

The Great Wall Street?

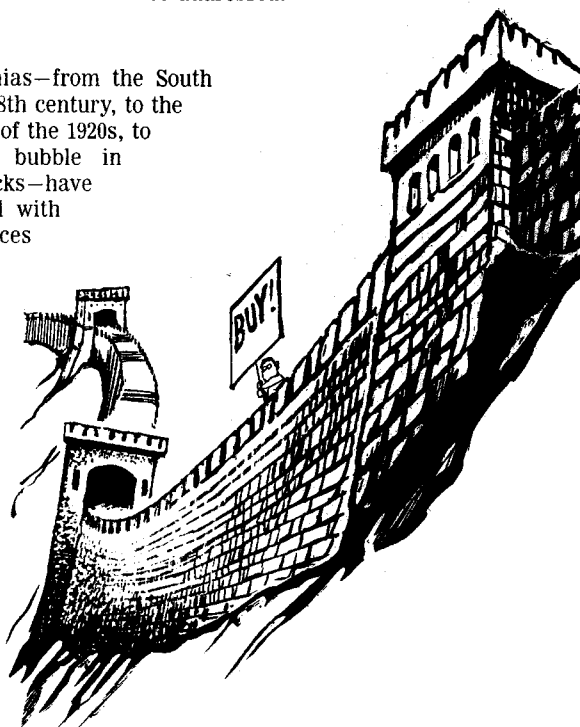
The punishing meltdown of over \$8 trillion in stock market wealth has focused public attention on the abusive practices and monitoring failures associated with the Internet bubble. Both legislative and regulatory efforts toward reform have followed.

The Sarbanes-Oxley Act should help to ameliorate conflicts of interest in the accounting profession. The exchanges and the Securities and Exchange Commission have set standards that should contribute to improved corporate governance. The requirement that chief executive officers certify the validity of their financial statements should bolster the credibility of those statements. But there has been no credible proposal to deal with the issue of corrupted research, which surely contributed to the bubble, and which is partly responsible for the widespread lack of confidence of the investing public. If comprehensive Wall Street reform is really to be accomplished, this issue must be addressed.

Bubble Mania

Speculative manias—from the South Sea Bubble of the 18th century, to the stock market boom of the 1920s, to the extraordinary bubble in New Economy stocks—have all been associated with fraudulent practices and business scandals. Predictably, each crisis produced legislation designed to ensure that such abuses would not be repeated. Some of the legislation was clearly beneficial. The Securities Acts of 1933 and 1934 have helped make our securities markets fairer and more transparent and still the envy of the world. But there is also a danger that legislators can overreact. After the South Sea collapse, the British Parliament passed the Bubble Act, which prohibited the issuance of stock certificates for more than a century, until the act was repealed in 1825. Certainly, the proper solution for abuses in the capital raising process was not the prohibition of new issues.

Moreover, some of the abuses recently uncovered by New York's Attorney General Eliot Spitzer and others are not amenable to a legislative solution. In particular, I refer to the pervasive conflicts of interest inherent in the way the major Wall Street firms are organized. The incentives facing security analysts and underwriters militate against their serving as effective guardians of the interests of shareholders. The industry itself must take the lead in providing a solution.



Conflicts of interest in firms are inherent and pervasive.

Thirty years ago, the research departments of large Wall Street firms were, in effect, subsidized by commissions paid by retail and institutional investors. Security analysts rightly felt that they were working for their investing clients. But after fixed commissions were deregulated in 1975 and competition dramatically reduced the commission structure, there was no longer a ready profit source to pay for research.

By the late 1970s, the major Wall Street firms realized that their profitable investment banking departments could provide the profits to pay for their expensive research departments. And that's how the conflicts arose. Analysts' salaries and bonuses became determined in part by their role in assisting the underwriting department. Many research analysts became nothing more than tools of the investment banking division.

Traditionally, a "Chinese Wall" separated the research function of Wall Street firms, which supposedly worked for the benefit of investors, from the profitable investment banking function, which worked for corporate clients. But especially during the Internet bubble and new issue mania of the late 1990s, that wall became more like Swiss cheese.

One indication of the tight relationship between security analysts and investment banking clients is the paucity of "sell" recommendations. There has always been some bias in the ratio of "buy" to "sell" recommendations, since analysts don't want to offend the companies they cover for fear that they will be cut off from the flow of information. But as banking revenues became the major source of support for research, analysts were increasingly paid to be bullish rather than accurate. In one celebrated incident, an analyst who recommended that Trump's Taj Mahal bonds be sold because they were unlikely to pay their interest was summarily fired after

threats of legal retaliation from "The Donald" himself. (Later, the bonds did default).

This is far from an isolated incident. An analyst from BNP Paribas alleged that he was forced out of his job after a "sell" recommendation on Enron. And a bank stock analyst at Credit Suisse First Boston alleged that he was canned after issuing a sweeping recommendation to sell bank stocks. Small wonder that most analysts have purged their prose of negative comments that might give offense to current or prospective investment banking clients. In the late 1990s, the ratio of "buy" to "sell" recommendations climbed to 100-to-one, particularly for brokerage firms with large underwriting businesses.

There is convincing evidence that analyst recommendations are fainted by investment banking relationships. Brad Barber of the University of California studied the performance of the "strong buy" recommendations of Wall Street analysts and found it nothing short of "disastrous." Indeed, the analysts' "strong buy" recommendations underperformed the market as a whole by 3% per month while their "sell" recommendations outperformed the markets by 3.8% per month. Even worse, researchers at Dartmouth and Cornell found that stock recommendations of Wall Street firms, without investment banking departments did much better than the recommendations of firms that had banking relationships with the companies they covered. Another study from Investors.com found that investors lost over 50% when they followed the advice of an analyst employed by a Wall Street firm that managed the initial public offering of the recommended stock. Research analysts were basically paid to tout the stocks of the firm's underwriting clients. And analysts lick the hands that feed them.

Earlier this year, Mr. Spitzer found a smoking gun. While Henry Blodgett and other analysts at Merrill Lynch were officially recommending some Internet stocks, the same analysts were referring to the stocks in e-mail messages as "junk," "dogs," or less attractive epithets. Merrill did not admit guilt

but it settled with New York and other states for \$100 million. Merrill, as well as Goldman Sachs and Salomon Smith Barney, promised certain reforms such as not directly tying analysts' pay to investment banking revenues, clarifying their stock recommendations, and better disclosing potential conflicts of interest. But simple promises are unlikely to be effective without systemic changes that remove the conflicts of interest that are the root cause of the problem.

If there is no profit center available to pay the cost, then there will be no incentive for firms to do the independent research that is helpful in making markets efficient. And neither legislation, the entreaties of self-regulatory organizations, nor the goodwill of Wall Street executives will ensure that quality unbiased research reports will be produced. Sarbanes-Oxley may well ameliorate some of the conflicts of interest in the accounting profession. But the industry itself must address the conflicts of interest inherent in the organization of our large securities firms.

Unfinished Business

Stating the problem is easier than finding the right solution. Prudential Securities simply eliminated the conflict by jettisoning their investment banking department. Whether that model can produce the ongoing profits to sustain a high quality research effort remains to be seen. Another approach, proposed by Peter Solomon, is for Wall Street firms to band together to form an independent research cooperative from which the firms could buy research services. Whether the "street" would be willing to pay for such a nonproprietary enterprise, especially when it offended important banking clients, is uncertain. But clearly something needs to be done, and it will have to be done by Wall Street itself. Solving the problem of corrupted research must still be regarded as unfinished business on the road to Wall Street reform.

Mr. Malkiel, a professor of economics at Princeton and a director of Prudential Financial, is author of "A Random Walk Down Wall Street" (W.W. Norton, 7th edition, 2000).

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This is the first in an occasional series.
