

Report for Congress

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Enron and Stock Analyst Objectivity

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Summary

Stock analysts provide research on companies and make recommendations on their stocks. When analysts are employed by brokerage firms and provide information for the firms' retail and institutional clients, they are called sell-side analysts. Analysts who work specifically for institutional investors like mutual and pension funds are known as buy-side analysts. Because of their widespread presence in the national media, sell-side analysts' recommendations have become part of the public domain and they can have significant influence on stock prices.

Enron is the former Fortune 500 company which on December 2, 2001, made the largest bankruptcy filing in U.S. history. It is now under investigation by various governmental agencies and is the subject of congressional hearings. Like many corporations, maintaining a strong and generally growing stock price was an integral part of Enron's overall financial strategy. Throughout its expansionary phase from the late 1990s to 2000, Enron worked at and generally received the continuous support of sell-side analysts. The general absence of sell-side analyst skepticism of Enron persisted through November of 2001 with virtually none of the analysts covering Enron urging investors to sell.

The performance of the stock analysts in the Enron case has rekindled interest in the issue of analyst objectivity, a subject that had received earlier attention in SEC studies and investor warnings and congressional hearings. The fundamental concern is that sell-side analysts have had their independence compromised as they have become closer to their firms' investment banking arms. Indications are that analysts employed by firms with investment banking ties to Enron seemed even less inclined than other analysts to issue sell recommendations on its stock.

In February 2002, Representative Michael Oxley, Chairman of the House Financial Services Committee, and House Capital Markets Subcommittee Chairman Richard Baker announced new rule proposals that would attempt to reduce the ties between analysts and investment banking. Among other things, the rules would require that the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) prohibit analysts from reporting directly to investment bankers and prohibit analysts from receiving compensation for specific investment-banking deals. The SEC approved the rules in May and it, the NASD, and the NYSE are investigating analyst conflicts of interest concerns at major Wall Street firms. Major corporate accountability legislation, the Sarbanes-Oxley Act of 2002 (P.L. 107-204), signed into law by the President on July 30, 2002, would, among other things, limit analysts' supervision and compensation evaluation to personnel not involved in investment banking. Meanwhile, analyst conflicts of interest problems at major Wall Street firms are being investigated by a consortium of states led by New York, which reached an April 2002 settlement with Merrill Lynch that included penalties, and some analyst reforms. In late December 2002, the SEC, the NYSE, the NASD, and state regulators, reached an agreement with other top investment banks, including Bear Stearns, and CS First Boston that includes fines, the insulation of research from investment banking, and the subsidization of independent research, but no admission of wrongdoing.

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Enron and Stock Analyst Objectivity

Introduction

Stock analysts¹ provide research on companies and make recommendations on their stocks. When stock analysts are employed by and do analysis for brokerage firms and the firms' retail and institutional clients, they are called sell-side analysts. Many institutional investors are clients of such brokerage firms and pay attention to their analysts' research. Some sell-side analysts work for brokerage firms, including large Wall Street firms that also do investment banking work such as underwriting securities offerings and consulting on mergers and acquisitions. A smaller number work for brokerage firms that do not do investment banking. There are also a small number of outfits that are not brokerage firms and provide similar stock research and analysis. Some analysts work specifically for institutional investors like mutual and pension funds and are known as buy-side analysts.

Originally, only a limited number of people had access to sell-side recommendations and analysis. However, by the 1990s, the large growth in the number of small stock investors, and the emergence of the Internet and financially oriented television boosted interest in sell-side analysts' recommendations. Many sell-side analysts' recommendations to "buy," "sell," or "hold" particular stocks have become part of the public domain with potentially significant influence on the market's pricing of stocks. Along with outside auditors, boards of directors, and regulatory agencies like the Securities and Exchange Commission (SEC), stock analysts have been thought to play a role as watchdogs for the interests of corporate shareholders. Thus, for many observers, the surprising and sudden implosion of the Enron Corporation has raised serious questions about sell-side analysts' objectivity. If investors cannot rely on their analysis and advice, especially when the other watchdogs also may have failed, confidence in the markets can be seriously undermined to the potential detriment of the economy.

Enron's Stock Performance

Enron is the former Fortune 500, energy-trading conglomerate, which on December 2, 2001 filed the largest bankruptcy petition in U.S. history. Enron is now the defendant in shareholder law suits, under investigation by the SEC, the Justice Department, and the Labor Department, and subject of numerous congressional hearings and investigations. As with many corporations, maintaining a robust and generally growing stock price was an integral part of Enron's overall

¹ Stock analysts may also be called securities analysts and financial analysts.

financial strategy. It also may also have figured into its downfall. The *Wall Street Journal* observed:

No longer is a higher stock price simply desirable, it is often essential, because stocks have become a vital way for companies to run their businesses. The growing use of stock options as a way of compensating employees means managers need higher stock prices to retain talent. The use of stock to make acquisitions and to guarantee the debt of off-the-books partnerships means, as with Enron, that the entire partnership edifice can come crashing down with the fall of the underlying stock that props up the system. And the growing use of the stock market as a place for companies to raise capital means a high stock price can be the difference between failure and success. Hence, companies have an incentive to use aggressive – but, under the rules, acceptable – accounting to boost their reported earnings and prop up their stock price. In the worst-case scenario, that means some companies put out misleading financial accounts.²

Figure 1. Enron’s Stock Price and Trading Volume, March 1998 - February 2002



Source: BigCharts.com

Between 1998 and August 2000, Enron’s stock price per share rose from the \$20 range to its historical high of about \$90. In early 2001, in the aftermath of the dot.com meltdown, the stock began a descent which was accelerated by a series of depressing corporate reports and developments starting with the unexpected resignation of its chief executive officer (CEO), Jeffrey Skilling, in August 2001.

² Steve Liesman, “Many Accounting Practices Are Difficult to Penetrate,” *The Wall Street Journal*, Jan. 23, 2001, p. C1.

There were numerous examples of the importance to Enron of having a robust and growing stock price: In a number of cases, Enron's corporate acquisitions were at least partially financed by the transfer of Enron stock. Acquisitions which involved Enron stock allowed the company to conserve its cash and limit its use of debt, thus helping it to maintain its critical investment grade credit ratings. Many of Enron's now controversial off-balance sheet partnerships depended on a "safety-valve" design which in the event of a downgrade of Enron debt, would grant stock to the partnership investors. The contingent stock commitments helped make the partnerships creditworthy. This worked as long as Enron's stock did not fall.³

Analysts' Performance on Enron

During the course of their ongoing corporate research, sell-side and sometimes a few independent analysts advise investors to buy, sell, or hold stocks, although the terms they use may vary from firm to firm. At times, the recommendations have qualifiers such as a "strong" buy.

By September 2001, Enron stock had lost 60% of its 2001 high value. The company had just gone through the surprising departure of its CEO, and its broadband initiatives were floundering. Still, according to one tally, 16 of the 17 sell-side analysts covering the company were either issuing "buy" or "strong buy" recommendations.⁴ The remaining analyst recommended a "hold". There were no recommendations to "sell."

Despite the apparent escalation in the company's problems, these recommendations remained faithful to the historical tone of analysts' treatment of Enron. For example, the research firm, Thompson/First Call categorized analyst recommendations in the following way: One is a strong buy; two is a buy; three is a hold; four is a sell, and five is a strong sell. Using data on analyst recommendations, it determined that between May 2000 and the end of September 2001, Enron analysts had a consensus recommendation of 1.5 – midway between a buy and a strong buy. (Consensus recommendations for companies in the S&P 500, or for the 5000 firms that analysts cover, reportedly tend to range between 2.0 and 2.2.)

In early October 2001, the consensus recommendation actually rose from 1.5 to 1.3 when a number of analysts raised their recommendations prior to Enron's third quarter earnings report. In mid-October, Enron reported a third quarter loss of \$618 million and disclosed a \$1.2 billion reduction in shareholder equity, partly related to partnerships losses. During subsequent days, Enron faced a number of downgrades and several analysts stopped covering Enron.

On October 22nd, Enron acknowledged an SEC inquiry into possible conflicts of interest related to some of its partnerships. On October 31st, Enron announced that

³ At least one debt rating agency, Moody's, has reported that it incorporates market-based data like stock price information into its calculation of corporate default ratings.

⁴ See: Dennis Byrd, "The Unreliable Crystal Ball of Analysts", *Chicago Tribune*, January 21, 2001,

the SEC inquiry had been upgraded to a formal investigation. On November 8th, Enron filed documents with the SEC that revised its financial statements for the past five years to account for \$586 million in losses. On November 19th, Enron restated its third-quarter earnings. On November 20th, concerns about Enron's ability to survive its growing financial problems sent the company's stock down nearly 23% to a nearly 10-year low. On November 26th, Enron shares fell 15% to \$4.01. On November 28th, Dynegy pulled out of its proposed acquisition of Enron that might have saved the company after credit rating agencies downgraded Enron debt to junk bond status. Enron's shares fell to \$1.

On November 29th 2001, Enron was trading in the 40 to 60 cents range. That day, despite the continual buildup of bleak news about Enron, of a reported 13 sell-side research analysts covering Enron, one issued a "strong sell," six had "strong buys," and six advised investors to "hold."⁵

Analysts have largely defended their coverage of Enron by noting that Enron continually withheld vital financial information like the debt hidden by some of its off-balance-sheet partnerships. Many also have said that Enron was consistently unresponsive to their entreaties to provide them with substantive data on the underpinnings of its earnings growth, some calling Enron officials "masters of obfuscation." And some analysts say that Enron simply misled or stonewalled them when they asked probing financial questions. During a hearing held by the Senate Governmental Affairs Committee⁶ on February 27, 2002, analysts from Citigroup, Lehman Brothers, Smith Barney, and Credit Suisse-First Boston emphasized that they based their research on publicly available corporate information and that in Enron's case, where it did not disclose debts carried by partnerships – they received inaccurate and incomplete data on the company.⁷ But, other observers claim that too

⁵ Joan McKinney, "Baker Plans Hearings on Enron, *the Advocate Online* (Baton Rouge)," December 16, 2001.

⁶ In a report released October 7, 2002, *Financial Oversight of Enron: The SEC and Private-Sector Watchdogs*, the Senate Governmental Affairs Committee, charged that Wall Street analysts and credit rating agencies were too caught up in generating fees for their firms from the companies they covered to be reliably perceived as "independent." It observed that "Enron revealed both groups to be not nearly so reliable as the general public perceived them to be." It also charged that the SEC, "the watchdog of last resort for Enron," had missed its opportunity to mitigate damage from the company's eventual implosion by not doing routine due diligence on it over the past several years, characterizing the SEC's role in regulating companies as "largely passive interaction."

⁷ At a hearing held by the House Financial Services Committee on July 8, 2002, Jack Grubman, then the managing director of U.S. Equity Research Division at Salomon Smith Barney (Citibank's investment bank subsidiary) was questioned about his downgrading of the fallen telecom company WorldCom to "underperforming" on June 21, two business days prior to its announcement of an earnings restatement by \$3.8 billion for improperly accounting for certain earnings between 2001 and 2002. (Mr. Grubman gained notoriety for what many allege were often overly optimistic reviews of now fallen telecom company stocks.) In late August 2002, the House Financial Services Committee expanded its probe into charges of financial mismanagement at Global Crossing (the telecom firm that has been accused of cooking its accounting books and which in January 2002 made the then fourth
(continued...)

many analysts simply avoided asking the hard questions and were largely placated by the company's now apparently inflated reporting of successive quarters of robust earnings growth. It has also been suggested that many analysts may also have been impressed with the fact that Enron was creating new kinds of markets that they did not necessarily fully understand, but which seemed very promising. As recently as September 2001, Enron was reported to be the second most highly rated stock in the S&P 500 Index, behind the now troubled Tyco.⁸

Nonetheless, as early as 1999,⁹ scattered and unconnected analysis was emerging that portrayed key aspects of Enron's financial structure in either very cautionary or outright negative terms. Based on publicly available documents like Enron's 10-K filings and reports from industry trade journals, the analyses uncovered a number of areas of concern, including that Enron: (1) had a great deal of legal insider selling by its officers and directors, a possible indicator that they were pessimistic about its future; (2) had a percentage return on capital that was low for a contract trading house, suggesting that Enron would probably need ever increasing amounts of capital to sustain returns insufficient to produce any real profit growth; (3) had diverted considerable debt off its books; (4) had partnerships whose general managers were Enron officers, suggesting conflicts of interest; and (5) was entering the market in fiberoptic broadband trading about the time that the market was beginning to suffer from a major glut of broadband capacity.¹⁰

Because of these concerns, one analyst and short seller, Jim Chanos, shared his findings and concerns with sell-side analysts in early 2001. He reported, however, that the other analysts remained largely unconvinced.¹¹

Analyst Bias

The widely-held view that many analysts improperly gave Enron "a pass," particularly in the company's final months, has helped revive recent public policy discussions on the conflicts of interest and other incentives that may undermine analyst objectivity, particularly for sell-side analysts.

⁷(...continued)

largest bankruptcy filing in U.S. history) and analyst conflicts of interest at Salomon.

⁸ Adam Levy, "The Deal Machine," *Bloomberg Markets*, Jan. 2001.

⁹ The German utility company Veba walked away from a merger negotiations with Enron in 1999 after becoming concerned about Enron's debt through its consultants, Price Waterhouse Coopers. The consultants told Veba that via a web of complex accounting and deal-making, Enron had swept tens of millions of dollars in debt off its books. Price Waterhouse Coopers learned about the transactions through consulting public sources like trade publications and securities filings. "Enron's Dealings Dashed Merger" *Orlando Sentinel*, Jan. 28, 2001.

¹⁰ For example, see: Peter Verbarg, "Can You Have Too Much?" *Canadian Business*, September 18, 2000, p. 99. and Jonathan R. Laing, "The Bear That Roared: How Short-Seller Jim Chanos Helped Expose Enron," *Barron's*, Jan. 28, 2002, p. 18.

¹¹ Laing, "The Bear That Roared."

On July 3, 2001, the SEC issued a six-page investor alert, “Analyzing Analyst Recommendations.” The alert warned investors not to rely exclusively on analysts’ recommendations, urging them to exercise independent judgment and to consult a number of information sources as part of their decision-making process. It also described the relationship between analysts and their firms, and between analysts and issuers, and observed that some analysts are employed by brokerage firms that underwrite, own, or trade in stocks covered by the analysts. And it noted that an analyst may own shares in companies that he or she covers.

On July 31, 2001, the Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee of the House Financial Services Committee held the second of two hearings on the objectivity of sell-side stock analysts. During the July 31st hearing, the subcommittee’s chairman, Richard Baker, announced that he had three major concerns: (1) pressures on analysts from institutional investors with a large stake in a particular issue; (2) pressures from issuers that may choose an investment bank based on its propensity to issue optimistic reports; and (3) financial journalists’ responsibility, in citing an analyst with potential conflicts of interest, to discover and disclose such conflicts.

Both the congressional hearings and the SEC’s investor alert were addressing widely-held concerns that, over time, that the readiness of many analysts employed by brokerage firms have seen their ability to provide objective analysis has been compromised by some incentives and pressures that stem from their changed relationship with their employers. In the mid-1970s, the SEC and various institutional investors persuaded the New York Stock Exchange to abolish its requirement that its member brokerage firms charge fixed brokerage commissions. The deregulation of brokerage commissions resulted in a new era of price competition and a substantial falloff in the size of commissions earned by full-service brokerage firms. By the 1990s, as large numbers of high tech firms began going public, many brokerage firms shifted their emphasis to more profitable investment banking services like underwriting public offerings, facilitating secondary and follow-up offerings, and consulting on mergers and acquisitions. By 2000, investment banking functions accounted for about 68% of the \$28 billion in earnings of the top five brokerage firms.¹²

Years ago, investment banking firms established barriers between their research departments and investment banking divisions to prevent one side from influencing the other — particularly with regard to the potential for illegal insider trading. The barriers became known as Chinese Walls.

Many observers believe that the emphasis on corporate finance in recent years appears to have helped contribute to the breaching of the Chinese Walls that had traditionally separated research arms of brokerage firms from investment banking arms. The investment banking divisions of many firms had historically used their own staff to perform due diligence on client/issuers. But in the new corporate-finance-centered environment, many firms began using securities analysts to help

¹² Emily Thornton, “Wall Street’s Chinese Walls Aren’t Strong Enough,” *Business Week*, Aug. 27, 2001, p. 56.

market issues and perform due diligence. As a result, it is argued that many research departments and their analysts have developed close ties with their firm's corporate finance operations.

Senior sell-side analysts provide securities research for institutional investor clients, helping to win them as clients for their firms' brokerage business. Many institutional investor clients of brokerage firms are then given "ground floor" access to stakes in initial public offerings (IPOs) that the firm is underwriting. Brokerage firms that do underwriting reportedly compete very little on the prices they charge; most reportedly charge about seven and a half percent of a deal's size.¹³ Directly following an IPO, the executives of the corporate issuer are subject to a six-month lockup in which they are forbidden to sell company stock. Thus, many issuers are said to place a great deal of emphasis on their probable trading price six months after an IPO. Having analysts who can help support that price is said to be an important part of a brokerage firm's "underwriting package."¹⁴

Some brokerage firms have required analysts to report directly to the investment banking side. There have also been instances in which analysts have had to get their recommendations pre-approved by staffers on the investment banking side.¹⁵ Some analysts are part of IPO "road shows"— presentations by underwriters and issuers to institutional investors to build interest in an IPO. Analyst conflicts of interest also may also result from the practice of analysts owning stocks in the companies that they cover. This ownership also includes shares obtained prior to an IPO that is underwritten by their firm, further raising ethics concerns of analysts buying and selling stocks for their own portfolios prior to issuing a new recommendation on the stock.

For some firms, analysts' compensation and bonuses are tied to the brokerage firm's overall revenues. In other cases, some firms have tied analysts' compensation to the amount of business that the securities firm conducts with a particular corporate issuer.

According to Sallie Krawcheck, CEO of Sanford Bernstein, a securities research firm with no investment banking affiliations, investment banks have traditionally paid about one half the cost of their research divisions. The other half has tended to come from Wall Street firms' trading profits and brokerage commissions.¹⁶

¹³ John C. Coffee, "Virtue and the Securities Analyst," *New York Law Journal*, July 19, 2001, p. 5. Sometimes analysts who work for brokerage underwriters issue "booster-shots" (glowing research reports) for new issuers just before lock-up periods expire.

¹⁴ *Ibid.*, p. 5.

¹⁵ For example, in 2001, it was revealed that analysts at JP Morgan were asked to inform their investment banking colleagues about any downgrades they planned to issue. See: Nick Goodway, "Merrill Coaches Analysts in Breaking Bad News," *The Evening Standard*, April 2, 2001.

¹⁶ Randall Smith and Aaron Lucchetti, Reforms at Merrill Lynch Likely to Stop Short of Goals, *Wall Street Journal*, May 23, 2002. p. A-1.

Issuer Pressures

The fundamental public policy concern is that the intertwining of analysts and investment banking has led to a situation in which some analysts' objectivity may have become secondary to pleasing corporate underwriting clients or potential clients with "buy" recommendations.

Many observers have indicated that if a negative research report associated with a negative recommendation was published, it often resulted in a negative backlash. In addition to the analysts' investment banking colleagues, critical reports would also trouble the covered company, which could decide to sever the analyst from further communications, hurting his future research. In addition, institutional investor portfolio managers may see their portfolios' value fall if an analyst's call is perceived to cause a stock to fall. As a consequence, there is a threat that portfolio managers may reduce or altogether stop directing its trades through an analyst's firm.

The Enron case appears to provide support for linking sell-side analyst lack of objectivity to their brokerage connections. As a major issuer, Enron had relationships with dozens of Wall Street firms, reportedly generating a total of \$323 million in fees for the firms that underwrote Enron's issues.¹⁷ Those firms also benefitted from merger and acquisition work generated by Enron, including 41 separate merger and acquisition transactions. Enron's involvement with Wall Street included loans from affiliated banks, various dealings with their brokerage affiliates, and the receipt of letters of credit. It also did derivatives trading with some Wall Street firms and was involved in partnerships with some of the firms and/or their officials.¹⁸

And although Enron spokespersons deny it, a number of analysts who followed the company say that a brokerage firm's analysts had to provide positive recommendations in order for the firm to get business from it.¹⁹ In any case, few were negative. According to research done by the AFL-CIO, on August 15, following the resignation of CEO Jeffrey Skilling, Merrill Lynch was the only sell-side firm whose analyst downgraded Enron, albeit modestly. But for sell-side analysts at firms that did underwriting for Enron, the earliest downgrade appears to have been J.P. Morgan-Chase, going from buy to the slightly less confident "long-term buy" on October 24, 2001. And of the sell-side firms that covered Enron, the only firm that actually downgraded Enron to a "sell" was Prudential, which downgraded Enron twice in the week that followed the announcement of the \$1.2 billion charge to earnings in October.²⁰

¹⁷ Ben White, "Analysts Faulted For Forecasts," *The Washington Post*, Jan. 11, 2002, p. E1. Goldman Sachs collected \$69 million, followed by Credit Suisse First Boston with \$64 million, and the Salomon Smith Barney arm of Citigroup with \$61 million.

¹⁸ *Levy*, *The Deal Machine*.

¹⁹ Tim Huber, "Conflict for Dain Analyst?," *The St. Paul Pioneer Press*, Jan. 23, 2002.

²⁰ "Testimony of Damon Silvers, associate general counsel, AFL-CIO, Before the Subcommittee on Consumer Affairs, Foreign Commerce, and Tourism of the Senate (continued...)"

By contrast, through 2001, independent research firms devoid of any brokerage affiliations appeared to have been much more likely to issue pessimistic announcements on Enron. An unscientific survey of independent investment newsletters by *Forbes Magazine* found of the eight that were surveyed, six were advising their subscribers to sell by May 1st 2001, and two in October 2001. One advised subscribers to sell until the price fell to \$9, then advised a “buy.” Only one newsletter persisted with a “buy” through November 2001.

Over the years, a number of studies have lent legitimacy to concerns that analyst objectivity has increasingly become undermined by the conflicts of interests caused by their relationship with the investment banking side. For example, a 2001 SEC study of nine major Wall Street firms found that analysts at all nine firms consulted with investment bankers on possible mergers and corporate finance deals,²¹ participated in road shows, and initiated coverage on prospective investment banking clients. In addition, investment bankers at seven of the firms had input into the analysts’ bonuses. Six firms stated that analysts periodically give investment bankers advance notice of recommendation changes, but no firms indicated that their bankers had the power to stop an analyst from downgrading a recommendation. The study also found that of the 57 analysts reviewed, 16 made pre-initial public offering investments in companies that they later covered. Right after their firms took the companies public, all of the analysts issued “buy” recommendations.²²

As of May 1, 2002, the research firm Thompson First Call reported that 65% of stocks covered by Wall Street firms were rated “buy” or “strong buy.” By contrast, 35.5% were rated “hold” and 2.5% were rated “sell” or “strong sell.” The 2.5% of stocks that garnered a “sell” and “strong sell” rating represented a historical high. Morgan Stanley may be a major factor in this. In March, it adopted a system in which analysts rank companies against peer firms. The new protocol has resulted in a far larger number of negative ratings.²³ In late 2001, the “sell” and “strong sell” recommendations represented 1.6% of the total. In 2000, they counted for 0.9 %.²⁴

A recent study by professors at the Stanford University’s School of Business found that when analysts’ firms were the lead underwriters of a stock, 72% percent of the analyst recommendations were to buy, and 0.7% were to sell. For other

²⁰(...continued)

Committee on Commerce, Science and Transportation,” Dec. 18, 2001.

²¹ Reported in: “Written Testimony Concerning Conflicts of Interest Faced by Brokerage Firms and Their Research Analysts,” Laura S. Unger, Acting Chair, U.S. Securities & Exchange Commission, July 31, 2001.

²² Ibid.

²³ Cheryl Winakur and Lynn Cowan, “Brokers Revise Ratings System, But Positive Bias Stays Intact,” *Asian Wall Street Journal*, *The Wall Street Journal*, May 9, 2002.

²⁴ Ibid.

analysts covering the same stocks, 56% of the recommendations were buys and 7% were sells.²⁵

Since mid- 2001, the New York State Attorney General’s Office (the Office) has been investigating how analysts at Merrill Lynch & Co. (Merrill) may have routinely promoted struggling technology firms that they had little actual faith in while the banks earned fees underwriting the firms’ stock. In April 2002, the Office released a report on its investigation which reported that scores of internal Merrill communications and emails showed that star dot.com analyst, Henry Blodget, and other analysts in the firm worked with their colleagues on the firm’s investment banking side to write positive reports on various underwriting clients. But, at the same time, the communications are said to show that privately the firm’s analysts periodically derided a number of their publicly touted client companies as “junk” and “crap.”²⁶ Merrill officials retorted that the communications were taken out of context. (For more on this and other related probes, see the *Various Probes* section below.)

Investor Reliance on the Recommendations?

Clearly, a large number of Enron’s analysts resisted recommending selling the stocks to the end. But, analysts’ recommendations only have impact to the extent that investors rely on them.

A study on the impact of analysts’ recommendations on stock prices examined returns from U.S. stock between 1982 and 1997 and calculated how well analyst profit forecasts explained changes in share returns.²⁷ It found that a modest 12% of stock movements could be attributed to analyst recommendations and observed that analysts generally react to changes in market values rather than dictate them. In general, it concluded that analysts add little value to investors’ decision making. However, it did observe that analysts may have a much greater effect on the share values of “high-tech companies” – thus appearing to wield greater influence on firms located in sectors where the financial reporting tends to provide the least amount of corporate information.²⁸

But, while many relatively unsophisticated retail investors rely on recommendations of securities analysts, many institutional investors do not. Many institutions do find considerable utility in the general corporate research provided by

²⁵ Brendan Boyd, “Stanford Study Finds Stock Analysts’ Bias,” *The Washington Times*, Aug. 24, 2000. p. B10.

²⁶ Caroline E. Mayer and Robert O’Harrow Jr, “Rein In Analysts, Dealers Agree; N.Y., Merrill Lynch In Talks on Reform,” *The Washington Post*; April 13, 2002.

²⁷ Eli Amir, Baruch Lev, and Theodore Sougiannis, “What Value Analysts?” *Paine Webber Working Paper Series in Money, Economics and Finance*, No. PW-99-12, 1999.

²⁸ *Ibid.*

sell-side analysts: For example, some observers think that sell-side analysis may confer an advantage in predicting corporate earnings.²⁹

However, for reasons having largely to do with perceived sell-side analyst bias, institutional investors tend to take sell-side analysts' buy and sell recommendations with a "grain of salt" when it comes to investment decisions. Studies indicate that stock markets, especially with regard to their sophisticated investors, tend to heavily discount the "buy" recommendations of analysts employed by a corporate issuer's underwriters.³⁰ Reportedly, another reflection of institutional investors' less than serious take on sell-side-analyst-issued recommendations is the view that an analyst's "hold" actually translates into "sell."³¹

The conventional wisdom is that for long-term investors of most traditional stocks, biased stock recommendations generally shouldn't have a significant impact on earnings. Nonetheless, there were probably scores of investors whose interest in long-term investing in ultimately troubled dot.com or related stocks during the "internet bubble" may have been enhanced when the stocks continued to garner encouraging analyst recommendations. Still, in various investor surveys, many ultimately unsuccessful investors in "internet bubble" stocks placed significant blame on themselves.

Debate over Possible Reforms that Prefigured the Analyst Reforms of 2002

As described at length later in this report, the year 2002 would witness a bevy of stock analyst reforms. This section lays the groundwork for that discussion by outlining the policy debates that prefigured those reforms.

The central public policy debate over the objectivity of sell-side analysts has been that of what do about incentives that undermine their independence. The debate primarily involved two areas: (1) analyst conflicts of interest that derive from their involvement in investment banking; and (2) analyst conflicts of interest that derive from ownership of shares of companies that they cover.

Analysts' conflicts from their involvement in investment banking

Some observers have advocated reforms that would result in the total separation of brokerage firms' research side from their investment banking side: Analysts would

²⁹ Hoover, "Why Bother With Stock Analysts If They Liked Enron As It Died?"

³⁰ Roni Michaely et. al. "Conflict of Interest and the Credibility of Underwriters' Analyst Recommendations," *The Review of Financial Studies*, Issue No. 23, 1999.

³¹ For example, see: Dr. George S. Mack, "Setting the Record Straight: Industry Excesses or the Usual Overreaction," *Wall Street Research Online*, 2001.

be forbidden from any involvement or interaction with investment bankers or investment banking-related activities. But many credible, independent analysts have tended to view this an unrealistic outcome: David Becker, the SEC's general counsel, has observed that he is not “. . . sure that we can realistically expect complete disinterest from analysts employed by firms whose principal source of income comes from investment banking fees and other activities dependent on the sale of securities.”³²

Historically, reform initiatives do not involve outright proscriptions on analysts and investment banking interaction. Instead, they have tended to focus on the removal of some specific analyst-investment banking relationships that may give analysts incentives to issue potentially biased recommendations.

Analysts' conflicts of interests from owning shares in companies they cover

Historically, there has been less concern, but concern nonetheless, over the potentially negative implications of analysts owning stock in the companies they cover: Analysts may “front run” or purchase stocks prior to issuing a positive recommendation. Analysts may be biased in their recommendations because they own stock in the company. And analysts may short sell stocks (bet on a stock's price falling) that they recommend as a “buy”—potentially reflecting a lack of faith in the recommendation.

As part of an ongoing investigation started in 2001, the SEC found that three of 57 stock analysts it reviewed sold shares they were telling the public to buy and garnered individual profits of between \$100,000 and \$3.5 million. The SEC also examined potential conflicts at large brokerages and found that 16 of the 57 analysts it examined had invested in companies they evaluated and reported on before the stock was offered to the public.³³

The most stringent approach to analysts owning shares in the companies they cover is an outright ban. A handful of brokerage firms have voluntarily adopted such a policy. Representative John J. LaFalce, the ranking member of the House Financial Services Committee in the 107th Congress (who decided not to seek reelection to the 108th Congress) called upon the SEC to do whatever rulemaking is necessary to prevent analysts from owning stock in companies they cover. The congressman indicated that such conflicts of interest undermine the objectivity and the efficacy of the work that they do and that eliminating or minimizing them would boost public trust in the profession.³⁴ But other observers question the need for a broad-based ban and call for a more selective ban that would allow analyst stock purchases of stock

³² “Becker Asks Whether Independence Of Sell-Side Analysts Is Achievable Aim,” *Securities Regulation & Law Report*, Aug. 20, 2001.

³³ Carol Vinzant, “Analysts Sold Stock They Pushed, SEC Says; Profits Ranged Up to \$3.5 Million, Agency Finds in Probe for Conflicts,” *The Washington Post*, Aug. 1, 2001, p. E1.

³⁴ For example, see: “Analysis: Investigation Uncovers Questionable Practices Among Many Wall Street Analysts,” *CNBC Early Edition*, Aug. 1, 2001.

that he or she had earlier recommended as a “buy.” They have contended that permitting analysts to do so would produce no conflict of interest, would involve no public harm, and would still allow analysts “to put their money where their mouth is.”

Others, including outgoing SEC Chairman Harvey Pitt,³⁵ opposed a mandatory ban. In the fall of 2001, Chairman Pitt observed that he was “more concerned with analysts buying cheap stock in companies before they go public and trading ahead of their investor recommendations” than analysts owning stocks in the companies they cover. He also dismissed the notion that there was “. . . any inherent need for a prohibition against an analyst owning stock” – saying that he was sure that Wall Street firms would “come up with solutions that are in the best interest of investors.”³⁶

An often-discussed alternative to imposing a ban on analysts owning stock that they cover is mandatory disclosure of those holdings and perhaps disclosure of their corporation’s holdings and corporate involvement.³⁷ Prior to the various analyst reforms (below) of 2002, there was at least one large Wall Street firm that had opted for voluntarily disclosing its analysts’ holdings. It could have been argued that mandatory disclosure of an analyst’s holdings and the holdings and dealings of his employer would be in conformity with the SEC’s historical focus on empowering investors through fostering transparent markets that require full disclosure of material information by market participants. Roni Michaely, professor at the Johnson Graduate School of Management at Cornell University, has argued that since analyst

³⁵ On November 5th 2002, amid controversies over his actions regarding his choice of William Webster to head the accounting oversight board (prescribed by the Sarbanes-Oxley Act of 2002, P.L. 107-204), Chairman Pitt tendered his resignation. In December, President Bush nominated William Donaldson, founder of the investment research firm, Donaldson Lufkin & Jenrette to replace him. Mr. Donaldson awaits Senate confirmation before he can replace Mr. Pitt.

³⁶ “Securities and Exchange Commission SEC Nominee Pitt Talks of Reviewing Rules, Promises He Will Serve American Investors,” *Securities Regulation & Law Report*, July 23, 2001. p. 1069.

³⁷ An SEC study of nine major Wall Street firms that was conducted in 2001 found that: 1) Some firms’ analysts reports affirmatively state that they or their employees hold positions in recommended securities, while other firms use boilerplate noting, “the firm or employees may have positions in the recommended issuer; 2) Some analysts’ ownership in stock of the covered company was not disclosed in the research report at all; 3) 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; 4) Most firms disclose whether they have recently underwritten a public offering or act as a market maker, as required by existing SRO rules; 5) 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; and 6) Sell-side analysts routinely recommend securities during public appearances in the media, infrequently reveal any conflicts of interest to investors. See: “Written Testimony Concerning Conflicts of Interest Faced by Brokerage Firms and Their Research Analysts,” Laura S. Unger Acting Chair, U.S. Securities & Exchange Commission, July 31, 2001.

bias is not illegal, it is probably better to educate investors about it. Some observers have also suggested that mandatory disclosures should also apply to analysts who appear on television. There is currently no requirement that an analyst who appears on television must divulge any conflicts of interest they, or their employer, may have.

Critics of disclosure alone, have been more concerned with eliminating or minimizing the conflict that may be inherent in analysts owning the stocks they cover rather than simple disclosure. Additional concerns about a system of mandatory disclosure of stock ownership have centered on how to ensure that the disclosure is both accessible and meaningful to retail investors.

Non-Legislative Reforms

The SIA Guidelines

In June 2001, on the eve of the first set of analysts hearings conducted in the House, the SIA issued a set of voluntary “best practice” guidelines on the treatment and conduct of analysts. The guidelines were prefaced by the association’s observation that, “At the heart of these and other best practices adopted by SIA is the core principle that the investors’ interests must come first. This principle is the source of the trust and confidence that the securities industry has earned from the public.”³⁸

The guidelines state that each firm should develop its own standards of conduct and that those standards should address such areas as rating stocks, and methods of valuation. The standards should be written down, and they should be circulated annually to all relevant employees. In addition to the three general reforms identified in the previous section, the SIA guidelines recommended that: (1) management should encourage analysts to say when a security should be bought or sold, or to say whether the security is expected to out-perform or fall below a specific benchmark; (2) analysts should not trade against their public recommendations; (3) and they should disclose holdings in the companies they cover; and (4) analysts should not report directly to investment banking divisions; and (5) investment banking should not pre-approve analysts’ recommendations. Draft research reports should be shared with investment banking divisions only to verify facts, and only if the analyst’s recommendation has been deleted.

Within a couple of months, virtually all of the SIA’s several hundred member firms, including its large Wall Street member firms had endorsed the guidelines. Some firms such as Merrill Lynch, Credit Suisse First Boston, and Edward D.Jones, have gone further, forbidding their analysts from owning the stocks they cover. Others, such as Goldman Sachs, decided against such prohibitions, opting to simply require disclosure of analysts’ holdings.

SIA officials say that their flexible, guidelines-based approach gives brokerage firms the flexibility they need to help mitigate potential analyst bias in a variety of

³⁸ “Best Practices for Research,” *The SIA*, 2001.

unique ways, thus providing their customers with a wide range of choices. The officials observed that while some firms prohibited analysts from owning the stock they cover, there are investors who might regard analysts owning a stock they cover as the “ultimate endorsement.”³⁹

But some observers, including Representative Baker, chairman of the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, have criticized the guidelines for not having any real teeth with respect to sanctions, enforcement, and accountability. Critics have also raised questions about the guidelines’ language that “analysts’ pay should not be directly linked to the firm’s investment banking transactions, its trading revenue or its management fees. . .” They have noted that even if one assumes that firms would comply with the language, they could still link analysts’ fees to the firm’s banking transactions in creative, indirect ways.⁴⁰

In the summer of 2001, Chairman Baker asked that the SEC or some other entity be charged with the responsibility of enforcing compliance with the guidelines. Representative Baker also said that he had not ruled out addressing the analyst conflicts of interest through legislative means, but that he preferred a self-regulatory approach. SIA officials have opposed suggestions that the markets require some official intervention in these matters, stating that the marketplace is the ultimate disciplinary and enforcement mechanism since if a firm is providing flawed research, investors will simply take their research needs elsewhere.⁴¹

On June 27, 2001, Representatives Baker and Kanjorski announced that they were establishing an informal advisory group composed of financial analysts, academics and securities industry officials to review the SIA’s best practices guidelines. They also solicited comments from the general public on the guidelines.

The AIMR Guidelines

The Association for Investment Management and Research (AIMR), is an international, nonprofit organization of more than 49,000 investment practitioners around the world. Among other things, AIMR awards the Chartered Financial Analyst (CFA) designation to qualified financial analysts.⁴²

³⁹ Tony Vinas, “Trade Secrets,” *Industry Week*, Oct. 1, 2001

⁴⁰ Ibid.

⁴¹ Brian Kelleher. “A Wall Street Group on Tuesday Announced a Prohibition on Linking Analyst’s Pay to Lucrative Investment Banking Deals.” *Reuters*, June 12, 2001.

⁴² A Chartered Financial Analyst is a high level designation earned by passing exams over the course of three years. The exams cover economics, accounting, portfolio management, security analysis, and standards of conduct. Many sell-side securities analysts are not CFAs, although many do have MBAs. There is an internal debate within the securities industry over whether having an MBA or being a CFA better enables one to be an effective analyst. AIMR’s Code of Ethics requires its members to act in an ethical manner toward the public,

(continued...)

During the summer of 2001, the AIMR circulated an issues paper for member comment 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. The paper also urged separate reporting structure for personnel within the research and investment banking departments, arguing that it would prevent investment bankers from influencing analyst recommendations. It also rejected compensation arrangements that directly link analyst compensation to investment banking assignments and discussed external pressures that public companies and institutional clients sometimes exert on analysts. Retaliatory practices in which companies deny access to analysts who have assigned their stock an undesirable recommendation were also discouraged.

The Oxley/Baker Announcement of the Proposed NASD and NYSE Rules

On February 7, 2002, Representative Oxley, Chairman of the House Financial Services Committee and Representative Baker announced their support of proposed rules designed to strengthen the Chinese Walls as they applied to research analysts. The proposed rules were the collective byproduct of months of work on the part of the NYSE, the National Association of Securities Dealers (NASD), and the SEC. They would require the NASD and the NYSE to prohibit the stock brokers they oversee (NASD) and the researchers employed by their member brokerage firms (NYSE) from reporting directly to investment bankers, forbid analysts from receiving compensation for specific investment-banking deals, and restrict analysts from personally trading on stocks they follow during blackout periods. The SEC would oversee their enforcement.⁴³

In announcing the proposed rules, Chairman Baker observed:

Consider this Round 1 for comprehensive post-Enron reforms. These reforms are not voluntary, but are binding rules subject to strong oversight and enforcement. The failure of Enron last fall brought renewed scrutiny to analysts' conflicts. Even as the company was heading for bankruptcy, most of the large Wall Street firms continued to recommend its shares to the public. . . .⁴⁴

On May 8, 2002, after their adoption by the NYSE and the NASD, the SEC commissioners approved the new rules. The key points of the rules are:

⁴²(...continued)

clients, prospects, employers, employees, and fellow members. AIMR is the organization that awards the CFA designation to qualified analysts.

⁴³ On Mar. 7, 2002, the SEC announced that it was going to hire more than 100 additional investigators to review publicly traded companies and the analysts who follow them. Scott Bernard Nelson, "Analyzing the Analysts," *The Boston Globe*, Mar. 10, 2001.

⁴⁴ Gretchen Morgenson. "2 Proposed Routes to Limit Stock Conflicts of Interest," *The New York Times*, Feb. 7, 2002, p. C6.

- *Promises of Favorable Research.* The rule changes will prohibit analysts from offering or threatening to withhold a favorable research rating or specific price target to induce investment banking business from companies. The rule changes also impose “quiet periods” that bar a firm that is acting as manager or co-manager of a securities offering from issuing a report on a company within 40 days after an initial public offering or within 10 days after a secondary offering for an inactively traded company.
- *Limitations on Relationships and Communications.* The rule changes will prohibit research analysts from being supervised by the investment banking department. In addition, investment banking personnel will be prohibited from discussing research reports with analysts prior to distribution, unless staff from the firm’s legal/compliance department monitor those communications. Analysts will also be prohibited from sharing draft research reports with the target companies, other than to check facts after approval from the firm’s legal/compliance department.
- *Analyst Compensation.* The rule changes will bar securities firms from tying an analyst’s compensation to specific investment banking transactions. Furthermore, if an analyst’s compensation is based on the firm’s general investment banking revenues, that fact will have to be disclosed in the firm’s research reports.
- *Firm Compensation.* The rule changes will require a securities firm to disclose in a research report if it managed or co-managed a public offering of equity securities for the company or if it received any compensation for investment banking services from the company in the past 12 months. A firm will also be required to disclose if it expects to receive or intends to seek compensation for investment banking services from the company during the next 3 months.
- *Restrictions on Personal Trading by Analysts.* The rule changes will bar analysts and members of their households from investing in a company’s securities prior to its initial public offering if the company is in the business sector that the analyst covers. In addition, the rule changes will require “blackout periods” that prohibit analysts from trading securities of the companies they follow for 30 days before and 5 days after they issue a research report about the company. Analysts will also be prohibited from trading against their most recent recommendations.
- *Disclosures of Financial Interests in Covered Companies.* The rule changes would require analysts to disclose if they own shares of recommended companies. Firms will also be required to disclose if they own 1% or more of a company’s equity securities as of the previous month’s end.
- *Disclosures in Research Reports Regarding the Firm’s Ratings.* The rule changes will require firms to clearly explain in research reports the meaning of all ratings terms they use, and this terminology must be consistent with its plain meaning. Additionally, firms will have to provide the percentage of all the ratings that they have assigned to buy / hold / sell categories and the percentage of investment banking clients in each category. Firms will also be

required to provide a graph or chart that plots the historical price movements of the security and indicates those points at which the firm initiated and changed ratings and price targets for the company.

- *Disclosures During Public Appearances by Analysts.* The rule changes will require disclosures from analysts during public appearances, such as television or radio interviews. Guest analysts will have disclose if they or their firm have a position in the stock and also if the company is an investment banking client of the firm.

Depending on the particular provision, the analyst rules took effect either on July 9th, or September 9th 2002.

In addition the SEC will request the NASD and the NYSE to report within a year of implementing the rules on their operations and effectiveness, and whether they recommend any modifications or additions.

Immediately after the SEC's approval of the rules, House Financial Chairman Michael Oxley, and Subcommittee Chairman Baker jointly praised the agency's decision: "The new regulations represent major progress and substantial reform of market research. We believe that the quality of investor information will improve as a result."⁴⁵

The NASD Chairman and CEO Robert Glauber asserted that the new rules will strengthen the NASD's hand in bringing cases in the area and said that the NASD "will not hesitate to enforce these demanding new rules with a full range of disciplinary options ranging from stiff monetary penalties to suspension from the industry."⁴⁶

Officials at the Securities Industry Association (SIA), a major trade association of brokerage firms commended the SEC for its leadership in approving regulations to improve the integrity of broker-dealers' research. But the officials also repeated criticisms raised earlier (including a comment letter to the SEC in April 2002) concerning the "tipping" of information if firms are required to disclose potential nonpublic deals. They also expressed concerns that the rules would especially harm the ability of small regional brokerage firms to provide research and underwrite offerings for the mostly small firms that they worked for.⁴⁷ SIA officials have also emphasized the importance of the rules being uniformly interpreted by both the NYSE and the NASD.⁴⁸

⁴⁵ Leticia Williams, "SEC Tightens Rules for Analysts," *CBS. MarketWatch*, May 8, 2002.

⁴⁶ "Statement of NASD Chairman and CEO Robert R. Glauber Regarding SEC Approval of New Analyst Rules," May 8, 2002.

⁴⁷ Securities Industry Association Press Release, "Securities Industry Commends SEC for Leadership on New Regulations to Ensure Integrity of Research, Concerns about "Tipping," Costs, Impact on Small Firms Remain," May 8, 2002.

⁴⁸ Rachel McTague, "SEC Gives Nod on Markets' Analyst Rules To Boost Independence, (continued...)

Officials at some investment banks previously commented that the new rules might be pose an unworkable framework, requiring an inordinate amount of involvement on the part of lawyers.⁴⁹

Responding to the essentially unchanged rule proposals before their adoption by the SEC, a number of investment banks had raised concerns that the analyst rules might present an unworkable framework that required an inordinate amount of involvement on the part of lawyers.

Representative LaFalce, however, was fairly dismissive of the newly adopted rule changes, stating that, “individual investors, including millions of average Americans who invest their life savings for retirement, deserve more protection than cosmetic market reforms.”⁵⁰

And a couple of months before the SEC’s adoption of the rules, Barbara Roper, director of investor protection for the Consumer Federation of America, had observed that the proposals “sound like they are certainly trying to tackle the problem in a meaningful way.” But, she questioned whether they would have a meaningful impact “as long as firms have a financial interest in using analysts to support investment banking.”⁵¹

Scott Cleland, president of the Precursor Group, an independent research firm, has observed that as long as research is produced by firms whose main profit centers represent company interests over the interests of investor interests, he doubted that the proposals (now rules) would have a meaningful impact. While noting that some analysts appear to be doing a better job in the post-Enron environment, he expressed doubts that it would last.⁵²

In a comment letter to the SEC when the rules were in the proposal stage, officials from the AIMR questioned the effectiveness of the provision that prohibits paying the analyst based on his or her work on specific investment banking projects. assignment. They stressed that “most employers of research analysts no longer engage in this practice, yet analysts at these firms still experience considerable increase in salary and bonuses from their involvement in investment banking activities of the firm.”⁵³

⁴⁸(...continued)

Research Quality,” *BNA Daily Report for Executives*, May 9, 2002.

⁴⁹ The Securities Industry Association, “Regulatory Proposals Raise Difficult Compliance Issues, Impose Significant Costs,” February 2002.

⁵⁰ Ibid.

⁵¹ Jackie Spinner, “Rules Would Reign in Analysts,” *The Washington Post*, February 7, 2002.

⁵² Shelley Emling, “After Enron’s Collapse, Analysts Say They’re Looking Closer Before Recommending a Stock as a Sell, Hold or Buy,” *Atlanta Journal - Constitution*, March 26, 2002.

⁵³ “Association AIMR Says Proposed New Rules Governing Analyst Conflicts Don’t Go (continued...) ”

As a consequence, they argued that analysts' compensation should be "dependent on, and directly attributable to, the quality of (their) research and the success of (their) recommendations over time." The AIMR officials then recommended that securities firms "should be required to adopt performance evaluation and compensation schemes that will create strong incentives for independence and objectivity in research."⁵⁴

The period for member comments on the proposals ended in October 2002.

Reform Proposals that are Not a Part of the NASD/NYSE Rule Changes

A number of additional reforms for strengthening analyst independence have been put forth by industry observers and are not a part of the NASD/NYSE proposals. They include:

- Prohibit analysts from making verbal recommendations to institutional investors about their firms' upcoming IPO. (Analysts are forbidden by SEC rules from publishing written recommendations.)
- Place restrictions on analysts' ability to provide "booster shots." Booster shots are glowing research reports for new issuers given just before expiration of the 6-month lock-up period after an IPO – in which corporate officials are banned from selling the company's stock. (These would be restricted in the second round of NYSE-NASD analyst rules proposed in early October 2002, which are discussed below.)
- Impose uniform, industry-wide standards on the recommendation terminology that firms use. Currently, various firms employ a disparate number of terms to convey buy, sell, hold, and the various gradations between them.

The Second Round of NYSE-NASD Analyst Rules. On October 3rd, 2002, the NYSE and the NASD unveiled a second set of proposals dictating the way that member organizations, their research analysts, and investment-banking divisions are to manage and reveal conflicts of interest. Developed collectively by the NYSE, the SEC, and NASD, and jointly proposed by them, the second round of analyst rules are a response to various interpretive issues raised by investigations on the part of the three institutions as well as concerns raised within the securities industry.

Key parts of the proposals, which were released to the public in framework form devoid of detailed actual language, must be formally approved by the SEC, are a ban on analysts from taking part in sales pitches for investment banking business; a

⁵³(...continued)

Far Enough," *AIMR Press Release*, April 19, 2002

⁵⁴ Ibid.

proscription on research reports from being issued for 15 days prior to and after the expiration of “lock-up agreements;” and a requirement that analyst compensation be based in part on the accuracy of their stock selections. Additionally, according to the NYSE summary, the rules would:

- separate an analyst’s compensation from investment banking influence by requiring that a compensation committee review and approve of research analysts’ compensation;
- prohibit the compensation committee from considering a research analyst’s contribution to the firm’s overall investment banking business;
- require the basis for compensation to be documented and certified by an annual attestation to the exchange;
- prohibit research analysts from participating in solicitation or “pitch” meetings with prospective investment-banking clients;
- amend the definition of research analyst to include research directors and supervisory analysts or others who supervise, influence or control the preparation of research reports, and establish, or change ratings or price targets;
- establish a new registration category and qualification exam for research analysts (including continuing education to address relevant rules and regulations, ethics, and professional responsibilities); and
- amend the definition of “public appearance” to apply restrictions to research analysts making a recommendation in a newspaper article or similar public medium, and extend the 10-day and 40-day quiet periods for research reports of managers and co-managers of initial and secondary offerings to making public appearances.

Initial reactions to the proposals were mixed and involved a number of questions about their potential ramifications, including: 1) Will they allow investment banking departments to legitimately rely on research analysts’ expertise? 2) Will investment bankers ultimately be required to hire their own group of analysts – analysts who would not be able to publish research reports? and 3) Will investment banks be able to maintain their present forms of analyst compensation?

The AIMR’s Draft Proposals

In July 2002, the Association for Investment Management and Research (AIMR) issued a draft proposal, the AIMR Research Objectivity Standards, which set forth ethical business practices that various entities, including public companies and investment-management firms should follow to create an environment that promotes objective securities research and analyst independence. Among other things, sell-side firms that adopt the standards must:

- establish rating systems that help investors assess the suitability of a security to their own unique circumstances and constraints, rather than taking a “one size fits all” approach that treats all investors alike;
- over time, align analyst compensation to the quality of research and the accuracy of analyst recommendations.
- segregate research from investment banking in ways that ensure that investment banking does not influence research or the resulting recommendations;
- fully disclose all conflicts of interest of both the analyst and the securities firm, especially when analysts discuss their research and recommendations in public settings. (However, firms may permit analysts to own shares of the companies they cover are prohibited from selling when they have a “buy” or a “hold” on it, or from otherwise trading against their own recommendations.); and
- prevent employees from “front-running,” or trading in advance of issuing research reports;
- upon discontinuing coverage of a security, they must issue a “final” research report and recommendation, explaining the reason for doing so, rather than quietly discontinuing coverage to avoid putting a negative rating on a stock security;
- prohibit research analysts from participating in marketing activities, including “roadshows,” for corporate clients issuing new shares of stock.
- adopt a “three-dimensional” rating system that communicates risk in the context of a time horizon in addition to the “buy-hold-sell” recommendation itself.
- require sell-side analysts who make media-based public appearances to make their full research reports available to the public at reasonable prices.

The AIMR proposals also contain ethical standards for analysts employed by buy-side firms. Among other things, buy-side firms (institutional investors such as mutual and pension funds) who adopt the standards must: 1) see that in an effort to secure a favorable rating, their employees are not allowed to reduce, or eliminate (or threaten to reduce or eliminate) their firm’s business with a brokerage firm; 2) prohibit employees from encouraging the public company that is the subject of the research to retaliate against a sell-side analyst for issuing an unfavorable recommendation; and 3) provide full and fair disclosure of all conflicts of interest of the firm or its investment professionals.

Also, concerned that some corporate issuers may attempt to influence analyst research, the AIMR proposals also included a number of guidelines for them as well. Among other things, issuers are advised to: 1) not file legal suits against research

analysts for their recommendations; 2) not make accusations against research analysts in the media; and 3) not to seek to review a research analyst's report in advance of publication.

Abusive IPO Share Allocations

As previously discussed, the investment banking service of underwriting IPOs has historically been a source of great profits for the nation's largest securities firms. Generally, the firms that serve as lead underwriters charge about 7% of the total proceeds from an IPO. Between 1980 and 1994, gross proceeds from IPOs (in 2001 dollars) were \$184 billion. Companies that did IPOs during that period came from a mix of industries and generally had to show several previous quarters of profits. Between 1995 and 2001, a much shorter period of time, IPO proceeds totaled \$304 billion. Firms conducting IPOs became dominated by internet-related firms, many of whom had never reported a single quarter of profits. In the wake of the dot.com meltdown that commenced in mid-2001, both the number of IPOs and IPO proceeds have fallen precipitously: In 1999, Wall Street raised \$63 billion in IPOs, but by 2001 and 2002, this had fallen to \$34 and \$23 billion, respectively.

Historically, the securities firms that underwrite IPOs underprice the IPO shares relative to their market prices once trading in them begins on the secondary markets. This means that underwriters, corporate insiders, and the institutional investors with the greatest access to a company's IPO may benefit from the often substantial rise in share price that frequently occurs in a hot IPO's first day of trading known as the "pop." Between 1980 and 1989, the average return on an IPO at the close of the first day of trading was 7.4%. Between 1990 and 1994, this had grown to 11.2%. Between 1995 and 1998, with the significant emergence of internet-related IPOs, the average return climbed to 18.1%. From 1999 to 2000, the average IPO returned an unprecedented 65% at the close of the first day of trading.

As suggested above, the recent period of internet dominated IPOs was a very lucrative one for both the holders of IPO shares and the securities firms that underwrote them. The lucrative nature of the business for major securities firms was reflected in the very competitive IPO underwriting business. Two manifestations of that competitiveness were the firms use of IPO allocation strategies known as *spinning* and *laddering*. Spinning takes place when a securities firm provides select executives with shares of potentially hot IPOs to encourage their company's use of the firm's investment banking services or as a reward for having done so. Laddering is a practice in which institutional investors agree to buy shares of post-IPO stock, thus supporting the aftermarket in the stock in exchange for the securities firm giving them access to potentially hot future IPOs. Increases in a client firm's aftermarket trading boosts its securities firm's revenues from trading commissions involved in underwriting.

Under current federal securities law, proof of a quid pro quo arrangement is necessary to establish that an IPO allocation is illegal. It is very difficult, however, to document the existence of quid pro quo pacts and to date there have few if any indictments of this kind.

In the summer of 2002, at the request of Securities and Exchange Commission (SEC) officials, the New York Stock Exchange (NYSE), and the NASD named a group of leading representatives of the private and public sectors to a blue ribbon panel charged with presenting a report on recommended changes to the IPO process to the NYSE and the NASD. The two self-regulatory organizations will then make any rule proposals to the SEC. Among other things, the panel will examine the IPO underpricing phenomenon in which the IPO share prices established by the investment banks tend to significantly rise when trading commences in the aftermarket. The summer of 2002 also saw the NASD, the primary regulator of brokerage firms, formally propose that securities firms be prohibited from spinning IPOs. Later, in December 2002, as part of a larger agreement on stock analyst conflicts of interest, the SEC, the NASD, the office of the New York Attorney General, and securities regulators from the other states, reached an agreement with the nation's largest securities firms, including CS First Boston, and UBS Warburg, that will prohibit them from spinning. Interest in the 107th Congress in IPO allocation practices largely centered on an investigation by the House Financial Services Committee into spinning at the securities firms of Goldman Sachs Credit Suisse First Boston, and Citigroup-Salomon Smith Barney. In the fall of 2002, after months of inquiries, a committee report concluded that the three firms gave preferential access to IPOs offerings that they managed to executives and directors of some of their client firms. It specifically reported that Goldman Sachs had allocated shares in potentially hot IPOs to executives and directors at 21 of its investment banking client firms, including officials at Worldcom, resulting in Chairman Oxley's conclusion that this appeared to have allowed some executives at its client firms to reap unfair profits.⁵⁵

Various Probes

New York Attorney General Eliot Spitzer's probe of Merrill Lynch.

Starting in mid-2001, New York Attorney General Eliot Spitzer (the Office) began pursuing an increasingly high profile investigation of Merrill Lynch in New York state court that Merrill's research analysts, including noted dot.com stock analyst Henry Blodget, were recommending stocks to clients while disparaging the very same securities in private communications among themselves. The Office indicated that such actions were documented in internal Merrill emails that it obtained as part of the probe. Its central concern was that the firm was issuing analysis that mislead investors. The Office has broad authority under a New York State securities law that predated the federal securities laws, the Martin Act. The law permits the prosecution of Wall Street firms for conflicts of interest. By contrast, Federal laws generally require that prosecutors show "criminal intent" when charging that analysts misled investors through overly optimistic stock recommendations.

On April 8th 2002, the New York Attorney General obtained an order from the New York Supreme Court directing Merrill to disclose in its published research whether a company is an investment banking client or a prospective one. On April

⁵⁵ Rachel McTague, "Wall St. Firms Gave Preferred IPO Access to Clients' Execs, Directors, Oxley Charges," *BNA's Banking Report*, October 7, 2002

18th, the Office reached an agreement with Merrill requiring certain disclosure in research reports that the firm issued firm.

In initial negotiations with Merrill, the Office pushed for Merrill to create a restitution fund for investor clients who suffered financially from the firm's allegedly tainted stock recommendations. Later, the Office reportedly abandoned the idea of such a fund due to concerns over the mammoth challenge of identifying truly aggrieved investors and then distributing fund proceeds to them. Some reports indicate that an additional factor in the abandonment of the idea of a restitution fund was the argument by Merrill officials that such a fund would make the company vulnerable to a deluge of lawsuits. The Office also initially pressed for Merrill to sever the links between its analysts and its investment bank: Analysts would be barred from accompanying bankers on client visits and there would have to be assurances that the analysts are not paid from fees generated by Merrill's investment bankers. Merrill officials reportedly voiced fears that such changes would put it at a competitive disadvantage vis a vis competitors and the Office subsequently abandoned the idea.

On May 21st 2002, Merrill and the Office reached a settlement: Merrill does not face criminal charges. Company officials apologized for inconsistencies between views expressed by its Internet sector analysts and the firm's published stock recommendations. But, as is typical in most civil cases, there was no admission of wrongdoing. Such a formal admission could have made Merrill more vulnerable to potentially expensive investor lawsuits.

The settlement entailed Merrill paying a \$100 million penalty⁵⁶ – \$48 million to New York; \$50 million to be distributed among the other states; and \$2 million to go to the North American Securities Administrators Association (NASAA). In November 2002, six months after agreeing to the settlement, Merrill began making the payments. Missouri and Arizona, the only states that have not signed the settlement, are not receiving payments. The settlement also involves Merrill agreeing to other changes, including:

- *Trimming the link between compensation for analysts and investment banking.* The agreement requires Merrill to completely separate the evaluation and determination of compensation for equity research analysts from Merrill Lynch's investment banking business. Merrill's analysts may be compensated for working on stock sales or mergers to the extent that such participation is intended to benefit investor clients.
- *Prohibiting investment banking input into analysts' compensation.* Merrill is forbidden from soliciting or considering any information concerning the amount of investment banking revenue received from clients covered by the research analysts.

⁵⁶ The \$100 million represents one of the largest fines paid by a securities firm and represents 1/5 of Merrill's earnings in 2001 and a smaller fractions of its earnings in 2000.

- *Creating an investment review committee.* Merrill will create an independent investment review committee responsible for approving all research recommendations.
- *Establishing a person to monitor the settlement agreement.* Merrill will establish a monitor to ensure compliance with the agreement subject to the New York Attorney General's approval.
- *Requiring disclosures upon discontinuation of research coverage.* Upon discontinuation of research coverage of a company, Merrill will issue a report disclosing the termination of coverage and the rationale for such termination, and will also notify investors that the final rating should no longer be relied upon.
- *Required disclosure of compensation from a covered company.* In its research reports, Merrill must disclose whether it has received or is entitled to receive any compensation from a covered company over the past 12 months.

After the settlement, Mr. Spitzer indicated that he hoped that the Merrill framework would eventually serve as a “template” for Wall Street firms in general. And motivated by reasons that could include the need to preempt Merrill-like probes by Mr. Spitzer’s office and/or competitive motivations to appear as “investor friendly” as the post-settlement Merrill may appear, a few firms have adopted similar research oriented reforms: Salomon Smith Barney said that it would adopt reforms that were similar to Merrill’s, including separating its analyst’s compensation from their contributions to the company’s investment banking arm. It is also establishing a research review committee similar to what Merrill agreed to. CSFB, a unit of Switzerland’s Credit Suisse Group will begin compensating its analysts based on how their work helps investors, rather than their contributions to investment banking. Goldman Sachs is creating an ombudsman to advise analysts on conflict of interest situations and two groups of independent directors to oversee the review of analyst policies and compensation.

The settlement has been praised by a number of observers: Representative Lafalce said that it was a blueprint for a federal solution to Wall Street conflicts of interest problems. Annette Nazareth, the SEC’s Director of Market Regulation indicated that it was consistent with the NYSE/NASD analyst rules and that it helped align the interests of research analysts with those of investors without precluding any necessary additional future rulemaking. Others have praised the settlement for its potential to give a “shot in the arm” to analyst reforms at other Wall Street firms that should benefit investors. The settlement and the revelations that preceded it have both been praised for helping to make investors more aware of the potential shortcomings of investment banking analysts’ research.⁵⁷

Some observers characterize the Merrill settlement as significant reform, while others have said that it does little more than echo parts of the analyst rules adopted

⁵⁷ For example, see: The North American Securities Administrators Association’s Statement on the Merrill Lynch Settlement, May 21, 2002.

by the NYSE and the NASD and approved by the SEC. Mr. Spitzer says that the agreement distinguishes itself by separating analyst earnings from the investment banking division and prohibiting investment bankers from having control over analyst compensation. Chairman Baker has said that the SEC-approved SRO rules are stronger and more comprehensive than the terms of the Merrill settlement.⁵⁸

A “middle of the road” view is that the settlement failed to go all the way in recasting the analysts into completely independent and objective researchers, but that it represented a reasonable compromise.⁵⁹

Generally speaking, criticism of the settlement has taken two basic forms: 1) It will not significantly address conflict of interest issues; and 2) It represents a flawed approach to remedying Wall Street research due to the fact that it creates a dangerous precedent under which states may begin to supercede the traditional and many regard as more appropriate federal role in this area.

Criticism of the settlement due to perceptions that analyst conflicts of interest problems will still remain. A number of observers, including some former analysts and lawyers for investors have said that analyst conflict of interest pressures will still prevail at Merrill, the settlement notwithstanding: Merrill’s analysts will still be allowed to accompany and assist the firm’s investment bankers as they sell underwriting services to corporations and market the stocks and bonds that they underwrite to institutional investors. Some also note that the settlement’s wording says that Merrill’s analysts may be compensated for working on stock sales or mergers to the extent that such participation is intended to benefit investor clients. There are some observers who are concerned that there are a number of investment banking activities that could be interpreted as benefitting investor clients.

Critics of the settlement have also say that Merrill’s analysts will still be able to derive at least part of their compensation from pools of the firm’s investment banking revenues, preserving some of the conflict of interest dynamics. There are supplemental concerns that pressure will remain on its analysts to provide favorable stock ratings to Merrill’s significant investment banking clients due to concerns that they could lose their jobs if they do otherwise.

A number of observers have asked why Mr. Spitzer’s did not persist in his earlier insistence that Merrill spin off its research arm. His response is that it was never his intent to destroy the firm. There are also reports that Merrill was able to convince Mr. Spitzer’s office that a separated research division would not have been self supporting.

⁵⁸ Richard Hall, “Key Oversight Lawmaker Tell State AGs He Will Legislate to Stop Concerted Probe,” *Daily Report for Executives*, June 2002, p. A-22.

⁵⁹ For example, see the commentary by Professor Jack Coffee of the Columbia University Law School in: Gregg Worth, “Lingering Clouds: New Rules and the Merrill Settlement May Not Be Enough,” *Investment Dealers Digest*, May 27, 2002, p. 28.

Criticism of the settlement due to concerns that it could undermine federal initiatives in this area and/or cause damage to securities markets. After the settlement's announcement, Chairman Oxley derided Mr. Spitzer for "grandstanding" – saying that his efforts could roll back years of SEC regulation of the securities industry, thus risking "balkanizing" the industry.⁶⁰ He also warned that Mr. Spitzer's action could undermine company's ability to raise capital through securities firms like Merrill Lynch by "coercing" substantial sums from them.⁶¹ SEC officials did not publicly criticize the Spitzer initiatives, but there are unofficial reports that agency officials had some concerns that states like New York might attempt to impose structural changes on the securities industry as part of their settlements.⁶² By the late fall of 2002, Chairman Oxley was indicating that his earlier concerns about the problems inherent in the fragmented probes of securities firms had been somewhat assuaged because of the additional presence of the SEC and the SROs in what would become known as global settlement talks.

Henry Hu, a professor of corporate and securities law at the University of Texas Law School, noted that the Merrill settlement could be looked at as a one-time enforcement action, but that additional enforcement actions by the states could have a harmful impact on the capital markets.⁶³

Directly after the Merrill settlement, Chairman Baker charged that Mr. Spitzer's office had gone beyond its original jurisdiction in an unsuccessful initiative to "usurp" the federal government's rulemaking and oversight of the capital markets. He also criticized the settlement for being unenforceable and for creating the essentially meaningless position of "compliance monitor."⁶⁴

In response, Mr. Spitzer asserted that his efforts were essentially a response to a perceived void on the part of the SEC in addressing investment banking analysts' conflict of interest problems. He also stressed that concerns over state and federal jurisdictional frictions are exaggerated and that relations between his office and the SEC Chairman were fine, although they may disagree on the proper remedies.⁶⁵

⁶⁰ Kip Betz, "Merrill Settles Analyst Conflict Charge," *BNA Daily Report for Executives*, May 22, 2002, p. A-15.

⁶¹ Gretchen Morgenson, "Investors Want Cops On the Street," *The New York Times*, May 26, 2002, p. 3-1. By the late fall of 2002, Chairman Oxley indicated that his earlier concerns about the inherent problems of the fragmented probes of securities firms had been somewhat assuaged because of the added presence of the SEC and the SROs in what would later become the global (multiple regulator) settlement talks that in late December 2002 culminated in an agreement with top investment banking firms. (See the section below, *The Broad-Based Settlement*.)

⁶² Kathleen Day, "States Pressing Analyst Probe; Securities Firms Fear Patchwork of Rules, Back SEC Investigation," *The Washington Post*, May 1, 2002.

⁶³ Ben White, "Lawmaker Vows to Thwart Spitzer; La. Congressman Decries State Move," *The Washington Post*, May 24, 2002, p. E-1.

⁶⁴ Niamh Ring, "Baker Calls Merrill Rules Unenforceable," *The American Banker*, May 24, 2002.

⁶⁵ Eric Berquist, "Regulatory Void Forced State to Take Action," *The American* (continued...)

In the 1990s, state regulators were often ahead of the SEC in appraising investors of problematic securities market risks or fraud in areas such as trading in microcap stocks and problems associated with day trading. A number of state-based initiatives often set the stage for broader federal probes.⁶⁶ But, historically states have tended to focus their probes on individual brokers' and the nature of their supervision on the part of their firms. Thus, traditionally, broad state-based investigations of securities firms' practices as Mr. Spitzer is doing in New York are rather unusual.

Other actions by the New York State Attorney General, including its IPO profiteering suit against Five telecom executives. In addition to its role in the multi-state task force investigating analyst improprieties at major Wall Street firms (see below), in September 2002, Mr. Spitzer's office announced that it was reviewing potential criminal fraud violations regarding practices of securities analysts at Credit Suisse First Boston (CSFB). The CSFB case was referred to the New York Attorney General by Massachusetts securities regulators who asked Mr. Spitzer's office to assist it in the pursuit of criminal charges under the Martin Act. The Massachusetts regulators had obtained internal CSFB emails that they say indicated that the firm's chief high tech investment analyst, Frank Quattrone, used analyst recommendations to win investment banking business for CSFB.

On September 30th, in an unprecedented act, the Office sued five telecom corporate executives, seeking the return of millions of dollars in profits that they received from being "spun" shares in hot initial public offerings (IPOs) from investment banker, Salomon Smith Barney. Specifically, the suit, which was filed under the state's Martin Act, alleges that between 1998 and early 2002, the executives pocketed IPO shares worth millions of dollars in exchange for encouraging their companies to employ Salomon for underwriting work, failing to disclose the underwriting relationship as required. Under the state law, the Office need not demonstrate that there was a quid pro quo between Salomon and the corporate heads. It merely needs to show that there was a failure to disclose material facts that could have an impact on investor value: Spitzer's office contends that both the non-disclosure of the executives' IPO-based profits and the nature of the investment banking relationship the officials had with Salomon meet this test.⁶⁷ Under federal laws, there is a higher burden of proof of the existence of quid pro quo relationships, which can be very challenging to document.

⁶⁵(...continued)

Banker, May 29, 2002. p. 4.

⁶⁶ For example, see: Gretchen Morgenson, "Investors Want Cops On the Street."

⁶⁷ On October 2, 2002, in related inquiries, House Financial Services Committee Chairman Michael Oxley announced some of the findings of the committee's investigation into three leading investment banking firms, Goldman Sachs, Credit Suisse First Boston, and Citigroup-Salomon Smith Barney. Chairman Oxley reported that the three firms gave preferential access to IPOs offerings that they managed to executives and directors of some of their client firms. This in turn allowed some of the executives to collect what Chairman Oxley characterized as unfair profits. Rachel McTague, "Wall St. Firms Gave Preferred IPO Access to Clients' Execs, Directors, Oxley Charges," *BNA's Banking Report*, October 7, 2002.

The suit developed from the Office's initial probe into whether Salomon's analysts inflated stock ratings to help give the firm an advantage in securing underwriting business. Former star Salomon telecom analyst Jack Grubman is seen as a pivotal character in the allocation of the hot IPOs to preferred corporate executives. Documents connected with the suit are said to show that Salomon's analysts were pressured into issuing the kind of stock ratings that would help generate underwriting business. Citigroup, Salomon's parent company, chose not to initially comment on the suit, but observed that it was aggressively attempting to resolve questions about past practices and to adopt extensive reforms.

Initial reactions to the suit were mixed. Some observers questioned whether the courts will accept cases that do not try to prove that there was actual quid pro quo between Salomon and the telecom executives. But, regardless of the case's legal outcome, others applaud Mr. Spitzer's office for giving much needed exposure to the practice of IPO spinning, perhaps helping to discourage it.

The Probe by the North American Securities Administrators Association (NASAA) and other State-based Efforts. On April 23rd 2002, the NASAA, an association of state and provincial securities regulatory officials announced the creation of a multi-state task force, which will focus on identifying acts of securities fraud associated with securities analysts and seeking punishment as has New York has. By mid-summer 2002, the task force numbered 44 states. Co-chaired by California, New Jersey, and New York, the task force will focus on at least 12 securities firms, including Morgan Stanley and Salomon Smith Barney, Credit Suisse First Boston, UBS Paine Webber, J.P. Morgan Chase, Lehman Brothers, Bear Stevens, Deutsche Bank Securities, Piper Jaffray, and Goldman Sachs. To mount a more efficient probe and to help quell securities industry concerns that the firms would be inundated with subpoenas from multiple states, individual states have agreed to undertake probes of specific investment banks.

On May 24th, Chairman Baker wrote the attorneys generals of all the states except New York, requesting that they not replicate Mr. Spitzer's attempt to construct rules "governing the business practices of a marketplace with international reach and established national oversight." He also warned that he would "consider the advisability of introducing legislation" if the states pursue investigations into conflicts of interest at financial services firms.⁶⁸

⁶⁸ Richard Hill, "Key Oversight Lawmaker Tells State AGs He Will Legislate to Stop Concerted Probe," *BNA Daily Report for Executives*, May 28, 2002. On July 1st 2002, officials from North Carolina, California, and New York, which collectively oversee \$220 billion in public pension assets and other funds, said that they will ask any Wall Street investment bank doing business in their states to voluntarily comply with the terms of the Spitzer-Merrill agreement. The officials, New York State Comptroller H. Carl McCall, California State Treasurer Philip Angelides, and North Carolina Treasurer Richard Moore, also warned that any firm that doesn't take steps to separate its investment banking businesses from its stock-research operations would run the risk of being barred (continued...)

In an early June response, NASAA spokespersons said that the states sought to punish securities firms if wrongdoing was found, but would leave subsequent regulation of the industry to Congress and the SEC. They also commented that NASAA was sensitive to Chairman Baker's concerns over the possible emergence of a "patchwork" of 30 types of state securities regulations, but observed that this was never its intent since "no one wants patchwork regulation."⁶⁹

In an agreement with the NASD and the SEC, Massachusetts securities regulators are leading a probe of research practices at the investment bank, Credit Suisse First Boston (CSFB). (The state referred some parts of the CSFB case to the New York Attorney General's Office for possible criminal prosecution under the Martin Act.)

In early October 2002, Massachusetts Secretary of the Commonwealth William Galvin, filed an administrative complaint against CSFB, charging that in order to help it build its investment banking business, it bribed officials at prospective investment banking client firms with hot IPO shares that it controlled. As part of the complaint, the state is pursuing: a \$2 million penalty; separation of CSFB's research and investment banking; removal of links between CSFB analyst compensation and

⁶⁸(...continued)

from doing any more work for their states. And after seeing their state pension funds lose billions in stock and bond investments in a series of corporate scandals in 2001 and 2002, the officials will also require the state funds' money managers to annually disclose how their portfolio managers and research analysts are compensated and to provide detail about their procedures for analyzing investment opportunities. The money managers would also have to reveal any potential conflicts of interest between the investment advice they offer and other financial work and services that their firms are involved in. (Some money management firms are owned by investment banks that do stock and bond underwriting.) Matthew Goldstein, "Spitzer Opens a New Offensive on Wall Street," *The Street.com*, July 1, 2001.

⁶⁹ Richard Hill, "Forty States Now in Task Force of States Probing Analyst Conflicts; 12 Firms Targeted," *BNA's Daily Report for Executives*, June 6, 2002. In mid-June, NASAA's president gave reporters a copy of a one page document showing two versions of proposed legislative language for an amendment to a bill largely dealing with auditor regulation being drafted by Banking Committee Chairman Paul Sarbanes. The bill, the Public Company Accounting Reform and Investor Protection Act of 2002 was reported out of the Banking Committee on June 18th, eventually becoming P.L. 107-204. (See the *Legislation* section in the text.) Reportedly drafted by Morgan Stanley, which is currently under investigation by Mr. Spitzer's office, the amendments never attracted congressional sponsors, but would have basically preempted states' ability to impose conditions, restrictions, or limitations relating to subjects addressed under the federal securities laws. NASAA officials charged that securities industry was trying to undermine investor protection by shutting down ongoing state investigations into research practices at major brokerage houses. However, representatives from the Securities Industry Association emphasized that the trade group had no connection with the amendments. Rachel McTague, "NASAA Says Securities Industry Working To End State Probe of Research Analysts," *BNA's Daily Report for Executives*, June 18, 2002. Thomas Mulligan, "Reform Bill Won't Curb State Securities Regulation," *Los Angeles Times*, June 19, 2002.

investment banking; and a ban on CSFB analyst's involvement in marketing investment banking services.⁷⁰ In a lengthy response that it issued in late November, CSFB dismissed the regulator's complaint as "fundamentally flawed. . ." and "riddled with factual mistakes and flatly incorrect descriptions. . ."⁷¹

The SEC's probe and its analyst certification proposal. On April 25th 2002, the SEC announced that it had begun a "formal inquiry" on Wall Street research practices in conjunction with the NYSE, the NASD, New York Attorney General Eliot Spitzer and other state regulators. According to Chairman Pitt, a key rationale behind the probe was the agency's belief that with respect to stock research, investors should know what they are getting into. Unofficial reports from sources familiar with the probe indicated at least part of the motivation for the investigation stems from the fact that the agency was already engaged in a review of the rules governing stock analysts and that the agency had concerns that states like New York "might seek to impose structural changes the industry as part of a settlement."⁷²

The SEC probe, which some have criticized for being too slow in coming, is seeking instances in which analysts recommended stocks to help firms expand their investment banking business.⁷³ The agency has requested records pertaining to stock analysts and their internal communications with brokers and investment bankers from "dozens" of investment firms, including Morgan Stanley, Goldman Sachs, and J.P. Morgan.⁷⁴

In early June 2002, Representative Edward Markey reported that after requesting an investigation update, the SEC informed him that it had 10 pending enforcement

⁷⁰ In one series of e-mail messages turned over to Massachusetts regulators, a CSFB analyst complained in May 2001 about unwritten rules that "have been imposed by [investment] banking so as to keep our corporate clients appeased." Among them: "[I]f you can't say something positive [about firms who are also investment banking customers], don't say anything at all"; and "just go with the flow of other analysts rather than try to be a contrarian." Credit Suisse, CSFB's the parent has indicated that it would not be averse to spinning off its research unit.

⁷¹ Patrick McGeehan, "Credit Suisse First Boston Denies Fraud Charges Made by Massachusetts," *The New York Times*, November 26, 2002. p. 11.

⁷² Kathleen Day, "States Pressing Analyst Probe; Securities Firms Fear Patchwork of Rules, Back SEC Investigation," *Washington Post*, May 1, 2002.

⁷³ On July 11, 2002, the SEC announced that it had established a "Securities Analysts" section on its Web site, noting that the section had been launched in an effort to provide investors and market participants with easy access to a variety of sources of information pertaining to securities analysts." The section includes links to the new analyst rules on the Web sites of the NYSE and the NASD. The section can be accessed by visiting the SEC's Web site at www.sec.gov, and clicking on "Market Regulation" and then clicking on "Securities Analysts."

⁷⁴ Chaffin, "Fate of Executives Key to Merrill, Spitzer Talks."

inquiries into research-analyst conflicts of interest, and that the SEC reported that the NASD had 20 pending enforcement inquiries into such conflicts while the NYSE had initiated 17 such inquiries. Rep. Markey who is the ranking member of the House Energy and Commerce Subcommittee on Telecommunications and the Internet said that the efforts were an indication that the SEC and the SROs were pursuing a significant number of cases of potential securities law violations by sell-side analysts and commented that the report was “good news.”⁷⁵

By late November 2002, some news reports were indicating that the agency’s investigations had slowed due to bureaucratic disarray due at least in part by the announced resignation of Chairman Pitt.

On August 2, 2002, the SEC proposed Regulation Analyst Certification (AC) for public comment. Under this proposed regulation, research reports disseminated by brokers or dealers would be required to include certifications by the research analyst that the views expressed in the research report were an accurate reflection of his or her personal views. The reports would also have to disclose whether the analyst received compensation or other payments in connection with his or her specific recommendations or views. Analysts would also be required to provide certifications and disclosures in connection with their public appearances. The agency said that the proposal is aimed at promoting the integrity of the work done by research analysts.

Citigroup Decides to Separate Research and Investment Banking

Citigroup’s investment bank, the Salomon Smith Barney investment banking group, has been under investigation by the SEC, the NASD, states in NASAA, the Justice Department, and the New York State Attorney General’s Office for its stock research practices.⁷⁶ On October 30 2002, Citigroup announced that its Salomon Smith Barney investment bank would partition research and investment banking by spinning off a unit that will contain both its securities analysts and its retail brokers. The unit will be headed by Sallier Krwacheck, former CEO of the independent research company, Sanford C. Bernstein. The unit will be underwritten by fee-based

⁷⁵ Bruce Albert, “Hill Leader Warns of States Meddling in Brokerage Rules,” *Newhouse News Service*, June 4, 2002.

⁷⁶ In late September 2002, Citigroup agreed to pay \$5 million to settle NASD charges that former Salomon analyst Jack Grubman misled investors by recommending Winstar Communications as the telecommunications company was falling into bankruptcy. The settlement only involved Winstar-related NASD charges against Salomon and did not address other NASD allegations against the firm: For example, at the same time, the NASD filed a complaint against Jack Grubman, formerly the Managing Director of the firm’s Equity Research Department, and Christine Gochuico, a Salomon Vice President and an assistant to Grubman, concerning their stock research practices.

revenues from its private clients and trading revenues and commissions from both private clients and institutional investors. Its analysts will be compensated from those revenues and will work exclusively for those clients. Ms. Krawcheck will report directly to Sandy Weill, Citigroup's chief, not to the head of the investment banking unit.

A spokesman for Mr. Spitzer's office said that it found the development at Citigroup to be encouraging and that it indicated that the firm was moving in a desirable direction. Rep. Edward Markey observed that the move was "a positive and welcome response to investigations into conflicts-of-interest at the firm initiated by" Mr. Spitzer's office.⁷⁷

Some early criticism of the new Citigroup unit focused on the potential limitations of having it report to the Citigroup head. (Research directors at a few other financial groups like Merrill Lynch and Goldman Sachs have a tradition of reporting to the head of their firms.) A central question concerning the overhaul, is the extent to which an environment of analyst independence can be fostered when the unit is required to answer to the head of Citigroup. In a related vein, some critics have questioned the meaningfulness of the reforms given the continued presence of CEO Weil who presided over the firm during the years in which there were alleged research conflicts.

The Broad-Based Settlement

On October 3rd 2002, at the conclusion of talks brokered by NYSE chairman, Richard Grasso,⁷⁸ Chairman Pitt and New York Attorney General Spitzer announced that in conjunction with the NYSE, and the NASD, they had agreed to develop reforms for investment banking, research, and initial public offerings. Among other things, the verbal agreement was called "a foundation for a global settlement" for the collection of disparate probes.⁷⁹

⁷⁷ "Citigroup to Separate Research Function From Rest of Firm Amid Regulatory Scrutiny," *BNA's Daily Report for Executives*, October 31, 2002, p. A-28 .

⁷⁸ There are reports that Mr. Grasso's actions were motivated in part by the fact that a number of the securities firms under investigation are on the NYSE board and they had concerns that a continuation of the SEC/New York Attorney General jurisdictional battles could cause serious jeopardy to the nation's capital markets. "Spitzer, Pitt Call Truce on Wall St; Financial Enforcers Vow to Cooperate," October 4, 2002, *The Washington Post*, p. E-01. Since the end of 2000, according to fall 2002 figures released by the Securities Industry Association, major Wall Street securities firms had cut 32,287 employees in the United States or 8.8% of their domestic work force. Cheryl Winokur Munk and Chad Bray, "Talk of Boca: Investor Confidence High on Industry Agenda," Dow Jones News Service, November 4, 2002.

⁷⁹ On December 3rd, in a subchapter of the global investment research probes, five of the Wall Street securities firms involved in the global negotiations, Goldman, Citigroup's (continued...)

On December 20, 2002, SEC Chairman Harvey L. Pitt, New York Attorney General Eliot Spitzer, North American Securities Administrators Association President Christine Bruenn, NASD Chairman and CEO Robert Glauber, New York Stock Exchange Chairman Dick Grasso, and state securities regulators announced a global settlement with the nation's top investment firms (including Bear Stearns & Co., Credit Suisse First Boston, Deutsche Bank, Goldman Sachs, J.P. Morgan Chase & Co., Lehman Brothers, Inc., Merrill Lynch & Co., Morgan Stanley, Salomon Smith Barney, Inc., and UBS Warburg).

While a number of the details have not been finalized⁸⁰, the broad terms of the agreement, in which no firm admitted to wrongdoing, include:

- *The insulation of research analysts from investment banking pressure.* Firms will be required to sever the links between research and investment banking, including analyst compensation for equity research, and the practice of

⁷⁹(...continued)

Salomon Smith Barney brokerage unit, Morgan Stanley & Co., U.S. Bancorp Piper Jaffray Inc. and Deutsche Bank AG, agreed to pay \$1.65 million each to the U.S. Treasury, NYSE and the NASD for failure to preserve e-mails. The SEC, the NYSE and the NASD found the firms to be in violation of: 1) a part of Section 17(a) of the Securities Exchange Act of 1934 by failing to preserve for a period of three years, and/or preserve in an accessible place for two years, electronic communications relating to the business of the firm, including interoffice memoranda and communications; and 2) NYSE Rule 342 and NASD Rule 3010 by failing to establish, maintain and enforce a supervisory system to assure compliance with NASD and NYSE rules and the federal securities laws relating to retention of electronic communications. The firms consented to the allegations, without admitting or denying them. In addition to the payments, the firms also agreed to review their procedures regarding the preservation of e-mail communications for compliance with federal securities laws and the rules of the NYSE and NASD. Each firm also agreed to inform each regulator, in writing, within 90 days that it has established systems and procedures reasonably designed to achieve compliance with the statute and rules relating to e-mail retention.

⁸⁰ For example, Citigroup has agreed to pay the largest penalty of any firm, \$400 million, to settle its piece of the probe, which centers on, among other things, whether it securities firm former senior analyst Jack Grubman of its Salomon Smith Barney securities arm, was pressured to upgrade the stock of AT&T Corp., a corporate client, by Citigroup's CEO, Sanford I. Weill. Included in the findings that will be a part of the final settlement will be evidence of a series of telephone exchanges between Mr. Grubman and Mr. Weill before AT&T's upgrade in late 1999. Citigroup, Messrs. Weill and Grubman all have denied wrongdoing. In mid-January 2003, the NASD was reportedly pushing for findings that said that Mr. Grubman's glowing reports on telecom companies amounted to "boosterism." In addition, it was reportedly seeking language that referred to allegations that Mr. Grubman boosted his rating of AT&T for personal reasons and references to Mr. Grubman's "enthusiasm" lasting well beyond the bursting of the stock-market bubble. By contrast, New York's Spitzer was been said to prefer less harsh language that characterized Mr. Grubman's ratings on some stocks "were inconsistent with his true views," and cites several examples through his e-mails. Charles Gasparino, "War of Wording Holds Up Wall Street Deal --- New York Attorney General, NASD Differ on Language For Research Settlement," *Asian Wall Street Journal*; Jan. 17, 2003)

analysts accompanying investment banking personnel on pitches and road shows. This will help ensure that stock recommendations are not tainted by efforts to obtain investment banking fees.

- *A complete ban on the spinning of Initial Public Offerings (IPOs).* Brokerage firms will not allocate lucrative IPO shares to corporate executives and directors who are in the position to greatly influence investment banking decisions.
- *An obligation to furnish independent research.* For a five-year period, each of the brokerage firms will be required to contract with no less than three independent research firms that will provide research to the brokerage firm's customers. An independent consultant ("monitor") for each firm, with final authority to procure independent research from independent providers, will be chosen by regulators. It is hoped that this will ensure that individual investors get access to objective investment advice.
- *Disclosure of analyst recommendations.* Each firm will make publicly available its ratings and price target forecasts. This will allow for evaluation and comparison of performance of analysts.
- *Payment of fines and investor restitution.* Each of the firms will pay a fine, pay monies toward investor restitution, and will be required to escrow funds that will be used to pay for the required independent research. The agreement that was reached totals more than \$1.4 billion in total penalties, and includes the previously arranged payments by Merrill Lynch. (This includes \$900 million in fines, \$450 million over five years to a fund that will buy stock research from firms that do not do investment banking, and \$85 million for investor education.) The fines will be split 50-50 between the states and federal regulators. Generally, the banks that the regulators determined had published the most overly bullish reports and were most abusive in the allocation of initial public offerings will pay the greatest amounts. (See the table below for a breakout of the payments.)

At the announcement of the agreement, Attorney General Spitzer observed:

This agreement will permanently change the way Wall Street operates. Our objective throughout the investigation and negotiations has been to protect the small investor and restore integrity to the marketplace. We are confident that the rules embodied in this agreement will do so. The cooperation among my colleagues at the SEC, NASAA, NYSE and NASD has enabled us to reach this important agreement.

In the months following the settlement, the SEC intends to release a report on the findings that led to the broad-based settlement. Attorney General Spitzer's office

with responsibility for investigating Salomon Smith Barney, expects to come out with a detailed report of their findings, which it expects to be useful for shareholders who wish to pursue lawsuits. The settlement also requires approval by the NASD and the SEC, both of whom are expected to do so.

Coincident with the announcement of the settlement, Attorney General Spitzer's office also announced that former Salomon Smith Barney telecom analyst Jack Grubman agreed to a lifetime ban from the securities business, and a \$15 million fine, allowing him to avoid criminal charges. The deal reportedly has the support of the SEC, which must also sign off on it.⁸¹ Mr. Spitzer and the other regulators also say that in the future criminal or civil fraud cases may also be initiated against a number of individual analysts.

Reactions to the settlement's significance have varied greatly with many observers tentatively praising its putative benefits, while others have questioned whether it represents a significant development.

For example, one observer called the settlement insubstantial, noting that it essentially mirrored the earlier SEC-approved NYSE and NASD analyst reforms and that its \$1.4 billion in required payments was "walking around money" for the banks given their hundreds of billions of dollars in cumulative net worth. Questions have also been raised about the required independent research and whether investment bankers may be inclined to select research firms that tend to issue "buy" and "strong buy" – not "sell" recommendations.⁸² A less harsh, but still somewhat skeptical view is that the "the devil is in the details" and that there may be a need for settlement language that bans the independent research firms from attempting to capture other types of contracts with the large securities firms by distorting their analysis to curry favor with them.⁸³

But, another observer commented that the \$1.4 billion in payments was not an insignificant amount, and they probably approached reasonable limits on what the banks can pay. (This was a comment somewhat echoed by the SEC's director of enforcement, Stephen Cutler, who said that it is was an amount that would be seriously felt by the firms.) But, the observer emphasized that the reputational damage suffered by the banks through the effective admission embodied in the

⁸¹ Ben White, "Wall Street Agrees to Mend Its Ways; Changes in Rules Part of \$1.4 Billion Settlement Over Conflicts of Interest," *Washington Post*, Dec. 21, 2002, p. A-1.

⁸² For example, see the comments of James Cox, professor of corporate finance and securities law at Duke University on: "Paying Up," PBS NewsHour, Dec. 20, 2002. Additional criticism of the roughly \$900 million in restitution is that it constitutes a basically meaningless transfer of funds from the investment banks' shareholders to the "victimized" shareholders in other firms – minus the substantial cut taken by their lawyers. (Robert Samuelson, "Stock Market Theater," *Washington Post*, Jan. 2, 2002, p. A-19.)

⁸³ Susan Harrigan and Joshi Pradnya, "Brokerages Agree To \$1.4B Settlement," *Newsday*, December 21, 2002, p. A06.

settlement that something had gone wrong will be far more devastating over the long haul than the fines will be. On the requirement to make independent research available, the observer also suggested that initially investors are likely be leery of various kind of research, but over time, would regard having investment bank-based and independent firm-based research “side by side” as valuable.⁸⁴

A number of investors’ lawyers are concerned that in allowing the investment banks to avoid admitting wrongdoing, the settlement effectively curtails the full disclosure of evidence of their illegal conduct documented during the investigations. They are concerned that without the benefit of the complete disclosure, investors’ legal claims against the banks will not be as effective as they could be.⁸⁵

Plaintiffs’ lawyers have also criticized the lack of explicit plans for sharing any of the money being collected with investors. Mr. Spitzer and the various regulators have said that they want the funds to go toward investor restitution, but they say that they will face daunting challenges in determining who would be eligible and how much those individuals should receive.⁸⁶

On the issue of restitution, Chairman Oxley has indicated that it was imperative that the settlement compensate investors whose trust was misplaced. He remarked that “the concept of making investors whole should be central as we move forward” and that he would be closely tracking these developments.⁸⁷

Attorney General Spitzer indicated that the primary purpose of the settlement is to restore confidence in the securities markets by helping to ensure investors that the markets were fair. Various observers have agreed, calling it a good and significant agreement. But, others derided it, some characterizing it as political theater significantly driven by the need for an exit strategy on the part of Mr. Spitzer’s office (with its limited resources), the NASD and the NYSE who were reportedly embarrassed by the analyst conflict, and the SEC with its leadership problems.⁸⁸

Other observers, however, suggest that we should take a “wait and see” approach with respect to the December settlement and the various analyst reforms that preceded it, saying that it will take some time to see whether they will have real tangible impact. But, some also caution that in some past instances, government

⁸⁴ For example, see the comments of Charles Elson, director of the Center for Corporate Governance at the University of Delaware on: “Paying Up,” PBS NewsHour, Dec. 20, 2002.

⁸⁵ Thor Valdmanis, Some Investors Balk at \$1.4B Wall Street Deal; Settlement May Hurt Lawsuits Against Firms,” USA Today, Dec. 23, 2002, p. B-1.

⁸⁶ Ibid.

⁸⁷ Michael Gormley, “Wall Street Firms Agree to Pay \$1.5 Billion to Settle Conflicts of Interest,” AP Worldstream, December 20, 2002.

⁸⁸ See the comments by Cox and Samuelson in footnote 81.

regulators have not always been able to stay focused on the implementation of some previous settlement agreements after they were inundated with new regulatory concerns.⁸⁹

The Global Settlement Payments

(in \$ millions)

Firm	Retrospective Relief	Independent Research	Investor Education
Bear Stearns & Co.	50	25	5
Credit Suisse First Boston	150	50	0
Deutsche Bank	50	25	5
Goldman Sachs	50	50	10
J.P. Moran Chase & Co.	50	25	5
Lehman Brothers, Inc.	50	25	5
Merrill Lynch & Co., Inc.*	300	75	25
Morgan Stanley	50	75	0
Citigroup	300	75	25
UBS Warburg	50	25	5
Total	900	450	85

* This represents payment made in prior settlement of research analyst conflicts.

⁸⁹ White, "Wall Street Agrees to Mend Its Ways; Changes in Rules Part of \$1.4 Billion Settlement Over Conflicts of Interest." p. A-1.

Legislation Passed in the 107th Congress: P.L. 107-24

On April 24th 2002, the House passed major corporate accountability legislation, H.R. 3763, the Corporate Auditing Accountability, Responsibility and Transparency Act (Oxley). On July 15th, the Senate passed major corporate accountability legislation, S. 2673, the Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes) as H.R. 3763. The House and Senate bills then went to conference committee, which on July 24th adopted a conference report on corporate accounting reform legislation (H.R.3763), which essentially derived from the provisions in S.2673 as passed in the Senate. The legislation was passed by the House and the Senate on July 25th. On July 30th it was signed into law as the Sarbanes-Oxley Act of 2002 (P.L. 107-204). With respect to securities analysts, the provisions in P.L. 107-204 are basically the same as those that were in S. 2673 as passed earlier in the Senate:

P.L. 107-204 directs the SEC, the NASD, or registered national securities exchanges to adopt rules for securities brokers or dealers that are designed to limit analyst conflicts. They should include:

- Restricting the prepublication clearance of analyst research reports by investment banking personnel or others who are not directly involved in research analysis.
- Limiting the supervision and compensation evaluation of securities analysts to personnel not involved in investment banking;
- Forbidding personnel associated with investment banking activity from retaliating against security analysts when they publish unfavorable research reports that may adversely effect a firm's investment banking relationships;
- Establishing structural and institutional safeguards to assure that securities analysts are separated by appropriate informational barriers from investment banking activities that might bias their work; and
- Requiring securities analysts to disclose in public appearances and brokers or dealers to disclose in research reports potential conflicts of interests with respect to their securities holdings in covered firms or the covered firm's client status with their securities firm. Similar disclosure would be required when there are compensation arrangements between a broker or dealer or a securities analyst and a corporate issuer who is the subject of their research reports. Disclosure would also be required when securities analysts receive compensation that is related to their firm's investment banking activities.