# STATEMENT

## Senator Joe Lieberman
## Opening Statement:

### "The Watchdogs Didn't Bark: Enron and the Wall Street Analysts"

**Governmental Affairs Committee Hearing**
Wednesday, February 27, 2002

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Thank you all for being here for this hearing, "The Watchdogs Didn't Bark: Enron and the Wall Street Analysts." This is the third in our series of hearings on the largest bankruptcy in American history and is part of an ongoing attempt to assess the damage, learn the lessons, and help craft the solutions to the problems that led to the fall of Enron and its many connected catastrophes.

Future hearings of the full committee and its investigative subcommittees will look at the role of other watchdogs including federal agencies, auditors, and the Board of Directors. Today we focus on the private analysts whose warnings could have, and many say should have, alerted investors to the fiscal fissures in Enron's foundation before everything crumbled, but who instead continued to urge investors to buy Enron's stock even after it began to crumble. Why were the analysts blinded to the company's deceit and disintegration, and how can we prevent similar failures in the future?

These are crucial questions, because the Enron earthquake has left millions of Americans worrying that their stocks are standing on shaky ground. According to a recent *BusinessWeek*/Ipsos-Reid poll, 68 percent of investors said they have little or no faith that the stock market treats average investors fairly. And 54 percent of investors said they are concerned about the honesty and reliability of the investment information they receive. According to *BusinessWeek,* "the worry is that thousands of companies have consistently, and legally, overstated earnings for the past few years." In other words, even when the Enron smoke clears, people are worried that there may be more accounting smoke and mirrors lurking. This is consequential. It's serious not only for our investors but for our economy.

The average investor today is like a swimmer who's seen a shark. She or he doesn't know how many more sharks are in the water or whether there are any good lifeguards on duty.

Making sure those lifeguards are on the lookout is part of our purpose here, and it is a very important purpose, because this is more than a crisis for a small slice of America's economy. It really hits at the very heart of our prosperity. Spreading 401(k) accounts and rising markets have spurred a seismic shift in stock participation over the last two decades. From 1930 to 1980, the number of Americans investing in the market hovered between 5 and

15 percent. By 1998, that had jumped to more than 50 percent.

It's these middle-class Americans, the new investor class, who are most shaken today. When equipped with trustworthy, up-to-date, and independent information on a company and its competitors, investors—whether professional or amateur—can choose stocks wisely. But without sound information—or even worse, with misleading information—they may as well go gambling.

We don't expect Wall Street analysts to be fortune tellers, but average investors expect them to filter out the vast and potentially confusing flow of information about companies and markets—to dissect and decipher the financials of companies, especially those with hard-to-understand business models, in a way that's meaningful not only to Wall Street insiders but to investors on Main Street. Information, after all, is one of the most precious cargos in America's economy, and Wall Street analysts are expected to transport it with maximum care.

This is the unwritten agreement that has drawn middle class investors into the market and it's what they rely on in entering the markets. They know there is risk, that not every stock will always rise, but they rely on the watchdogs – public and private – to keep the stock market fair and to give them accurate information to help them decide where to put their money and, with it, their hopes for economic advancement and retirement security.

The question we ask today is have the Wall Street analysts kept their side of the agreement? I regret to say, based on the investigation this Committee has done, that my answer is no, they have not. Ten out of 15 analysts who follow Enron were still rating the stock as a "buy" or a "strong buy" as late as November 8 **[CHART ON ENRON ANALYSTS' RATINGS]**, which was three weeks after the initial report of the company's hidden losses appeared in *The Wall Street Journal* and about two weeks after the SEC announced an investigation of Enron.

Enron's ad campaign, as you may remember, was "Ask why?" It now seems clear that too many analysts failed to ask "why" before they said "buy." And often when they did ask "why" but didn't get a straight answer from Enron's executives they went right on touting the stock.

At least one analyst did know better. On May 6, 2001, the Off Wall Street Consulting Group issued a report calling Enron stock overvalued and pointing out many of the problems that would later be revealed in full when the company collapsed. That was on May 6, 2001. Among other things, the report questioned the fact that the company appeared to be using accounting tricks to pump up its revenue.

Regrettably, the analyst's performance with Enron is indicative of a broader problem. David Becker, General Counsel of the SEC, said last August, and I quote, "Let's be plain: broker-dealers employ analysts because they help sell securities. There's nothing nefarious or dishonorable in that; but no one should be under any illusion that brokers employ analysts simply as a public service."

This is jarring news to many investors, who have considered "strong buy," "buy," "hold" and "sell" recommendations to be honest investment advice.

One of the most stunning facts I have learned is that committee's investigation is no matter what the market does, analysts seem to just keep saying "buy." According to Thomson Financial, two-thirds of all analyst recommendations are "buy." And only one percent are "sell." Take a look at this chart. It shows that **[CHART ON RECOMMENDATIONS AND S&P 500.]** In fact, over the last two years, no matter what the S&P 500 did, the recommendation of the major analysts was virtually unchanged.

How can that be?

I fear – and I am not alone in this fear – that one of the reasons is that the vast majority of analysts work for Wall Street firms and banks, particularly in the investment banking business. In fact, analysts' compensation is often tied directly to the success of their firms' investment banking business. And analysts usually develop cozy relationships with the companies they cover—relationships that are valuable to their firms and could be endangered by their release of a critical report or opinion.

All of these influences compromise analysts' objectivity and mean that the average investor should take their bottom-line recommendations with at least a grain of salt, if not with a whole bucket.

A new set of proposed rules designed to improve analyst independence, crafted by the National Association of Securities Dealers before the Enron debacle, were submitted to the SEC on February 7, and I believe they are a valuable step forward. The rules would limit compensation that analysts can receive from investment banking activity, restrict analysts' trading of stocks they cover, ban them from reporting to their firms' investment banking divisions, and prohibit them from promising favorable ratings to companies they cover.

But because of how deeply analysts are entwined with the fate of the companies they cover, I believe more must ultimately be done to guarantee that their analyses are truly independent.

As President Franklin Roosevelt said in 1937, "We have always known that heedless self-interest was bad morals; we know now that it is bad economics." Over the last few months, because of Enron, too many people and our economy as a whole, have painfully rediscovered the meaning of those words over the last few months thanks to Enron. Our job is to make sure that from this point forward, this wisdom spreads not through painful experience but through proactive and progressive policies.

I look forward to hearing from our witnesses today, who I hope can help us do just that.

***Press Statement***

***Enron Chart***

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