to prove themselves viable, they just needed the right story. The traditional focus on cash flow changed to a focus on monetizing the story via IPO. In our view, this was the ultimate pyramid scheme, involving billions of dollars. The *Financial Times* (Dec. 5, 2000) notes that venture capital investments in Internet companies rose from $176 million in 1995 to $19.9 billion in 1999. In the five years ending Nov. 1990, IPOs by Internet companies plus venture capital investments and secondary offerings provided $150 billion to Internet companies alone. That's roughly the GDP of Norway.

VCs came to rely so heavily on the IPO market that according to *Forbes* (5/15/00), "within days, even hours, of NASDAQ's tumble, venture firms went on the defensive, slashing company valuations, freezing contracts with young private companies and backing out of deals altogether."

Clearly the Internet mania resulted in an enormous misallocation of capital, one that we believe was fostered by a uniformly bullish Wall Street. While investors had every right to fund Internet rather than energy companies, surely the boom and subsequent bust would have been less severe with a degree of analytical objectivity.

"Sell Now!"
Certainly there were analysts who understood the risks of investing in unproven Internet companies, but negative reports or sell recommendations were rare. Yet, off Wall Street, two editors of *Red Herring,* a magazine and web site for high tech investors, were skeptical of the stock market hype. In 1999, Anthony B. Perkins and Michael C. Perkins wrote "The Internet Bubble" (Harper Business) to argue that despite the promise of the Internet, making money in Internet stocks was far from a sure thing.

The authors compiled a list of 133 publicly traded Internet companies that they urged investors to "Sell Now!" Neither author has an investment background, yet both could see the chasm between Internet stock prices and reality. They quote Jim Breyer of Accel Partners (a venture capital firm), "It's emotion, it's frenzy, it's the fad, and 90 percent of the companies should never have gone public and will go out of business or hit very hard times."

The 133 Internet companies the authors reviewed in June 1999 boasted a combined market value of $410 billion on sales of only $15.2 billion. That means the companies were selling for more than 25 times sales when 25 times earnings typically has proven to be a rich valuation for IPOs. To justify the lofty valuation of their group of upstarts, the authors concluded the 133 companies *as a group* would have to increase revenues more than 80 percent a year for five years. By comparison, Microsoft's revenues rose 53% a year in the five years following its IPO. This conclusion is based on a number generous assumptions, including a price to earnings ratio of 40 times earnings five years from the date of the calculation, and reasonable net margins. The authors developed their model with help from investment bankers, analysts and venture capitalists. The book was published as the Internet boom was still in progress, warning investors to stay far, far away.

Buy or at least accumulate
While the editors of a business technology magazine were warning investors about the coming Internet crash, Wall Street was encouraging investors to buy, or at least "accumulate" Internet stocks.

For example, drkoop.com was one of the 133 stocks reviewed by the *Red Herring* editors, and by their calculations, was significantly overvalued. Bear Stearns, however, was not so bearish. In July 1999, the Wall Street firm (and underwriters of the company) published a report rating the stock a "buy." While the report did discuss risks including a "crowded consumer health care portal market," the report highlighted the company's "first mover advantage" and called the company "one of the most attractive vertical portal opportunities on the Internet." According to a table inside the report, the stock was selling for just over 30 times estimated sales for the year 2000. Losses were projected through at least 2001. Like many Internet companies, drkoop.com struggled financially, ultimately joining the many Internet stocks selling for less than $1.

In December 1999, Merrill Lynch rated a group of 16 Internet stocks "buy" or "accumulate." According to an Internet/E-Commerce report, the Merrill team's recommendations included Yahoo, Lycos, Priceline.com, Webvan, 24/7 Media, Ubid, Etoys and iVillage. The author of the report (Henry Blodget) did note the increasing competitive pressures in the "B2C industry," but his concern was a far cry from the "Internet Bubble" authors' admonishment to "Sell Now!"

The bullish bias on Wall Street led to widespread rationalization of the absurd valuations for Internet companies, helping to justify further misallocation of capital. In a January 1999, Credit Suisse First Boston published a report titled *Rational Exuberance? Is there method behind the madness in Internet stock valuations?* While the report did not purport to expressly defend the unprecedented valuations of the time, the report did want "...to offer some counterweight to the argument that current market values are completely unfounded." The report claimed, for example, that investors should be willing to pay more for Internet companies because of their modest capital needs. (Ironically, it was the drying up of external sources of capital that led to the demise of most Internet companies.) The report also used Amazon.com as an example of a company with a business model "...already more attractive than its competition," while noting that, "Those onlookers that refuse to look beyond the income statement are missing the substance of the model."

We think the *Red Herring* authors were closer to the mark. "Business fundamentals don't change," they argued. "A company's earnings are a function of the economic and social contributions it creates. Unless a company can demonstrate how it will create that sustained flow based upon its contribution, there is nothing to invest in."

Telecom bubble

It is our view that the virtual uniformity of "buy" recommendations on Wall Street not only fostered an Internet bubble, but it created the telecom bubble as well. Just as in the Internet mania, unproven telecom companies were funded based on wildly optimistic projections. Rather than objectively evaluating these rosy scenarios, Wall Street analysts fueled this euphoria with dozens of buy ratings, lofty "target prices" and wildly optimistic industry projections. The difference, however, was that while upstart Internet companies relied primarily on venture capital and equity financing, the "new era" in telecom also created hundreds of billions in debt. The ramifications of this debt build-up are just beginning.

According to a recent *Wall Street Journal* article (May 11, 2001) the $650 billion raised by telecom companies in recent years is proving to be one the biggest "financial fiascoes ever." The article, "Telecom Debt Debacle Could Lead to Losses of Historic Proportions" is in Appendix V. Losses to investors are estimated to approach the $150 billion government clean-up of the S&L crisis. Furthermore, the nature of telecom makes it difficult to salvage companies that fail. For example, because upstart telecom companies are typically unprofitable, their value as an acquisition is diminished. And because high tech gear is quickly outdated, the salvage value of their assets is greatly reduced. It's no wonder that earlier this year Bank One called telecom one of the problem areas in its portfolio.

Like the Internet bubble, ripples from the telecom problem reach from Wall Street to Main Street. According to *USA Today*, in the five months ending in April, telecom carriers and equipment makers fired more than 130,000 employees worldwide. Capital spending in 2001 is estimated to increase 2.1% compared to the whopping 34% increase last year. Managements are dealing with reduced revenue projections, but must continue to service the same amount of debt.

Certainly these companies should be accountable for their actions. But Wall Street can pressure management to make acquisitions, buy back stock, or expand. Not coincidentally, such activities require large amounts of new debt or equity securities. According to John Windhaussen, Jr., president of the Association for Local Telecommunications Services, "Wall Street analysts were telling our companies to build, build, build. We didn't worry about a return on investment."

According to Broadband Networking News, Glenn Waldorf, a telecom analyst at UBS Warburg agrees. "I think the current situation is partially Wall Street's creation," Mr. Waldorf said. "In its enthusiasm, Wall Street took approximately 35 CLECs public. However, there were not 35 strong management teams capable of running what is unquestionably an extremely difficult, complex business." Mark Langner, a telecom equity analyst at Epoch Partners Langnar agrees: "The capital markets have given everyone a false sense of security over the last four to five years."

Back in April, Windhaussen estimated that 100 carriers, or one-third of the total had failed since December. The *Wall Street Journal* article mentioned above notes that Wall Street firms made $7 billion in fees by raising debt and equity for companies since 1995.

The pervasive climate of bullishness on Wall Street is perhaps best illustrated by the sudden notoriety of Ravi Suria. Mr. Suria was a credit analyst at Lehman Brothers when he issued a report in mid-2000 critical of Amazon.com. While examining the company's convertible debt he concluded the securities were fraught with risk. The negative report thrust Mr. Suria into the spotlight. The obscure analyst's report drew scathing public rebuttals from Amazon's management. According to *Fortune* magazine (10/2/00), Lehman prevented Mr. Suria from debating Merrill's Henry Blodget on CNBC. Lehman also refused to publish a subsequent negative report. On June 26, Mr. Suria was the subject of a *Wall Street Journal* story.

Such was the notoriety attained by pointing out the obvious, that Amazon boasted poor operating fundamentals and a heavy debt load. To us, this is certainly testimony to the lack of independent thinking on Wall Street. The *Sunday Telegraph* (2/25/01) agrees, noting that "Even if Suria is wrong, his full frontal assault on Amazon has raised piercing questions about the cozy relationship between companies and the analyst community. Critics argue that many equity analysts have been slow to downgrade Internet companies. The litany of allegations includes lazy following of a company line and a conflict of interest since many of the companies are, or might be, potential investment banking clients."

It's difficult to believe a company with financials as shaky as Amazon.com was able to issue billions of dollars of debt and equity. Yet, Amazon is representative of how so much capital was diverted toward suspect enterprises. New technology was embraced by eager investors, whose enthusiasm was rarely tempered by objective analysis.

Under Allocation of Capital

We cannot stress enough that while Wall Street is aggressively seeking investment banking business in the technology and financial sectors, other important companies are ignored. We found nearly 1000 U.S. companies, each with more than $250 million in market capitalization, with fewer than three buy recommendations outstanding. Call the CEO of any of these companies and I doubt you will hear too many good things about Wall Street. Below is a sample of these companies, **real companies, in your districts** that are being hurt every day by Wall Street's gamesmanship. We believe the misallocation of capital associated with such gamesmanship harms the overall economy as well.

					# of Recommendations	
Ticker	**Company**	**State**	**Congressman**	**Buy**	**Sell**	**Hold**
CNL	Cleco Corporation	LA	Baker	2	0	1
SJM	J.M. Smucker	OH	Ney	0	0	2
CTB	Cooper Tire and Rubber	OH	Gillmor	2	0	4
CBIZ	Century Business Services, Inc	OH	LaTourette	0	0	1
OMX	Office Max	OH	Tubbs Jones	2	1	9
PYX	Playtex	CT	Shays	1	0	4
CUNO	Cuno, Inc	CT	Maloney	2	0	1
WTSLA	Wet Seal, Inc	CA	Cox	2	0	2
UGS	Unigraphics Solutions	CA	Royce	2	0	1
FLE	Fleetwood Enterprises	CA	Miller	2	1	1
GY	GenCorp, Inc	CA	Ose	0	0	1
DOL	Dole Food Co	CA	Sherman	1	0	0
SUG	Southern Union Co	TX	Paul	2	0	3
POWL	Powell Industries Inc	TX	Bentsen	1	0	0

CHX	Pilgrim's Pride Corp	TX	Sandlin	0	0	2
EE	El Paso Electric	TX	Hinojosa	0	0	1
TSO	Tesoro Petroleum Corporation	TX	Gonzalez	0	0	5
SKS	Saks, Inc	AL	Bachus	2	0	14
ISP	International Specialty Products	DE	Castle	0	0	1
OGE	OGE Energy Corp	OK	Lucas	1	0	5
GPC	Genuine Parts Co	GA	Barr	1	0	6
UFI	Unifi, Inc	NC	Jones	2	0	2
DL	Dial Corp	AZ	Shadegg	2	0	7
WSO	Watsco, Inc	FL	Weldon	2	0	1
PSS	Payless ShoeSource	KS	Ryun	1	0	5
SEB	Seaboard Corp	KS	Moore	0	0	0
INGR	Intergraph Corp	AL	Riley	1	0	0
VOL	Volt Information Sciences	NY	Fossella	0	0	0
VALU	Value Line, Inc	NY	Meek	0	0	0
OSG	Overseas Shipholding Group	NY	Crowley	2	0	0
GTIV	Gentiva Health Services	NY	Ackerman	1	0	0
TOPP	Topps	NY	Velazquez	2	0	1
GFF	Griffon Corporation	NY	Israel	1	0	0
FSS	Federal Signal Corp	IL	Biggert	2	1	1
CCC	Calgon Carbon Corp	PA	Mascara	2	0	1
JLG	JLG Industries Inc	PA	Kanjorski	2	0	3
KMT	Kennametal, Inc	PA	Hart	2	0	3
YRK	York International Corp.	PA	Toomey	2	0	1
BTGC	Bio-tech General	NJ	Ferguson	2	0	0
K	Kellogg, Inc	MI	Rogers	1	1	15
FLIR	FLIR Systems, Inc	OR	Hooley	1	0	0
H	Harcourt General, Inc	MA	Capuano	0	0	1
LFB	Longview Fibre Company	WA	Inslee	1	0	1
BKI	Buckeye Technologies	TN	Ford	2	0	2
TII	Thomas Industries Inc	KY	Lucas	1	0	0
CEM	Chemfirst Inc	MS	Shows	1	0	1
BEZ	Baldor Electric Co.	AR	Ross	2	0	2
Totals				**58**	**4**	**111**

4. Enhanced credibility for loose or "creative" accounting practices

It is our view that if analysts were truly independent of the companies they followed, they would demand and eventually receive better accounting practices and disclosure from the companies. Instead, analysts most often want to see favorable results to justify their buy recommendation. Most analysts love a company that hits its expected EPS number every quarter, even if they used every bit of creative accounting at their disposal to reach the number. Our all-too-flexible accounting rules make such machinations possible.

In a recent *Business Week* article, one portfolio manager said, "CEO's are obsessed with growth. They, as in the past, tortured accounting to produce income statements that would be applauded by Wall Street."

Three items make it particularly difficult to understand how profitable a company actual is.

1. Write-off accounting - Wall Street analysts actually cheer on companies to take large "one-time" charges to write down losses and set up significant reserve accounts. The analysts realize that it will be easier for the company to reach its future earnings target because of the existence of this large reserve. Despite the SEC's vigilance on this issue, there are still many borderline expenses that can be charged against these reserves. The constant flow of one-time charges (that sometimes occur almost every year) makes it very difficult to determine how fast a company is actually growing. Wall Street bankers want companies to spend aggressively. If they make a mistake, they can bury the costs in a charge without being penalized by analysts.

2. Stock options - Stock options are a very complex issue. We may never know how much compensation expense has been understated at companies where stock options (instead of cash) were used to pay employees. Throughout the Internet boom we saw very few analysts warn about the potential dilutive effect of stock options. At issue is the fact that accounting rules do not measure the true "economic cost" of stock options. Many of our concerns about stock options and current accounting standards for stock options can be found in a report included in Appendix H titled "Stock Options: Be Prepared for a Sea Change."

3. Pro forma numbers - While this abuse has been around for years, the publication of pro forma numbers to remove the focus from the poor numbers reported under GAAP has dramatically increased in recent years. The SEC's Chief Accountant calls pro forma results "EBS accounting"--for Everything but Bad Stuff. Far too often they seem to be used to distract investors from actual results. The use of pro forma numbers is another accounting trick that analysts should be upset about, but instead it has been embraced by Wall Street.

5. Safe haven for aggressive fund managers

One little-discussed effect is the problem caused by Wall Street's research being combined with a variety of "momentum" investment strategies. Momentum investors look for stocks with ever-rising chart patterns, having little regard for business fundamentals. In fact, some proclaim, "I don't care whether the valuation of the stock is 5x revenue, 10x revenue, even 100x revenue, if the chart looks good and the analysts plan to keep promoting the stock, I'll buy the stock." It has become very easy for the fund manager to justify his investment by saying, "Sure it is expensive, but 19 of the 20 analysts are recommending "buy," so it must be a decent stock to own." We certainly believe in free markets, but when speculation is allowed to run out of control, due to a lack of integrity in the financial markets, and a tendency towards pyramid scheme type behavior (as discussed in the IPO scandal accusations), these investment methods can exacerbate the financial mania.

One illustration of the degree of risk investment managers are willing to take comes from analyzing the high valuation stocks held in their portfolios. Shown below are the average valuation statistics for 10 of the more popular growth-oriented mutual funds. Remember, these are average valuations for all of the stocks held by these funds:

P/E	Price/Book	Price/Sales
39.1	8.3	7.6

Together these funds control more than $170 billion in assets. The funds are so similar that when you compare how the funds have performed, they have correlation coefficients of 80% to 95%. Shown below are their ten most common holdings. Clearly the mangers are buying what Wall Street is recommending.

	# buys	#sells	#funds
Cisco Systems	32	3	10 of 10
General Electric	19	1	8 of 10
Pfizer	29	1	8 of 10
EMC	22	0	9 of 10
Microsoft	25	0	8 of 10
Sun Micro	20	1	9 of 10
AIG	18	0	7 of 10
American Online	33	2	7 of 10
BEA	29	1	8 of 10
Veritas	27	0	9 of 10

Potential Solutions

We do not pretend to be experts in the area of securities law and regulation. We present the following ideas in the spirit of general directions to take, not specific laws to change. Not included in our list of solutions are proposals that try to tinker with analyst compensation schemes or require some type of peer review. We believe the problems are so significant, and so critically important, that bold solutions, not incremental change, is required:

1. Separation of research from investment banking and trading
2. Requiring that Wall Street place a price tag on its research
3. Improvement of conflict disclosure on published reports
4. Tighter ethics rules and better analyst education
5. Move towards less-flexible accounting rules
6. Limit the use of stock options
7. Quadruple the SEC budget
8. Recommendation database
9. Investor education

1. Separation of research from investment banking and trading

The best solution to the problem would be to completely separate research from both investment banking and trading. Regulators should admit that the current "Chinese Wall" has too many holes to make enforcement of this policy possible. All of the conflicts cited in our first section certainly suggest the imaginary wall is not working. The potential profits for both the firm and the individual are just too great to expect compliance.

In practice, the complete separation of research from both banking and trading would require a significant change in Wall Street's business practices. It would amount to re-regulation in an era that has stressed deregulation. However, given the size and consequences of the problems we have presented, this solution is well worth considering. Even serious consideration of this re-regulation might force Wall Street to begin "cleaning up its act." However, extreme political courage would be necessary as the lobbying forces that would try to prevent this change would outweigh those arguing for the change by at least a factor of 100-to-1.

2. Requiring that Wall Street put a price tag on their research

Wall Street firms should be forced to put a specific price tag on their research. This potential solution is somewhat complex, but if complete separation is not feasible, it might be the best solution to the problem. To understand this solution it is first necessary to understand how Wall Street research is sold to institutional investors.

Portfolio managers too often see Wall Street research as "free goods." Portfolio managers need access to Wall Street's trading ability to get the best execution on their transactions, and also need access to IPOs, if this is part of their strategy. To gain this access, the managers must do business with the big brokerage firms. The research is bundled with trading and IPOs and the portfolio manger is expected to do an often unspecified amount of trading volume to continue receiving these services.

Generally, if a portfolio manager wants to buy independent research he must agree to a specific price and often sign off on an invoice. This subtle difference is a significant barrier to entry for many small independent research firms who would like to sell their research ideas to portfolio managers. If the large brokers had to put a specific price on their research service, free-market competition would be significantly enhanced. If you still find this brief explanation confusing, consider the following analogy:

A portfolio manager has two choices for lunch . He can either receive for free an artery-clogging triple cheeseburger (Wall Street research), or walk up 10 flights of stairs to buy a $20 garden salad (independent research). The manager knows the salad will be much better for him, but the cheeseburger will be prepared by the finest French chef, have the best sauces and garnishes, and in fact be served directly to him by the finest wait staff (institutional salesmen). It will be hard to resist. Competing with this free lunch is difficult for the salad vendor who cannot afford to deliver and must spread his fixed costs over the few customers who make the effort to visit him. As a result, his salad seems expensive.

This example is over-dramatized, but it helps to illustrate the enormous competitive disadvantage that independent research firms actually face. A few independent research firms (including ourselves) have been able to compete against these enormous odds, but dozens more analysts never seek to set up independent firms, because competing against firms that essentially give away their research is just too daunting a prospect.

Admittedly, the details of this plan would require careful consideration between lawmakers, regulators, and investment managers. It is the spirit of this idea that is valuable to consider. Regulators should ask, "What can we do to cause truly independent research to flourish?" rather than taking on the arduous task of enforcing more rules, level the playing field and make it easier for independent firms to compete.

Once again, if you try to legislate this change, be sure you have your extra-strength industrial ear plugs. The howling from the large brokers, who fear open competition in the research marketplace, will be extraordinarily loud.

3. Improvement of conflict disclosure on published reports

At a bare minimum Wall Street should be forced to significantly improve the disclosure of conflicts of interest on its written reports. Rather than bury the disclosure in a vague footnote that often reads like the fine print attached to a sweepstakes offer, we would suggest full front page, highlighted disclosure of some combination of:

1. Banking fees received
2. Banking service performed
3. Loans or other securities held
4. Proprietary trading desk positions

Additionally, whenever someone publishes the number of buy recommendation that a group of brokerage firms has on a particular company, a strongly worded disclosure should accompany the information. This would make many more individual investors aware of the numerous conflict of interest situations.

4. Analyst ethics and education

Another possible solution could be a tightening of the securities laws that would make the statements made by the analysts in our first section a violation of some federal law. When analysts can openly admit that buy recommendations can be "bought," the laws are not strong enough. It is difficult to know exactly where to draw the line. This is a question best left to those with more legal and regulatory experience than we posses.

The industry should admit that the self-regulatory aspect of the largest professional organization (The Association for Investment Management and Research, known as AIMR, which administers the Chartered Financial Analyst (CFA) exam for analysts) has failed. The organization, now seen as the "union card" for analysts, has attempted to enforce a code of ethics. One ethical standard is a very well-worded "reasonable basis" standard that should apply to most of the abuses we have noted. However, as a privately funded organization that lives in constant fear of being sued, enforcement of these standard is practically impossible. The organization usually waits until some court or other regulatory body has administered sanctions before its acts. This makes the effect of losing one's CFA charter minimal. In fairness to AIMR, most of the analysts we have cited in this report are not CFAs, but many of their supervisors are, and they have just as much responsibility as the analyst himself. If regulators feel AIMR is any way a guardian of the highest standard of ethical behavior, they are mistaken.

The AIMR should refocus on its educational effort. As the business has become more complex and international, AIMR has tried to force a variety of new subjects on those taking their exam. The result has been CFAs that know a little bit about a lot of subjects, but that are often unprepared to perform the basic tasks of an entry-level analyst. In short, the old standard for passing the exam, "Would you let this person manage your money?" has devolved into "Does this candidate know something about zero-premium put-spread collars, leptokurtosis, swaptions, and mental accounting?" We believe that AIMR should focus more on teaching basic valuation methods, a sense of market history, and most importantly how an analyst should reach an independent conclusion about a stock.

5. Less-flexible accounting rules

In a perfect world the analytical community would demand better disclosure and accounting practices from the companies they follow, but if we cannot change the structure of Wall Street, we should attempt to make accounting rules less flexible. These changes would cause considerable consternation among both accountants and companies. Accountants like the flexibility because on the one-hand they fear shareholder lawsuits, but on the other, they want to avoid the tough calls that would contradict management. The companies like the status quo because of the ease in which they can manage their quarterly earnings. The problem is that unpleasant news is often hidden until the fundamentals of their businesses are so weak reality can no longer be denied.

6. Limit the use of stock options

Twenty years ago it seemed that many corporate executives did not know the price of their stock. Today management seems to hang on every 1/4 of a point. We certainly encourage management to work for the long-term best interest of their shareholders, but stock options often are a great incentive for short-term management of the company. We've found that options can encourage managements to take more reckless actions to please Wall Street, with analysts then working diligently to keep stock prices levitated while company insiders liquidate holdings.

Ironically, rather than align the interests of shareholders and management, stock options often lead to divergent interests. If analysts were objective, investors would be alerted to the repercussions of short-term thinking. At a minimum, stock options should have a higher profile in financial statements rather than be limited to disclosure in footnotes. Options have a true economic cost and investors have a right to know that cost. We have included a report that our firm has produced on this topic in Appendix H.

7. Quadruple the SEC budget

While we hesitate to suggest that "hiring more policemen is the best way to fight crime," this may be the only solution. At the very least this could be used as the hammer. Put on the record that Congress stands ready to quadruple the SEC's budget (double the staff, and double their pay) if the problem is not solved in 12-24 months. This could be the best $2 billion our government ever spends. Ensuring fair play in capital markets where trillions of dollars are involved is an important matter.

We commend outgoing Chairman Levitt for his strong statements in the area of analyst conflict and strongly endorse his action on fair disclosure. He clearly seemed to understand the problem. The lack of action on analyst objectivity is frustrating, but perhaps reflects political realities. The staff is clearly overwhelmed monitoring 8,000 public companies and thousands of investment managers. New resources would have to be committed to improve the objectivity of Wall Street research.

8. Analyzing the analyst – develop a Recommendation Database
While investigating this subject in the preparation of our testimony we were presented with an interesting solution by Kei Kianpoor, the co-founder of Investars.com. Mr. Kianpoor suggests that all brokerage recommendations be reported to the SEC on a timely basis in electronic form. A database could be established so that anyone could analyze the performance of an individual analyst or firm. Standards have now been established to careful restrict how investment managers report performance to their clients, but there are no restrictions on trumpeting analysts' performance. Recommendation data is currently very difficult to collect, but under this proposal everyone would have access. We favor ideas that promote full disclosure.

9. Investor education
So many investors have learned about investing during a period of steadily rising markets that we must take great care to be sure they understand both risk and return. We would suggest three areas of emphasis.

1. Investors must learn they are buying a fractional share of an actual business, and not just a piece of paper to be traded like a baseball card.

2. Teach that every asset has a price at which it becomes overvalued and another price at which it becomes undervalued. Investing would be easy if all you had to do was choose the best company. Very few people would walk into an auto showroom and buy a car without asking its price, almost no one asks about the price (valuation, not the commission) before buying a mutual fund.

3. Teach Americans that investing is both a right, and a responsibility, just like voting. No single investment will damage the financial system. No single vote will damage the political system. However, in total, societies that either invest or vote, without proper care, are destined to suffer unpleasant consequences.

Prepared written testimony of Gregg S. Hymowitz, a Founder and Principal of EnTrust Capital Inc., for the U.S. House of Representatives' Committee on Financial Services. Testimony prepared for Thursday, June 14, 2001. For the U.S. House of Representative's Capital Markets, Insurance and Government-Sponsored Enterprises Subcommittee's hearing entitled, "Analyzing the Analysts: Are Investors Getting Unbiased Research from Wall Street?" To be presented at 2128 Rayburn House Office Building at 10:00 am.

Mr. Chairmen Oxley and esteemed members of the Committee, I am Gregg Hymowitz, a Founder and Principal of EnTrust Capital Inc., which is an approximately $1.2 billion regulated investment advisory company and hedge fund operator catering to high-net-worth individuals and families. Prior to the founding of EnTrust, I was a Vice President at Goldman Sachs in the private client services group, managing money for individuals.

It is my pleasure to share with you this morning my thoughts and observations on the question of whether Wall Street analysts and their research are biased and if conflicts of interest exist. And what, if anything, could or should be done to improve the process. My comments today represent solely my personal views and not necessarily the views of EnTrust Capital or my partners.

Broadly defined, I believe there are three types of analysts. There are Wall Street analysts whose firms do investment-banking business with the companies they cover; research-only investment houses that often may have a broker/dealer business but do not engage in capital market transactions with the individual companies; and buy-side analysts who typically do not publish research. They may (on occasion) appear in the media with their recommendations.

Most of my comments this morning will focus on the analysts whose firm may be engaged in or attempting to secure an advisory role with the issuer as it relates to potential capital-market transactions.

Is there a conflict of interest among sell-side analysts and the companies they cover? In my opinion the answer is yes. But the relationship between the analyst, issuer, and the investing public is a complex network of checks and balances. The competing interests and needs of each constituent group is ultimately settled in the most efficient marketplace in the world, the stock market. I do not mean to imply that such efficiencies come cheaply—they do not. Hundreds of thousands of individuals (new and old-hand investors) have lost tremendous amounts of capital over the past year.

The conflict the sell-side analyst has is relatively simple to understand. Typically, the analyst works for an investment bank whose bankers are attempting to woo business from the issuer, often in the form of a capital-market transaction, IPO, M&A engagement or other type of advisory position. Therefore, most analysts recognize it does not behoove their firm's self-interest to have a negative view on the issuer or the issuer's sector if their bankers are also vying to pitch business to the company.

Additionally, most analysts' compensation at investment banks has historically been partially determined by the amount of high-margin capital market transaction revenues for which each analyst was responsible. Hence, you have a paucity of outright sell recommendations on the Street.

The communication between analysts and issuers is symbiotic. The issuer needs the analyst coverage to have his or her story told on the Street and to get potential investors interested in buying, and the analyst's life blood is an open communication channel to the issuer. One could surmise that communication is easier and more open between parties when they are aligned. If you are the CEO of a publicly traded company you may be more likely to return a phone call from the analyst who has your stock rated a strong buy sooner than the one who has a "sell at any price" rating on your company.

Given that most sell-side analysts work for broker/dealers, and such firms are in the business of generating trading commissions as a source of revenue, the analyst is often used as a commodity for the broker/dealer whose desire is to entice investors into executing trades through them. The old chestnut about catching more flies with honey than with vinegar holds true here as well.

The pressures and conflicts on the sell-side analyst during the recent equity bubble was exaggerated by the compressed period of time the capital markets were accommodative. Remember, it was roughly during eighteen months that many of these dot-coms were funded. The pressure on investment bankers to win a piece of the pie was enormous—banks couldn't afford to be left behind. Therefore, many analysts confronted added pressures to rapidly understand new business models. An investment bank pitching Internet IPO's couldn't afford to have an equity analyst in the pitch meeting stating he or she was negative on the so-called "space." It just wouldn't fly.

During this market frenzy, investment banks, due to the demand from the investing public and the supply created by the venture capitalists, took hundreds of companies public that in historical terms would never have made it out the door. But the capital markets changed dramatically with the wildly successful offering of companies like Netscape Communications Corporation and Yahoo! Inc.—companies with little or no profits. The need for new valuation metrics became apparent.

For a short period of time, public equity markets during this kinetic period acted more as secondary venture-capital markets. These new markets attracted great enthusiasm because the rewards were potentially huge. Now many investors have learned the painful lesson of investing in public start-ups: While the rewards are potentially much greater, the risks are definitely higher.

Analysts have taken heat on their coverage of these infant industries during the most recent market downturn. Parenthetically, there was little or no public uproar of analysts' rosy coverage in 1999, when many investors were making money in the market hand-over-fist. Much of the current criticism is based on the new methods of valuation analysts and investment bankers created to entice individuals into investing in these immature companies. Free cash flow and earnings metrics were replaced with multiples of sales, developers, and my favorite, Web 'hits!' Now while many of these metrics (in the short run) have turned out to be just plain silly, we need to remember twenty years ago a now widely recognized metric called EBITDA—Earnings Before Interest Tax Depreciation and Amortization—was created to analyze certain companies. At the time they had no earnings. Today cable and media companies have billions in earnings, employ hundreds of thousands, and are some of the largest companies in the world.

There is nothing new about what the equity analyst is doing today albeit in a more frenzied environment. Investment banks have been recommending the stocks of their clients for hundreds of years, roughly since the 1792 Buttonwood Agreement. However, one dramatic change has been who is now receiving this information and how it is being delivered. Historically the "morning call"—where analysts provided daily information to the Street—was the province of the institutional money manager. They understood where this information was coming from and typically was able to evaluate the relative importance of an opinion—particularly whether the analyst giving the information had a reputation of providing competent analysis.

With the rise of the Internet and its accompanying ubiquitous and seamless information flow, Wall Street research calls are everywhere—on the Web, television, radio and print. Recently, with the frenzy of day trading, the analyst calls took on exaggerated importance. Often the trading public seized upon these calls and stocks would move significantly. I believe the institutional manager has always understood these calls as just one person's view, no more—and no less.

When day trading reached epic proportions and the greed was tangibly thick, the analyst calls, to an investing public, became almost as important as the fundamentals of a company. This added another dimension to the potential conflicts analysts have, in that it made the need for the "big call" that much more important. Analysts suddenly started labeling their pieces with bold, creative, and often humorous titles. Anything that created a soundbite or material enough to cause a reaction leading to trading business for their firm or enhancing their influence was fair game.

In a society where every second information becomes exponentially more omnipresent, there are going to be comprehension gaps. For years the institutional money manager understood from where the research hailed, and as it became more pervasive, the individual investor has now caught on. In this age of information overload I believe the individual has the responsibility to perform his or her own due diligence not only on the companies one invests in but also on the analyst chosen.

Currently, there is no shortage of resources available to individuals either online or in the public library when it comes to ways to analyze companies or individual analysts. For decades now *Institutional Investor* has been ranking equity analysts and today there are dozens of free Web sites (*e.g.,* The Motley Fool, Validea.com and TheStreet.com) which rank analysts. These resources, among others, are doing an excellent job of informing those investors who are willing to invest the time in doing due diligence on which analysts to follow. But, for the individual who merely sees the stock market as a craps table and is willing to expend money based upon an analyst's recommendation without doing any of his or her own research on either the issuer or the analyst, does so at one's own peril.

I would also like to address the conflict of the analyst (sell- or buy-side) who appears in the media, whether in print or on-air, recommending the purchase or sale of a security. The potential for conflict is clear—the analyst goes on television talking about a stock that the analyst likes, which he or she owns, and investors go and buy the stock. The stock goes up and the analyst's firm makes money. I do not believe this potential conflict is troubling if certain common-sense precepts are followed.

From the viewer's perspective, the Number One Rule should be *always do your own research.* I believe viewers are better served if the analyst owns the stock he or she is recommending. I would much rather accept advice on a particular stock from someone who has his or her own money in the game. Of course, appropriate disclosure should be made when stating a recommendation.

The news media outlets have done a responsible job in attempting disclosure to their viewers, as much as possible about what their guests own. They have required guests to avoid any appearance of impropriety by not taking advantage of appearances. If anything, the investing public loses the opportunity to hear from many great investors because the burden of having to divulge positions and its concomitant responsibility has limited one's activity prior to and after a public endorsement. This keeps many worthwhile guests away.

Tangentially, one idea that may coerce analysts to be more thoughtful in their recommendation is for investment banks to urge analysts to own the stocks they suggest, so they have their own capital at risk—it is too easy to spend other people's money. With proper internal-trading safeguards to prevent such things as front running, in addition to appropriate disclosure, I believe analysts owning the stocks they recommend may actually help ameliorate any biases that potentially exist. At EnTrust Capital we always say to analysts: Don't tell me what you *like,* tell me what you *own.*

Many individuals want to find a causal relationship between the market's severe correction and the lack of sell recommendations among sell-side analysts. I believe no causal relationship exists. While there have been many buy ratings on the steel, food and consumer nondurable stocks—with little if any sell recommendations—they did not experience the meteoric rise many tech stocks had over the past couple years. It was a confluence of events that caused equity prices of certain sectors to rise disproportionately to the rest of the market—much had to do with Y2K, the Internet revolution, easy monetary policy, and accommodating capital markets. Most important, however, it was investors' appetite for these securities, momentarily short supply, and a shrinking of the equity risk premium. Once each of these events normalized, many of these immature enterprises had no earnings to fall back on. With no cushion in valuation, and capital markets shutting down, these companies went out of business.

Incorrectly, many believe that there are few sell recommendations on Wall Street. There are numerous firms that specialize in providing only sell recommendations. These firms provide an excellent counterbalance. Unfortunately much of this research is not widely circulated to the individual investor because it is costly.

Then there is the cheapest and best research in the world one can do: what I call "walking the mall." The individual investor needs to get out there and do his or her own due diligence. Try out The Gap, buy the latest pair of Nike's, compare the Dell computer to your friend's Compaq. Ultimately the individual is the investor *and* the consumer.

There are also many countervailing pressures on analysts that work toward providing a balanced view. First and foremost on Wall Street, reputation and record mean everything. The analysts over time whom are the most thoughtful, responsible and correct, earn the respect of the investment community, marketplace, and the public at large. Wall Street is a humbling place: You can be a star one day and a has-been the next. It's only with mindful research over a period of years the analysts really earn their stripes. It is this institutional pressure for analysts to be correct that is the largest force compelling honest work.

One clear way of holding analysts accountable is for the investment banks to publish each analyst's performance record, based on his or her recommendations. This would provide more information to the investors and aid those who are superior stock pickers.

While some have toyed with the idea of separating the research department of sell-side firms with the investment-banking department, I believe this idea to be unwise, impractical, and commercially nonviable. Lest we not forget, most of the conflicts I have presented are either now well known to the investing public or disclosed by the investment banks. Such disclosure language is often longer in length than the actual research.

I would rather see investment banks improve disclosure by making it more material. Instead of providing two pages of gibberish—in order to avoid lawsuits—provide investors with concise material disclosure statements. It is more important from a potential conflict standpoint to know if the bank is currently engaged by the issuer or is pitching the firm new business, rather than the typical historical disclosures.

The disclosure statements should consist of whether the analyst personally owns the security. As I stated previously, equity ownership by analysts is a positive occurrence, not something to be shunned. The public company may consider whether or not it should disclose when it has engaged a currently publishing investment bank. Such disclosure could be accomplished without getting into the specifics of the engagement and thereby not affecting the commercial realities of its business.

The new information age combined with Regulation FD—Fair Disclosure—is impacting the role of the analyst. With companies now severely limited to what they can say to analysts prior to generally released news, the importance and edge that analysts have over the investing public as it relates to any individual issue has significantly diminished. Therefore, many analysts are now utilized less for expertise on a particular company and more for their knowledge of a particular sector. Sector research, while not devoid of potential conflict, is clearly less prone to bias.

In today's new Regulation FD-world the usefulness of the analyst is confined by the quality and quantity of the information issuers are providing to the public. While this is not a forum on issuer disclosure, it is my opinion that the lack of uniformity in such information ultimately leaves the investing public with only half a knowledge deck. While there are standard SEC filings required, often the most valuable information comes from other sources in which there appears to be no set standards.

Investing is as humbling as golf. Every day is riddled with mistakes. Unfortunately, often the only way to learn in this business is from mistakes and that costs money. Investors have learned a hard lesson: with huge rewards come equally huge risks. The bubble has burst. Just as there was the 1636 Dutch tulip boom, the 1828 French cotton craze, so too, is there the most recent, the biotech and Internet bubbles. There will be other manias with new and probably ever-more-fanciful valuation metrics in our future. Investors should not believe everything they read, hear or see. In the new Regulation FD Internet-age the playing field has been leveled, and therefore the responsibility must accordingly be shared.

Thank you.

The Analyst Paradox:
If They're So Plagued With Conflicts, Why Do They Do a Such Good Job?

James K. Glassman

Resident Fellow, American Enterprise Institute

And

Host, www.TechCentralStation.com

Testimony before a hearing on "Analyzing the Analysts: Are Investors Getting Unbiased Research from Wall Street?"

Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
The Hon. Richard H. Baker, chairman

June 14, 2001

American Enterprise Institute
1150 17th Street, N.W.
Washington, D.C. 20036
202/862-7198
jglassman@aei.org

Mr. Chairman, members of the committee:

Thank you for inviting me to testify today on this important subject.

My name is James K. Glassman. I am a resident fellow at the American Enterprise Institute, concentrating in matters of economics, financial markets and technology. I am also host of the website TechCentralStation.com, a cyber-think tank that focuses on matters at the intersection of technology, finance and public policy. For six years, I wrote a nationally syndicated financial column for the Washington Post. I am now chief columnist and senior consultant to Folio(fn), a financial services firm. In addition, I am a weekly financial columnist for the New York Daily News and the International Herald Tribune. I am co-author of *Dow 36,000*, a book on stock valuation, and author of a forthcoming investment primer titled *The Secret Code of the Superior Investor.* I have devoted much of my professional career both to educating small investors and to analyzing and advocating public policies in the economic sphere.

This hearing examines "whether securities analysts are providing unbiased research to investors." As a witness, I am asked to "discuss any conflicts of interest that may affect the objectivity and independence of analysts and what, if anything, needs to be done to improve the quality of information to investors."

Background

After five years of unprecedented gains, the U.S. stock market declined sharply last year and continued to fall in 2001. Over the past 12 months (through June 11), the Standard & Poor's 500-Stock Index, the most popular benchmark, declined 13 percent. The Nasdaq Composite, dominated by technology stocks, fell 42 percent.

Many analysts were caught off-guard by the decline, which represented the first bear market in a decade. Some of the best-known Wall Street analysts, including Mary Meeker of Morgan Stanley Dean Witter and Henry Blodgett of Merrill Lynch were celebrated for making accurate recommendations of high-tech companies, but in 2000, the share prices of many of those firms, including Amazon.com, Priceline.com and Yahoo! plummeted. A recent article in Fortune magazine called Ms. Meeker "the unquestioned diva of the Internet Age" and reported she made $15 million in 1999 – a year in which the Nasdaq roughly doubled – by urging her clients to buy high-tech stocks. But now, wrote Peter Elkin of Fortune, she is "the single most powerful symbol of how Wall Street can lead investors astray."

Mr. Elkin wrote that Ms. Meeker "came to see herself not merely as an analyst but as a player – a power broker, a dealmaker, a force to be reckoned with." It is just this conflict

– an erosion of the famous "Chinese wall" between the investment-banking side of a large Wall Street firm and the research side – which, in the eyes of critics, threatens the objectivity of analysts and the wealth of investors.

Meanwhile, other analysts whose stock selections turned sour have been accused of different sorts of conflicts of interest. The New York Times criticized analyst Richard Juarez of Robertson Stephens, who continually advocated purchase of iBasis, an Internet stock which dropped from $49 to $4 and which, the Times noted, Mr. Juarez was, at the time, selling out of his personal account. Laura Unger, acting chair of the Securities & Exchange Commission, recently was reported to have "warned Wall Street firms to resolve 'blatant' conflicts that surrounded the business of bringing shares to the public and then recommending them to investors."

These same concerns have led to the hearing today.

Conflicts of Interest

There is little doubt that conflicts of interest pervade the securities industry. Many of the best-known and most influential analysts work for firms that have extensive and lucrative investment-banking relationships with companies the analysts cover. A negative analysis by an analyst could embarrass investment bankers or even lose business for the firm. A positive analysis could lift the stock, make issuing more debt or equity easier, thus enriching the investment bankers. In addition, some analysts play a direct role in winning investment-banking business for a firm. A second kind of conflict involves analysts owning, buying or selling shares in companies that they cover.

But it is important to understand that conflicts of interest pervade investment banking in large part because they pervade life. A husband and wife with a three-year-old son develops a conflict of interest by deciding to have another child, but that potential conflict rarely deters them, nor should it.

Or, more to the point, consider journalists: Surveys show that most journalists lean to the left of the political spectrum. For example, a study by the Roper Center of 139 Washington bureau chiefs and congressional correspondents found that in the 1992 presidential election, 89 percent said they voted for Bill Clinton, 7 percent for George Bush. The same study found that 59 percent characterized the 1994 Contract with America as "an election year campaign ploy" while 3 percent said it was a "serious reform proposal." Kenneth Walsh, then of U.S. News & World Report, surveyed White House correspondents from 1980 to 1992 for his book, *Feeding the Beast*, and found that, by a margin of 37 to 5, they had voted for Democratic presidential candidates over Republican. Yet every journalist to whom I have ever spoken claims that his professionalism overrides these conflicting political leanings. Does it? The answer is that we can judge for ourselves by reading the articles they write or the TV segments in which they appear. Some surmount the conflict; some do it. But the fact that all journalists produce something for public consumption means that individuals can see the product and judge for themselves. By the way, no one would deny that Members of Congress have conflicts of interest too. They must balance allegiances to family, donors, party, constituents, and principle. Setting precise rules on how this balance must be achieved would be fruitless and counterproductive. And, in the end, Members are judged by their actual production, their votes, and service to their district.

But back to stock analysts: their situation is similar to that of journalists except that their judgments are *clearer* and more easily assessed by the public. The essential problem with a conflict of interest of any sort is that it leads to poor judgment. In the case of journalists who lean left or right, it would mean a political or ideological bias that might subtly color reporting and might be difficult to discern by the public. In the case of stock analysts, it could mean that a company with poor fundamentals and poor prospects is given a positive recommendation. In this case, however, the analyst's judgment could be assessed quickly by the public. An analyst who consistently gave bad advice would be rejected as not useful either to investors or, ultimately, to the firm that employed her.

In other words, recommendations tainted by conflict of interest are decisions made in the full glare of publicity. An analyst cannot hide for long.

For this reason, conflicts of interest do not greatly trouble me. An analyst who recommends bad stocks in an effort to sell investment banking services will be an analyst whose track record – closely watched by journalists and professional tracking services – will soon lose him his job. Still, there is no forgiving an analyst who hypocritically and corruptly sells shares in a stock he is recommending. One such episode and, I believe, the analyst is finished. It is important that the full light of publicity shine on such activities.

Disclosure

While I believe that the perils of conflicts of interest are overrated and overstated, I do favor voluntary and extensive disclosure by analysts of their personal holdings and any other affiliations that might color their decisions. But, again, it is important not to exaggerate the benefits of disclosure. What, for example, should an investor make of the disclosure that an analyst owns 1,000 shares of a stock she recommends? That the stock may be more deficient than if the analyst did *not* own the stock because the analyst has an additional incentive of personal gain? Or, is the case the opposite: That the stock may be a particularly good one since the analyst *does* own it and thus has her own money on the line? I am not really sure that disclosure is all that helpful – except in the case of an analyst who sells stocks he recommends. In my own financial writing, however, I disclose any of the personal holdings I mention in a column, allowing readers to make their own judgments from these facts but knowing I could just be confusing them.

Performance of Analysts

The recent critique of analysts comes down to this: Biased by conflicts of interest, analysts recommend companies that do not deserve "buy" ratings. The disaster of 2000 is the evidence, and well-paid analysts who make mistakes are fair game. There is no doubt, as I will show, that last year was a terrible one for analysts, but journalists and politicians

– in fact, all of us – often rush to judgment based on events that happened yesterday, without looking closely at history. Anecdotes, especially recent ones, are powerful, but they prove nothing. The essential question is this: How good have the recommendations of analysts been over time? If analysts have performed well, then the evidence would be strong that they have, in the aggregate, surmounted any conflicts of interest that may have colored their judgments.

Our good fortune is that just this question has been examined at length in a study published in the April 2001 issue of The Journal of Finance, a highly regarded publication for scholars. In the article, "Can Investors Profit From the Prophets? Security Analyst Recommendations and Stock Returns," the authors, all economists at California universities, present evidence that would almost certainly surprise many critics. They found that the consensus recommendations of analysts between 1986 and 1996 were prescient and profitable. This research reinforces earlier studies that have found that professional securities forecasters acted "rationally" – that is, with proper judgment.

The authors of the new study – Brad Barber of the University of California at Davis, Reuven Lehavy and Brett Trueman of Berkeley, and Maureen McNichols of Stanford – looked at a database of 360,000 pieces of advice from 269 brokerage houses and 4,340 analysts over 10 years. They gathered recommendations regarding each stock into a consensus in one of five groups – from 1 (most favorable) to 5 (least favorable). Consensus ratings, by the way, are easily available for free on the Internet, from such financial websites as CBS MarketWatch and Yahoo! Finance.

Every time an analyst initiated coverage of a stock or changed his or her rating of a stock, the consensus was recalculated by the researchers, and, if necessary, the stock moved by the researchers into a new group. Over the 10-year period, the group 1 stocks returned an annual average of 18.8 percent while the group 5 stocks returned an annual average of just 5.8 percent, with the other groups arranged in order between them. The stock-market benchmark over this period returned an average of 14.5 percent.

The researchers then applied controls for market risk, size, book-to-market ratios and price-momentum effects. They found that the highest rated stocks still outperformed the lowest by a wide margin. The group 1 stocks beat the benchmark by 4.1 percentage points, and the group 5 stocks trailed the benchmark by 4.9 percentage points.

These results are truly exceptional. Rare, for example, is the mutual fund that can beat the Standard & Poor's 500-Stock Index by four points over 10 years. In fact, the benchmark has *beaten* a majority of funds over the past two decades. The results of the Barber study suggest that analysts are truly able to pick winners.

Last month, the four researchers produced a follow-up to their study, examining, in the same manner, the four years from 1997 to 2000. In the first three of those years, a portfolio of the group 1 stocks generated an annual average return that was 4 points higher than the market as a whole while the least-favored stocks generated a return that was 9 points lower. But the final year, 2000, was a debacle for analysts – five standard deviations away from the previous 13 years' results. During that year, the most highly recommended stocks produced a return that was 31 percentage points *below* the benchmark while the least-favored stocks did best – 49 percent *above* the benchmark. The year 2000 appears to have been an anomaly, an outlier – though, clearly, more research is needed. Still, Dr. Barber and his associates looked at issue of conflicts by simply examining whether significantly more investment-banking activity occurred during 2000. It did not. Dr. Barber calls the year "a mystery," with a performance completely at odds with those of the previous 13 years.

Conclusion

Mystery or not, the year 2000 does not in itself provide enough evidence on which to base a new set of conflict-of-interest regulations. My own assessment of stock analysts is that they are, for the most part, solid and conscientious professionals who try their best to find good companies in which investors can put their savings. Are the judgments of some of them biased to the point of error by conflicts of interest? Of course. And if those analysts are wrong enough times, then clients won't trust them and will move elsewhere. Allan Sloan, writing in Newsweek, is correct when he wrote last week that analysts "became the bad guys when the bubble burst 15 months ago, and America began one of its favorite activities: searching for someone to blame."

The truth is, many analysts were right for most of the 1990s, as stock prices rose substantially, and were wrong in 2000 and the beginning of 2001, as stock prices fell sharply. Overall, however, they have done much better than the laws of chance would allow – better, it appears, that mutual fund managers and newsletter writers.

But even if their performance were poor, I would not favor this committee's writing laws to order certain kinds of disclosure or forbidding certain conflicts. Individual firms and the securities industry as a whole have strong incentives to increase disclosure and to limit conflicts in order to increase public faith in markets – and, more important, client faith in their companies.

If ever there was a case of transparent, well-monitored information on which the public can make its own judgments, it is stock-market analysts' recommendations and ratings. They are out there for all to see, to criticize, to respond to.

In the end, however, the recommendation of an analyst is only one tool in an investor's kit. Personal observation of companies in action, examination of income statements and balance sheets, news stories and even word-of-mouth all go into investors' decisions to buy and sell – as they should. Many investors, however, rely on analyst research because they do not have the time or inclination to do their own. Analysts have a professional and moral obligation to make sure that research is the most honest and thoughtful they can offer. Most of them, it appears, live up to that obligation. But scrutiny of analysts, in a forum like this one, is appropriate and beneficial. Precipitous legislative action is not.

Thank you, Mr. Chairman and members of the committee.

Statement of
Marc E. Lackritz
President
Securities Industry Association
Before the
Subcommittee on Capital Markets, Insurance,
and Government Sponsored Enterprises
Committee on Financial Services

June 14, 2001

Chairman Baker, Congressman Kanjorski and members of the Subcommittee, I am Marc Lackritz, president of the Securities Industry Association.

I am very pleased to have this opportunity to meet with you today. This Subcommittee is addressing a very important issue. It is an issue of great concern to the investment banks, broker-dealers and mutual funds that make up the securities industry.

The subject of today's hearing concerns how this industry fulfills its obligations to its customers – to the nearly 80 million Americans who directly or indirectly own shares of stock. Our most important goal is to foster the trust and confidence of America's shareholders in what we do and how we do it. We want to address directly their questions and allay any doubts that may exist.

As SIA's By-Laws clearly state, "SIA member firms hold these values: adherence to ethical and professional standards, commitment to the best interests of clients; and exercise of unquestioned integrity in business and personal dealing in the industry and with the firms."

We succeed as an industry only when we succeed for investors. We succeed only when we serve investors in ways that help them reach their investing and saving goals. Period.

To this end, we in the industry have just adopted and released a *Best Practices for Research.* These *Best Practices* explicitly confront the matter before this panel: The role of the securities analyst. The details of the *Best Practices*, which I'll discuss in a moment, reaffirm and restate forcefully the best means to protect the independence of securities analysts and to ensure the objectivity of their important work.

◆

First, however, you may ask: "Who are these securities analysts? And what do they do?"

Once a fairly unnoticed, even obscure, group, securities analysts have grown in visibility – even, at times, to prominence – in the past decade. There are a couple of reasons for this. For one, the sustained bull market spawned something of an equity culture in America. For another, advances in technology, online trading and the increased concern about saving for retirement all have democratized shareholding, creating a massive audience for the research by securities analysts.

Information is the lifeblood of our markets. The information that analysts provide contribute to this flow of information that originates from many sources. As the SEC acknowledged in a November 1998 statement: "Analysts fulfill an important function by keeping investors informed." When we read or hear on TV that a brokerage firm downgrades the XYZ Corporation or that Acme Communications' new design for fiber optic cable is expected to increase sales revenue due to improved performance, it is the securities analyst who renders this judgment.

How do securities analysts do what they do?

Analysts are themselves highly educated professionals. Most have advanced degrees and many have degrees in the fields to which they devote their research. Securities firms understand that it isn't possible to evaluate a new gene splicing company or a computer chip manufacturer without an extensive scientific background. Securities firms hire this kind of talent so that they can evaluate investment opportunities thoughtfully and wisely.

Analysts do lots of detective work. They immerse themselves in the dozen or so companies they each cover, scrutinizing the balance sheets and management, eyeballing the products or services the company produces, visiting the stores or other outlets where the products are sold, talking to customers and suppliers, getting a sense of the industry of which the company is part -- and much more. They literally kick the tires. As the 1998 SEC statement explains: "They digest information from Exchange Act reports and other sources, actively pursuing new company information, put all of it into context, and act as conduits in the flow of information."

In this process, the analysts also assess the specific economic sector in which that company operates and they take the pulse of the overall economy and try to figure out how that will affect the company. Then they roll-up all this information, run it through their evaluation models and draw their conclusion. This is the objective, quantifiable part of the process.

Then there is the subjective, gut-feeling -- even creative -- part. Though impossible to measure, securities analysts draw on their experience viewing economic cycles and fads, watching companies thrive and flounder, looking managers and CEOs in the eye and engaging in a host of other hands-on activities.

From this process they attempt to project the near term and, much more important, long-term economic health, viability and prospects of the firms. Then, typically, they take these projections and other performance criteria and apply to them a number of analytic measurements from which they make their assessments. Much of the time these are assessments of how the companies will perform.

There is great value added by securities analysts. For one thing, they uncover, sort through, digest and give structure to vast amounts of data. For another, their experience and their immersion in the deep workings of an industry give them the skills to look at highly technical data – for example, the laboratory results in trials of new medicines, or the production processes for a new jet engine – to draw conclusions from this and to explain them in terms that investors can understand.

This process and the value added by securities analysts have been appreciated widely. For example, the United States Supreme Court and the SEC have both said that "[t]he value to the entire market of analysts' efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by their initiatives to ferret out and analyze information, and thus the analysts' work redounds to the benefit of all investors.'" *Dirks v. SEC*, 463 U.S. 646, 659 n. 17 (1983) (quoting 21 S.E.C. 1401, 1406 (1981))

◆

How good a job, you could ask, do securities analysts do?

As a group, they do pretty well. A recent academic paper (published in the April issue of the Journal of Finance and then updated in May)[1] reviewed approximately 500,000 analyst recommendations from 1986-2001, and concluded that the consensus recommendations that analysts make on specific stocks prove prescient and profitable. The authors found "sell-side analysts' stock recommendations to have significant value".

Aside from this comprehensive study, it is notable that 71% of recommendations listed in First Call are "buys" or "strong buys." This seems appropriate, considering that the 12 years from 1988 through 1999 saw the Dow Jones Industrial average and the Standard & Poors 500 index both post an average gain of 16% a year. Critics of analysts were much less vocal then.

To be sure, in the past year or so, as the market declined and the Internet bubble burst, it seems that securities analysts have a few bloodied noses. They do. And they are not alone. Just about everyone working in, reporting on and commenting about securities recently has tripped at least a few times. But, of course, it's not only in the investment world in which bad years distressingly and abruptly interrupt a string of good. Michael Jordan, Babe Ruth, Tiger Woods, Tom Cruise, -- all superstars -- have occasional bad times, even bad years.

This is not to say that all securities analysts are in the Tiger Woods category. As individuals, their performances vary, with some doing better than others. This is to be expected for, as we noted, analyzing companies, assessing their prospects and projecting their performance is an art as well as a science. Some securities analysts make wrong calls more than they would like. But here it is important to emphasize three points.

---

[1] "Can Investors Profit from the Prophets? Security Analysts Recommendations and Stock Returns" Journal of Finance, Vol. LVI, no. 2, April 2001, covered the period 1985 to 1996 and a database of 360,000 separate pieces of advice from 269 brokerage houses and 4,340 analysts over this 10 year period. "Prophets and Losses: Reassessing the Returns to Analysts' Stock Recommendations" Journal of Finance, May 2001, updates the study, covering the period 1997-2000. Although investors would have outperformed the market indexes following the consensus recommendations of analysts, to implement this trading strategy would require buying and selling stocks frequently—since so many analysts were included in the study and they changed their recommendations frequently, with turnover rates at times in excess of 400% annually would produce significant transaction costs. In other words, analysts do a good job picking stocks, but an investor following all their recommendations would incur commissions and other costs, such as taxes, that could reduce the investor's performance to that of the market indices. This is not to say that analysts' recommendations are not valuable. As the authors point out, "there is one group of investors who can take advantage of our findings—those who are otherwise considering buying or selling, and so will be incurring transaction costs in any case. For these investors, analysts' recommendations remain valuable."

In the update, the years 1997-1999 produced similar results. However, the results for 2000 were strikingly different. "After a string of years in which security analysts' top picks significantly outperformed… the year 2000 was a disaster," with the recommendations producing significantly worse results than the market indexes. However, the author termed these results a "mystery" or a true outlier, and "we cannot conclude that these results (2000) are necessarily driven by increased analyst involvement in investment banking".

One. To be wrong in projecting the performance of a company or a security is very different from failing to try their hardest to serve the interests of investors. It is very different from allegedly succumbing to pressures to tilt one way or another in their analyses and projections.

Two. Similarly well-trained, experienced and even wise analysts can differ over how much weight to give such otherwise seemingly objective facts as the company's sales figures, gross (or net) revenues, debt, inventory levels, cost of customer acquisition and a host of other data. For example, some analysts may hail as good news a change in a company's top management while others may see it as a cautionary yellow flag of trouble ahead. That's why we have a market – to clear these conflicting views every day and at an agreed-on price. And the market and investors do a remarkably good job of sorting out the good assessments from the bad.

Three and most important. Even if analysts agree on what is going on inside a company, they may differ in their reading of the macro environment in which that company operates. This environment – a specific sector (such as autos or computers), or a broad sector (such as technology or capital goods), or a geographical region or even the economy as a whole – can influence enormously how the company performs.

The question before this Subcommittee is whether, as they conduct their research, can these analysts be subjected to direct or subtle pressure to skirt objectivity and shade their conclusions one way or another? This is a legitimate question. The answer is: "Yes they can." We in the industry as well as those who regulate us long have been well aware of this. For this reason, there are strong legal mandates in the Securities Exchange Act of 1934 and similar regulations and laws are on the books to ensure research integrity and objectivity. Some of the more important of these requirements include the following provisions:

- Section 15(f) of the Exchange Act provides that firms must have systems reasonably designed to prevent insider trading.

- New York Stock Exchange ("NYSE") Rule 472 provides that firms must have a reasonable basis for making a recommendation.

- NASD Rule 2210(d)(2)(B) and Interpretation .40(2) of NYSE Rule 472 direct firms, in publishing a recommendation, to disclose certain situations that could pose a conflict of interest, such as whether the firm makes a market in the security, whether the firm was a managing or co-managing underwriter of a public offering of the issuer's securities within the past three years, whether the firm or its employees involved in preparing the research report may have a position in the securities or options of the recommended company, or whether an officer or employee of the firm is a director of the company being recommended.

- NASD Rule 2210 (d)(2)(B)(ii) requires that the broker-dealer shall provide available information supporting the recommendation.

- The NASD and NYSE have both advised their members that broker-dealers are prohibited from accumulating positions in NYSE-listed or NASDAQ-listed securities in advance of a research report for the purpose of selling to investors who receive the research report. *See* NYSE Information Memo 91-8; NASD NTM 95-75.

- Analysts are also generally subject to "quiet periods" barring them from issuing research on a company while the analyst's firm is acting as an underwriter for a registered offering of the company's securities. There are carefully tailored exceptions to this prohibition contained in SEC Rules 137, 138 and 139. The goals of these rules are to balance the need of investors for timely research with the need to ensure that a research report does not "gun jump" a securities offering, and does not induce purchasing that would artificially boost the price in the aftermarket.

Firms themselves have adopted checks and balances to ensure the integrity of their operations. The *Best Practices* described below came, in most instances, from the firms.

These are tough regulations, as are the internal safeguards. Yet, it is clear that some doubts now may be clouding the perception of how securities analysts operate. That is why we're meeting today. It is to banish these clouds that the Securities Industry Association has formalized and bolstered the safeguards by endorsing and releasing earlier this week these *Best Practices for Research*

In these, we articulate clearly the means to protect the independence and objectivity of securities research and the securities analysts.

We make an unambiguous re-commitment that analysts' judgments are to be dictated solely by the data they find and by the insights they bring through their years of experience.

We reaffirm that the securities analyst serves only one master: The investor. Not the issuer or the potential issuer.

While this new statement of *Best Practices*, forcefully reaffirms many safeguards and procedures already in place, it is far more than a reaffirmation. It is a loud, clear declaration by us -- louder and more explicit and more precise than ever before -- that there should be and can be no doubt that the primary role of securities research is to amass, assess and analyze data that ultimately inform individual and institutional investors so that they become wiser investors. Nothing the analyst does can be in conflict with this preeminent responsibility.

The *Best Practices* make our commitment unambiguously clear. It is the investing client who comes first. Once we established that critical element, the rest of the Practices flow logically. Let me offer some examples from its main points:

One. The integrity of research should be fostered and respected throughout a securities firm. Each firm should have a written statement affirming a commitment to the integrity of research.

Two. The firm, research management, analysts, investment bankers, and other relevant constituencies should together ensure the integrity of research, in practice and in appearance.

Research should not report to investment banking. Recommendations should be transparent and consistent. A formal rating system should have clear definitions that are published in every report or otherwise readily available, and management should support use of the full ratings system.

Three. No outside or investment bank approval of investment recommendations. An analyst should not submit research to investment banking or to corporate managements for approval of his or her opinions or recommendations. Nor should business producers promise or propose specific ratings to current or prospective clients when pursuing business. The SEC recognized the great value of analyst objectivity when it declared in 1998: "Where analysts are acting independently and objectively, investors gain from the publication of their insights."

Four. A research analyst's pay should not be directly linked to specific investment banking transactions.

Five. Research should clearly communicate the relevant parameters and practical limits of every investment recommendations. Analysts should be independent observers of the industries they follow. Their opinions should be their own, not determined by those of other business constituencies.

Six. Disclosures should be legible, straightforward and written in plain English. Disclaimers should include all material factors that are likely to affect the independence of specific security recommendations.

Seven. Personal trading and investments should avoid conflicts of interest and should be disclosed whenever relevant. Personal trading should be consistent with investment recommendations.

There are a number of other important points in the *Best Practices*, copies of which I am submitting to this Subcommittee.

I must note that SIA's *Best Practices for Research* are not binding on its members. SIA is not a regulator. The anti-trust laws impose limits on a trade association's ability to set standards. But the fourteen largest firms engaged in 95% of underwriting in the U.S. have endorsed these *Best Practices*, from their top management, including their CEOs, to their research departments. That in itself is a remarkable achievement in only a few months' time.

Congress, the SEC, the SROs, and other regulators should give these best practices an opportunity to work. By developing this consensus set of *Best Practices*, SIA members have reaffirmed and formalized the commitment that is implicit in existing rules and regulations.

◆

Let me conclude by repeating what I stressed earlier. The securities analyst will serve only one master: The investor.

We also pledge to continue and expand our investor education efforts so that investors well understand the risks and rewards inherent in the market as well as the basic investment precepts. The Securities Industry Association and our member firms, through such publications as *Your Guide to Understanding Investing, Investor Topics, Understanding Market Risks* and *Managing Your Expectations* and through elaborate interactive websites, already devote considerable resources and attention to educating investors. We plan to devote even more effort.

This is very important because no matter how much we in the securities industry do by ourselves, we can contribute only half of the ingredients needed for successful investing. This is because successful investing is a partnership – a partnership between securities professionals and the investor.

Therefore, just as the securities industry is renewing its commitment to do its part, we ask investors to take at least two important steps to ensure that they are doing their part.

First, remind yourself that among securities analysts there are almost always differing opinions about the prospects of an individual company. Look at and evaluate the differing opinions. Deal with actions that affect your financial health just as you would with those affecting your physical health. Consider getting a second opinion. And just as you would check out the reputation of your doctor, check on the securities analyst. They have track records and compete with each other based on these records. In fact, the competition is growing more intense, as such publications as *The Wall Street Journal* and *Institutional Investor* and as websites compare individual analysts' performances, and rate them.

Second. Remind yourself that a securities analyst's assessment of a company is just one of a number of factors that you should consider when investing your money. You should do your own assessing -- from your own particular perspective. Ask yourself: Does stock of the company belong in your portfolio? Does it fit into your investment strategy? Do you have the risk tolerance for it? And so forth with the kind of questions only you and your financial advisors can answer. If you make your own investment decisions and do not seek professional investment advice, you must ensure that your decisions are well-suited to your situation. If you buy professional advice, such as through a full-service broker, you need to work with your registered representative to develop a strategy that makes sense for you.

We ask our customers, we ask investors: Help make our partnership work. Be an informed and prudent investor.

◆

The long-term interests of the securities analysts and the securities firms for which they work are best served by analysts using their most skilled powers of research and best judgments. The market is a very powerful and unforgiving enforcer. Flawed projections lose customers.

All of us in this industry know only too well the truth of the adage that it takes months to win a customer but only seconds to lose one. All of us nod in agreement to Wal-Mart Founder Sam Walton's repeated advice to his managers: "There is only one boss – the customer. And he or she can fire everybody in the company from chairman on down, simply by spending his or her money somewhere else."

Indeed, ours is a fiercely competitive industry – not only among members of this industry but also between those of us who offer securities as a vehicle of investment and those who offer alternative forms of investment. No securities firm wants to give advice that will hurt a client. Firms that offer bad investment guidance penalize themselves.

We believe that the *Best Practices*, endorsed by so many major firms, demonstrate a vigorous renewed commitment to the investor. We hope they will go a long way towards ensuring that the public justly retains its trust and confidence in our markets and our industry.

Thank you very much.

◆◆◆

Oral Testimony for June 14 Hearing of House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Benjamin Mark Cole, financial journalist and author of *The Pied Pipers of Wall Street - How Analysts Sell You Down the River*, Bloomberg Press, 2001.

With the Nasdaq cut in half from 2000, and Internet stocks trading for pennies on the dollar, many Americans are asking themselves, "What happened?"

How come no major securities house predicted you might lose half your dough on the Nasdaq in less than a year? Or almost all your money on an, eToys, Priceline or iVillage?

It reminds me of that old joke from 1970s, made fresh again by recent events: How do you end up with a million bucks on Wall Street? Start off with $2 million.

What the general investing public doesn't realize yet – though it is catching on – is that Wall Street research has become hopelessly corrupt.

Today's so-called analysts are more akin to lawyers in court – they regard their job as one of advocacy, to make the best case why a stock is a terrific buy. Ask an analyst if what he or she is doing is dishonest, and they will answer that you "don't understand their job description."

What happened to analysis? Why does a "sell signal" make up less than one percent of analyst recommendations?

The answer lies in the way Wall Street makes money today, compared with 1975.

Twenty-five years ago, Wall Street made money on ordinary, retail trading commissions, which were fixed by regulation. That environment – something of a cross between Shangri-La and Fat City – made Wall Street a clubby place of almost assured profits.

The prized customer was a wealthy individual or family that liked to trade stocks, and the prized employee was the stockbroker with a "good book" of business.

But the SEC erased fixed trading rates in 1975, an action then fought tooth-and-nail by the industry, which wanted no part of free enterprise and competition. In the years since, if inflation is taken into account, trading commissions have fallen to a penny on the dollar, if one looks at thrifty investor using a discount online brokerage.

For the securities firms, the downward plummet of trading rates raised a serious problem. How do we make lots of money, like we all came to Wall Street for?

Wall Street, after 1975, had to come up with a new way to make lots of money, and they found it, happily for them, in their own corporate finance departments, also known as investment banking.

Investment banking is the business of underwriting initial public offerings of stock, or secondary offerings, bond underwriting, or advising companies on mergers and acquisitions.

Too, increasingly, brokerages have moved upstream in the financing cycle of companies, often providing private equity, also called venture capital, to a company before they take it public.

This can be extremely lucrative. CIBC Oppenheimer, (now CIBC World Markets) invested $30 million in private equity into Global Crossing Ltd. the telecom giant. After the company went public, and the stock surged, that stake became worth $4.3 billion. And Goldman Sachs invested $36 million in private equity, or stock, in Storage Networks Inc., a stake which became worth $1.6 billion after Goldman took Storage Networks public.

Some quick numbers to illustrate the changing nature of Wall Street. In 1974, the US securities industry underwrote $42 billion worth of stocks and bonds. In 1999, the industry underwrote $2.24 trillion, more than 50 times the pre-1975 level.

Trading commissions made up more than 60 percent of industry revenues before 1975, but today make up less than 16 percent, a fraction that is shrinking every year.

The simple story is this: Wall Street makes it money in investment banking, not on retail trading commissions.

With this change came a change of who held power in a brokerage. In days of yore, – as quaint as it may seem today – the stockbroker with his book of business, was the power employee within a brokerage. Sometimes they were referred to as "customer's men." When an analyst wrote a report, he looked over his shoulder at the customer's men, who would hold him accountable.

Things have changed. Today, analysts look over their shoulders at investment banking and trading departments, the new profit centers.

The results of this switch in loyalties are obvious to all within the industry, so much so that brokerage analysts are referred to, often dismissively, as "sell-side" analyst. Perhaps not surprisingly, numerous industry and academic studies have found that analyst recommendations, as a group, underperform the market. Investors would be better off tossing darts at a Wall Street Journal than following analyst recommendations.

Though the role of analysts has changed dramatically in the last 25 years, their regulatory environment is little changed from 1975 or even 1945. Analysts have safe harbor under the law, even to the extent that they can tell their larger clients that a stock is really a dog, while keeping the "buy" signal on for the public. That is entirely legal.

It is even legal for analysts to tell their trading departments that a "buy" signal will be out on morrow. If the analyst is influential, the trading department can bulk up on the stock, and then sell into retail demand generated by the buy signal. All legal. Brokerages call this "building inventory to satisfy demand. Just servicing our customers." Others might call that a license to print money.

What is disturbing in the last 25 years is to see many practices once limited to regional and one-branch brokerage shops, the so-called schlock shops, become commonplace on Wall Street proper. In particular, when a brokerage finances a company before an IPO, and then has an analyst issue a "buy" recommendation, it is mimicking practices commonplace Off Wall Street for generations.

Solutions:

•Increase the budget of the SEC for all enforcement actions and beef up the US Attorney's Office for securities industry prosecutions.

•Require that brokerages create a uniform standard for rating the accuracy of analyst recommendations, and that analyst "batting averages," if you will, be constantly published on an industry website, maintained by the National Association of Securities Dealers.

•In the 1930s, the SEC examined whether brokerages should have both underwriting and retail trading operations under one roof. It may be time to reexamine that situation.

•Care and feeding of short traders. In a nutshell, allow short traders to have contracts specifying terms for returning borrowed shares. Short traders can be a tonic on the market.

•Better mandatory disclosure of analyst conflicts of interest in both broadcast and print media.

Thank you very much for inviting me to share these observations and recommendations.

Written Testimony of
Scott C. Cleland
Chairman and CEO
The Precursor Group®

"Who's Looking Out for Investors?"

Before the U.S. House of Representatives
Financial Services Committee
Subcommittee on Capital Markets,
Insurance, and Government Sponsored Enterprises

Hearing on

"Analyzing the Analysts:
Are Investors Getting Unbiased Research from Wall Street?"

Thursday, June 14, 2001

I. Introduction

Mr. Chairman, thank you for the honor of testifying before your subcommittee and for the Subcommittee's interest in the business perspective of an *independent investment research broke-dealer*.

My testimony includes:

- An introduction of the Precursor Group® perspective;
- An explanation of our interest in testifying;
- Our assessment of the problem; and
- Our recommendations to help fix the problem.

II. Precursor Group® Perspective

1. I am Scott Cleland, founder and CEO of the Precursor Group®, an independent research broker-dealer, which provides investment research to institutional investors. My partner Bill Whyman and I founded the Precursor Group® a year ago very intentionally as an *independent* firm in order to better serve our investor clients' interests and not to serve companies' interests or investment banking interests.

- **We see a real market opportunity for pure investment research un-compromised by company conflicts of interest.**
- We have learned that the investment research marketplace is thirsting for trust and our business is trying to quench a part of that thirst.

2. **Our business is simple. We work for institutional investors; they pay us research commissions on their trading to the extent that we help improve their investment performance.**

- If our research helps investors identify opportunities or avoid pitfalls, we get paid in trading commissions.
- If our research does not help investors, we do not get paid.
- We have a market-driven, merit-based business model.

3. **We are unusual in that we are a pure research firm** in a business dominated by integrated full-service brokerage firms that bundle investment banking, trading and research.

- **We are exclusively an investors' broker-dealer**, akin to a buyer's broker in real estate.
- We are not the traditional sellers' or company broker-dealer, which tries to represent *both* companies' and investors' interests.

4. **We have done our best to align our financial interests with investors' interests.** We are very serious about avoiding conflicts of interest, actual *and perceived*, so we:

- Do no investment banking for companies;
- Do not manage money or own a stake in any companies;
- Do not allow Precursor Group® researchers to trade individual stocks -- as a condition of employment; and

- Do not trade securities for proprietary gain.
    - We get paid through agency trading commissions, which is the primary payment mechanism that institutional investors use to pay for investment research.
    - Our contracted-out agency trading is not a conflict of interest because:
        - We act only as an agent and never as a principal that has capital at risk – so our agents execute stocks for others at their request but we never actually own a stock of a company.
        - Our clients have complete freedom to chose which of our four contracted-out trading clearing firms they want to use.
        - So our institutional investor clients completely control whether and how we get paid with their shareholder or pension fund resources.
        - This arrangement eliminates any financial conflict.

5. **We are a pure research firm because we do not believe one firm can well serve different masters at the same time: investors *and* companies.**
    - We strongly believe true independence yields better research.

III. Why am I testifying?

1. **Our interest in testifying is clear.**
    - The powerful investment banking and trading economic interests that have effectively suffocated the independent research views *within* Wall Street firms, have the same economic potential to suffocate independent research *throughout* the industry.
    - **The contagion of conflicts of interest is systemic; they can spread industry-wide** because the economics of individual firms are the same as the economics of the industry-at-large.

2. **Specifically we believe that:**
    - The regulatory system is heavily biased against independent research broker-dealers like ourselves that avoid conflicts of interest, in favor of full-service broker-dealers laden with financial conflicts of interest, perpetuating the problem;
    - Regulatory barriers to entry effectively prevent market forces from providing adequate economic checks and balances that would better serve investor interests; and
    - Business conflict trends (like bankers allegedly pressuring mutual funds to pay increased research commissions for IPO allocations and for trading liquidity) threaten to concentrate the research commission pool in the hands of only full-service firms snuffing out competitive independent research providers and ill serving shareholders.

3. **Thus we are calling for:**
    - **More competition in research, not less;**
    - **Less regulation of research, not more; and**
    - **More disclosure and regulatory oversight of conflicts of interest, not less.**

IV. The Problem:

1. **All the attention on the independence of analysts and research is somewhat misplaced, because it is only the most obvious symptom of a much more serious underlying malady in the industry.**

- The problem is the structural financial incentives in our current brokerage system that bundles higher-margin banking and trading with research.
  - This structural bias can badly serve investors, as many learned from the "surprise" cratering of the tech sector.
  - This structural bias also produces poor research and increases market volatility.

2. **A serious flaw in the regulatory system is that structurally it does not encourage fierce competition for new ideas and information that benefits investors.**

- Investment banking and proprietary trading has largely co-opted the brokerage research function as an arms length extension of the company represented.
- The cold reality is that the lion's market share of the brokerage research system is structured around the banking business of companies.
  - That's why only ~1% of analyst recommendations are sells.
  - That's why sell side analysts lose their jobs for authoring negative research about a company.
  - That's why so many institutional investors have so heavily beefed up their in house research staffs.
  - That's why the system produces "consensus earnings expectations," which so eerily mirror company "guidance" and why independent or divergent expectations routinely get purged from the "consensus" system as "outliers."

3. **A conflict-ridden system profoundly distorts the amount and type of information the market receives.**

- This means that the market generally gets only the information companies want the market to get and not the information investors need to make sound investments or the full and free flow of information that the market needs to operate best.
- The conflicts of interest are so systemic and economically powerful that they threaten the independence and diversity of the research viewpoints that the marketplace needs to function to its fullest potential.
- This conflict-ridden system also contributes to market volatility by powerfully discouraging distribution of research that is contrary to a company's interest.

4. **It is common sense that you find what you look for.**

- If you have powerful economic and compensation incentives to not look for information that may be negative to companies, the very real tendency is not to look for it and not to find it.
- This incentive system serves companies, but not investors or the market.

5. **There is substantial evidence that there is a problem:** this hearing, the SEC's and other governmental authorities' multiple regulatory and enforcement inquiries, academic research, and recent cover stories in Barron's and Fortune.

- But too many are too quick to blame the analysts or individual brokerage firms.
  - I don't think it is right to make them scapegoats.
- Sell-side analysts and full-service broker-dealers are simply doing what the regulatory system encourages them to do – bundle lower-margin research with higher margin banking and trading businesses.
  - **It is common sense that a system naturally produces the behavior that it rewards.**
  - Analysts are generally compensated by the banking business they produce; and many now can also participate in private funds at favorable allocations and prices of companies their firms take public.
  - So it is unfair to criticize behavior that the system condones, encourages and actually perpetuates.
- **The current problems with research won't go away until the systemic problem of conflicts of interest is better resolved.**

6. **Recently, Americans lost roughly four trillion dollars of wealth in the NASDAQ in a matter of months and only 1% of analysts' recommendations were "sell."**

- The problem isn't with the analysts' recommendations; it is with a regulatory system, which so obviously favors company interests over investors'.
- These analysts and brokerage firms work predominantly for companies, to <u>sell</u> companies' stock, so it is unrealistic to expect these analysts and firms to cross their main client -- companies.
  - It's simply not smart to bite the hand that feeds you.

7. **The problem is really the regulatory system overall, that structurally reinforces conflicts of interest in the system.**

- The common and accepted practice of bundling together different lines of business (research, banking and trading) with conflicting goals commingled into one payment stream, begs for trouble.
  - One can't play with fire without getting burned.

8. **Other industries have taken conflicts of interest more seriously and addressed the problem more directly and openly.**

- *Law:* The legal profession is serious about avoiding conflicts of interest. Each side is represented by an advocate working solely for its interests, which serves the ends of justice. The prohibition extends to the <u>appearance</u> of conflicts, so that, even with "full disclosure" one lawyer does not represent both sides.
- *Real Estate:* The real estate industry faced a similar conflict of interest problem to the brokerage industry in that a real estate broker is employed by and represents the financial interests of the seller -- not the buyer. The problem was largely addressed by acknowledging and disclosing that the conflict was real, by informing and encouraging buyers of real estate to employ buyer's brokers to ensure that their interests are adequately represented, and by getting an independent home inspector to research the house's potential problems.

V. <u>Recommendations:</u>

1. **Fuller disclosure.**

Encourage fuller and more practically useful disclosure of conflicts of interest.

- Disclosure today is generally limited to acknowledging that various financial conflicts of interest may or do exist, which is helpful only to a point.
- **What would be more helpful and relevant for consumers of investment research to know is *the <u>extent</u> of* a broker-dealers' conflicts of interest.** Specifically:
    - What is the majority or controlling financial interest or compensation behind the research? Or
    - Who does the researcher mainly work for and what drives their compensation? Companies? Or investors?

2. **Avoid conflicts by allowing for and encouraging an alignment of interests.**

Like in law and real estate, encourage investors to seek research that is more aligned with their interests and ensure that regulations don't discourage the alignment of interests between research and investors.

- Today the investment research system assumes that the investor hens are safe in the same bundle with the investment banking fox, as long as the regulator farmer ensures that the hens are aware the fox is in the henhouse.
    - Wouldn't it be wiser to encourage hens that want to hire other hens to not be required to hire the investment banking fox too?
    - The farmer's naïve assumption here is that with enough disclosure, regulatory "chicken wire" and patrolling, the hens have nothing to fear from the fox.

3. **Enable market forces to better protect investor interests.**

Reduce regulatory barriers to entry for investor or buyer brokers, and rely more on market forces and competition to meet investor demand for objective research.

A. Currently the regulatory system believes *one regulatory size fits all broker-dealers*.
- Broker-dealers like us, who only provide research and conduct no banking or proprietary trading business, have the same licensing, regulatory and audit burdens as broker dealers that do all three lines of business.
- This is a major barrier to entry and operation since most regulations and licensing requirements are focused on preventing problems in investment banking and trading.
    - Of the roughly 900 pages of regulation we are subjected to, no more than ten pages apply to research.
    - And only a small percentage of the questions on our licensing exam applied to research.
- This nonsensical situation is akin to requiring an electrician to be licensed and regulated also as a plumber and a carpenter, in order to operate solely an electrician.

B. **The real world impact of this unnecessarily burdensome regulation is to discourage market entry of pure research broker-dealers** like us, and tilt the competitive playing field towards broker-dealers with inherent conflicts of interest.

- Since the regulatory system encourages bundling, it implicitly discourages specialization in research only.
- Having more pure research would result in improved quality and accountability of research.

4. **Ensure the full and diverse competition of research ideas and information in the marketplace.**

Ensure that the economics of investment banking and proprietary trading do not suffocate the economics of investment research and independent research because markets need a full and diverse competition of ideas and information to operate to their fullest potential.

- **More specifically, ensure that institutional brokerage lists (which brokers get paid <u>research</u> commissions) are not cornered and shortened by the banking and trading appetites of the large brokerage firms, at the expense of research firms. This would be to the detriment of the investing public: fund shareholders and pension plan beneficiaries.**

A. To employ another analogy to make the "suffocation" risk more clear here, full-service brokerage (bundled banking, trading and research) is like a delicate and interdependent ecosystem that requires balance to survive and thrive.

- Think of the brokerage ecosystem as a pond where if too much oxygen or nutrient gets into the pond, the weeds and algae grow out of control and eventually suffocate all other pond life.
- Now think of the brokerage marketplace as a "pond" ecosystem where investment banking is the "weeds," trading is the "algae," research is the "fish," and money is the "nutrients" in the system.
- The destructive dynamic at work here is that the banking weeds and trading algae are threatening to devour all of the pond's money/nutrients, ultimately suffocating the research fish.

B. **This destructive out of balance dynamic is structural.**

- Investment banking and proprietary trading are scale businesses that tend to get more profitable with size and broadest distribution.
- Research does not require scale; one person free of conflicts and economically motivated can discover what hundreds cannot because the hundreds have conflicts that limit them from pursuing certain avenues of inquiry.
- Investment research is a quality not quantity or scale business; it is a *quality of thought* business.
    - Investment research is about new ideas, fresh perspectives and better judgment.
    - Research is about seeking out what is *new* to the market.
- In addition, banking and trading are *product* businesses, shares or bonds, where investment research is a *service* business in the form of advice and information.

C. **This problem manifests itself in buy-side broker lists** (the lists of brokers that a given institutional investor will pay research commissions to in a given quarter or year.)

- The problem is that the large full-service brokerage firms are allegedly demanding more and more of the commissions that are set aside for research, in return for either:
  - preferred access to IPO deal flow, and/or
  - better trading liquidity, the ability to get out of a big position quickly.
- Because commissions tend to be all commingled together, it is problematic to determine how out of balance this system is becoming.
- It is also important to note that the money that is paid in the form of commissions is charged directly to the fund shareholder or pension plan assets, not paid by the fund manager.

D. The conflict of interest problem that has already suffocated the independence of research within most full-service brokerage firms, now threatens to suffocate independent research long term.

- The same imbalance in a brokerage company's economic model exists in the brokerage industry model because *the problem is structural.*

VI. Conclusion

The free and competitive flow of ideas is what best serves investors and makes markets work most efficiently.

- This demands a highly competitive research market, which rewards research that improves investment performance.
- The problems with conflicted research are merely a symptom of a serious structural conflict of interest malady in the system.

The structure, economics, and regulation of the brokerage industry all mutually reinforce the subjugation of investor interests to company interests.

- When markets are going up, no one notices, when markets go down they do.

It does not take a rocket scientist to see where this is heading.

- As investment banking and proprietary trading corner more and more of the research commission market:
  - **Research will only become more and more biased towards company interests;**
  - The economics of independent research may not be sufficient to ensure that markets still enjoy a free and vigorous research debate; and
  - American shareholders and pension plan beneficiaries will be ill served.

Mr. Chairman, thank you again for the honor and opportunity to share the views of an *independent research broker-dealer* before this Subcommittee.

Attachment: "What Ails Investment Research?" Precursor Group®, May 2001

ATTACHMENT

What Ails Investment Research?

The Precursor Group® May 2001

Introduction

Why is there so much market volatility? Why are investors so often surprised by companies? In large part because the "sell-side" investment research system is so biased toward the company view. The Wall Street firms that produce most "investment research" are rife with potential financial conflicts of interest. There is precious little quality, independent investment research that serves as a source of new ideas or as a check and balance on the "Street/Company" spin.

What Ails Investment Research?

Bundled Services: Most investment research is not sold separately, but as part of a bundle of services including access to investment banking and trading liquidity. As part of a financial bundle, research functions largely as advertising for other more profitable lines of business — banking and proprietary trading. Without separate pricing, low quality research is concealed in the bundle of services. Consequently, there is little accountability or measure of research value in the marketplace, and little incentive to improve the quality and objectivity of research. This suggests the current research system simply does not value research much.

Conflicts of Interest: Investment research is compromised by financial dependence on other lines of business with very different masters than investors. Investment banking and proprietary trading heavily subsidize Wall Street research, creating both real and perceived financial conflicts of interest. Since a research analyst's compensation is often largely driven by investment banking deals, there exists a stark conflict between the analyst's responsibility to investors and responsibility to the firm's corporate finance clients. The evidence of this conflict of interest is powerful: according to First Call, of the 28,000 U.S. stock recommendations, only ~1% are "sells." This suggests it is not in the interest of most investment research to warn investors in advance of problems.

Expedient to Depend on Company Information: Companies are the easiest source of information, and are also highly sophisticated in managing their investment "story" through investor-public relations and lobbying firms. Because original research is difficult, time-consuming, costly and risky, it is simply easier to adopt the company's worldview and version of the facts. Securities & Exchange Commission (SEC) fair disclosure regulations also give companies wide latitude to manage information flow tightly — as long as they are equally stingy to all parties. This suggests the investment research system implicitly re-enforces the incorrect assumption that companies know all, see all and share all.

Rehash Rather than Research: Since an underlying purpose of most investment research is to sell companies to investors, Wall Street markets the positive and does not fully research the negative. The large conflict between company and investor interests tends to produce a superficial rehash of public company information or benign commentary on industry developments. The result is a Wall Street system focusing more on "re" than "search" — more backward-looking reporting and reformatting, and not much forward-looking searching for what is new and original in the market, the core value of research to investors. This suggests most investment research has become an echo chamber for the company line.

Conclusion

Former SEC Chairman, Arthur Levitt calls the problem with investment research a "web of dysfunctional relationships." The result of a dysfunctional research system is biased and poor investment research. This increases market volatility and surprises that blindside investors, skews the market toward investment banking at the expense of investor interests, and doesn't fully help investors anticipate change, capture opportunities and avoid risk.

Quotes from the Industry & Academics

What Ails Investment Research?
The Precursor Group® May 2001

Bundled Services

"Research analysts have become integral members of the investment banking units....[t]heir compensation is tied importantly to the fee revenue that they generate for the investment-banking unit."
Samuel Hayes, professor emeritus at Harvard Business School, June 20, 2000, Wall Street Journal

"Research analysts have become either touts for their firm's corporate finance departments or the distribution system for the party line of the companies they follow." Stefan D. Abrams, Chief Investment Officer for Asset Allocation, Trust Company of the West, December 31, 2000, New York Times

"[Y]ou can't get paid for research anymore, because the commissions have been whittled down; you have to look elsewhere for money....Today, it's investment banking – looking for deals to do."
Chuck Hill, Research Director, First Call Thompson Financial, August 14, 2000, Interactive Week

Conflicts of Interest

"I see... a web of dysfunctional relationships – where...the analyst attempts to walk the tightrope of fairly assessing a company's performance without upsetting his firm's investment banking relationships."
Arthur Levitt, Former SEC Chairman, April 6, 2000, Remarks at the Economic Club of Washington

"Analysts must bring in deals, and there is an inherent conflict of interest....Quality becomes a function of the deal calendar. It's only natural that the credibility of sell-side research falls as banking steps up."
Andrew Barth, U.S. Research Director, Capital Guardian Trust Co., October 1, 2000, Institutional Investor

"[A]nalysts affiliated with the lead underwriter of an offering tend to issue more optimistic growth forecasts than unaffiliated analysts....[T]he magnitude of the affiliated analysts' growth forecasts is positively related to fee basis paid to lead underwriters." Patricia Dechow & Richard Sloan, University of Michigan; and Amy Hutton, Harvard Business School, June 1999, Research Paper:"The Relation Between Analysts' Forecasts of Long-Term Earnings Growth and Stock Performance Following Equity Offerings."

"[T]he way an analyst can get fired is to damage an existing investment banking relationship with a company or sour a future investment banking relationship."
Mitch Zacks, Vice President of Zacks Investment Research, December 31, 2000, New York Times

Expedient to Depend on Company Information

"They (analysts) get spoon-fed the information by investor relations officers and they have a very strong tendency to put a positive swing or twist on everything....And like sheep they follow."
Hugh Johnson, Chief Investment Officer, First Albany Corporation, September 24, 2000, Reuters

With the SEC Fair Disclosure regulations, "nobody's going to have the inside dope. Analysts now will distinguish themselves more on scholarship and analytical ability rather than connections and relationships." Ted Pincus, CEO, Financial Relations Board, October 1, 2000, Institutional Investor

Rehash Rather Than Research

"[W]e find there's a lack of initiative; they rarely really aggressively question what the company is telling them. What we get instead of research is reporting."
Gary Langbaum, Fund Manager, Kemper Total Return Fund, December 11, 1997, Wall Street Journal

"Our findings....[suggest] that analysts mostly react to changes in market values rather than cause them."
Eli Amir, Tel Aviv University; Baruch Lev, New York University and Theodore Sougiannis, University of Illinois, September 2000, Research Paper: "What Value Analysts?"

References

What Ails Investment Research?
The Precursor Group® May 2001

Periodicals

Editorial Comment. "Shoot All The Analysts." Financial Times, March 19, 2001. www.ft.com

Fuerbringer, Jonathan. "When Being Wrong Won't Hurt: Economists' Ideas Are Valued More Than Their Forecasts." New York Times, October 15, 1999. www.nytimes.com

Guglielmo, Connie, Cantwell, Rebecca, and Mulqueen, John. "Special Report: Analyze This." Interactive Week, August 14, 2000. www.zdnet.com

Hill, Miriam. "Even Research Comes With Spin." The Philadelphia Inquirer, August 1, 2000. www.phillynews.com

Kawamoto, Dawn, and Kanellos, Michael. "Stock Analysts Roll With The Punches." CNET News, January 18, 2000. www.cnet.com

Levitt, Arthur. Remarks at the Economic Club of Washington, April 6, 2000. www.sec.gov

Maremont, Mark. "As Wall Street Seeks Pre-IPO Investments, Conflicts May Arise." Wall Street Journal, July 24, 2000. www.wsj.com

McGee, Suzanne. "After Oracle Misfire, Wall Street's Research Is Blasted." Wall Street Journal, December 11, 1997. www.wsj.com

Morgenson, Gretchen. "How Did So Many Get It So Wrong?" New York Times, December 31, 2000. www.nytimes.com

Pulliam, Susan. "Goldman Raises Eyebrows With E-Commerce List." Wall Street Journal, June 20, 2000. www.wsj.com

Roberts, Kristin. "Wall Street Analysts Miss The Ball." Reuters, September 24, 2000. www.reuters.com

Rynecki, David. "The Price Of Being Right." Fortune, February 5, 2001. www.fortune.com

Sargent, Carolyn and Kenney, Jane. "The 2000 All-American Research Team." Institutional Investor, October 1, 2000. www.iimagazine.com

Vickers, Marcia. "The Fall of the Net Analyst." Business Week, December 11, 2000. www.businessweek.com

Academic Research

Amir, Eli (Tel Aviv University), Lev, Baruch (New York University), and Sougiannis, Theodore (University of Illinois). Research Paper: "What Value Analysts?" September 2000.

Dechow, Patricia, Sloan, Richard (University of Michigan), and Hutton, Amy (Harvard Business School). Research Paper: "The Relation Between Analysts' Forecasts Of Long-Term Earnings Growth and Stock Performance Following Equity Offerings." June 1999.

Michaely, Roni (Cornell University & Tel-Aviv University), and Kent Womack (Dartmouth College). Research Paper: "Conflict of Interest and the Credibility of Underwriter Analyst Recommendations." February 1999.

STATEMENT OF THOMAS A. BOWMAN, CFA
PRESIDENT AND CHIEF EXECUTIVE OFFICER
THE ASSOCIATION FOR INVESTMENT MANAGEMENT AND RESEARCH
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES SUBCOMMITTEE
Analyzing the Analysts: Are Investors Getting Unbiased Research from Wall Street?
JUNE 14, 2001

➢ Opening Remarks

Good morning, my name is Thomas A. Bowman, President and Chief Executive Officer of the Association for Investment Management and Research® (AIMR®) and holder of the Chartered Financial Analyst® designation. I would like to thank Congressman Baker and members of the committee for the opportunity to speak on this important issue on behalf of the more than 150,000 investment professionals worldwide who are members of AIMR or are candidates for the Chartered Financial Analyst (CFA®) designation, most of whom are not subject to the conflicts under discussion today.

➢ Background on AIMR

AIMR is a non-profit professional membership organization with a mission of advancing the interests of the global investment community by establishing and maintaining the highest standards of professional excellence and integrity. AIMR is most widely recognized as the organization that conducts qualifying examinations and awards the CFA designation. In 2001, over 86,000 candidates from 143 countries registered to take the CFA exam.

CFA charterholders, candidates, and other individuals who are AIMR members subscribe to a *Code of Ethics and Standards of Professional Conduct* that require them, among other things, to:

(1) Exercise diligence and thoroughness in making investment recommendations;
(2) Have a reasonable and adequate basis, supported by appropriate research and investigation, for such recommendations or actions;
(3) Use reasonable care and judgment to achieve and maintain independence and objectivity in making investment recommendations or taking investment action;
(4) Act for the benefit of their clients and always place their clients' interests before their own;
(5) Distinguish between facts and opinions in the presentation of investment recommendations; and
(6) Consider the appropriateness and suitability of investment recommendations or actions for each client.

Although AIMR members are individuals rather than firms, AIMR has had success with development and implementation of the AIMR Performance Presentation Standards™ (AIMR-PPS™) and the Global Investment Performance Standards™. These standards require firm-wide compliance and have been embraced by the global investment industry. Based on our experience, I can tell you that ethical standards are most effective when voluntarily embraced rather than externally and unilaterally imposed. AIMR is firmly committed to developing and recommending practical, long-term solutions for the conflicts that research analysts face and for the ethical dilemmas that we are discussing today.

Since investment professionals work in a global marketplace, implementation of a domestic standard in the U.S. would solve only part of the problem. As a global organization, AIMR is in a unique position to effect positive change throughout the world.

- **Analyst Independence**

Clearly, deteriorating investor confidence in the independence and objectivity of sell-side research reports and recommendations does NOT advance the interests of the global investment community. Before we discuss this important issue, however, we first must understand that analysts do not work in a vacuum. The pressures to provide positive research reports and favorable investment recommendations come from many sources, not all of them internal to their firms. Before we can develop solutions to reduce their impact on the research process, we first must identify and expose not only the pressures but also the contributors and processes that cause them.

It is important to recognize that the conflicts that sell-side analysts face are not new. But the pressures on the analyst have escalated in an environment where penny changes in earnings-per-share forecasts make dramatic differences in share price, where profits from investment-banking activities outpace profits from brokerage and research, where the demographics of the investors who use and rely on sell-side research have shifted, and where investment research and recommendations are now prime-time news.

The particular conflict posed by analysts' involvement in their firms' investment-banking activities has been the focus of recent media attention. But this is by no means the only conflict that we must address if we are to provide an environment that allows analysts to operate without undue or excessive pressures to bias their reports and recommendations. Pressure to prepare "positive" reports and make "buy" recommendations may also come from corporate issuers and institutional clients who may have their own vested interests in maintaining or inflating stock prices. An investment professional's personal investments and trading pose another conflict, one that AIMR addressed extensively in a 1995 topical study that now forms an important component of our *Code and Standards*. Human factors also affect the content and quality of a research report or investment recommendation. Analysts are not infallible, after all, even when independent and objective.

Let me elaborate a bit on some of these pressures. We do not dispute that some sell-side firms pressure their analysts to issue favorable research on current or prospective investment-banking clients. However, the relationship between the research and investment-banking functions is symbiotic. Analysts need to work with their investment-banking colleagues to help evaluate prospective clients. They also sometimes participate in marketing activities to support securities offerings of companies they recommend. Although we do not believe that this collaborative relationship is inherently unethical, the investment-banking firm must take particular care to have policies and procedures that minimize, manage effectively, and adequately disclose to investors any and all potential conflicts.

Effective management of these conflicts requires firms to:

(1) Foster a corporate culture that fully supports independence and objectivity and protects analysts from undue pressure from investment-banking colleagues;
(2) Establish or reinforce separate and distinct reporting structures for their research and investment-banking activities so that investment banking never has the ability or the authority to approve, modify, or reject a research report or investment recommendation;
(3) Establish clear policies for personal investment and trading to ensure that the interests of investors are always placed before analysts' own;
(4) Implement compensation arrangements that do *not* link analysts' compensation directly to their work on investment-banking assignments or to the success of investment-banking activities; and
(5) Make prominent and specific, rather than marginal and "boilerplate," disclosures of conflicts of interest.

In addition to pressures within their firms, analysts can also be, and have been, pressured by the executives of corporate issuers to issue favorable reports and recommendations. Regulation "Fair Disclosure" notwithstanding, recent history, supported by the results of a research study issued by Reuters, has shown that companies retaliate against analysts who issue "negative" recommendations by denying them direct access to company executives and to company-sponsored events that are important research tools. Companies have also sued analysts personally, and their firms, for negative coverage. Such actions create a climate of fear that does not foster independence and objectivity.

Institutional clients may also pressure analysts to issue positive reports. In the short-term, stock prices are often very sensitive to rating changes. Portfolios with significant positions in a particular security may be adversely affected by a rating downgrade. Poor portfolio performance may have a subsequent negative impact on the portfolio manager's performance evaluation and compensation. Consequently, some portfolio managers support sell-side ratings inflation and may retaliate against analysts they perceive as "negative" by shifting brokerage to another firm or by reporting those analysts to the company in question, thus launching the corporate retaliation mentioned earlier.

All of these conflicts are discussed at length in a position paper that AIMR will soon issue for public comment and which will form the basis for our development of AIMR Research Objectivity Standards. These standards will promulgate best practices for addressing each of these conflicts and we will call upon analysts themselves, their employers, issuers, investors, and the media to assist in their development and to support and adopt them when issued. Again, I point to the successful implementation of investment performance standards as a precedent to show that a voluntarily embraced standard—which is the model we will recommend with the AIMR Research Objectivity Standards—has the greatest likelihood of creating effective, long-term solutions for the issues we are discussing today. Although AIMR, as an individual membership organization, cannot require firms to adopt these standards, we believe that competitive forces similar to those that led to adoption of AIMR-PPS in the United States and Canada will come into play here as well.

➢ **Communication of Research Reports and Recommendations**

Finally, we must address the ways in which research and recommendations are communicated to investors, particularly the investing public. How and by whom recommendations are communicated can seriously impair an investment professional's ability to fulfill his or her responsibility to know each client and to assess the suitability and appropriateness of a particular investment given the client's investment objectives and constraints. All of these vital issues are addressed in the AIMR *Code of Ethics and Standards of Professional Conduct.*

Increasingly, private investors are demanding and accessing research reports and recommendations through their brokers, the media, and the Internet. Although a typical research report is many pages in length, these intermediaries often condense the report to its "bottom line"—an earnings forecast or a buy, hold, or sell recommendation. Although this makes a good sound bite—and we can't keep people from trading on headlines—investors need to be informed, and should understand that headline ratings or recommendations do not provide sufficient information to justify buying or selling a security.

Investment research is multi-faceted and investment decision-making can be complex. Research results that are over-simplified not only lose their value, but they also may have a detrimental impact on the investment decision-making of those who rely on them. Brokerage firms, the media, and other investor-information providers should review and revise, if necessary, the form and content of their communications. At a minimum, they should urge investors to become familiar with entire reports before assessing, either on their own or with a professional advisor, whether the recommendation is appropriate to their particular situations, investment objectives, and constraints before taking any investment action.

The AIMR Research Objectivity Standards will also address how best to communicate research and recommendations effectively in order to provide comparable, transparent, and useful information on which investors of all levels of sophistication and knowledge about the investment process can reasonably rely.

Closing Remarks

In closing, I would like to impress upon the committee that AIMR and its members appreciate the seriousness of the problem facing research analysts, but also its complexity. A precipitous solution is not the answer. We believe that the profession can address the issues and develop effective, workable solutions. We are confident that the AIMR Research Objectivity Standards can be that solution if embraced and adopted by those who have a stake in preserving the integrity of research and the professionals who conduct it.

I will be happy to answer any questions that you might have. Thank you.

TESTIMONY OF DAMON A. SILVERS

ASSOCIATE GENERAL COUNSEL

AMERICAN FEDERATION OF LABOR AND

CONGRESS OF INDUSTRIAL ORGANIZATIONS

BEFORE THE HOUSE SUBCOMMITTEE ON CAPITAL MARKETS,

INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISE

ON

ANALYZING THE ANALYSTS—ARE INVESTORS GETTING UNBIASED

RESEARCH FROM WALL STREET

JUNE 14, 2001

Good morning, Mr. Chairman. My name is Damon Silvers, and I am an Associate General Counsel of the American Federation of Labor and Congress of Industrial Organizations. The AFL-CIO believes today's hearing on investment analyst independence is of vital importance to working families and their pension funds, and would like to thank the Subcommittee for its efforts in this area.

Defined benefit pension funds that provide benefits to the AFL-CIO's 13 million members have approximately $5 trillion in assets. These plans include thousands of pension plans sponsored by AFL-CIO member unions, public employee pension plans, and single employer pension plans subject to collective bargaining. Since the passage of ERISA in the 1970's, these funds have increasingly invested in equities. 401-k and other defined contribution plans, employee stock ownership programs, and union members' personnel savings account for further extensive investments in equity markets by America's union members.

However, few union members either have the time or the skills to master the raw data that informs the financial markets, and even fewer have routine access to insiders in the companies they invest in. Most union members, and the trustees of their funds, for that matter, rely on a variety of professionals for their information about the equity markets. For that reason, America's working families have an enormous stake in the accuracy and honesty of the investment information they receive from the analyst community.

Recent trends in equity investing have increased the importance of the analyst community for workers' retirement funds. Increasingly, large institutional investors have placed the majority of their equities in index funds. Leading funds like the California Public Employee Retirement System and the Operating Engineers National Pension Fund have over 70% of their equity portfolio in index funds.

Indexed investing both minimizes fees and reflects a sound understanding of the difficulty of large funds outperforming the market as a whole. However, at the same time it puts these funds at the mercy of overall market pricing. If the investors who are trading are following conflicted analyst advice, indexed investors will purchase shares at inflated prices and eventually receive lower returns on their equity portfolios. Essentially, the funds who invest in index funds are placing their trust in the transparency and honesty of our markets, and have no defense against systematic distortions such as those created by conflicted analysts.

In that context, what are we to make of Thomson Financial's survey of December, 2000 that 71% of all analyst recommendations were "buy" and 2.1% were "sell," with the remaining 28% hold? In the remainder of my testimony I would like to suggest that what has happened here is the collapse of what used to be called the Chinese Wall between underwriting and analysis, and that only regulatory action can rebuild it.

The large firms that produce analyst reports for public consumption have always been in a number of distinct businesses within the securities industry. They underwrite securities issues, for which they receive a fee from the issuer. They run trading desks, where they earn commissions on trades for clients toward whom they have fiduciary duties.

There is substantial statistical evidence that analysts' decisions whether or not to recommend that investors buy a stock is influenced by whether their firm is an underwriter for the issuer. That is the conclusion of a 1999 study by Roni Michaely of Cornell University as well as a 1997 study by Hsiou-wei Lin of National Taiwan University and Maureen McNichols of Stanford Business School.[1] CFO Magazine reported last year that analysts who work for full-service investment banks have 6% higher earnings forecasts and close to 25% more buy recommendations than analysts at firms without such ties.[2]

In some ways what we find more persuasive than the statistics are the comments of analysts in the financial press. In the last few months, analysts have been quoted by name saying such things as "a hold doesn't mean it's ok to hold the stock" and "the day you put a sell on a stock is the day you become a pariah."[3]

---

[1] Conflict of Interest and Creditability of Underwriter Analyst Recommendations. Michaely, Roni and K Wolmak Review of Financial Studies 1999 vol 12 no 4 653-686; Underwriting Relationships and Analyst Earning Forecasts and Investment Recommendations. Lin, Hsiou-Wei and McNichols, Maureen. Journal of Accounting and Economics vol 25 (1) pp 101-127 1997.

[2] What Chinese Wall?, Barr Stephen, CFO, March 1, 2000.

[3] Wall Street's Secret Code Spoils Investors' Aim, Noelle Knox USA Today, December 21, 2000; CFO, ibid.

It should not be surprising that this is true given that issuers pick underwriting firms based on their ability to bring effective positive analyst coverage to their businesses. This is the conclusion of a soon to be published paper on why firms switch analysts by Laurie Krigman of the University of Arizona, Wayne Shaw of Southern Methodist University and Kent Womack of the Tuck School Business at Dartmouth College.[4]

In addition, the data cited by CFO Magazine suggests several quite disturbing things. First is that it is not just existing relationships that are affecting analyst recommendations, but also the prospect of future business. The result is a systematic positive bias affecting recommendations across the board. Secondly, the response from the securities industry that analyst involvement in underwriting helps ensure that the firms only do quality deals at the right price is simply inadequate to explain the distortion in the data affecting all recommendations.

But these conflicts are exacerbated by the ways in which analysts are used and compensated. It has become a common practice for analysts to accompany teams from the corporate finance department on underwriting road shows, and most importantly, analyst compensation has become tied at many firms to analysts' effectiveness at drawing underwriting business.

[4] Why do Firms Switch Underwriters? Wayne H Shaw, Kent Womack, Forthcoming, Journal of Financial Economics.

In addition, the consolidation of the financial services industry, and in particular the repeal of Glass-Steagall, has created a wide array of further potential conflicts. Issuers are in a position to withhold business from the firms of critical analysts across a wide array of markets, including commercial loans and commercial banking services, pension fund and treasury money management, insurance contracts. This leverage is particularly powerful when the issuer is itself a financial services company. For example, CFO Magazine reported last year that the troubled financial service giant First Union cut off all bond trading business with Bear Stearns in response to negative comments by their analyst, and Bear Stearns ordered the analyst to be more positive. I'm not suggesting the committee revisit the repeal of Glass-Steatgall, but rather that the sub-committee look closely at the consequences of that repeal, and what additional protections investors need in light of the new business realities the repeal has created.[5]

At the same time, issuer executive compensation has been linked to issuer stock price, and often in ways that give incentives to executives to manipulate short term movements in stock prices. The result is that issuer executives have tremendous personal incentives to use the resources of their companies to pressure analysts into issuing conflicted reports.

The rise in the importance of proprietary trading at major firms also creates further possible conflicts of interest for analysts. A version of this problem has always existed when firms' trading operations market making operations lead to a buildup of inventory in particular issuers' securities. However, the addition of firms investing significant capital

---

[5] Ibid.

in proprietary trading makes the risk of senior executives aware of the positions taken in proprietary trading encouraging research departments to prop up demand for certain securities.

Recognizing that there is a problem, the securities industry is currently at work on codes of best practices that attempt to address some of the issues raised at this hearing. We would however urge the Committee to look closely at any such code to see if it leaves room for continued linkage of analyst compensation to underwriting activity, or continued participation by analysts in marketing securities underwritten by the analysts' firm. The decay of the so-called "Chinese Wall" is driven by extremely powerful financial pressures and it will not be halted or reversed by either general statements of a desire to be honest or subtly crafted principles that on closer examination leave room for a continuation of business as usual.

There has been some good news though in the effort to protect analyst independence. Much of the literature in the 1990's on securities analysts' behavior noted the ability of issuers to reward and punish analysts by providing and withholding information. This power meant that analysts who were doing their best to be loyal to their customers could not provide customers with the timely information that is the minimum requirement of the job without tilting their recommendations so as to ensure they weren't on the losing end of the business of selective disclosure. As the SEC recognized when it promulgated Regulation FD, selective disclosure not only harmed those not privy to the selective disclosure, it gave issuers power that resulted in warping the behavior of those who *were* the recipients of the selectively disclosed information.

Despite the improvements wrought by Regulation FD, we believe that there is a need for this Subcommittee to work with the Securities and Exchange Commission to develop new regulatory approaches. Some measures the Subcommittee should raise with the Commission include bars on linking analyst compensation in any measurable way to the financial performance of the underwriting and M&A businesses of their firms, and bars on analyst participation in marketing underwritten offerings, including attending road shows. The Subcommittee should also consider whether in view of the tensions at work here whether a more blanket approach comparable to that used to protect plan participants under the fiduciary scheme in ERISA may be the only solution. Such an approach would block firms from issuing analyst reports on companies while they were acting as underwriters of those same companies. In our view this approach would be more consistent with the role analysts play as fiduciaries for their clients.

Working with the Commission on these new initiatives will take time. In the meantime, we believe the Subcommittee has an immediate task. As we all know, Regulation FD was quite controversial when it was adopted, and we soon will have a new Chairman at the SEC. We think this Subcommittee would do a great deal to protect investors and the analyst community if, at a minimum, it used its influence with the Commission to protect Regulation FD and ensure it continues in place.

In conclusion, the AFL-CIO believes the question of analyst independence is vital for the retirement security of America's working families. We urge this Subcommittee and the full committee to work closely with the SEC, NASD, and the National Exchanges to address the concerns you have heard today. While we do not have specific regulatory language, we think it is high time rulemaking was begun to address the industry's apparent tolerance of the collapse of the "Chinese Wall." We look forward to working with the Subcommittee further on this important issue.

APPENDIX

July 31, 2001

EXCHANGE

Subcommittee on Capital Markets

Richard H. Baker, Chairman

Securities, Insurance, Government-Sponsored Enterprises

The News from U.S. Rep. Richard H. Baker
Sixth District, Louisiana
FOR IMMEDIATE RELEASE: July 31, 2001
CONTACT: Michael DiResto, 225-929-7711

Opening Statement
The Honorable Richard H. Baker, Chairman
House Financial Services Committee Subcommittee on
Capital Markets, Insurance and Government Sponsored Enterprises
Hearing, July 31, 2001
"Analyzing the analysts II: Sources and ramifications of analyst conflicts of interest"

Like the Copernican revolution before it, Quantum physics has had its impact as much for its scientific discoveries as for how it transformed the way we perceive the world. When scientists found that the very act of perceiving a particle of light altered the outcome of experiments to discern the nature of light waves, it challenged traditional notions of the scientist as passive observer of events and further blurred the lines between reality and our perception of it. At that moment in history, it is said, the scientist emerged from behind the curtain to become an active participant in and as influential a factor as all others in the outcome of experiments.

Over the last few years we've witnessed a similar emergence of market analysts from behind the scenes and out of the traditional cloister that protected their painstaking objective research. Not surprisingly, the markets, as I imagine occurs with all speculative bubbles, entered a phase that conflated perception with reality, or as one analyst put it, "Stocks don't go up or down because they have a specific 'value.' They go up or down because investors decide to buy or sell." In the "quantum marketplace," reality - whether the price of a company's stock will go up or down - depended less on any inherent factors of "proper" value than on an analyst's saying it would.

During the same period we also witnessed an explosion in financial media coverage and its powerful impact on events. In fact, I would hazard that in no other area of journalism do reporters and commentators, like the scientist altering the experiment while conducting it, shape reality in the very act of reporting and commenting on it. In other words, while a journalist reporting on a possible plane crash has no effect on whether it actually will, the same cannot be said about a journalist reporting on the possibility of a company's stock doing the same. In today's marketplace, analysts and journalists are players, not passive observers.

While this new situation has resulted in positive increases in the amount of information accessible to investors, it has also brought new responsibilities and, we now know, new dangers. Perhaps not coincidentally, the new high profile union of financial analysts and journalists coincided with a breakdown in the traditional Chinese wall shielding analysts from the investment banking side of their firm's business. While the market went up and up, it was understandable that analysts were unanimously bullish on nearly every stock. Only when the market turned downward and the unanimous "buys" and "strong buys" remained did questions begin to arise about analysts' conflicts of interest and their ability to remain objective within the new market structure.

We have begun a process to understand the problem, and we will not cease until we have helped to find an adequate solution. In our first hearing on this matter in June we saw that conflict-of-interest problems exist and are pervasive. Second, the existing industry association best-practices proposal doesn't go far enough to address the problems, nor, I might add, do subsequent actions taken by individual firms. And third, while self-regulatory reform is preferred, future legislative or regulatory solutions may be required.

For the sake of insuring that the growing number of $200 investors receives the same care as the $200,000 investor, we are proceeding on the careful task of discovering the extent to which the Chinese wall has eroded and whether strong steps need to be taken to reconstruct it.

Ranking Member, Rep. Paul Kanjorski, D-Pa., and I have established a review board to provide the subcommittee "expert guidance" in examining industry association proposals for analyst standards and practices. Consisting of pertinent regulators, noted academics, market professionals and representatives of other organizations, the review board's members were asked to submit separate and independent written reports to the subcommittee by August 21st, with recommendations for sufficiently remedying the problem of biased and unclear investment research.

However, before this process moves toward receiving those proposed remedies, it's essential that we understand the full scope of the problem. This problem didn't begin with the analysts, and its harmful implications don't end with them, either.

Accordingly, while today's hearing will further explore the connection between investment-banking pressure in inflating stock recommendations and the impact on an individual's investments, I hope witnesses will also address additional sources and ramifications of analyst conflicts, including:

1. Pressures placed on analysts from institutional investors who may be highly staked in a particular stock;
2. Pressure from companies that may select an investment bank based on the prospect of rosy coverage from the firm's analysts; and
3. The responsibility of financial journalists, when citing an analyst who may have conflicts of interest, not only to discover but to fully disclose the potential conflicts, and the ramifications when they don't.

As events and public disputes last week indicated, the stakes are high here. By as early as next year this Congress may be asked to take up the controversial issue of Social Security reform. We have the prospect of addressing what is, in my view, one of the boldest policy initiatives in generations, to give every American, not just a select elite, the opportunity to participate in real wealth creation. This subcommittee has an obligation, therefore, to help erase the controversy by that time, and dispel all doubt in responding affirmatively to the question: "Are the markets ready for the challenge and responsibility?"

I thank all of our witnesses for appearing today and look forward to their testimony.

Michael N. Castle

Opening Statement of Congressman Michael N. Castle

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

Hearing on

"Analyzing the Analysts II: Additional Perspectives"

July 31, 2001

THANK YOU CHAIRMAN BAKER FOR CALLING THIS ADDITIONAL HEARING ON SECURITIES ANALYSTS CONFLICT OF INTEREST. I ALSO APPRECIATE OUR DISTINGUISHED PANELISTS FOR APPEARING TODAY TO SHARE WITH US THEIR VIEWS AND MOVE THIS IMPORTANT DEBATE FORWARD. IN PARTICULAR, I WANT TO WELCOME ACTING SEC CHAIRWOMAN, LAURA UNGER, FOR JOINING US TODAY AND FOR THE EFFORTS SHE HAS MADE ON BEHALF OF INVESTORS AT THE SEC.

I HAVE BEEN STUDYING THIS ISSUE VERY CAREFULLY. I WAS, NEEDLESS TO SAY, DISTURBED BY THE ACTIONS OF ANALYSTS ALL OVER THE COUNTRY DURING THE INTERNET BOOM OVER A YEAR AGO. IT IS PAINFULLY APPARENT THAT MANY OF THESE ANALYSTS WERE MISLEADING THE INDIVIDUAL INVESTOR, IN ORDER TO GAIN PERSONALLY OR THROUGH THEIR INSTITUTIONS. THESE TRANSGRESSIONS WERE THE RESULT OF LAX RULES ON CONFLICT OF INTERESTS AMONG ANALYSTS, THE STOCKS THEY HOLD, THE INSTITUTIONS THEY WORK FOR AND ITS VARIOUS BUSINESS UNITS, PARTICULARLY INVESTMENT BANKING.

ONE STATISTIC THAT JUMPED OUT AT ME WAS FROM A REPORT (IN BARRON'S) THAT TRACKED ANALYST STOCK RECOMMENDATIONS JUST BEFORE THE DROP IN THE NASDAQ LAST YEAR. THIS WAS THE FACT THAT ANALYSTS GAVE ONLY 206 OR 0.8% OF STOCKS A "SELL" OR "STRONG SELL" RATING. AT THE SAME TIME, ALMOST 74% OF ALL STOCKS TRADED ON THE NASDAQ WERE GIVEN A RATING OF "BUY" OR "STRONG BUY."

WHILE I HAVE BEEN ABLE TO IDENTIFY THE PROBLEMS IN THIS INDUSTRY, AT THIS POINT IN TIME, I AM NOT IN FAVOR OF LEGISLATING A SOLUTION. HOWEVER, WHAT I HOPE TO HEAR TODAY ARE SOME GOOD SELF-REGULATORY AND POSSIBLE REGULATORY IDEAS ABOUT HOW WE CAN GO ABOUT LEVELING THE PLAYING FIELD FOR INDIVIDUAL INVESTORS. I AGREE WITH THE CHAIRMAN THAT THE SELF-REGULATORY SOLUTIONS PROPOSED SO FAR FAIL TO CORRECT THE FUNDAMENTAL PROBLEM -- THAT IS, THAT THE ANALYSTS WHO GIVE ADVICE ON THE PUBLIC AIRWAYS ARE NEITHER INDEPENDENT NOR UP-FRONT ABOUT THE INSTITUTIONAL FORCES THAT INFLUENCE THEIR INDEPENDENCE.

WHAT ARE THESE FORCES? FIRST, SOME FIRMS STILL ALLOW THEIR ANALYSTS TO OWN STOCKS FOR WHICH THEY RENDER ADVICE. I CONGRATULATE THOSE FIRMS THAT HAVE CORRECTED THIS OVERSIGHT AND URGE OTHERS TO FOLLOW THEIR LEAD. SECOND, UNDER CURRENT PRACTICES FOR ESTABLISHING A "CHINESE WALL," I SEE NO WAY THAT AN ANALYST CANNOT BE INFLUENCED BY THE INVESTMENT BANKING INTERESTS OF HIS FIRM. WHETHER THIS IS A NECESSARY EVIL OR SOME FORM OR REGULATION IS REQUIRED TO ADDRESS THIS PROBLEM REMAINS TO BE SEEN. THIRD, ANALYSTS' COMPENSATION AND OTHER INCENTIVES MUST BE STRUCTURED IN A MANNER THAT ALLOWS THE ANALYSTS TO RETAIN THEIR INDEPENDENCE.

FINALLY, IN AN ERA WHERE MORE AND MORE INDIVIDUAL INVESTORS ARE PARTICIPATING IN THE STOCK MARKET, WE NEED TO START USING PLAIN ENGLISH. IF AN ANALYST GIVES A "HOLD" RECOMMENDATION ASSUMING THE GENERAL PUBLIC KNOWS THIS IS WALL STREET-SPEAK FOR "SELL," THEY CANNOT SHRUG THEIR SHOULDERS WHEN THE BUBBLE BURST AND SAY INVESTORS MUST DO THEIR OWN RESEARCH.

AS A LAWYER, I UNDERSTAND THE FIRST RULE OF EVERY PROFESSION IS

TO ADOPT TERMINOLOGY THAT REQUIRES THE GENERAL PUBLIC TO TURN TO PROFESSIONALS TO HELP THEM DECIPHER THE CODE. HOWEVER, A FEW YEARS AGO BUSINESS GROUPS LOBBIED THE FEDERAL GOVERNMENT TO PUBLISH REGULATIONS IN EASY-TO-UNDERSTAND TERMS. I THINK IT IS GOVERNMENT'S TURN TO ASK INDUSTRY TO START USING EASY-TO-UNDERSTAND TERMS.

MR. CHAIRMAN, AGAIN I THANK YOU FOR KEEPING THIS IMPORTANT OVERSIGHT ISSUE AT THE FOREFRONT OF THE SUBCOMMITTEE'S AGENDA. I LOOK FORWARD TO LISTENING TO THE TESTIMONY.

Rubén Hinojosa
TX – 15

OPENING STATEMENT OF CONGRESSMAN RUBÉN HINOJOSA
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES
HEARING ON WALL STREET ANALYSTS II

TUESDAY, JULY 31,2001

Thank You Mr. Chairman, I welcome the opportunity to address the subcommittee on the topic of accurate reporting by Wall Street Analysts. I take particular interest in today's hearing because of the impact Wall Street reporting has on the securities consumer.

With the new age of information, consumers are increasingly accessing securities analysts reports and utilizing this information in the formulation of their judgment on which stocks to purchase, sell, or hold. For this reason, I firmly believe that this Subcommittee should examine whether analyst are providing consumers the most unbiased and informative reporting possible.

Though some firms have already acted and prohibited their analyst from owning stock in companies in which they report, we need to research whether this should be standard law and not notable business practices.

Personally, I was very concerned to learn the limited number of times all analysts recommended the selling stock in their reports. In looking at a sample of reports, analyst continually advised securities consumers to keep possession of stock in hi-tech companies that ultimately foreclosed. If these analysts are suppose to represent the industry's best minds, then at some point should not their reports on this company have reflected a sell position?

Financial reports are becoming integral components in the investment market, and as such work should be done to ensure fair securities reporting practices. The use of disclaimers that describe possible conflicts of interest in an analyst report is one proposed idea of how to accomplish this task. I thank Chairman Baker and Ranking Member Kanjorski for helping to bring some answers to these questions and his work to bring reporting standards to the securities market. I welcome all the panelist today, and look forward to a productive hearing. Thank you Mr. Chairman, I yield back my time.

Statement of Congressman Steve Israel
Capital Markets Hearing
July 31, 2001

Steve Israel

Thank you Chairman Baker for convening this second hearing on "Analyzing the Analysts."

Since this hearing, I have been paying close attention to the tech analysts on MSNBC.

Often, I have wondered if any of those analysts hold stock in any of the companies they give advice on.

I believe that the NYSE and the NASD are on the right track by having rules that govern disclosure by analysts and their firms.

Also, I plan to closely watch the NASD's proposed rule that would require analysts to disclose in research reports ownership in companies which they have relationships with.

We must make sure that there are proper checks and balances in place.

Recently, I was made aware of the manipulation of Senior Citizens by stockbrokers.

In fact, the statistics are stunning: $40 billion dollars per year is lost to fraud and one in fourteen seniors are defrauded each year.

I wonder how many of our Senior Citizens watch MSNBC, hear the advice of an analyst, and ask their broker to buy or sell a stock.

I believe that all individuals, especially Senior Citizens, should be made aware of an analyst's relationship with a company; and they should have access to the special information that only analysts receive.

In closing, I would like to briefly mention the practices of Merrill Lynch.

I read that at Merrill Lynch, analysts are no longer permitted to purchase stocks within their area of responsibility, and this policy applies to all senior and junior members of the team.

Merrill is on the right track, and I hope to see their polices as well as others improve, as we tackle this issue together.

Only then, will all of us be on an equal playing field.

Thank you.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON ANALYZING WALL STREET ANALYSTS:
ADDITIONAL PERSPECTIVES

TUESDAY, JULY 31, 2001

Mr. Chairman, today we meet for the second time to consider the issue of analyst independence, a subject of great significance to our nation's capital markets. Increasing the transparency of analysts' work should make it easier to detect faulty research, and it should enable investors to more easily evaluate the differing views of all analysts who cover a particular stock. Increased transparency should also help restore confidence in Wall Street research.

Since we last met on this subject in June, a number of developments directly affecting the subject of analyst independence have occurred. I therefore feel that I should summarize some of these events before we begin today's proceedings.

First, the National Association of Securities Dealers, or NASD, recently proposed changes to its disclosure rules. These amendments propose, among other things, to include common stock as a financial interest that firms and analysts must disclose. More importantly, the proposal would also require abbreviated disclosures during public appearances on radio and television shows. When implemented, these changes should help retail investors to better understand analyst conflicts. Officials with the NASD have also personally assured me that this rulemaking is not the last step that their organization will take to enhance analyst objectivity.

A number of securities firms have additionally announced revisions to their existing policies to manage analysts' conflicts. These changes exceed the recommendations for best practices announced by the Securities Industry Association at our last hearing. For example, at least three companies -- namely Merrill Lynch, Edward Jones, and Credit Suisse First Boston -- have announced plans in July to prohibit their analysts from owning securities in the companies they cover in their research. In the coming weeks, I expect that other firms will follow the lead of these companies by announcing changes to their own policies and practices designed to increase the independence of research.

Furthermore, the nation's largest brokerage firm announced that it had agreed to pay $400,000 to a pediatrician in Queens, New York, who claimed that he had lost more than $500,000 following the advice of his broker who regularly cited the bullish research of a prominent Wall Street analyst. Although this settlement established no legal precedent by itself, it does raise important ramifications for the brokerage business, especially if other investors in the weeks and months ahead pursue similar cases. I predict that just one or two more settlements of this type will create an incentive for the investment banks to take further action to improve the quality and trustworthiness of their research.

Although each of these actions demonstrates that the marketplace has begun to self-regulate on the issue of analyst objectivity, we must still do more. Mr. Chairman, in the weeks since our last hearing, the debate has intensified about whether we should privatize Social

Security. Social Security presently covers about 160 million workers. Because more than 20 percent of the adult American population is functionally illiterate, we can extrapolate that about 35 to 40 million working Americans cannot read or understand a business prospectus.

Yet we would be asking these very same individuals to make decisions about their retirement funds under Social Security privatization schemes. If they cannot read and comprehend a business plan or an accounting statement, it seems likely that many of these individuals would become excessively reliant on the advice of Wall Street researchers when making their investment decisions. Industry therefore has an obligation and a responsibility to comprehensively address the issue of analyst conflicts and resolve all related concerns before we begin any public policy debate on the future of Social Security.

That said, Mr. Chairman, today's hearing will further our understanding of the nature of this growing problem and help us to discover what other actions might restore the public's trust in analysts. As you know, I generally favor industry solving its own problems through the use of self-regulation whenever possible, and I was pleased to join with you in recent weeks in creating a review board to assess the adequacy of the industry reform proposals.

I will also listen carefully to today's testimony and continue to encourage our Committee to move deliberately on these matters in the months ahead. As I advised at our last hearing, we should not demagogue on the issue of analyst objectivity to score political points. Only cautious action on this subject will help to ensure that our capital markets remain strong and vibrant.

In closing, analyst independence is an issue of the utmost importance for maintaining the efficiency of and fairness in our nation's capital markets. Thank you again, Mr. Chairman, for the opportunity to raise my concerns before today's hearing.

STATEMENT OF REP. JOHN J. LaFALCE, RANKING MEMBER
COMMITTEE ON FINANCIAL SERVICES
HEARING ON ANALYST INDEPENDENCE

July 31, 2001

Mr. Chairman and Mr. Kanjorski, I want to thank you for holding this second set of hearings on the important issue of analyst independence. I look forward to hearing the perspectives of the SEC and representatives of the media on this issue.

Your hearings, Mr. Chairman, and my many meetings with market participants, regulators, academics and constituents, have increasingly convinced me that analysts conflicts have seriously eroded confidence, not only in the capital formation process, but in the way stocks are evaluated by investors who seek objective advice in a highly complex marketplace.

It has also become clear to me that the analysts and their role in boosting and supporting the stock price of certain companies is but one piece in a series of activities that contributed to the market exuberance of the late 1990s and the early months of this century. We must redress these practices.

The centrality of the market as both the measure of a company's success and a fundamental source of wealth creation for insiders has tilted companies' attention toward their stock price and away from the fundamentals of their business. Executive compensation is now deeply intertwined with the performance of a company's stock. The stock price, in turn, is very much affected by the expectations of the securities analyst and the investor community. Companies live and die by meeting analysts' predictions each quarter. Missing the estimates by as little as a penny can send a company's stock price plummeting, even when there has been no substantive change in the firm's condition or prospects.

Since your last set of hearings, Mr. Chairman, the SIA, in an effort to stem the public and vocal tide of criticism, released its voluntary guidelines on the conduct of securities analysts. Shortly after its release much of the industry claimed they were already following these guidelines. In response, Ms. Unger was quoted in the press as saying, that this would "suggest that perhaps the [guidelines] need to be enforced more stringently." Perhaps so. Shortly following those remarks, in a very positive, but telling step, Merrill Lynch and Credit Suisse First Boston, amongst others, barred their analysts from owning the stocks that they cover. In my view this move was a clear indication by the industry that something is very wrong. It is also an indication that the wrong can be righted.

As result, I have written to Ms. Unger and the NASD on two occasions to call for rulemaking beyond the enhanced disclosure recently proposed by the NASD to amend Rule 2210. We know that the role of the analyst is both a mechanism to win business and a voice to speak objectively about the business fundamentals of the companies they cover. This advice is relied upon by large and small investors alike. What is at risk is a person's retirement, and therefore a person's financial security and fortune. **Conflicts are not simply facts to be disclosed.** Conflicts of interest undermine the objectivity of the analyst and the efficacy of the work that they do. Like any profession that requires trust by the public, conflicts need to be minimized or eliminated, **not simply disclosed.** Lawyers, when they appear to serve two clients with opposing interests, must necessarily withdraw, or otherwise eliminate the conflict or seek a waiver by both clients. Is this any different? Aren't investors every bit the client that the issuer is? Therefore, I have suggested to Ms. Unger, and I invite her to respond today, to the following recommendations:

1. To affirm, through regulation, the actions of Merrill Lynch and CSFB, by banning securities analysts from owning or having an interest in the stocks that they cover.

2. Engage the academic community, the NASD and market participants to arrive at a workable construct that will alter the present compensation structure of analysts to separate analyst compensation from their investment banking function and reward them based on the quality of their research.

3. Consider requiring securities firms to disclose on each research report or recommendation, how many issuers they cover and an aggregate breakdown by category, of the ratings assigned to these issuers. For example, XYZ investment covers 200 public companies, of these companies, 50 are "strong buys," 100 are " buys," 49 are "holds," and 1 is a "sell."

I made additional suggestions to the Commission in late June following your first hearing, Mr. Chairman. Without objection, I would ask that it be made part of the record. I also support many of the modest changes suggested by the NASD in its proposed rulemaking.

Mr. Chairman, I am increasingly concerned that industry self regulation may not be sufficient to guard against the problems and abuses we are seeing, and that more disclosure of these conflicts, in itself will not suffice to protect the individual investor. I urge the regulators to act quickly to eliminate these conflicts to restore the confidence that some have squandered. **If the regulators do not, Congress must.**

U.S. House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

MICHAEL G. OXLEY, OH, CHAIRMAN

JAMES A. LEACH, IA
MARGE ROUKEMA, NJ
Vice Chair
DOUG BEREUTER, NE
RICHARD H. BAKER, LA
SPENCER BACHUS, AL
MICHAEL N. CASTLE, DE
PETER T. KING, NY
EDWARD R. ROYCE, CA
FRANK D. LUCAS, OK
ROBERT W. NEY, OH
BOB BARR, GA
SUE W. KELLY, NY
RON PAUL, TX
PAUL E. GILLMOR, OH
CHRISTOPHER COX, CA
DAVE WELDON, FL
JIM RYUN, KS
BOB RILEY, AL
STEVEN C. LaTOURETTE, OH
DONALD A. MANZULLO, IL
WALTER B. JONES, NC
DOUG OSE, CA
JUDY BIGGERT, IL
MARK GREEN, WI
PATRICK J. TOOMEY, PA
CHRISTOPHER SHAYS, CT
JOHN B. SHADEGG, AZ
VITO FOSSELLA, NY
GARY G. MILLER, CA
ERIC CANTOR, VA
FELIX J. GRUCCI, Jr., NY
MELISSA A. HART, PA
SHELLEY MOORE CAPITO, WV
MIKE FERGUSON, NJ
MIKE ROGERS, MI
PATRICK J. TIBERI, OH

TERRY HAINES
CHIEF COUNSEL AND STAFF DIRECTOR

JOHN J. LaFALCE, NY, RANKING MEMBER

BARNEY FRANK, MA
PAUL E. KANJORSKI, PA
MAXINE WATERS, CA
CAROLYN B. MALONEY, NY
LUIS V. GUTIERREZ, IL
NYDIA M. VELÁZQUEZ, NY
MELVIN L. WATT, NC
GARY L. ACKERMAN, NY
KEN BENTSEN, TX
JAMES H. MALONEY, CT
DARLENE HOOLEY, OR
JULIA CARSON, IN
BRAD SHERMAN, CA
MAX SANDLIN, TX
GREGORY W. MEEKS, NY
BARBARA LEE, CA
FRANK MASCARA, PA
JAY INSLEE, WA
JANICE D. SCHAKOWSKY, IL
DENNIS MOORE, KS
CHARLES A. GONZALEZ, TX
STEPHANIE TUBBS JONES, OH
MICHAEL E. CAPUANO, MA
HAROLD E. FORD, JR., TN
RUBÉN HINOJOSA, TX
KEN LUCAS, KY
RONNIE SHOWS, MS
JOSEPH CROWLEY, NY
WILLIAM LACY CLAY, MO
STEVE ISRAEL, NY
MIKE ROSS, AR

BERNARD SANDERS, VT

July 30, 2001

Ms. Laura Unger
Acting Chairman
Securities and Exchange Commission
450 5th Street, NW
Washington, DC 20549-0609

Dear Ms. Unger:

In anticipation for your testimony before the Capital Markets Subcommittee on Tuesday, July 31, 2001, I write to you to request you to consider additional measures to confront the analyst objectivity issue. On July 5, 2001, I wrote to you and Ms. Mary Shapiro of the NASD asking that you consider my broad concerns on this issue. I noted in that letter that the SEC and the NASD should act promptly on rulemaking to directly confront these conflict issues. Attached is a copy of that letter to this one. I await a response.

Since that time, Merrill Lynch and Credit Suisse First Boston took the important step of banning analysts from investing in the stocks that they cover. Their action is an important indication by the industry that something is very wrong with the way the system currently works. As I have said publicly, "conflicts may have profoundly undermined analyst integrity, and possibly even misled investors, as analysts held fast to companies as the market eroded out from under them." I applaud their decision and hope that it will energize you to go further. In addition, over the last several weeks, I have met with constituents, representatives from industry and the securities regulators on this issue and have become increasingly convinced the agency should act immediately to eliminate these conflicts.

In your testimony on Tuesday I would like you to address the items I specified in my first letter, and consider additional steps that I believe you should consider that are outlined below:

1. To affirm, through regulation, the actions of Merrill Lynch and CSFB, by banning securities analysts from owning or having an interest in the stocks that they cover.

2. Engage the academic community, the NASD and market participants to arrive at a workable construct that will alter the present compensation structure of analysts to separate analyst compensation from their investment banking function and reward them based on the quality of their research.

3. Consider requiring securities firms to disclose on each research report or recommendation, how many issuers they cover and an aggregate breakdown by category, of the ratings assigned to these issuers. For example, XYZ investment bank covers 200 public companies, of these companies, 50 are "strong buys," 100 are " buys," 49 are "holds," and 1 is a "sell."

Finally, I support the NASD's recent effort to enhance disclosure of conflicts of interest by modifying Rule 2210. But, I believe these efforts do not go far enough to confront the systemic conflicts of analysts that necessarily taint their advice, skew the market and ultimately harm investors.

I look forward to your testimony on Tuesday and your response in that testimony to this letter and my other correspondence to the Commission.

Sincerely,

/S/

JOHN J. LaFALCE
Ranking Member

U.S. House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

MICHAEL G. OXLEY, OH, CHAIRMAN

JAMES A. LEACH, IA
MARGE ROUKEMA, NJ
Vice Chair
DOUG BEREUTER, NE
RICHARD H. BAKER, LA
SPENCER BACHUS, AL
MICHAEL N. CASTLE, DE
PETER T. KING, NY
EDWARD R. ROYCE, CA
FRANK D. LUCAS, OK
ROBERT W. NEY, OH
BOB BARR, GA
SUE W. KELLY, NY
RON PAUL, TX
PAUL E. GILLMOR, OH
CHRISTOPHER COX, CA
DAVE WELDON, FL
JIM RYUN, KS
BOB RILEY, AL
STEVEN C. LaTOURETTE, OH
DONALD A. MANZULLO, IL
WALTER B. JONES, NC
DOUG OSE, CA
JUDY BIGGERT, IL
MARK GREEN, WI
PATRICK J. TOOMEY, PA
CHRISTOPHER SHAYS, CT
JOHN B. SHADEGG, AZ
VITO FOSSELLA, NY
GARY G. MILLER, CA
ERIC CANTOR, VA
FELIX J. GRUCCI, Jr., NY
MELISSA A. HART, PA
SHELLEY MOORE CAPITO, WV
MIKE FERGUSON, NJ
MIKE ROGERS, MI
PATRICK J. TIBERI, OH

TERRY HAINES
CHIEF COUNSEL AND STAFF DIRECTOR

JOHN J. LaFALCE, NY, RANKING MEMBER

BARNEY FRANK, MA
PAUL E. KANJORSKI, PA
MAXINE WATERS, CA
CAROLYN B. MALONEY, NY
LUIS V. GUTIERREZ, IL
NYDIA M. VELÁZQUEZ, NY
MELVIN L. WATT, NC
GARY L. ACKERMAN, NY
KEN BENTSEN, TX
JAMES H. MALONEY, CT
DARLENE HOOLEY, OR
JULIA CARSON, IN
BRAD SHERMAN, CA
MAX SANDLIN, TX
GREGORY W. MEEKS, NY
BARBARA LEE, CA
FRANK MASCARA, PA
JAY INSLEE, WA
JANICE D. SCHAKOWSKY, IL
DENNIS MOORE, KS
CHARLES A. GONZALEZ, TX
STEPHANIE TUBBS JONES, OH
MICHAEL E. CAPUANO, MA
HAROLD E. FORD, Jr., TN
RUBÉN HINOJOSA, TX
KEN LUCAS, KY
RONNIE SHOWS, MS
JOSEPH CROWLEY, NY
WILLIAM LACY CLAY, MO
STEVE ISRAEL, NY
MIKE ROSS, AR

BERNARD SANDERS, VT

July 5, 2001

Ms. Laura Unger
Acting Chairman
Securities and Exchange Commission
450 Fifth Street
Washington, DC 20549

Dear Ms. Unger:

I am encouraged by your recent statements in the press about the apparent inadequacy of the recent SIA guidelines on analyst objectivity. You were quoted recently as suggesting that there is an apparent inconsistency in the fact that 13 of the 14 firms which signed the SIA's guidelines already follow these principles. You properly noted this would "suggest that perhaps they need to be enforced more stringently." In addition, I am supportive of the recent SEC investor alert issued to warn investors of the potential dangers related to analyst conflicts and how that may affect individuals' investment methodology.

In light of your statements, the SEC's investor alert, and the testimony the Committee recently received on this issue recently, I have become increasingly convinced that the SEC and the NASD should consider immediately a full review of the current regulatory framework as it relates to analysts, with a view toward implementing more stringent and more enforceable standards.

As I said in my opening statement before the Capital Market Subcommittee, "conflicts may have profoundly undermined analyst integrity, and possibly even misled investors, as analysts held fast to companies as the market eroded out from under them." Former SEC chairman, Arthur Levitt noted, "I wonder how many investors realize the professional and financial pressures many analysts face to dispense recommendations that are more in a company's interest rather than the public's interest."

As you know, my colleagues Mr. Baker and Mr Kanjorski have established a review board to evaluate the SIA's proposals on securities analysts. I welcome their efforts. However, I am still very concerned that these proposal remain voluntary and do not go far enough to protect investors from the serious problems they face when relying on the recommendations of analysts who have apparent and direct conflicts of interest relating to their investment advice. Moreover, I am concerned that industry self regulation in this area may not be sufficient or desirable. Based on what we know to have occurred over the last several years, it is indeed telling that the vast majority of the investment banks signing on to the SIA's guidelines have stated that they are already complying with these "best practices" procedures.

I should note, however, that I view the National Association of Securities Dealers (NASD) proposed amendments to Rule 2210 as a welcome first step in addressing the conflict issue. The NASD's proposal to strengthen existing disclosure requirements and require analysts to make similar disclosures during television and other appearances clearly recognize the need for enhanced information for the average investor. However, in my view, these disclosure requirements, although positive, are still woefully inadequate to confront the systemic conflicts of analysts that necessarily taint their advice, skew the market and ultimately harm investors. We intend to provide the Commission and the NASD with more detailed comments pursuant to the NASD comment request.

Government action is needed now to protect investors. I would urge the Commission and the NASD to consider proposals well beyond the modest suggestions the NASD has put forward including:

- additional disclosure requirements to enhance those suggested in the NASD proposed rulemaking. For example, the Commission and the NASD should seriously consider requiring disclosure of the specific nature and extent of all economic holdings of the analyst and the firm with respect to the issuer without regard to threshold tests.

- consideration of whether recommendations that are passed along by a broker or by other means may also need to carry appropriate cautionary disclosure language regarding analyst and other conflicts.

- consideration of prohibiting analysts from having **any** economic interest in the companies they cover.

- consideration of requiring analyst compensation to be completely unrelated to the successful completion of capital market transactions. That is, compensation would focus on the quality of the research **alone**.

The rulemaking process takes a long time. I urge you to begin the consideration of these options now as you seek to protect investors in this highly volatile market place. I encourage the agency to seek ways to require the analyst to return to his or her first mission – being an ethical, independent and informed source of information for investors.

Please inform me of the timetable for your review of these issues and the range of policy responses you and the other securities regulators are considering.

Sincerely,

/S/

JOHN J. LaFALCE
Ranking Member

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises
July 31, 2001

"Analyzing the Analysts II: Additional Perspectives"

Thank you, Mr. Chairman, and I commend you for holding this important hearing today, the second of our series of hearings on the issue of Wall Street research practices. These practices have come under fire in the past year – and for good reason.

As we learned at our first hearing on analysts last month, and as even the trade group for analysts acknowledged, conflicts of interest pervade Wall Street's research machine and taint the recommendations of equity analysts. That's one reason institutional investors pay little attention to sell-side analysts, relying on their own research professionals instead. Robert Sanborn, former portfolio manager of the Oakmark Fund, says that anyone who follows a recommendation from a sell-side analyst is an "absolute fool." Most investment advisors caution investors to consider analysts' recommendations not as definitive in any way, but rather as a single factor in making a buy or sell decision. That is good advice. But even as a single factor in an investment decision, an analyst's recommendation should, at the very least, be free from the taint of bias.

The financial media has played an important role in elevating the profile of Wall Street analysts. Mary Meeker and Henry Blodget are now familiar names to a large number of America's investors. Many have criticized the news media for its failure to hold analysts accountable for wildly wrong predictions.

I would urge the news media to require guests and sources to disclose whether they hold any interest in stock, long or short, and whether their firms have business relationships with the company. Then let investors weigh that information. Some news media already take these steps--but it should be universal.

(more)

Having said all that, as a free-market Republican, I am loathe to legislate in this area. My preference is for industry to clean up this mess. I am encouraged by steps that some companies have taken to address this issue. I will continue to work with the industry to make sure sufficient steps are being taken to resolve the problems and to restore confidence in Wall Street research practices.

This Committee has established a peer review board of industry practitioners, money managers, academics and regulators to comment on the industry's proposals for reform. That group will present its findings to the Committee at a hearing this Fall.

I look forward to our distinguished witnesses today, who will provide new perspectives on the issue, including that of Commissioner Laura Unger, who has done considerable work on this matter as Acting Chairman of the Commission, and, on our second panel, a variety of esteemed experts in research, investment banking, and the financial media.

Thank you again, Mr. Chairman. I welcome our witnesses and thank each of you for your testimony today.

###

TESTIMONY OF

LAURA S. UNGER, ACTING CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING CONFLICTS OF INTEREST FACED BY BROKERAGE FIRMS AND THEIR RESEARCH ANALYSTS

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

U.S. HOUSE OF REPRESENTATIVES

JULY 31, 2001

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

WRITTEN STATEMENT OF

LAURA S. UNGER
ACTING CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING CONFLICTS OF INTEREST FACED BY BROKERAGE FIRMS AND THEIR RESEARCH ANALYSTS

BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

JULY 31, 2001

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee:

I am pleased to testify today on behalf of the Securities and Exchange Commission ("Commission") as you consider the issues surrounding conflicts of interest faced by brokerage firms and their analysts.

Financial analysts exert considerable influence in today's marketplace. The increased popularity of investing in stocks coupled with the media's intense focus on recommendations has dramatically raised the public profile of analysts. Recently, however, public scrutiny has shifted towards examining the conflicts of interest that may affect analysts' recommendations. Congress[1] and the Commission[2] have shone a

[1] On June 14, 2001, the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Financial Services Committee held a hearing entitled, "Analyzing the Analysts: Are Investors Getting Unbiased Research From Wall Street?"

[2] *See* Remarks by Acting Chairman Laura S. Unger at the Ray Garrett Jr. Corporate and Securities Law Institute, Northwestern University School of Law, *"How Can Analysts Maintain Their Independence?"* (April 19, 2001).

spotlight on this issue, while almost countless press reports[3] have provided further accounts of the numerous conflicts affecting brokerage firms and their research analysts.

As I noted in a recent speech, there is a mood of skepticism about analysts' stock recommendations. This skepticism is due, in large part, to a blurring of the lines between research and investment banking. For example, analysts' compensation is increasingly becoming tied to the investment banking business they generate. Moreover, analysts often own shares -- including those obtained before initial public offerings ("IPOs") -- in the companies they follow and recommend. Analysts at times issue "booster-shot" research reports close to the expiration of lock-up periods.[4] In addition, some firms have structures where analysts report, at least indirectly, to the investment banking unit.

I recently called on the industry to take an active role in dealing with these and other problems surrounding analysts' conflicts of interest. It is fair to say, as I will fully describe in my testimony here today, that the industry, as well as the self-regulatory organizations ("SROs") have heard this call to action.

Today I will discuss: (1) the myriad sources of conflicts of interest that threaten the objectivity of analyst recommendations; (2) preliminary observations from a recent series of on-site examinations by SEC staff concerning current practices in the industry; and (3) recent initiatives in this area to cure the problem.

3 *See e.g.* Justin Schack, *"Should Analysts Own Stock in Companies They Cover,"* INSTITUTIONAL INVESTOR, (April 1, 2001); and Charles Gasparino, Deals & Deal Makers: *"Outlook for Analysts: Skepticism and Blame,"* WALL ST. J., Jun 13, 2001, at C1.

4 Underwriters typically obtain lock-up agreements from the issuer's private equity holders not to sell their securities into the public marketplace for a specified time after an IPO, typically 6 to 12 months. These lock-ups are designed to prevent disruption of the new market for the securities by the immediate introduction of private placement stock into the public marketplace.

SOURCES OF CONFLICTS OF INTEREST

It has become clear that research analysts are subject to several influences that may affect the integrity and the quality of their analysis and recommendations.

There are numerous pressures that exist within full-service brokerage firms, but four potential areas of conflict stand out. They are as follows:

(1) Attracting and Retaining Clients: The analyst's firm may have underwritten an offering for a company or seek to underwrite a future offering. The analyst may have been a part of the investment banking team that took the company public.

(2) Firm Profits: Positive reports by brokerage firm analysts can also trigger higher trading volumes, resulting in greater commissions for the firms.

(3) Compensation: An analyst's salary and bonus may be linked to the profitability of the firm's investment banking business.

(4) Equity Stakes: The analyst, other employees, and the firm itself may own significant positions in the companies the analyst covers. Analysts may participate in employee stock purchase pools that invest in companies they cover or they may own stock directly. And, in a recent trend called "venture investing," firms and analysts may acquire a stake in a start-up company by obtaining discounted, pre-IPO shares.

CURRENT INDUSTRY PRACTICES

Existing rules of the SROs require broker-dealers to disclose whether they make a market in the recommended security and whether they have recently underwritten a public offering in the company's securities. In addition, the National Association of Securities Dealers ("NASD") requires that the firm, and/or its officers or partners (but not the covering analyst) disclose ownership interests in the company's options, rights and warrants (but not common stock). The New York Stock Exchange ("NYSE") requires the firm and the covering analyst to disclose whether they "may" have an ownership interest in the company's securities (including both options and common stock).[5]

SEC staff has conducted on-site examinations of full-service broker-dealers focusing on analysts' conflicts of interests. The staff has reviewed firms' written disclosures. It also selected for examination nine firms that underwrote significant numbers of IPOs, particularly Internet and technology-related IPOs.[6] The staff reviewed documentation and interviewed senior management of firms' research and investment banking departments and research analysts. These examinations focused on analysts' financial interests in companies they cover, reporting structures, and compensation arrangements.

While these examinations are ongoing, I will share with you some of our staff's preliminary observations:

- *Research analysts provided significant assistance to investment bankers.*
  All firms examined reported that research analysts were not formally supervised by investment bankers, but all firms reported that research analysts provided assistance to investment banking, such as consulting on possible mergers, acquisitions and corporate finance deals, participating in road shows and initiating research coverage on prospective investment banking clients. Many firms pay their analysts largely

---

5 The NYSE also requires the firm to disclose if any employees of the firm are directors of the company covered by the research report.

6 These firms include eight of the top 12 underwriters in terms of the number of new issues underwritten in 2000, based on data available on the EDGAR system.

based upon the profitability of their investment banking unit, and investment bankers at some firms are involved in evaluating the firm's research analysts to determine their compensation.[7] Seven firms reported that investment banking had input into research analysts' bonuses.

- *Many research analysts were significantly involved with start-up companies well before the companies had established an investment banking relationship with a broker-dealer.*

  This involvement typically included establishing an initial relationship with the company, reviewing the company's operations, and providing informal strategic advice. Many times, these analysts were invited to invest in these companies' private placements, which were not available to the public generally. The staff also found that if the company went public and the analyst's firm underwrote the IPO, the analyst always issued positive research on the company.

- *It is commonplace for research analysts to provide research reports on companies that the analysts' employer firms underwrite.*

  In 308 of 317 IPOs examined, for example, the firm that underwrote the security also provided research coverage.

- *Analysts sometimes provide investment bankers with prior notice of changes in recommendations.*

  Six firms stated that at times analysts provide investment bankers and client management with advance notice of a pending change in the analyst's

---

7 At one firm, the head of investment banking set the aggregate bonus pool for the research department and exercised discretion over individual analysts' bonuses. At another firm, some senior analysts have contracts that provide for them to receive bonuses based on the amount of investment banking revenue generated by the business sectors the analysts cover.

recommendations. None of the firms reported that investment bankers had authority to stop an analyst from downgrading a particular company's rating.

- *Some research analysts own securities in companies they cover.*

  These analysts sometimes acquired their shares in private placements prior to the initial public offering for a fraction of the IPO price. The staff found that 16 of 57 analysts reviewed had made pre-IPO investments in a company they later covered. Subsequently, the analysts' firms took the company public and the analyst initiated research coverage with a "buy" recommendation. Examiners found that three of these analysts executed trades for their personal accounts that were contrary to their recommendations in their research reports.[8]

- *Existing regulations do not prohibit analysts from owning stock in companies the analysts cover, but some firms' policies do.*

  Other firms permit analysts to own stock in companies they cover but forbid them from executing personal trades that are contrary to the analysts' outstanding recommendations.

- *At the firms examined, compliance with SRO rules that require firms to monitor the private equity investments of employees (including analysts) was found to be poor.*

  Nearly all firms examined were unable to identify accurately all private equity investments by their employees in companies the firms took public. Consequently, firms did not always know whether their research analysts owned stock in companies they underwrote and upon which their analysts then issued research reports.

---

8 These analysts generated profits of between $100,000 and $3.5 million by selling their shares while continuing to maintain a "buy" recommendation. One analyst sold securities "short" while maintaining a buy recommendation on the subject company.

- *Disclosure of analysts' and firms' ownership in recommended securities varies widely.*

  Some firms' analysts' reports affirmatively state that they or their employees hold positions in recommended securities (very few firms provide actual percentages of ownership), while other firms use boilerplate noting, "the firm or employees *may* have positions in the recommended issuer." The staff found some instances in which the analysts' ownership in stock of the covered company was not disclosed in the research report at all.

- *Disclosure in analysts' reports of whether the firm has an investment banking or other relationship with the company covered is limited to disclosure of whether the firm has recently acted as underwriter or market maker, as required by existing SRO rules.*

  Most firms disclose whether they have recently underwritten a public offering or act as a market maker, as required by existing SRO rules. Some firms affirmatively state that they have acted as an underwriter or a market maker; other firms state only that they "may" have acted as an underwriter or "may" make markets in the security.

- *Sell-side analysts routinely recommend securities during public appearances in the media (such as on financial television and radio programs), but rarely reveal any conflicts of interest to investors.*

  SRO rules require that analysts reveal conflicts. The obligation to disclose conflicts of interest is not dependent on the communication medium used -- it is the same whether the recommendation is made in a written research report, on television,[9] or via an electronic communication.[10]

- *Examiners found indications that some research analysts issued "booster-shot" research reports.*

  These reports reiterated "buy" recommendations shortly before, or just after, the lock-up period expired. The staff reviewed the lock-ups of 97 companies in which the firm that underwrote the IPO, or an analyst employed by that firm, owned stock in the company. In 26 of these instances, the analyst issued a "buy recommendation" within a week of the expiration of the lock-up period. "Booster shot" reports may generate buying interest in the stock and help increase the stock price while the firm, the firm's clients, or the analysts sell their shares.

- *Analysts' rating terminology may be unclear to investors.*

  Full-service broker-dealers use a variety of undefined terms to describe their investment recommendations, including: "buy," "sell," "strong buy," "hold," "neutral," "accumulate," "near-term accumulate," "long-term buy," "outperform," "market perform," and "market under-perform." The wide variety of terms may confuse investors.

RECENT DEVELOPMENTS

The industry, the SROs, and the Commission have recently taken action to improve the objectivity and independence of research analysis.

---

9 *See*, e.g., *Brill's Content*, "Financial Analysts Are Recommending Stocks on Television Without Revealing Their Firms Have Ties to Some of the Companies Involved" (April 2000), which chronicled analysts' failure to divulge conflicts of interest during public appearances.

10 Despite the language of its rule, the NASD has stated that it does not interpret the disclosure requirement to apply to media appearances by analysts. The NYSE has stated that its disclosure obligation does apply to media appearances.

1. *Industry Initiatives*

a. SIA Best Practices

The Securities Industry Association ("SIA") recently set forth "Best Practices for Research," which establish useful guidelines for brokerage firms and their analysts in addressing situations that can give rise to analyst conflicts that impair the value of their research for investors. The SIA importantly notes that the investor, not the firm or the analyst, is the intended beneficiary of research. The more significant practices recommended by the SIA include: prohibiting analysts' compensation from being based on fees obtained in specific investment banking transactions; shoring up analysts' independence by not having them report to investment banking personnel; disclosure of analysts' ownership positions in securities they cover; and a general prohibition on analysts trading against their recommendations.

b. AIMR Issues Paper

The Association for Investment Management and Research ("AIMR") recently circulated to its members for comment a proposed issues paper, "Preserving the Integrity of Research," that identifies and discusses certain conflicts of interest and pressures experienced by analysts working for full-service brokerage firms that may bias their reports and recommendations. AIMR's paper calls for a separate reporting structure for personnel within the research and investment banking departments, thus preventing bankers from influencing analyst recommendations. AIMR also disavows compensation arrangements that directly link analyst remuneration to investment banking assignments. The paper also discusses external pressures that public companies and institutional clients sometimes exert on analysts and discourages retaliatory practices.

c. Firm Initiatives

Securities firms are revising their existing policies and procedures to manage conflicts. For instance, at least three securities firms have recently adopted policies prohibiting analysts from owning securities in companies they cover in research.[11]

2. SRO Rule Changes

There are gaps and inconsistencies between NYSE and NASD rules governing disclosure of analyst conflicts.[12] The NASD requires that its member firms (but not individual analysts) affirmatively disclose certain proprietary holdings (options, rights, and warrants but surprisingly not common stock). The NYSE permits a generic disclaimer.

The NASD recently proposed for member comment changes to its conflict disclosure rule that would fill certain gaps and address inconsistencies in their rule.[13] The NASD's proposal would extend the obligation to disclose conflicts of interest to individual analysts of NASD member firms and cover common share ownership. The amendments would also require abbreviated disclosures during public appearances

---

11 *See* "Credit Suisse Limits Holdings Of Its Analysts" WALL ST. J., July 25, 2001, at C14; "Edward D. Jones Puts Limits on Stock Owned by Analysts" WALL ST. J., July 12, 2001, at C13; and "Merrill Alters a Policy on Analysts" WALL ST. J., July 11, 2001, at C2.

12 *NASD Rule 2210* requires disclosure that the firm "and/or its officers or partners own options, rights or warrants to purchase any of the securities of the issuer whose securities are recommended, unless the extent of such ownership is nominal." The NASD rule does not mandate the disclosure of common share ownership of a recommended issuer, nor does it require that the analyst who prepared a research report disclose ownership of any financial interest in a recommended issuer. *NYSE Rule 472* covers all financial positions (including common shares) held by a firm and a covering analyst, but permits the use of generic disclosure language such as "... the firm or employees may own securities or options of the issuer recommended in this report." Neither rule requires disclosure of the size of the financial interest.

13 On July 2, 2001, the NASD issued a Notice to Members (NTM 01-45) that proposes amendments to its disclosure rule that, among other things, would include common stock as a financial interest that must be disclosed and would require financial interest disclosures by analysts as well as firms.

(television, radio, *etc.*), and that disclosures in written reports be "specific" and "prominent." The NASD's proposal asks questions about some important details, such as whether disclosure of stock ownership should be required only at a minimum level such as 5%, and whether disclosure of firm relationships with a company should be broadened in scope but apply to a shorter timeframe. The NYSE is also reportedly considering amendments to strengthen its conflict disclosure rule.

3. Commission Initiatives

The Commission plans to work with the SROs to improve and more diligently enforce their existing rules governing the disclosure of conflicts of interest.

In addition to Commission examinations, the Commission's Office of Investor Education and Assistance ("OIEA") issued an Investor Alert last month, explaining to investors exactly what conflicts analysts might face and how investors should interpret disclosures about these conflicts.[14]

The Alert explains the relationships between securities analysts and the investment banking and brokerage firms that employ them and educates investors about potential conflicts of interest analysts may face. In particular, the Alert notes, some analysts work for firms that underwrite - - or even own - - the securities of the companies the analysts cover. And in other cases, analysts themselves might own stocks in the companies they cover - - either directly or indirectly through employee stock-purchase pools in which they and their colleagues participate. Some firms link an analyst's annual salary and bonuses to the profitability of the firms' investment banking business.

---

14 OIEA's alert is entitled: *"Analyzing Analyst Recommendations,"* available on the Commission's web site at www.sec.gov/investor/pubs/analysts.htm.

The Alert urges investors not to rely solely on analyst recommendations when deciding to buy, hold, or sell stock. Instead, investors should consult multiple sources of information, such as the company's financial filings, while considering their own investment goals and tolerance for risk. The Alert also provides tips to help investors find out whether an analyst or the analyst's firm has a financial interest in a company's securities.

SOME CONFLICTS MAY ALWAYS EXIST

We encourage further consideration by the industry and the SROs to minimize and manage conflicts of interest. At the same time, we recognize that some conflicts may always exist.[15] At a minimum, the Commission should continue to promote both clear, meaningful, and prominent disclosure, as well as effective investor education, so that investors may weigh for themselves the significance of any conflicts.

The role of investor education is particularly important because there are other pressures originating outside the firms that may affect research analysis and recommendations. Since these pressures are largely outside the control of the firm, arguably they are more difficult for the firm to address. These pressures include:

(1) Pressure from institutional investors: Institutional investors, such as mutual funds, that are clients of the analyst's firm may have a significant position in the security of a company covered by an analyst. An analyst may be inhibited from issuing a rating downgrade that would adversely affect the performance of an

---

15 It should be noted that there may be benefits from research analysts working with investment bankers. For example, an investment banker underwriting a company's offering will sometimes employ its firm's research analysts to help it conduct its due diligence investigation into the company it is underwriting. The due diligence investigation helps ensure that the prospectus contains all material information required to be disclosed. In these cases, research analysts can play an important role in facilitating the due diligence process, especially in expedited offerings.

institutional client's portfolio for fear that the client would take its brokerage business elsewhere. Moreover, many publications rate analysts based upon input from institutional investors.

(2) Pressure from issuers: The management of companies an analyst follows may pressure him/her to issue favorable reports and recommendations. Less than favorable recommendations may not be well received by management and issuers may threaten to cut off an analyst's access to its management if the analyst issues a negative report on the company. This could cause the analyst to issue a more favorable report than his/her analysis would suggest.

CONCLUSION

Analyst practices are now firmly in the spotlight. That spotlight has exposed the conflicts analysts face. This exposure is beneficial for investors. Analysts and their employer firms should carefully consider their policies and procedures regarding research and, when possible, minimize conflicts of interest that might bias their research and recommendations. Where actual and potential conflicts do exist, they should be clearly and meaningfully disclosed to investors.

I am hopeful the recent industry initiatives will help to reduce or more effectively manage the conflicts that threaten analysts' fairness and objectivity. I am also optimistic that appropriate amendments to SRO rules, coupled with vigilant enforcement of these rules, will improve disclosure of conflicts of interest by firms and their analysts. We will closely monitor these developments. We also look forward to working with the Subcommittee as we move forward.

Thank you.

ORAL TESTIMONY OF RONALD GLANTZ

Chairman Oxley, Chairman Baker, Ranking Members LaFalce and Kanjorski, and members of the committee, thank you for inviting me to testify on Wall Street's research practices.

My name is Ronald Glantz. I was in the investment business for 32 years before retiring last year. I began my career on Wall Street as an equity research analyst. Money managers polled by Institutional Investor Magazine selected me the top analyst in my field for seven consecutive years. I then became Director of Research, Chief Investment Officer, Director of Economics and Financial Markets, and a member of the Management Board of Paine Webber, one of the largest brokerage firms in the United States. I ended my career as a Managing Director of Tiger Management, one of the largest hedge funds in the world. This has given me a good perspective on how the role of analysts has changed over the last three decades.

When I began in the business, the top-rated equity research firm was named Laird. Within five years it failed. So did most of the other top-rated firms. What happened? When I began, the average commission was over 40 cents a share. A few years later, commissions paid by institutions such as banks, pension funds, and mutual funds became negotiated, almost immediately falling to less than 6 cents a share. The only way for research firms to survive was to merge with someone that could spread research costs over a larger base, usually brokerage firms whose main clients were individual investors. Retail commissions had remained fixed, and retail brokerage firms discovered that good research helped them gain retail clients and stock brokers. By the end of the 1970s, the largest number of top analysts were at Paine Webber, which had bought the top-rated research firm, and Merrill Lynch, which hired talent from failing research firms.

Companies pressure analysts to recommend their stock, since a higher price means:

- Fewer shares have to be issued when raising new funds or acquiring another company.
- They are less vulnerable to being taken over.
- Executives make more money when they cash in their options.
- Shareholders are pleased.

It is easy to reward favored analysts. They are given more access to management, "helped" in making earnings estimates, and invited to resorts for "briefings." And, most important, their firm receives lucrative investment banking business.

Companies penalize analysts who aren't sufficiently enthusiastic. Let me give you a personal example. When I was a brokerage firm analyst, I downgraded a stock. The company's chief financial officer called my firm's president to say that unless I recommended his stock, he would cease doing investment banking business with my firm and would order the bank which managed his company's pension fund to stop doing business with my firm. I have seen top analysts removed from company mailing lists, their telephone calls left unreturned, and even physically barred from company presentations. Once I was doing a reference check on an analyst I was considering hiring. A CFO told me that the analyst was disliked so much that he was deliberately given misleading information.

In 1980, top analysts made just over $100,000 a year. Today, top analysts make up to $20 million a year. How is this possible, considering that institutional commissions have fallen even further and brokerage firms now discount retail commissions to avoid losing customers to such firms as Schwab and e-Trade?

What happened is that brokerage firms discovered that highly-rated research helped them gain investment banking clients. Soon the largest number of top analysts were at investment banking goliaths such as Morgan Stanley and Goldman Sachs. They could pay considerably more, because investment banking transactions were much more lucrative than trading stocks. The institutional commission on trading $300 million-worth of stock was only $300,000, of which less than $25,000 would go to the research department. This barely paid for printing and mailing research reports on that company. However, underwriting a similar dollar value of a new issue would bring in at least $10 million, and bankers thought nothing of giving a million dollar fee to the analyst responsible for the business. A merger or acquisition could bring in even more. Soon firms were including anticipated investment banking fees in the contracts they offered analysts. The huge fees earned by investment banking gives them the ability to influence and, in some cases, even control the equity research department. As we all know, whoever "pays the piper" names the tune.

Analysts used to view retail customers and investment managers as their clients. My first boss told me, "Widows and orphans depend upon you to give good advice." Now the job of analysts is to bring in investment banking clients, not provide good investment advice. This began in the mid-1980s. The prostitution of security analysts was completed during the high-tech mania of the last few years. For example, in 1997 a major investment banking firm offered to triple my pay. They had no interest in the quality of my recommendations. I was shown a list with 15 names and asked, "How quickly can you issue buy recommendations on these potential clients?"

Let me pause here to assure you – most analysts still want to give good advice. Not only is it the right thing to do, it helps their reputation, which brings in investment banking business. Nevertheless, the pressures are enormous.

When I was Director of Research, analyst compensation was based upon the performance of his or her recommendations, commissions generated, and ratings by institutional clients and the retail system. Today, name analysts are given guaranteed contracts, whether or not their recommendations are any good. Every year *The Wall Street Journal* lists the analysts who have provided the best investment advice. These analysts are rarely the best paid in their field. Why is that? Investment banking. It is an open secret that "strong buy" now means "buy," "buy" means "hold," "hold" means that the company isn't an investment banking client, and "sell" means that the company is no longer an investment banking client. Less than 1% of all recommendations are "sell." Some analysts call their best clients and tell them that their real opinion differs from their published opinion, even though this is illegal.

But what about the individual investor? No one told my 86-year-old widowed aunt that the Internet stocks she was buying in 1999 had no hope of ever earning any money, that the analyst recommending purchase was being paid by investment banking.

Investment banking now dominates equity research:

- Bankers often suggest and are usually asked to approve hiring analysts from other brokerage firms.
- Investment banking provides the bulk of proven analysts' pay package.
- Some analysts report directly to investment banking.
- Analysts routinely send reports to the companies and to bankers for comment before they are issued.
- Three years ago, Tiger was able to hire the top rated analyst in his field. He had consistently been negative on one company, a major source of investment banking fees because of its many acquisitions. Then his firm hired an investment banking team from another brokerage firm. As reported in *The Wall Street Journal*, the analyst was fired so that a "more compliant" analyst could be hired, one who would recommend potential investing banking clients. Disillusioned, the analyst moved over to money management, where the quality of recommendations was still more important than the quality of relationships with potential buyers of investment banking services.

To give one of many personal examples, four years ago, I came up with some extremely negative information on a company, including bribery, defective product, accounting irregularities, and serious pollution problems. I called the three most visible analysts recommending the stock, one of them the top-rated analyst in his field, and gave them my evidence. Everyone continued to recommend the stock. Why? This company was an investment banking client.

The genie has been let out of the bottle. As long as investment banking is the most profitable part of the firm, then investment bankers will find a way to pay analysts who bring in business. Money managers can hire their own analysts. But my elderly aunt will never know whether the advice she is receiving is unbiased or not. That's not only bad for the average investor, it undermines one of the primary reasons for having a stock market – the efficient allocation of investment dollars.

My proposals can only address part of the problem. At the least:

1. Brokerage firms should list in large type on the first page of all buy recommendations any investment banking business they have had with the company over the last three years and any equity ownership by the analyst, members of his or her immediate family, or the firm.

2. No buy recommendation should be permitted if the analyst, members of his or her immediate family, or the brokerage firm purchased stock or options for their own account in the month preceding the report, nor should they be permitted to sell stock until three days after a sell recommendation is issued.

3. Any shares purchased of a new issue by the analyst, members of his or her immediate family, or a money management arm of a brokerage firm should be held for a minimum of one year.

Thank you.

Resume

Ronald A. Glantz

Born and raised in Baltimore, Maryland, Mr. Glantz graduated *cum laude* from Harvard in 1962 and received his M.A. from The Fletcher School in 1963. After serving as an economist on the staff of the Secretary of the Treasury, he received his M.B.A. from Harvard in 1966. Following two years as a consultant with Booz-Allen and Hamilton, Mr. Glantz joined Laird as chief economist and security analyst in 1968. He moved to Mitchell Hutchins in 1972, which merged with Paine Webber, where he was Director of Research, Chief Investment Officer, Director of Economics and Financial Markets, and on the Management Board. Mr. Glantz joined Montgomery Securities as a general partner in 1985 and moved to Dean Witter in 1990, where he was Director of West Coast Research. He was on *Institutional Investor's* All-American Research Team for 17 years, including seven as top automobile analyst. Mr. Glantz joined Tiger Management, one of the two largest hedge funds in the world, as a Managing Director in 1997 and retired in 2000.

Chairman Oxley, Chairman Baker, and distinguished members of the subcommittee. My name is Christopher Byron, and I am a magazine, newspaper, and internet columnist, and radio commentator.

My columns appear weekly in the *New York Observer* newspaper, and on MSNBC Interactive on the Internet, where I host a daily webcast radio program entitled *High Noon On Wall Street.* I also provide a daily, drive-time radio commentary entitled *Wall Street Wake Up with Chris Byron* which is distributed by the Jones Radio Network and is aired daily on 40 radio stations around the country. In addition, I write a monthly column for *Red Herring* magazine.

You have asked for a brief biographical summary of my education and career. I am a 1968 graduate of Yale College, and hold a doctor of jurisprudence degree from the Columbia University School of Law, 1972. I have been in financial journalism without interruption for 30 years. I have been a Wall Street correspondent for *Time* magazine, as well as an editor and foreign correspondent for that publication. I have been an assistant managing editor for *Forbes* magazine, and a columnist for *Esquire, Playboy* and *New York* magazines, and the *New York Daily News.* I am the author of four books – the most recent of which is entitled *Delete Your Broker.com, Using The Internet To Beat The Pros on Wall Street.* It was published earlier this year by Simon & Schuster, Inc., and deals in part with the subject matter of your important hearing today – the changing role of financial analysts and journalism on Wall Street.

This is a subject about which I have an embarrassingly long perspective. I came to Wall Street as a reporter in the final boom days of the go-go 1960s bull market, and three decades later I am still covering the same basic beat: the ceaseless search for money in the equity markets of America – and now the world.

A lot has changed in that time. When I came to Wall Street as a reporter in 1969, almost no one owned or used a computer. Today, I know of no one who does not have one.

When I came to Wall Street, it typically took days – and sometimes a week or more – to obtain the single most valuable asset an investor can have: up-to-date financial statements from companies with stock in the market. Today, that information is available instantaneously, and for free, to anyone with a computer, a telephone, and a dialup connection to the Internet.

There has also been an enormous explosion in the public's interest in financial information itself. When I began covering the financial markets at the end of the 1960s and the beginning of the 1970s, the *Wall Street Journal* was viewed by members of my profession as, generally speaking, a second-tier publication in the news game. There was no CNBC, or CNNfn, and most importantly, there was no Internet.

Now, *The Wall Street Journal* is regarded as one of the world's great newspapers, and electronic media like CNBC and MSNBC.com on the Internet have global audiences on every continent. Simply by way of illustration, I do a daily webcast at noon, east coast time, that is distributed from my home office in Connecticut by MSNBC.com, to every time zone on earth, simultaneously. And it takes only a minute or two each day before I begin to receive back e-mail responses from my on-going webcast commentary, from listeners in cities around the globe. Every single day, I hear from people in London, Athens, Southeast Asia, Latin America, and Canada – to say nothing of listeners in cities all across America. It is quite a megaphone to speak into, when you're sitting in your den.

But there is one thing about Wall Street that has not changed at all. Fundamentally it remains what it has always been: the place where you go to get The Money. You may hear discussion from time to time about "socially responsible investing," and similar such concepts. But the reality is, people do not go to Wall Street to engage in "socially responsible investing" or anything like that. They go to Wall Street to get The Money – and the promotion of concepts like "socially responsible investing" is simply another way to get it.

The financial markets of Wall Street are, in my experience, the single most successful effort the United States has ever undertaken in self-regulation at the national level. It has worked as well as it has, I believe, because most people are, by their nature, honest, and because the oversight capacity of the Securities & Exchange Commission – as embraced in the Securities & Exchange Acts of 1933 and 1934 -- is a constant, hovering presence in the background as the self-regulatory activities of the National Association of Securities Dealers and the Exchanges themselves proceed.

But the huge amplification of voices now provided by the digital age is, in my opinion, creating a new and increasingly difficult challenges for the self-regulators and the SEC. One can make a strong and convincing case that the entire tech-sector bubble, which swelled the NASDAQ stock market to three times its size in barely 24 months, then popped in March of 2000 like a champagne bubble in a glass, was caused by Wall Street's amplified megaphones of cable television and, most especially the Internet ... megaphones through which the analysts shouted "come and get it" to uninformed investors all over the earth.

That fact has huge and obvious public policy ramifications for the Congress, because the collapse of the NASDAQ market has brought an end to the longest running bull market in the nation's history, and now threatens to tip the economy into a recession that no expert has yet shown a convincing way to avoid.

Trillions of dollars in national treasure have been drained from the economy by the implosion of what Federal Reserve Chairman Greenspan has termed the "wealth effect" created by that bubble, and the Bush Administration and the Federal Reserve are now engaged in an uncertain effort to replace it with a combination of tax rebates and lowered short-term interest rates. Yet if stock prices had not been pumped up to the indefensible heights they eventually reached in the first place, they would not now have fallen as far as they have and we would not now be groping for a way to pump them back up again.

This bubble was financed, largely, by individual investors. And it is the Wall Street analysts and the media voices that helped turn the analysts into pseudo-celebrities who must now bear responsibility for the consequences. In sme cases we have even seen the spectacle of professional investors simultaneously purporting to be analysts, investors, and journalists all at once.

For nearly four years – from the Yahoo IPO in April of 1996, to the deluge of IPOs that spread across Wall Street in the first three months of 2000 – the analyst community on Wall Street, and the media organizations that covered them, engaged in what amounted to a massive, shameless and totally irresponsible free-for-all riot in pursuit of money.

I have included, with this testimony, a collection of stories and columns I wrote during this period that attempted to call the public's attention to the colossal pocket-picking to which it was being subjected. Most particularly, I wrote repeatedly about the outrageous situation in which IPO's would be offered to investment bank clients at a cheap "pre-market" price, even as the bank's analysts engaged in nonstop commentary designed to pump up demand for the stock among individual investors in the after-market. Then, when the stock would come public, the insiders would instantly dump their shares into the waiting and out-stretched arms of individual after-market investors at four and five times their pre-market price. Within hours thereafter, the stock price would collapse. You can call it what you want, but I view schemes like that as nothing more than swindles and fraud.

You may review the trading histories of literally dozens of tech-sector IPOs during this period and find precisely this pattern repeating itself over and over again. To that end, I would thus respectfully call the Committee's attention to the following IPOs, which are simply illustrative of the process I have described:

-- VA Linux Systems, Inc. (insider price: $30; First sale to individuals: $320.)
-- theGlobe.com, Inc. (Insider price $9; first sale to individuals: $97.)
-- WebMethods, Inc. (Insider price $35. First sale to individuals: $336.)

There are many, many more like them. These stocks, and countless more, were pumped to wildly unsupportable prices by impossibly grand claims from analysts regarding their potential as businesses. The fact that these claims echoed through the megaphones of TV and the Internet, to reach individual investors from every corner of the globe simply underscores just how much capital can be raised on Wall Street now that the whole world has access to the same information simultaneously. And this is only the first instance in which this unexpected alliance of analysts and the electronic media has come to bear on the market. Unless efforts are undertaken now to prevent a recurrence, we may look for even more disruptive performances in the future.

To that end, I would respectfully suggest consideration of the following:

■ That so-called Sec. 17B of the Securities & Exchange Act of 1933, which, in layman's terms, requires anyone who is paid by an issuer to circulate, publish or otherwise disseminate stock recommendations, be augmented to require, as a matter of law, that anyone publishing or disseminating such information disclose, on the same document in which the dissemination takes place, any financial interest, either direct or indirect, he or she may hold in the stock in question. It is not enough for self-regulatory bodies such as the Securities Industry Association and individual investment firms, to do this on a "voluntary" basis. In this particular area, volunteerism has shown itself to be inadequate, and the law should be brought to bear. If Sec. 17B of the 1933 Act does not violate anyone's First Amendment rights, then I doubt that the augumentation I have suggested would do so either.

■ Secondly, I believe that Sec. 10B of the 1934 Act, which deals with fraud on the market, should be aggressively enforced by the Securities & Exchange Commission. In the now famous Foster Winans case, a *Wall Street Journal* reporter ran afoul of the Act by using information obtained in the course of his work for that newspaper, to trade in stocks before publication of his stories – in violation of an agreement he signed with his newspaper not to do so. His essential violation thus amounted to promising not to do something, then doing it anyway. That basic principal can, and I think should, be applied to an implied covenant that can be presumed to exist between *all* disseminators of financial information that is offered to the public under color of impartiality. Any conflict of interest can be waived by disclosure, to be sure, but the regulatory authorities, and ultimately the Congress, can set clear, convincing and unambiguous standards as to what sort of disclosure constitutes adequate disclosure. The goal should not be the "minimum" disclosure necessary to give comfort to the disseminator of the information, but the minimum necessary to give comfort to the consumer of the information that he or she is being fully informed as any hidden agendas lurking in a recommendation.

I thank you kindly for our time and patience.

House Committee on Financial Services
31 July 01

Good morning Mr. Chairman my name is Charles L. Hill. I would like to thank Congressman Baker and members of the committee to let me give my views on this important issue.

Let me first mention the usual disclaimers. The views expressed here today are my personal ones and are not necessarily those of my employer, Thomson Financial / First Call, where I am director of financial research, or those of the Boston Society of Security Analysts, where I am a vice president and a director. I am a Chartered Financial Analyst and proud of it. My only aim today is to uphold and improve on the quality and the integrity of my profession.

The problems we are talking about today are not new. They tend to wax and wane with each stock market cycle. The only difference this time is that some of the problems may be worse than in past cycles. There do seem to be some secular trends underway that may have been exacerbated by the cyclical swing in the market, and that need to be corrected. Any prolonged corrections in stock prices tend to wring out some of the excesses we are talking about today. Nevertheless, some of the underlying secular trends are disturbing and it may take more than just a market correction to remedy the situation.

Let me point out that in this market downturn, as in past ones, investors always look for scapegoats. The broker analysts are always an easy target. There is no doubt some basis for this, but it is most probably overdone. Let the record show that even at the time of the market's frothiest peaks, there were many broker analysts doing very thorough and objective research. The problem was that there were not enough in this category. There were too many whose work was shoddy and/or biased because of naivete, laziness, or outside pressures.

But let's not paint all the analysts with the same brush. As a former sell side analyst for 18 years, I shudder at the thought of returning to that field and having to compete with the top analysts of today. With all the technology tools available today, there is no question in my mind that today's stock research from the top sell side analysts is better than that from the top analysts of 25 years ago. What we need to improve is the quality and objectivity of the work from the rest of today's sell side analysts that are not currently doing their job as well as they should.

Before we turn to the causes of deteriorating stock research quality, it is worth looking at how the problems of quality and bias can manifest themselves. There are four data items by which analysts can distort an investors perceptions of a company's stock, or leave the investor confused.

1. Recommendations

2. Target Prices
3. Earnings Estimates
4. Earnings Basis

1. Recommendations

This sub-committee has previously raised this issue and has cited our data. The rough rule of thumb is that about one-third of all broker recommendations are in the most positive category (strong buy or whatever the broker's equivalent term is), about one-third are in the second most positive category (buy or whatever the broker's equivalent term is), about one-third are in the third most positive category (hold or the equivalent), while only about 1% are in the two bottom categories (sell and strong sell or their equivalents).

The individual investor needs a decoder that would put all the brokers' various terminology for their recommendations on a common scale. The brokers are doing a better job of putting in each research report a definition of what their recommendation terminology means, making it easier for investors to compare one broker's recommendation with another. However, not all are doing this. A better answer might be if the brokers could agree on a common scale with common terminology.

Unfortunately, the investor needs a second level on their decoder to adjust for the over optimism of the broker analyst recommendations. Since the better companies get more analyst coverage then do the weaker companies, there is a justification for somewhat of a positive bias to the recommendations. As of the end of July, 27.6% and 36.9% of the recommendations were in the "strong buy" and "buy" categories, respectively. Only 1.1% and 0.4% were in the "sell" and "strong sell" categories, respectively. That means the number of buys of all kinds were 47 times the number of sells of all kind. That much of a positive bias is hard to justify.

Last year, when the market was at peak levels, and many stocks were substantially overvalued, the ratio was even worse. On 1 March it was 92:1. On 1 May it was 100:1. As the market began falling, the ratio was still a very high 99:1 on 1 August. By 1 October it was 78:1. And today it is 47:1. It is a bit hard to understand why the recommendations were even more positively biased than normal at the market peak.

2. Target Prices

Target prices are another area where the analyst has the opportunity to put their naivete or biases to work. Target prices became the rage in the late 1990's but their popularity seems to have abated slightly. Many were unrealistic, but many of the analysts that were providing those have lost considerable credibility.

3. Earnings Estimates

Most analysts most of the time tend to start out too high with their estimates as the earnings report time for that period draws closer. On average the analysts take the estimates too far near the end of the period. More than half the companies in the S&P500 beat the final estimates every quarter. Whether the analysts have been misled by the companies guidance, and whether they knowingly went along with that guidance is debatable, but there does seem to be a too regular pattern of companies beating the estimates, particularly at some companies.

4. Earnings basis

One of the problem areas that is mushrooming as a problem, but is often overlooked is the determination of the earnings basis used to value the stock. The SEC requires companies to report earnings on the basis of Generally Accepted Accounting Principles (GAAP). Most everyone would agree that those numbers often need to be adjusted to exclude non-recurring or non-operating earnings. The problem is what one person considers non-recurring or non-operating another may not. There is no "right" answer. It is all in the eyes of the beholder.

A big part of the analyst job is to determine the appropriate basis for earnings as used in the price/earnings ratio or other earnings based valuation yardsticks. A companies earnings can often be enhanced by excluding items that normally would not be or by including items that would normally be excluded. The excesses in this area have been most common in the technology sector, where the use of the "cash earnings" or "proforma earnings" have taken on a wide variety of special meanings that have greatly enhanced some companies earnings.

There is a growing trend for companies to put out releases that emphasize an earnings number that has been adjusted to a basis the company espouses, sometimes to the almost total exclusion of the GAAP results. While companies should have the right to present earnings on a basis of their choosing in addition to the GAAP numbers, there should be ample quantification and discussion of the unusual items the company believes should or should not be excluded or included. The company release should provide the investor with the tools to adjust the results to a basis the investor believes appropriate.

Whether the companies do this appropriately or not, it is still a big part of the analyst job to examine the information and decide what is legitimately included or excluded. Today, too many analysts are being spoon fed by the companies to go along with many in the investment community would consider inappropriate if more time had been spent on the determination and/or if the time had been spent more objectively.

The analysts are the ultimate gatekeepers on keeping the companies from gilding the lily by espousing a basis that is out of step with normal practices. Not every restructuring charge or investment gain or inventory writedown is the same so some leeway is necessary in deciding what should be excluded or included, but based on recent practices it seems the analyst need to be more discerning and/or more objective.

These are four places in their reports that analysts can mislead investors. They can do so in any of these areas by either not doing thorough enough research, by not exercising good judgment, or by not being completely objective. The cyclical downturn will hopefully weed out some of the analyst with the first two failings, but will do little about the objectivity issue.

Analyst objectivity is subject to pressure from four different places.

1. The Analysts Themselves
2. Investment Banking
3. Public Companies
4. Institutional Shareholders

1. The Analysts Themselves

It may seem odd to list the analysts themselves as one of the factors affecting analyst objectivity. This bias may be conscious or subconcious. For whatever reason, most analysts have fallen in love with the industry they cover (otherwise most that had not would have moved on to another industry that was more favorable in their eyes). Secondly, they have selected as their coverage list what they consider the best companies within their industry.

As a result, the analysts come to the table looking through rose colored glasses. Their optimism can be characterized as an honest bias, but on that, nevertheless, colors their thinking.

2. Investment Banking

The pressure from the investment banking side of an analyst's firm is the one that gets all the publicity. It is an easy one to make a good media story about. But let's not be too hasty to blame the brokers.

In the days when I was a sell side analyst (1970 to 1988), the monetary incentives for analysts were directed at how good their research was. The institutions directed certain percentages of their commission business to specified brokers in return for research services provided by those brokers. Letters were sent each quarter to the brokers saying how much of their commission business had been directed to those brokers for research and listing the analysts who were the most valuable to the institution sending the letter. The analysts named most frequently usually got the biggest share of the research department bonus, and most, if not all, of that bonus pool came from the commission business research produced. Any remuneration for investment banking work by the analyst might have added a little sweetener to the pot. It was the frosting on the cake. Today it is the cake in many cases.

But in those days the incentives were such that the analyst were able to be objective and were able to devote most of their research time to fundamental research on their industry rather than chasing investment banking deals.

But the buy side institutions need to look in the mirror. It is the old story. You get what you pay for. With commission rates driven to almost nil, and with a greater premium put on trading execution, the institutions are paying for research to the extent they once did. Therefore, the brokers have had to look elsewhere to find a way to compensate the analysts, which inevitably led to the investment banking side of the house. Until the brokers again get reasonable compensation for their research product, so analysts can again be compensated primarily by research, it will be difficult to restore the so-called Chinese Wall of old between research and investment banking.

3. Public Companies

The investment banking arms of some of the brokers are not alone in putting pressure on analysts to say only nice things about a company. Some of the companies themselves do the same. Again, compensation is the issue. Some managements have significant cash bonus or options tied to stock performance. There have been occasions when companies have threatened to cut analysts off from communications with the company if they do not toe the company line. The SEC's new Regulation FD does now provide some limited protection for the analyst.

4. Institutional Shareholders

Even the institution shareholders can wield some clout by making it difficult for analysts who put out research reports that cause any stocks the institution owns to decline in price while they are still major holders.

With all the pressures an analyst faces today that impact their research time and their objectivity, is not as easy to do as thorough and objective research as it was in the past. Let's not blame the broker analysts for all of the problems. It is important to look at the underlying causes and find ways to remove the pressures that are causing the problems. It is to easy to expect the broker analysts will be able to solve the problems on their own. It is up to all the interested parties to understand the underlying causes and sit down together to try and solve them. It is in the best interest of all parties.

TESTIMONY OF MR. MATT WINKLER
EDITOR-IN-CHIEF
BLOOMBERG NEWS
BEFORE THE HOUSE FINANCIAL SERVICES COMMITTEE'S
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT
SPONSORED ENTERPRISES
REGARDING
"ANALYZING THE ANALYSTS II: SOURCES OF ANALYST CONFLICTS"
JULY 31, 2001

MR. CHAIRMAN, I AM DELIGHTED TO HAVE THE OPPORTUNITY TO APPEAR BEFORE THIS SUBCOMMITTEE AS PART OF YOUR CONTINUING DISCUSSION ON ANALYZING THE ANALYSTS.

MY NAME IS MATT WINKLER, AND I AM THE EDITOR-IN-CHIEF OF BLOOMBERG NEWS, A GLOBAL NEWS SERVICE WITH 1,100 REPORTERS AND EDITORS IN 80 BUREAUS AND 50 COUNTRIES. BLOOMBERG NEWS PRODUCES MORE THAN 4,000 STORIES DAILY ON THE ECONOMY, COMPANIES, GOVERNMENTS, FINANCIAL AND COMMODITY MARKETS AS WELL AS SPORTS, POLITICS AND POLICY. MANY OF THESE STORIES ARE PUBLISHED IN MORE THAN 350 NEWSPAPERS, INCLUDING THE NEW YORK TIMES, WASHINGTON POST, LOS ANGELES TIMES, LE MONDE, AND DAILY YOMIURI. SINCE ITS INCEPTION IN 1990, BLOOMBERG NEWS HAS RECEIVED MORE THAN 50 AWARDS AND CITATIONS FOR THE QUALITY OF ITS JOURNALISM FROM THE

OVERSEAS PRESS CLUB, GERALD LOEB FOUNDATION, SOCIETY OF PROFESSIONAL JOURNALISTS AND THE SOCIETY OF AMERICAN BUSINESS EDITORS AND WRITERS. BLOOMBERG NEWS IS THE MAIN CONTENT PROVIDER FOR BLOOMBERG PRINT AND BROADCAST MEDIA. THESE INCLUDE SEVERAL MAGAZINES, A NEW YORK-BASED RADIO STATION AND NETWORK AND A 24-HOUR TELEVISION NETWORK OPERATING IN THE U.S. AND IN A DOZEN LANGUAGES IN COUNTRIES IN EUROPE, ASIA AND SOUTH AMERICA.

FINANCIAL STORIES ARE BOTH COMPLEX AND CRITICALLY IMPORTANT. AS SOMEONE WHO IS PASSIONATE ABOUT PROVIDING THE PUBLIC WITH THE CONTEXT AND ANALYSIS NECESSARY TO MAKE SOUND DECISIONS, I WANT TO SALUTE THIS COMMITTEE FOR ITS EXTRAORDINARY COMMITMENT TO ENSURING THAT INVESTORS HAVE BROAD ACCESS TO THE HIGHEST-QUALITY INFORMATION ABOUT THE MARKETPLACE. WHEN THIS COMMITTEE GREETS WITH SKEPTICISM EFFORTS TO CREATE A PROPERTY RIGHT IN STOCK MARKET QUOTES, IT IS TAKING A STEP TOWARD ENSURING PUBLIC ACCESS TO INFORMATION. WHEN THIS COMMITTEE EXPLORES THE IMPACT OF REGULATION FAIR DISCLOSURE OR HIGHLIGHTS THE QUESTION OF WHETHER INVESTORS ARE GETTING UNBIASED RESEARCH FROM WALL STREET, YOU ARE TAKING A STEP TOWARD ENSURING PUBLIC ACCESS TO INFORMATION. IN THE INFORMATION AGE, THAT'S NO SMALL ACCOMPLISHMENT.

IT MAY TAKE A BEAR MARKET FOR INVESTORS TO REALIZE THAT MANY

STOCK ANALYSTS HAVE NEVER BEEN ANYTHING MORE THAN FANCY PITCHMEN FOR THE FIRMS THAT SELL SECURITIES. AS LONG AS SHARES WENT UP AS THEY DID IN THE 1990S, ANALYSTS RARELY HAD TO SAY "SELL". IN THEIR LINGO, THE STOCKS WERE NEVER "FULLY PRICED". NOW THAT THE NASDAQ COMPOSITE, THE SYMBOL OF THE GREATEST BULL MARKET EVER, IS DOWN ABOUT 50 PERCENT FROM A YEAR AGO, IT'S EASY TO ATTACK THE ANALYSTS BECAUSE THE FEW OCCASIONS WHEN THEY MIGHT HAVE SAID SELL CAME LONG AFTER THE DAMAGE WAS DONE.

ANALYSTS ALWAYS WILL HAVE A CONFLICT OF INTEREST AS LONG AS THE FIRMS THAT EMPLOY THEM PARTICIPATE IN INITIAL PUBLIC OFFERINGS, ARRANGE STOCK AND BOND SALES AND USE ANALYST RESEARCH TO HELP WIN NEW BUSINESS. IN SUCH CIRCUMSTANCES, IT'S HARD TO FIND ANY ANALYST ON WALL STREET WHO MET A STOCK HE OR SHE DIDN'T LIKE. ANALYSTS ARE PART OF THE SALES TEAM.

IN A BULL MARKET, THEY APPEAR TO BE BRILLIANT. WHEN THE MARKET STUMBLES, THEY'RE SCAPEGOATS FOR EVERY INVESTMENT THAT SOURED. THE CURRENT OUTCRY OVER ANALYSTS' NEGLIGENCE SHOULD REMIND US OF CAPTAIN LOUIS RENAULT IN "CASABLANCA," WHO WAS SHOCKED TO DISCOVER GAMBLING IN RICK'S CAFÉ AS HE COLLECTED HIS WINNINGS.

ANALYST CONFLICTS OF INTEREST ARE A SYMPTOM OF SOMETHING MORE

SINISTER. UNTIL THE SECURITIES AND EXCHANGE COMMISSION LATE LAST YEAR APPROVED REGULATION FD (FAIR DISCLOSURE), PUBLIC COMPANIES ROUTINELY INVITED ANALYSTS AND SOME OF THEIR SHAREHOLDERS TO PRIVATE MEETINGS AS THEY DISCUSSED SALES, PROFITS AND LOSSES.

UNTIL ADOPTION OF REGULATION FD, ANALYSTS WERE PROTECTED UNDER LAW FROM INSIDER TRADING LIABILITY, AND LIABILITY FOR "TIPPING", IF THEY DID NOT HAVE A SPECIAL RELATIONSHIP WITH THE CORPORATE OFFICIALS THAT FED THEM INSIDER INFORMATION -- A MONETARY OR OTHER QUID PRO QUO. THAT PROTECTION WAS DESIGNED TO SHIELD ANALYSTS FROM UNLIMITED RISKS OF LIABILITY FOR ATTEMPTING TO FERRET OUT INFORMATION. IT QUICKLY BECAME PERVERTED HOWEVER, AS ISSUERS FIGURED OUT THEY COULD PUNISH ANALYSTS THAT DID NOT GIVE THEM GOOD RATINGS. THE PUNISHMENT CAME IN THE FORM OF EXCLUSION FROM THE INSIDE INFORMATION GRAVY TRAIN WHICH WAS PROVIDED TO THEIR COMPETITORS. INSIDE INFORMATION WAS THUS JOINED WITH ANALYSTS' RECOMMENDATIONS IN A TROUBLING FORM OF BARTER. IT WAS AS IF A STUDENT COULD PUNISH THE TEACHER FOR GIVING HIM OR HER A BAD GRADE BY WITHHOLDING THE TEACHER'S PAY.

IN SHORT, THIS PRACTICE OF SELECTIVE DISCLOSURE INCREASINGLY MADE THE STOCK MARKET A FINANCIAL "ANIMAL FARM," IN WHICH SOME SHAREHOLDERS WERE MORE EQUAL THAN OTHERS.

THE SLOPED PLAYING FIELD CREATED BY SELECTIVE DISCLOSURE DURING THE 1990S WAS SO COMMON THAT MANY ANALYSTS AND PUBLICLY-TRADED COMPANIES ASSUMED IT WAS THE PRICE OF CAPITALISM. ANALYSTS EQUIPPED WITH INSIDE INFORMATION, THEY ARGUED, WERE NEEDED TO GREASE THE WHEELS OF THE MARKET, EVEN IF THEY COULD TRADE ON THAT INFORMATION BEFORE AUNT BETSEY AND THE REST OF THE COMPANY'S SHAREHOLDERS.

THE SEC DISAGREED BECAUSE IN TOO MANY INSTANCES TRADING IN A COMPANY'S SHARES TURNED OUT TO BE RIGGED, UNDERMINING THE INTEGRITY OF THE STOCK MARKET. AMONG THE MORE EGREGIOUS EXAMPLES:

* ON DEC. 1, 1998, AS WESTERN DIGITAL CORP.'S STOCK SURGED 37 PERCENT ONLY A SELECT GROUP OF INVESTORS AT AN ARIZONA RESORT KNEW WHY THE DISK-DRIVE MAKER WAS HAVING ITS BIGGEST ONE-DAY GAIN EVER. MOST OF THE IRVINE, CALIFORNIA-BASED COMPANY'S 3,700 SHAREHOLDERS COULDN'T EXPLAIN THE SUDDEN SPURT THAT ADDED $427 MILLION TO WESTERN DIGITAL'S MARKET VALUE IN A FEW HOURS. THEY WEREN'T INVITED TO A ROOM WITH SILK-COVERED WALLS AT THE PHOENICIAN HOTEL IN SCOTTSDALE WHERE THE COMPANY'S CHIEF EXECUTIVE CHARLES HAGGERTY SAID BUSINESS WAS GETTING MUCH BETTER.

* ON NOV. 20, 1998, BARNES & NOBLE INC. SHARES FELL 9.4 PERCENT AFTER THE LARGEST U.S. BOOKSELLER TOLD ANALYSTS ON A

PRIVATE CONFERENCE CALL THAT COSTS TO ADVERTISE THE NEW YORK-BASED COMPANY'S INTERNET BUSINESS WOULD BE GREATER THAN EXPECTED. BARNES & NOBLE SHARES FELL 3 TO 29 IN TRADING OF 3.9 MILLION SHARES, FIVES TIMES THE THREE-MONTH DAILY AVERAGE.

* ON AUG. 12, 1999, DURING THE FIRST 30 MINUTES OF TRADING, MARK TRAUTMAN WATCHED THE MARKET VALUE OF CLOROX CO. DROP BY $1.8 BILLION, OR 14.5 PERCENT, COSTING HIM $1 MILLION. THE BLEACH MAKER HAD REPORTED A 6 PERCENT GAIN IN FISCAL-FOURTH QUARTER PROFIT ON A 3 PERCENT DROP IN SALES.

TRAUTMAN, WHO HELPED MANAGE $65 MILLION AT SHAY ASSET MANAGEMENT, WAS CONVINCED SOMETHING ELSE HAD CAUSED CLOROX STOCK TO DROP 15 POINTS. LITTLE DID HE KNOW THAT CLOROX CHAIRMAN CRAIG SULLIVAN WAS TELLING SOME INVESTORS AND ANALYSTS ON AN INVITATION-ONLY CONFERENCE CALL THAT PROFIT WOULDN'T MEET EXPECTATIONS FOR THE NEXT TWO QUARTERS.

MR. TRAUTMAN, A CLOROX SHAREHOLDER, TOLD BLOOMBERG NEWS "IT'S OUTRAGEOUS THAT I DIDN'T HAVE THE SAME INFORMATION AS SOME OTHERS…I WAS COMPLETELY IN THE DARK."

UNTIL REGULATION FD, SUCH BRIEFINGS AMOUNTED TO LEGALIZED "INSIDER TRADING," ACCORDING TO THE CONSUMER FEDERATION OF

AMERICA, A WASHINGTON-BASED NON-PROFIT ADVOCATE FOR ABOUT 50 MILLION PEOPLE.

WHAT PRECISELY DOES REGULATION FD HAVE TO DO WITH ANALYST CONFLICTS OF INTEREST? EVERYTHING. CONFLICTS AND BIAS BREED IN THE DARK. THE MORE INFORMATION THAT IS AVAILABLE TO THE PUBLIC, THE GREATER OUR COLLECTIVE ABILITY TO ASSESS INDEPENDENTLY WHETHER THE ANALYSIS WE ARE RECEIVING IS POTENTIALLY BIASED.

DOES REGULATION FD "SOLVE" THE PROBLEM OF ANALYST CONFLICTS? OF COURSE NOT. I'D REPEAT, AS LONG AS FIRMS EMPLOY THEM TO PARTICIPATE IN INITIAL PUBLIC OFFERINGS, ARRANGE STOCK AND BOND SALES AND USE ANALYST RESEARCH TO HELP WIN NEW BUSINESS, ANALYSTS ALWAYS WILL HAVE A POTENTIAL CONFLICT OF INTEREST.

ANALYSTS WILL ALWAYS HAVE MORE INFORMATION THAN NON-ANALYSTS. SOME CHECK ON ANALYSTS' BEHAVIOR WILL FLOW FROM INSURING THAT THE PUBLIC AT LEAST HAS AN OPPORTUNITY TO ACCESS MATERIAL NONPUBLIC INFORMATION WHEN AN ISSUER MAKES IT AVAILABLE TO ANALYSTS.

INITIATIVES THAT ENHANCE THE BROAD DISSEMINATION OF INFORMATION TO THE PUBLIC WILL HAVE A SALUTARY IMPACT. JUSTICE BRANDEIS IS REMEMBERED FOR OBSERVING:

> PUBLICITY IS JUSTLY COMMENDED AS A REMEDY FOR SOCIAL AND INDUSTRIAL DISEASES. SUNLIGHT IS SAID TO BE THE BEST OF DISINFECTANTS; ELECTRIC LIGHT THE MOST EFFICIENT POLICEMAN.1

LIKE SEEING A POLICEMAN IN THE REAR VIEW MIRROR OR KNOWING A CONGRESSIONAL OVERSIGHT COMMITTEE IS LOOKING OVER YOUR SHOULDER, THE AVAILABILITY OF INFORMATION ENHANCES ACCOUNTABILITY. THAT SERVES AS A CATALYST THAT SOMETIMES PRODS BETTER BEHAVIOR, AND THAT'S VERY MUCH IN THE PUBLIC INTEREST.

IN THE CONTEXT OF ANALYSTS AND ISSUERS, FORCING THE ISSUERS TO REFRAIN FROM SELECTIVE DISCLOSURE OFFERS SOME HOPE THAT THEY WILL GIVE THE PUBLIC AN EQUAL OPPORTUNITY TO KNOW PERTINENT DEVELOPMENTS OF THE COMPANY AT THE SAME TIME AS THE ANALYSTS. THAT PUTS THE ANALYSTS TO THE TASK OF PROVIDING INVESTMENT ANALYSIS RATHER THAN ACTING AS TIPSTERS. IT FREES THEM OF AT LEAST SOME OF THE PRESSURES THAT THEY NOW FEEL TO SAY "HOLD FOR THE LONG TERM" OR SIMILAR CODE WORDS WHEN THEY MEAN "SELL". TO BE SURE, MANY ANALYSTS WILL HAVE TO CHANGE THEIR APPROACH, BUT THAT CHANGE SHOULD BRING MORE INTEGRITY TO THEIR ANALYSIS, AND GREAT BENEFIT TO THE MARKETPLACE.

AGAIN, I COMMEND YOU FOR YOUR WILLINGNESS TO EXPLORE THE IMPORTANT ISSUE OF ANALYST CONFLICTS.

###

1. L. BRANDEIS, *OTHER PEOPLE'S MONEY AND HOW BANKERS USE IT* 62 (1914).

House Financial Services Committee

Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee hearing to examine conflicts in Wall Street research practices

July 31, 2001

Testimony of Kei Kianpoor, CEO Investars.com

Netologic Inc.
Investars.com

Background: Investars.com

On behalf of the Investars.com team, I am honored to have the opportunity to contribute to these hearings and help restore confidence in Wall Street research.

We founded Investars in the fall of 1999 because we felt that investors needed historical perspective on the stock recommendations issued daily by investment bank analysts. With so many investors new to the market and showing a strong reliance on professional market research, we sought to enable investors to "examine the source" when a recommendation was issued – that is, to provide a means of assessing the investment bank's track record on the stock in question, on a given sector, and overall.

We developed a ranking system that takes brokerages at their word on stock recommendations, hypothetically investing or withdrawing money on a fixed scale depending on the recommendation type. All recommendations made for a given stock since Jan. 1, 1997 (or shorter time periods selected by the user) are factored into the firm's rate of return for that stock, and the complete portfolio of a firm's recommendations is compiled to form its overall Rate of Success Score (ROSS). The information is updated daily. Rankings spotlight investment firms, not individual analysts, tracking the performance of more than 250 institutions on individual stocks, industry sectors, and overall.

In addition to these institutional rankings, our site offers:

- An "IPO Underwriters" feature that compares investment banks' track records for stocks they have underwritten to their track records for stocks that they have not underwritten.

- Tradeplotter Charts, which graph a firm's recommendation history on a given stock against that stock's performance, offering a visual snapshot of the firm's track record for that stock.

- An Independent Research Ranking system, launching this week, that will connect investors to hitherto unknown small research firms that may have outperformed Wall Street's large investment banks.

As the name "Investars" indicates, our original intention when the service was conceived at the height of the recent boom was to identify "star" performers on given stocks and in given industries – that is, to help investors determine whose advice to follow. That intention endures. At the same time, the bursting of the tech bubble and subsequent scrutiny of the investment banks' role in inflating stock prices has thrust upon us a complementary mission: to help the investment community reform itself by providing new vehicles for accountability.

It so happened that by the time Investars.com was ready to launch in May of this year, the ROSS returns highlighted in our investment bank rankings were startlingly poor. As of our 5/29 launch, only four of the 19 banks that had issued recommendations on at least 500 stocks since Jan. 1, 1997 showed positive overall ROSS returns, and only two banks showed returns of over 5% . Complementing this grim overall picture, TradePlotter charts showing single-bank track records on bellwether stocks showed many roads to hell paved with good recommendations – for example, multiple reiterated "buy" recommendations following a stock price slide all the way down from triple digits to single.

Meanwhile, our new users' most frequent query was, "can you incorporate banks' IPO involvement into their track records?" Our ROSS methodology made it relatively simple to track "IPO Underwriter" performance – that is, compile each bank's collective ROSS return for stocks in which it managed or co-managed the IPO, and contrast that return with the bank's score on "Non-IPO" stocks.

On June 12, 2001 we reported that for the banks that had covered at least 500 stocks since Jan. 1, 1997, the average "Return for Stocks Without IPO Relations" was negative1.08%. But the average "Return for Stocks With IPO Relations" was a startling negative 51.27%. Thus the average "IPO Bias" – the difference between returns on IPO-led and Non-IPO-led stocks – was 50.76%.

Toward a Market Solution: New Forms of Disclosure

Possible explanations for this manifest "IPO Bias" have been copiously documented in recent months. Rather than reiterate, we will let the data speak for itself – and also point toward a means of reform that requires minimal regulation. Our brief is simple: disclosure is the cure. Mandating a freer flow of information will stimulate a market cure for the real and apparent conflicts of interest that have led to intense scrutiny of analyst practices and deeply shaken investors' confidence in the research issued by brokerages.

If average American investors are to make effective use of research produced by market professionals, they need tools to determine which of these market professionals are worth listening to. Assessment of this kind is possible only if the investment banks fairly disclose the facts. The heavy losses that investors suffered over the last year were aggravated by a system that lacked fair disclosure.

Regulators, investment banks, business information providers, and the media should join together to provide a freer flow of information to all investors, individual as well as institutional. Hindsight has made it clear that the boom-and-bust of the past four years did not leave lasting benefits for any constituency. Investors have suffered, businesses built on unrealistic premises have collapsed, and the brand equity of many brokers whose businesses depend on public trust are being eroded as we speak. We must join forces to implement common sense reforms that will benefit all parties.

Investment banks should:

1. make historical recommendation and earnings estimate data public;
2. fully disclose historical and current investment banking relationships; and
3. adopt a common recommendation language.

I. Make Public Data Public

The first issue is the distribution of Wall Street recommendation and earnings estimate data. Individual investors suffered in the recent boom-and-bust cycle because they lacked key facts. They lacked these facts because there was and continues to be a monopoly on the distribution of historical data.

Historical data on Wall Street recommendations and earnings estimates is key to being able to analyze track records. However, investment banks are generally unwilling to distribute historical data to individual investors. Many investment banks distribute their historical and current data to a small coterie of companies including Thomson Financial (First Call and IBES) and Multex, with the understanding that the data will only be made available to institutional investors. This system, which enables select companies to control and profit from the distribution of data, does not serve the public. Data distributors should make their money based on value added analysis, not the mere ownership of history.

BulldogResearch.com, one of the first companies to analyze the track records of investment banks, was unable to rank several investment banks due to this data monopoly. Another company that analyzes the track records of investment banks, Another company that analyzes the track records of investment banks, MarketPerform.com, was told By Multex and IBES (a Thomson Financial company) that Multex and IBES have agreements with financial institutions which do not allow them to sell historical earnings and rating changes data to public sites. When Investars.com sought to purchase recommendation data from Thomson Financial, we were told that since we distributed the information to individual investors we could not buy the data.

Validea.com, another services devoted to "analyzing the analysts," has also suffered from the lack of free information flow. Keith M. Ferry, Validea.com's President, has stated, "It is quite frustrating and rather confusing that Validea cannot re-distribute Wall Street recommendations to individual investors. Thomson Financial will not allow Validea to license the FirstCall/IBES recommendation data set if the intent is to provide this information to the average investor. We feel the continued unwillingness of the investment banks and data distributors to share this information with investors, along with objective performance statistics, is an injustice and needs to change."

As a first reform, Investars.com proposes that all historical recommendation and earnings estimate data made by investment banks and research firms be made available to <u>all</u> investors. The public stock recommendations of investment banks should be a matter of public record and preserved in a public venue such as an SEC database. Just as companies are required to file 10K forms with the SEC, so should investment banks be required to file their research data with the SEC.

<u>II. Full Disclosure of Investment Banking Relationships</u>

The second issue that we need to address is the disclosure of investment banking relationships. Investars.com's "IPO Bias" data highlights the fact that investment banks brought to the public markets many companies with questionable business models and recommended that the public buy stock in these companies. The possibility of conflict of interest was not obvious to investors, who lacked the historical data to assess which firms historically have had an IPO Bias and which ones have not.

As a second reform, Investars.com proposes that investment banks disclose to an SEC database their historical underwriting relationship with any company for which they offer research coverage. Important as such disclosure is, however, it is not an end in itself. Disclosure is only raw data. We call on the media, online brokers, financial advisors, research firms and sites such as Investars.com to educate and protect the public by placing this information in context. We are now able to provide far more detail than "bank X upgrades stock Y." In seconds we can explore an investment bank's track record and conduct a detailed peer group analysis. If full disclosure is not contained in the report, we should emphasize the implications of its absence.

III. Adopt a Common Language

The third issue that we need to address is Wall Street's language. Currently, the average investor needs to know the lingo of more than 200 investment banks and research firms using dozens of different rating scales. Even more disturbing, the language of Wall Street analysts has diverged dramatically from plain English. As Mr. Chuck Hill of Thomson Financial explained in a recent Dow Jones article, "it's widely understood on Wall Street that analysts' recommendations are inflated. For example, to the uninitiated a 'neutral' rating might suggest the analyst is neither favorably nor unfavorably disposed toward a stock… a 'neutral' rating by most investment firms really means 'sell.'" While institutional investors may understand Wall Street's language, individual investors should not need a degree in deconstruction to interpret this "brokerspeak." Investars.com recommends that Wall Street adopt a common rating scale and roll back the grade inflation. Such reforms are simple to implement.

Conclusion

It is important not to lose site of the beneficiary of these hearings: the average American investor. All investors must be equipped to assess the quality and integrity of professional market analysts. It is common sense – when you buy a car, you check consumer reports. When you buy a house, you have it inspected A new species of business information providers like Investars.com is creating the tools that give individual investors the ability to analyze the analysts. Although the virtual monopoly on historical data has thwarted the growth of this new industry, new tools have been developed that go a long way toward enabling the public to identify the best and most impartial research on Wall Street.

Research professionals should welcome this new accountability. It is true that our data indicates that in recent years analysts have on average under-performed the market and that analysts are less objective on stocks underwritten by their firms. However, lumped in this "average" are "star" analysts who are the least mentioned victims of the recent carnage. The value of Investars.com lies in helping investors identify the firms that did not allow chaos to cloud objectivity and highlight firms with successful track records.

The so-called "greater fool" market theory states that no matter how much a stock is worth, investors should buy it if they think that there would be a greater fool willing to buy it at a higher price. As long as individual investors don't have the same information as institutional investors, they will forever be the "greater fools" in the market.

In conclusion, we need to have a standard language and facilitate the flow of accurate information. Disclosure will allow the market to make Wall Street accountable. We now possess the technology to refer to an analyst's batting average and provide play-by-play commentary on their ratings. If we can publicize the good and the transparent and flag the foggy and the deficient, heightened investor awareness will enforce industry compliance with higher standards. Market forces will weed out firms who fail to regain public trust.

I am grateful for the opportunity to share our views with you today. Thank you.

Testimony of:

Adam Lashinsky
Silicon Valley columnist
TheStreet.com
(415) 733-8336
alashinsky@thestreet.com

July 31, 2001
House Committee on Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
2128 Rayburn House Office Building

"Analyzing the Analysts II: Additional Perspectives"

I. Nobody explained the game to the new players.

When I first started covering financial news and set out to write about publicly traded companies, I was told to look for sources in the *Nelson's Directory of Investment Research*. All I knew about the "analysts" listed in Nelson's, the pre-Internet Bible on Wall Street coverage, was that the people listed followed the companies I was investigating. If I needed a quote on, say, Caterpillar, I'd flip to the Caterpillar page in Nelson's and start dialing, hoping to find an analyst who'd return my phone call and say something germane on the record. I knew nothing about the firm where the analyst worked, nothing about the investment-banking ties the analyst may or may not have had, nothing about the difference between a "sell-side" and "buy-side" analyst, and almost nothing about which analysts were better than others. (A star next to an analyst's name meant she was a member of the all-star research team chosen by *Institutional Investor* magazine, a distinction whose methodology I didn't understand.) All I knew was that an analyst who returned my phone call was more valuable than one who didn't. Nobody explained it to me in any greater detail.

It took me a few years to figure out the answers to these questions. But by the time the tech-stock boom began in the mid-1990s and I was covering tech stocks in Silicon Valley, I did understand. Unfortunately for the individual investor who plunged into the stock market around the same time, nobody bothered explaining these things to him. The average neophyte investor found himself with about the same level of understanding about how the Wall Street research game is played as I had when I was a cub reporter 10 years earlier.

Consider the ramifications. An investor seeing "an analyst" plugging a stock on CNBC or in the *San Jose Mercury News*, where I worked before joining *TheStreet.com*, had every reason to believe that the analyst in question was a credible source, an objective observer of a company's financial prospects and therefore of its stock-market value.

The entry of the confused investor into the stock market wasn't a trivial event, as we know now. Forrester Research estimated that total online brokerage accounts, a decent proxy for individual investors, will grow from 5.3 million accounts in 1998 to 14.3 million in 2002. Another analysis estimates that retail trading accounted for 35% of the total volume on the Nasdaq in 1990 and spiked to nearly 60% in 2000. For the first time in the history of the U.S. capital markets the amateur investor on Main Street was having as much an impact on share prices as the professional investor on Wall Street. Old-timers (anyone trained in financial analysis before roughly 1995) decried the lack of attention to fundamentals. But the amateurs, often listening to the respected "analysts" on the tube, made gobs of money as the Nasdaq composite index marched from less than 1,000 in 1995 to more than 5,000 in early 2000. For reference, the composite currently stands at about 2,000.

Individual investors were justifiably angry that the sources they trusted for their investment advice had served them so poorly. If it's any comfort, individuals didn't fare much worse than professionals, who also believed we had entered a new economy where fundamental value didn't matter.

So let's cover briefly what professional investors understood all along and what individuals, with the help of this committee and instruction from the Securities and Exchange Commission, have come to understand. In short, Wall Street analysts by and large are part of the investment-banking operation of their firms. They receive a chunk of their compensation based on the corporate finance and M&A advisory fees their colleagues collect. Their part of the bargain is to provide research that makes their firms and themselves prominent without embarrassing either their firms (with research that criticizes a banking client) or themselves (with research that predicts poorly which way stocks will go).

Based on my conversations with hundreds of research analysts and institutional investors, there is no doubt that the "game" has become more egregiously abused over time. Two factors have led to this. One is simply the huge uptick in investment-banking opportunities during the technology-stock bubble. At the same time, thanks to Big Bang reforms of the 1970s, trading commission fees earned by brokerages have become commoditized. The money isn't in trading when investors pay fractions of a penny to trade a share of stock. The money is in banking, and analysts are part of the banking process.

The key to understanding the so-called scandal this committee seeks to investigate is that the game has been well understood for years. Institutional investors -- analysts and portfolio managers who work for pension funds, mutual funds and sophisticated hedge funds -- long ago stopped relying on equity analysts to help them make buy-sell decisions. These investors know about -- and generally are unbothered by -- the blatant conflicts of interest that exist on Wall Street. When three investment banks underwrite the IPO of a small technology company and 26 days later -- surprise, surprise -- analysts for those three, and only those three, brokerages initiative coverage on the stock, it is obvious to careful observers that a connection exists. This situation doesn't alarm the experienced investor. But nobody told the amateurs who were new to the game.

II. The role of the financial news media.

As I began to understand how Wall Street works, I made it a standard practice in my reporting to point out these conflicts. Just because an analyst worked for the investment bank that took public a company I was covering didn't mean I wouldn't talk to the analyst about the stock. I just wanted to be sure my readers understood the pros and cons of this analyst's perspective. After all, while the analyst might be predisposed to be positive about his client, he also tended to know the company better than an analyst who didn't have extensive access. These are trade-offs.

TheStreet.com started in late 1996 with the same principles I already was using. From the beginning it was standard operating procedure to mention any investment-banking conflicts any time an analyst commented on a stock. The goal, according to Dave Kansas, former editor in chief of *TheStreet.com*, was to make sure the reader understood that an analyst was "not some disinterested professor pontificating from the ivory tower" about a stock. That didn't make the person a bad source, just one colored by their experiences, as are we all.

TheStreet.com didn't get everything right. We shined a bright light on analysts. But at the same time we did our share to hype the momentum stocks of the era. We created the Red Hot Index -- notice that it hasn't been mentioned much lately -- which tracked the performance of the sizzling technology stocks of the late 1990s. And we wrote favorably about IPOs on the assumption that new offerings would continue doubling, tripling and quadrupling upon their introduction. Our own shares rose nearly four-fold on their first day of trading in May, 1999, so we benefited from the phenomenon we were covering.

Other financial-news outlets also pointed out analyst conflicts, but none with the formulaic and purposeful attention of *TheStreet.com*. Most financial news media quoted stock analysts the same way I did when I first started covering business in the late 1980s: Analysts who returned phone calls were the most valuable.

The diligence or oversights of print or online journalists, however, paled in comparison to the influence of broadcast journalism, especially CNBC. For years, CNBC acted as if conflicts of interest simply didn't exist. Analysts weren't questioned on their conflicts, fund managers weren't asked their positions in stocks they discussed. Yes, CNBC humorously pilloried flip-flopping analysts by comparing them to penguins. But no institution, in my opinion, did more to sell hyped-up stocks to poorly informed individual investors than CNBC during the late 1990s. By the way, there is undoubtedly a correlation between bullish hype and ratings. It always was in CNBC's interests to hype stocks because rising stocks meant greater viewership.

In sum, the media in general failed the investing public by failing to provide skeptical analysis about the stock market. After all, an investment bank's job is to sell. The media are supposed to scrutinize. If the financial media had been as critical of Wall Street as political reporters are of Congress, it's possible, though unlikely, that the bubble wouldn't have become as inflated as it did. Many skeptical journalists have much to be proud of for their work during the bubble era. But many should be ashamed of strapping on their pom-poms and simply cheerleading along with the salesmen.

III. The pressures analysts face.

This committee is better off hearing from analysts about the pressures analysts face. But I talk to analysts and their clients every day, and I can give you some insight. One prominent analyst I know once described his job as having to be willing to come into work each day and get clobbered repeatedly by a two-by-four. Who's delivering the punishment? By turns: Retail brokerage clients unhappy with a recommendation that didn't work out, companies bothered by unfavorable commentary, institutional brokerage clients displeased at not getting the early word, investment banking colleagues peeved that some report hurt a deal. And so on.

This isn't to make you feel sorry for analysts. It's just that one begins to understand how a profession so badly conflicted could try so hard to please so many and end up pleasing so few.

And it's important to point out here, again, who's complaining about rotten research and who isn't. The primary audience for Wall Street research is the institutional investors who are trading clients of the firm -- the ones who understand best what the research is worth. They aren't typically disappointed by the quality of the work, at least not enough to complain about it. If they are disappointed, they hire their own researchers to investigate companies. All the best investors conduct their own research and use the sell side to supplement their data and test their conclusions. Who's left? The individual, who typically is not paying for the research but is reacting to things he or she heard on television. Let me state that a different way: The people complaining loudest about the quality of Wall Street research generally are the people who aren't paying for it.

IV. Solutions.

This committee seems to be taking the approach that its best role is to use its bully pulpit to get the market's participants to clean up their act rather than to propose structural reform. As a columnist and observer of the capital markets, I support that approach. Analysts should be encouraged to disclose their conflicts of interest. Reporters should be urged to be critical. Investors should be admonished to do their homework before buying securities. Investment banks should be embarrassed at the way they have misled the general public.

But there are other, more radical, approaches Congress, together with the SEC, could take.

A. **Split investment banks from brokerages.** This step flies in the face of the last decade of financial services reforms intended to allow consolidation of the industry. But if the government feels that the public is being hurt by the system as it exists today, take apart the system. Brokerages that didn't have investment-banking arms no longer would be conflicted by investment-banking pressures. Investment banks could distribute research to whomever they liked, but it would be clearer whose interests they serve. Brokerages, of course, would find it difficult to make money under such a scenario. Conversely, perhaps all that's needed is a semantic shift. Perhaps if investment banks somehow were more honest about the fact that their research arms already lack independence then the charade would be over and everyone would be happier.

B. **Allow fixed-rate minimum commissions**. When Congress threatened the exchanges with price-fixing charges, it began the end to institutional investors paying for research. If trading isn't profitable, the brokerages will find other ways to make money. But if they could charge some clients more, those clients likely would be willing to pay for the privilege of receiving independent research. Research, after all, isn't public information the way the public filings of listed companies are. The way the system works today, however, brokerages don't try to make money on research, essentially because they are not allowed to.

C. **Require greater disclosure.** This process is underway, led by a series of best practices suggested by the Securities Industry Association. These are guaranteed to be little more than palliatives. It will help a paying client to know the conflicts of an author of a report, but only so much. Similarly, firms restricting stock ownership by analysts will have little impact. The big money is in investment banking, not trading for one's personal account. These are matters properly addressed by a firm's own compliance department, not Congress.

D. Support Regulation FD. The job of being a research analyst has become more difficult since Oct. 2000, when the SEC promulgated Regulation FD, for "fair disclosure." Because public companies must disclose all material information simultaneously, analysts with good social skills or financial muscle with senior management no longer have an edge. This is a good thing. In order to be effective, analysts must analyze again. An analyst recently wrote me an e-mail complaining that companies had to be allowed to supply him with a financial model. Otherwise, how could investors know what to expect? I reminded him that it is his job to build a model based on his research. Good modelers will make good money for their clients; bad ones will not. A dangerous move is afoot by the securities industry and some elements within the SEC to weaken FD. If Congress wants to do right by the individual investor and force analysts to analyze, it should throw its support behind Reg FD.

V. Conclusions.

Wall Street research during and after the stock-market bubble has become something of a joke. Analysts went from unknowns to superstars to goats in the span of five years. Fortunately, the market has a wonderful self-correcting mechanism. To restore its credibility, Wall Street is trying to promote the appearance of objectivity and independence in its research departments. Individual analysts are struggling to keep up in a Reg FD world and one where most of the participants now have the fabled decoder ring that lets them understand what analysts mean when they say buy, accumulate and hold, but rarely sell. As well, my sense is that the financial news media generally is embarrassed by its role and is correcting the situation by embracing its natural skepticism again.

For the time being, the investment-banking conflict will diminish because there is so little investment banking being committed. The key for this committee is to determine what regulatory oversight will be needed, if any, when the investment-banking machine cranks itself up again.

O