TESTIMONY
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BEFORE THE
UNITED STATES SENATE
COMMITTEE ON GOVERNMENTAL AFFAIRS
ON
THE COLLAPSE OF ENRON:
THE ROLE ANALYSTS PLAYED AND THE CONFLICTS THEY FACE
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BACKGROUND

Consumers Union[1] is pleased to provide this testimony on securities analysts' conflicts of interest. Investors need a credible source of information about investments. Individual investors often rely on the advice provided by Wall Street analysts. Yet, that advice may be far from independent or objective.

In hindsight, Enron's demise shows that potential conflicts at research operations at full-service brokerage houses may compromise the quality of research, and that the effects on individual investors, market stability, and the economy as a whole can be devastating.

According to expert testimony during congressional hearings last year, including statements by former Commissioners of the Securities and Exchange Commission, market forces put tremendous pressure on analysts to make positive recommendations. Analyst compensation is often based on investment banking fees linked to the companies on which the analyst offers advice. Analysts, or their firms, may own stock or have other interests in the companies on which the analyst is providing advice.

Conflicts of interest have a direct impact on individual consumer investors. Studies show that investors do worse listening to analysts with ties to companies and better with independent analysts. Investors were told to buy even when the analyst making the recommendation was selling the same stock. Overall, the vast majority of analyst recommendations are to buy. Only rarely are investors advised to sell.

Why is this discussion important? In 1990 less than a quarter of all American households directly owned stocks, today that number is more than half. Testimony by the AFL/CIO put it best:

> Families have an enormous state in the honesty of the investment information they receive from the analyst community. Few individual investors have the ability to digest raw data from financial markets, and even fewer may have access to insiders in the companies they invest in. Analyst research is likely to be the most detailed and analytical information small investors have to consult in making investment decisions.

In response to rising concerns about analyst independence and conflicts of interests the National Association of Securities Dealers (NASD) recently proposed improved disclosures of potential conflicts. The NASD first proposed rules on required disclosures for securities recommendations in response to the decline of technology stock. Consumers Union, Consumer Federation of America, and Consumer Action filed comments in response to that initial proposal. A copy of our comments is attached to this testimony. The current NASD proposal expands the reforms discussed pre-Enron and incorporates some of the recommendations made by Consumers Union and others. We are encouraged by these developments.

VIEW OF THE MARKETPLACE: THE PROBLEMS AND SOME SOLUTIONS

- Conflicts of interest will always exist where analysts are part of the same firms that loan money or have other business relationships with the companies on which the analysts offer their recommendations.
- These conflicts are likely to grow with the passage of the Gramm-Leach-Bliley Act, which repealed Glass-Steagall and allows banking, investment and insurance firms are allowed to merge – mergers that will create a myriad of potential conflicts of interest.
- Disclosure of conflicts does not get rid of the conflict of interest. Analyst recommendations may still be influenced by the relationships between the investment firm and its affiliates and the companies recommended by the analysts.
- Meaningful disclosures may serve as useful warnings to investors that the recommendations may be tainted. Disclosures should provide details of the nature of the relationships between the analyst, the analyst's firm and the company being recommended. Disclosures should be made any time a recommendation is being made and in a manner that calls the investor's attention to the disclosure. A uniform "food label" may be an appropriate mechanism to allow investors to

quickly identify potential conflicts.

- A "certification" system for independent analysts should be created. Investors reading a report from an independent analyst or listening to an independent analyst on TV that is so designated would know right away that the analyst is conflict-free. Investors could chose to disregard advice by analysts without the "independent" designation.
- A mechanism to rate the accuracy and reliability of Wall Street analysts would also help investors judge advice and recommendations.
- Addressing analysts' conflicts of interest alone will not be enough to restore investor confidence. If the circumstance that create the potential unreliability of analyst advice cannot be completely removed, then investors need assurances that other watchdogs are in place. Regulatory oversight and independent audits are key components. The SEC must be provided the resources to fulfill this mission.
- Another solution that may benefit investors would be the development of an independently funded investor driven watchdog organization.

THE ROLE OF ANALYSTS

Securities analysts enjoy a privileged position in the markets because of the central role they play in the efficient pricing of equities. The public losses confidence when market corrections, like the ones in the tech sector, go virtually unrecognized by industry analysts, many of whom continued to plaster "buy" recommendations on the stocks they covered, even as share prices plummeted. That colossal failure by analysts prompted many in the media, the regulatory community, and on Capitol Hill to ask what went wrong and what, if anything, can be done to fix it. With the collapse of Enron, we find ourselves asking the same questions.

One answer, acknowledged even by leaders in the industry, is that Wall Street research is pervaded by conflicts of interest that can, and have, corrupted the objectivity of research. Instead of turning a skeptical eye on questionable "operational earnings" numbers presented by corporate mangers or pointing to a lack of any prospect for company profits in the near term, or brazen refusals to provide clarification of company practices as reported with Enron, or a lack of understanding of company operations, too many securities analysts became cheerleaders for companies their firm was bringing public or had other financial dealings.

Conflicts of interest will exist as long as investment banking, trading and research are permitted to be bundled together in one firm. Beyond the industry's failure to recognize and warn investors – one reason analysts find themselves in the hot seat – several things have changed in recent years to make analysts' conflicts of interest an issue that policy-makers are compelled to address:

- The magnitude of research-tainting conflicts has grown as investment banking and proprietary trading have become increasingly dominant sources of revenue for full-service brokerage firms.
- The Internet and financial media, particularly broadcast media, has given analyst research new prominence. By turning securities analysts into media stars, the media has helped to magnify analysts' influence on share price.
- In part because of that new media exposure, retail investors suddenly have access to Wall Street analysts' research, but without the understanding more sophisticated players generally have of the conflicts that may bias that research.

ANALYST RECOMMENDATIONS

Media, academics, and experts who have testified before Congress over the past two years have offered convincing testimony on the nature, extent, and effects of analyst conflicts of interest. That testimony has shown that substantial conflicts pervade Wall Street research operation, that the quality of research is impaired by those conflicts, and that the economy and individual investors are harmed as a result.

- Former SEC Chairmen Arthur Levitt testified about a study that found sell recommendations account for just 1.4 percent of all analysts' recommendations, compared to 68 percent being buys.
- In the case of Enron, 16 out of 17 analysts had a buy or strong buy rating, one had a hold, none had a sell – even as the company stock had lost over half of it's original value and it's CEO suddenly resigned.
- William Mann, a senior analyst with The Motley Fool, told a congressional panel that Enron isn't the first time analysts maintained cherry ratings on a company as the company itself was collapsing and investors faced tremendous losses. During the descent of Lucent of the 38 analysts who covered the company 32 had buy ratings on the sock, 6 had holds, and none had a sell rating. Investment banks that had generated significant revenue from Lucent's acquisition and debt placement activities employed many of those analysts.
- Over the last 12 months 233 public companies have had to restate their earnings, and not surprisingly, none of these restatements have made the companies' operating results look better, according to Mann of the Motley Fool.

GROWING CONFLICTS OF INTEREST

It is difficult not to point to possible conflicts of interests between analysts, the firms that employ them and the financial relationships between those firms and the companies subject to the analysts' recommendations. What chance do consumers have of making informed choices when they can't depend on auditors or analysts to tell them the truth about the financial well being of companies?

The passage of the Gramm-Leach-Bliley Act also raises new concerns. The consolidation of the financial services industry creates new further potential conflicts. Issuers are in a position to withhold business from the firms of critical analysts across a wide range of markets, including commercial loans and commercial banking services, pension fund and treasury money management, and insurance contracts. This leverage is particularly powerful when the issuer is itself a financial services company.

- CFO Magazine reported last year that First Union cut off all bond trading business with Bear Stearns in response to negative comments by their analyst, and Bear Stearns ordered the analyst to be more positive. Recent press reports of similar threats made by Enron executives.
- According to USA Today, Lehman Brothers could not downgrade its strong buy recommendation on Enron (even if it was inclined to do so) because it was restricted as an advisor in the Dynegy buyout bid.
- An article appearing this Saturday in the Washington Post points directly to the relationship between banks and Enron. The article highlights how J.P. Morgan made loans to Enron, bought Enron stock, and recommended Enron stock to investors. Some of the largest banks in the country had similar arrangements. Analysts for some of those firms kept strong buy recommendations in place for Enron until it became painfully obvious that the company was collapsing. J.P. Morgan faces over $1 billion in losses and has lined up with other Enron creditors in bankruptcy court.

If you were an analyst, where would your place your allegiance? Do you act to protect the investment of your firm and try to boost the stock? Or do you advise investors to sell?

THE NASD PROPOSAL

The NASD proposal to address these developments, driven in part by the Enron debacle, is a good first step. The proposal relies heavily on disclosure. Even the best disclosure, however, does not get rid of the underlying conflict. Therefore, improved disclosure alone will not be enough to restore confidence in Wall Street analysts' research. But improving the ability of investors to assess the conflicts of interest is an appropriate place to start. More comprehensive solutions will take time. In the interim, there seems to be near universal agreement that improved disclosure is badly needed.

Reforms should also focus on creating incentives to produce objective research, boosting the competitiveness of that research, improving the clarity of analysts recommendations, prohibiting certain inherently abusive practices, supporting strong enforcement against abuses, and enhancing Regulation FD.

As long as research is offered within firms that combine investment banking, trading, and research, it will be subject to powerful conflicts of interest with significant potential to bias recommendations. And, as long as firms earn the bulk of their revenues on investment banking and proprietary trading, management will have little incentive to protect research departments from the corrupting influence of those conflicts. When analysts are rewarded (e.g., with sizable bonuses) for playing the game, when institutional clients continue to purchase Wall Street research despite its obvious biases, and when financial media continue to give prominent play to biased research, there is little up-side for either the analyst or the firm in issuing objective research. As a result, combating the problem will require a multi-faceted approach that combines enhanced disclosures, effective enforcement, and new incentives to produce objective research.

FURTHER RECOMMENDATIONS

We are encouraged that the NASD rule addresses some of the concerns consumer advocates raised in comments of earlier industry proposals. In those comments Consumers Union, Consumer Federation of America, and Consumer Action made the following recommendations:

Create an incentive to produce objective research

The primary goal of an effective policy to address research conflicts should be to provide an "up-side" for objective research. In other words, since powerful financial incentives to produce biased research will persist, policy makers should seek to provide equally powerful incentives to provide objective research. The best way to do that, in our view, is to put analysts' and firms' reputations clearly on the line.

We believe the National Association of Securities Dealers should be encouraged to develop standardized measurements of the success of analysts' recommendations and apply them to all analysts and firms making research publicly available. At a minimum, the ratings should be publicly available through the NASD. A better approach might be to require their disclosure on research reports.

Just as requiring airlines to publish their on-time records helped to improve their on-time performance, requiring analysts and firms to publish their research quality ratings would likely encourage them to produce more reliable recommendations. After all, no one wants to end up featured in a Gretchen Morgenson column on the worst analysts in the industry. Conversely, firms that perform well are likely to use that fact in promoting their services. Finally, using such ratings might encourage the media to be more selective in its use of analysts, choosing those with a reputation for quality research rather than those with a snappy line of patter.

Help make independent research more competitive

Given the disdain many institutional investors express for the recommendations of sell-side researchers, it is difficult to understand why they don't turn to independent research instead. The answer appears to be that they don't actually "pay" for Wall Street research. They get it as a part of a bundle of services that also includes trading and access to IPO shares. The fact that the research is, to all appearances free makes if extremely difficult for independent researchers to compete. One suggestion is to require Wall Street firms to bill separately for research. By making the costs of the research explicit, rather than hiding it in commissions that are passed on to shareholders, such an approach could open the door to greater use of independent research firms by institutional investors. If Wall Street firms had to compete on the basis of the quality of their research, this would provide an added incentive to improve that research's objectivity and clarity.

Require explicit, graphic disclosure of conflicts of interest

Almost everyone seems to agree that current disclosures of conflicts are inadequate and need to be improved. In fact, if the intent of the disclosures is to put average, unsophisticated investors on notice of conflicts, current disclosures are all but meaningless. The NASD has taken an initial step toward improving disclosures, for which they are to be congratulated. We want to ensure that the NASD proposal will produce the kind of disclosures that would grab investors' attention and make them aware of the nature and extent of those conflicts. To be effective, disclosures must be clearly labeled as disclosures about conflicts of interest; they must describe the nature of the conflict; they must expose the extent of the conflict; and they must extend to all the ways in which research is conveyed to average investors, including oral representations by brokers to clients. Truly effective disclosure should arm investors with the kind of healthy skepticism that institutional investors bring to the reading of Wall Street research. To the degree that the practices disclosed are embarrassing when laid out in unvarnished language, improved disclosure might also discourage some firms and analysts from engaging in certain types of behaviors that create conflicts.

Mandate standardized terminology for analyst recommendations

It has repeatedly been noted that, while insiders understood that "buy" means "hold" and "hold" means "sell," average investors weren't always up on the lingo. In its best practices, the SIA recommends that firms adopt formal ratings systems and publish the definitions of those ratings. At a minimum, firms should be required to do so and to disclose those ratings on every research report. A better approach would be for regulators to work with industry to develop uniform language that all firms are required to use. This would enable investors not only to understand the significance of an individual analyst or firm's ratings, but also to better compare the ratings issued by different analysts and different firms.

In addition, firms should be required to disclose on each research report, the percentage of stocks it currently covers that fall into each category. If an investor learns that every company the firm covers is rated a "buy," he or she may be less likely to rely exclusively on the recommendation. Instead, the investor may be inclined to probe more deeply to determine if the stock is appropriate for his or her portfolio.

Prohibit certain practices that create significant, unwarranted conflicts of interest

Certain practices that carry enormous potential for abuse and ought to be prohibited. These include analysts' practice of selling against their own recommendations and purchasing pre-market shares of a company and then issuing positive research to support the offering and some firms' practice of tying analyst compensation directly to specific investment banking projects on which they are involved. Similarly, to the degree that the practice of issuing "booster shots" is not already in violation of existing prohibitions on manipulation, it should be expressly prohibited.

Take strong enforcement action against abusive practice

When teenager Jonathan Lebed was hauled before the SEC on stock manipulation charges, he expressed some confusion over how what he had done differed from the practices of the main Wall Street players. He made a good point. After all, when Wall Street firms or their analysts issue positive research to promote interest in a stock as they prepare to unload their own holdings (against the analysts' buy recommendation), they are running their own version of the "pump and dump" scheme. The SEC should be at least as aggressive in going after these Wall Street insiders as it has been in going after the relative small fry who use Internet chat rooms to run their schemes.[2] If the SEC lacks either the resources or the authority to pursue that sort of aggressive enforcement program, Congress should give them what they need. If the SEC lacks the will to pursue such cases, Congress should use its oversight authority to help supply the backbone.

CONCLUSION

Substantial conflicts of interest are deeply embedded in the structure and practices of Wall Street firms. Voluntary industry efforts will do little to change behavior. However, we believe a multi-faceted approach that lays bare those conflicts, creates incentives for producing unbiased research, clarifies the language of recommendations, prohibits particularly abusive practices, and provides strong enforcement to back up standards has the potential to prompt significant improvements.

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[1] Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide consumers with

information, education and counsel about goods, services, health, and personal finance; and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of *Consumer Reports*, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports* with approximately 4.5 million paid circulation, regularly, carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

[2] This is not to imply that we condone the stock manipulations of Lebed and others, rather that we believe Wall Street insiders should be held to at least ~~as~~ high a standard.