TESTIMONY

Statement of Charles L. Hill, CFA
Director of Research, Thomson Financial/First Call
U.S. Senate Government Affairs Committee
Enhancing Analysts Independence and Improving Disclosure to Investors
27 February 2002

Chairman Lieberman, Ranking Member Thompson, and members of the Government Affairs Committee. I appreciate the opportunity to testify in front of this committee today. I believe the issue of analyst conflicts is an important issue that needs to be addressed. It is one of several investment issues that needed to be addressed before the Enron debacle, and now even more so. It is important not only to the future health of the investment community, but is of greater importance to the public's perception of and confidence in the overall capitalist system.

The most obvious symptom of the analyst conflict problem is the positive bias of analyst recommendations in general, as well as the extreme positive bias of their recommendations on Enron in particular.

For at least the last several years, roughly one-third of all broker analyst recommendations were strong buys (or whatever the brokers terminology was for the top category). Similarly, one-third were buys and one-third were holds. The total of both sells and strong sells was always less than 2%. That is still true today despite the severe criticism analyst recommendations have been increasingly subject to in recent months. It is interesting that the analysts recommendations were at their most positive levels at the peak of the market in the Spring of 2000.

That means that if an individual investor was able to decode what the broker recommendation terminology really meant (for example, most investment institutions translate "hold" to mean that the analyst is really saying "sell"), and was guided by the relative changes in their recommendations, those changes on average would not have been very helpful.

The above normal positive bias persisted until early 2001, even though the stock market indices were in decline from the spring 2000 highs. The shift that did occur was fairly minimal, roughly six percentage points shifted from strong buy to buy, and about five from buy to hold and about one from hold to sell.

In the specific case of Enron, the analysts were in a difficult position. Enron had morphed into what was essentially a hedge fund. As a result there was very little transparency in recent years as to where earnings were coming from. Analysts were virtually limited to Enron's historical earnings record and to the company's guidance for future earnings.

Therefore, it was not surprising that on the eve of Enron's third quarter 2001 earnings report, 13 broker analysts had a strong buy (or their equivalent terminology), 3 had a buy, and none had a hold, sell, or strong sell.

Despite a number of red flags from 16 October 2001 on, the analysts dallied in lowering or discontinuing their recommendations in the face of increasing risk. By 12

November, almost a month after Enron had announced a $1.2 billion write off that Ken Lay could not explain on a conference call, almost a month after the Wall Street Journal reported Enron executives stood to make millions from Enron partnerships, three weeks after the CFO was fired, two weeks after Enron announced it was being investigated by the SEC, and four days after Enron announced that it had overstated four years of earnings by $600 million – after all these red flags, there were still 8 analysts with a strong buy, 3 with a buy, 1 with a hold, and 1 with a strong sell. At that point, none had dropped their recommendations.

The new proposals from the NASD go a long way toward addressing some aspects of the bias problems. They provide for better disclosure of the firm's investment banking relationships with the company, and of the firm's and the analyst's holdings. They provide for some standardization of recommendations across the brokerage industry. The requirement for analyst reports to show the recommendation distribution of all the firm's recommendations hopefully will lead to less of a positive bias in analyst recommendations.

Unfortunately, the new NASD rules do not sufficiently address the key issue of analyst compensation. Until the so called "Chinese Wall" between research and investment banking is restored at the brokerage houses, there will continue to be a problem with analyst objectivity.